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## NEPC Hedge Fund Research

# Assessing the Value of Multi-Strategy Fund of Hedge Funds

*A Market Survey*

*2011*

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**NEPC Hedge Fund Research**  
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# **NEPC Hedge Fund Research**

## **Assessing the Value of Multi-Strategy Fund of Hedge Funds**

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#### **Executive Summary**

*Since the advent of hedge funds, fund of hedge funds (FOHFs) have been viewed as a specialized/skilled way to access and pool together investing talent in a timely and cost-effective manner. Varying philosophies and styles in identifying talent and constructing portfolios have helped to distinguish one FOHF from the next. Though far from being one monolithic block, in aggregate FOHFs make up one-fifth of hedge funds, managing almost one-third of all hedge fund assets today.*

*However, since the financial crisis, the not-so-institutionally focused FOHFs have lost assets to the more institutionally inclined (often larger) FOHFs and to direct hedge funds that are being patronized by investors seeking to institute their own hedge fund programs.*

*While the former is a result of a flight to “perceived” safety, the latter is driven by investors looking to save on a double layer of fees in a low-return environment that makes investors justifiably ask of FOHFs, “What am I getting for my fees?” To measure this, investors typically compare the historical performance of FOHFs to the HFRI Composite and express their dissatisfaction over a 70% capture of the latter over the long haul (since 1990). This forms the primary reason behind their plan to divert existing and new allocations away from FOHFs and toward direct programs. However, a vast majority of those who balk at the double layer of fees admit to a lack of skills and aversion to the risk of constructing a direct program.*

*This survey purports to resolve this conundrum, by drawing support from applied research by a cross-section of practitioners and academicians to conclude that investors are perhaps misjudging the true value inherent in FOHFs in return for their fees. Mere comparison of HFRI FOHF to HFRI HF Composite returns to assess performance is comparing apples to oranges. The comparison is flawed since HFRI Composite represents only funds that have survived over time while the HFRI FOHF also includes the history of investing with failed firms. The HFRI Composite is an aggregation of the performance of various hedge fund strategies implemented by hedge fund managers but not a representation of “how” a FOHF aggregates the underlying strategies and managers. In other words, the HFRI Composite fails to capture the biggest differentiator for FOHFs: their ability to construct portfolios in myriad ways. A true measure of value thus lies in comparing a FOHF’s performance to an investor’s own ability in constructing a portfolio of hedge funds. Any shortfall in one’s own experience (typical of first-time do-it-yourselfers and more risk averse investors) is likely attributable to a FOHF’s value addition through a combination of strategic asset allocation, dynamic/tactical shifts in allocation, and astute manager selection from a universe of both good and not-so-good hedge funds.*

*However, the attribution of value creation varies by FOHF and studies suggest that only a small universe of FOHFs prove to be value creators, overall. These best-in-class FOHFs offer both a viable choice for hedge fund investors (especially those who are disillusioned with FOHFs and cannot implement direct programs) and a benchmark for those investors looking to build their own FOHF. The challenge is to find such value creators among a multitude of 2,000 plus FOHFs.*

*This survey also aims to suggest a holistic approach (as demonstrated by NEPC Hedge Fund Research’s 6P due diligence criteria) to examine FOHFs in an attempt to identify such value-creating FOHFs. It further elucidates NEPC’s own observations of best practices/features in every “P” of our own 6P criteria that paint the picture of a value-creating FOHF. However, it is highly unlikely that a FOHF will possess all the desirable features; the key is to find the candidate in a peer group of like philosophy and style that presents the most attractive picture in aggregate.*

*Such value creators are likely to seize market opportunity by showing client sensitivity and proving their mettle consistently through good manager selection (beyond acting merely as*

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*concierges to access talent) and/or artful portfolio construction in an increasingly difficult investing environment. In reality, delivering successfully on manager selection and portfolio construction goes a long way in responding to investors' most sensitive needs i.e. to protect and grow their portfolio.*

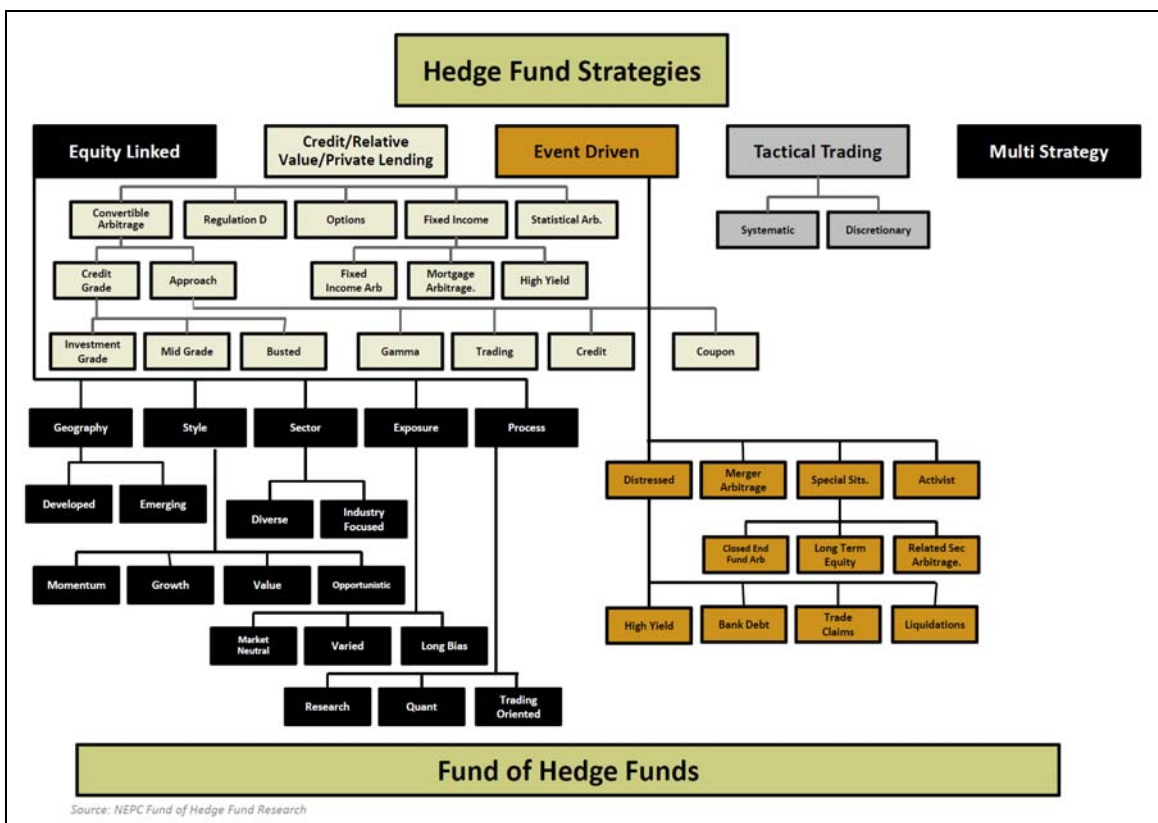
# NEPC Hedge Fund Research

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### Introduction

Although hedge funds have come to assume the status of an asset class in their own right, in essence hedge funds are investing strategies of varied nature spanning across traditional asset classes (e.g., equity, fixed income, commodities, currency) and sometimes private transactions on a global basis. What's common to these strategies is that they are organized privately (outside the public domain) and managed actively, which could include the application of both leverage and shorting techniques.

Depicted below is a snapshot of the hedge fund opportunity set.



The chart above attempts to capture the most widely practiced hedge fund strategies. However, given the flexibility for creativity and innovation in the hedge fund industry (and consequently the potential to charge a higher compensation), it attracts the best of talent. In addition, this industry is endlessly dynamic, devising new strategies that keep the landscape fertile with new investment ideas. Therefore, one would not be mistaken in equating hedge fund investing to a scout or hunt for investing talent.

Investors have a choice: they can either go scouting for talent themselves to identify the best-of-the-best hedge fund manager in any given area (as depicted above) or they can leverage the skills and acumen of expert investors who are adept at identifying talent. The latter are FOHFs.

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#### **Defining Fund of Hedge Funds**

As the term suggests, a FOHF is a fund that invests in underlying funds that practice one or more investing strategies depicted above. A FOHF could therefore invest in an array of managers focused on one of the following:

- A single strategy around more conventional/broad strategies (e.g., equity long/short, credit, event, global macro/CTA)
- A diversified mix of strategies (referred to as multi-strategy fund of hedge funds), each uniquely constructed to address specific investment objectives
- Niche or thin sleeves of the broader opportunity set to enhance portfolio value (e.g., commodities, tail risk hedging, emerging managers, emerging markets)

For the purposes of this survey, FOHF refers to multi-strategy fund of hedge funds to capture the broadest meaning, range, and scope of this investing approach.

#### **Style Classification of Multi-Strategy Fund of Hedge Funds**

The Hedge Fund Research Inc. (HFR) classifies multi-strategy FOHF in the following categories:

<b>Fund of Funds: Conservative</b>
FOFs classified as "Conservative" exhibit one or more of the following characteristics: seek consistent returns by primarily investing in funds that generally engage in more "conservative" strategies such as equity market neutral, fixed income arbitrage, and convertible arbitrage; exhibit a lower historical annual standard deviation than the HFRI Fund of Funds Composite Index. A fund in the HFRI FOF Conservative Index shows generally consistent performance regardless of market conditions.
<b>Fund of Funds: Diversified</b>
FOFs classified as "Diversified" exhibit one or more of the following characteristics: invest in a variety of strategies among multiple managers; have historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrate generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets.
<b>Fund of Funds: Market Defensive</b>
FOFs classified as "Market Defensive" exhibit one or more of the following characteristics: invest in funds that generally engage in short-biased strategies such as short selling and managed futures; show a negative correlation to the general market benchmarks (S&P). A fund in the FOF Market Defensive Index exhibits higher returns during down markets than during up markets.
<b>Fund of Funds: Strategic</b>
FOFs classified as "Strategic" exhibit one or more of the following characteristics: seek superior returns by primarily investing in funds that generally engage in more opportunistic strategies such as emerging markets, sector specific, and equity hedge; exhibit a greater dispersion of returns and higher volatility compared to the HFRI Fund of Funds Composite Index. A fund in the HFRI FOF Strategic Index tends to outperform the HFRI Fund of Fund Composite Index in up markets and underperform the index in down markets.

Source: HFR

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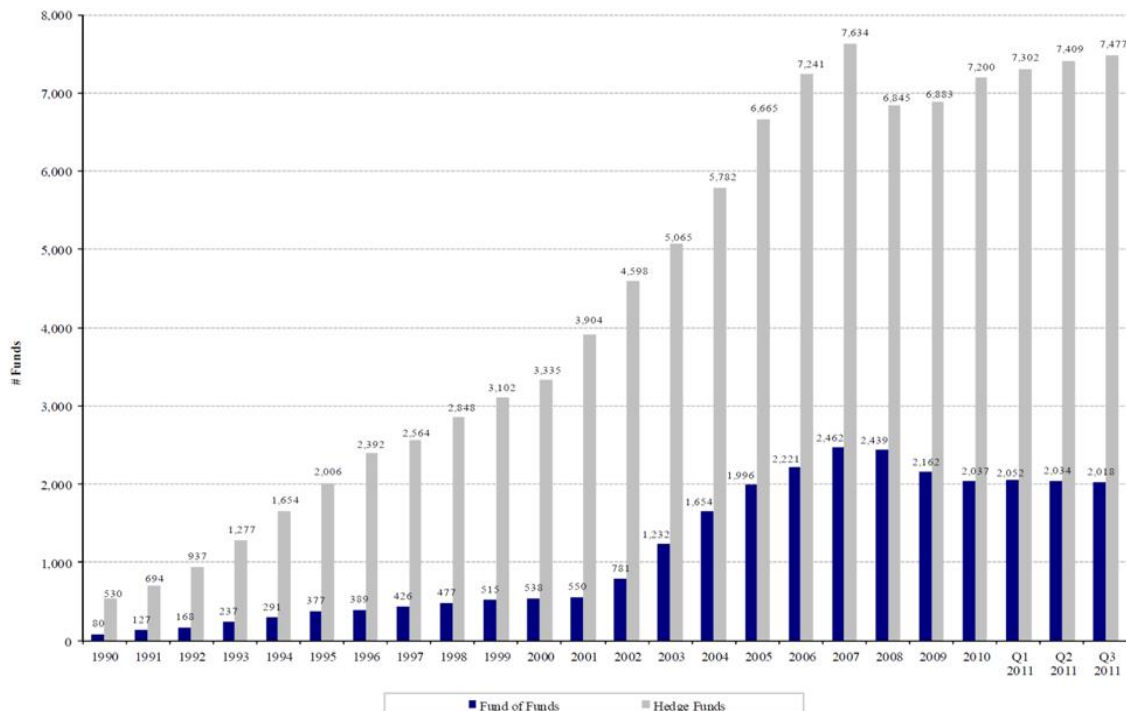
Whether a fund features in any one of the above-mentioned categories depends on “how” FOHFs mix and match the various sub-strategies through underlying managers. This helps define the style for a FOHF and is a reflection of a FOHF’s investment philosophy. Therefore, investors can take this a step further and classify FOHFs by investment philosophy (please see the section on *Philosophy*). But at its simplest level, “how” a FOHF blends various sub-strategies goes a long way in distinguishing one FOHF from the next.

### Fund of Hedge Fund Landscape

Back in 1949, Alfred Winslow Jones, a former reporter for *Fortune*, started the first hedge fund on twin principles of leverage and short sales—both integral to hedge fund investing today. Over time, new talent (e.g., Michael Steinhardt, George Soros) came to the fore. In 1969, Leveraged Capital Holdings, the first FOHF was born in Geneva with the purpose of investing in the best single managers of the time. In 1971, Grosvenor Capital Management, Chicago launched the first FOHF in the US. Two years later, Haussmann Holdings N.V. was created in Europe by the Permal Group.

Although initially adopted by high-net-worth individuals to “access” hidden talent, FOHFs spread to institutional investors and today their population comprises slightly over one-fifth of the total hedge fund universe.

**Estimated Number of Funds: Hedge Funds vs. Fund of Funds  
1990 – Q3 2011**



Source: HFR

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### **Assessing the Value of Multi-Strategy Fund of Hedge Funds**

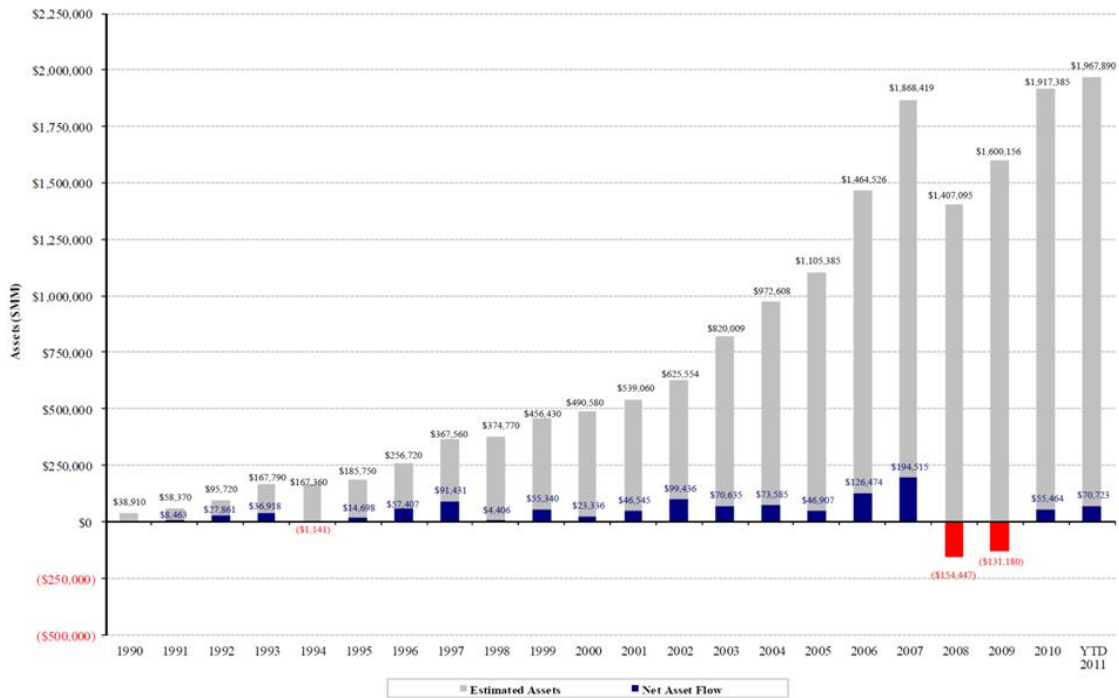
#### **A Market Survey: 2011**

Investors, both High Net-Worth Individuals and Institutions, have favored FOHFs for the following fundamental reasons:

- a) Access to closed funds, star managers, and exceptional investment opportunities
- b) Fund identification and fund selection: understanding complex strategies and intimate knowledge of hedge funds
- c) Access to hedge funds at lower minimums to create a diversified basket of hedge funds
- d) Quicker investment decisions to invest/divest from hedge funds
- e) Lack of bandwidth to ensure proper monitoring of underlying hedge funds

### **Estimated Growth of Assets / Net Asset Flow**

#### **Hedge Fund Industry 1990 – YTD Q3 2011**



Source: HFR

With assets under management (AUM) at \$639 billion, FOHFs make up almost one-third of the total hedge fund industry (estimated at \$1.9 trillion, as depicted above). At their peak in 2007, FOHF assets made up 43% of the hedge fund industry. The sharp drop is explained by the decline of FOHF assets by almost 20% post-2008 (due to redemptions), with little offsetting benefits, if any, arising from performance. Coupled with this, the overall hedge fund industry (through direct hedge funds) recouped almost half its lost assets and displayed additive performance. Thus, the numerator declined and the denominator increased resulting in the sharp drop in percentage.

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#### Recent Trends in Fund of Hedge Funds

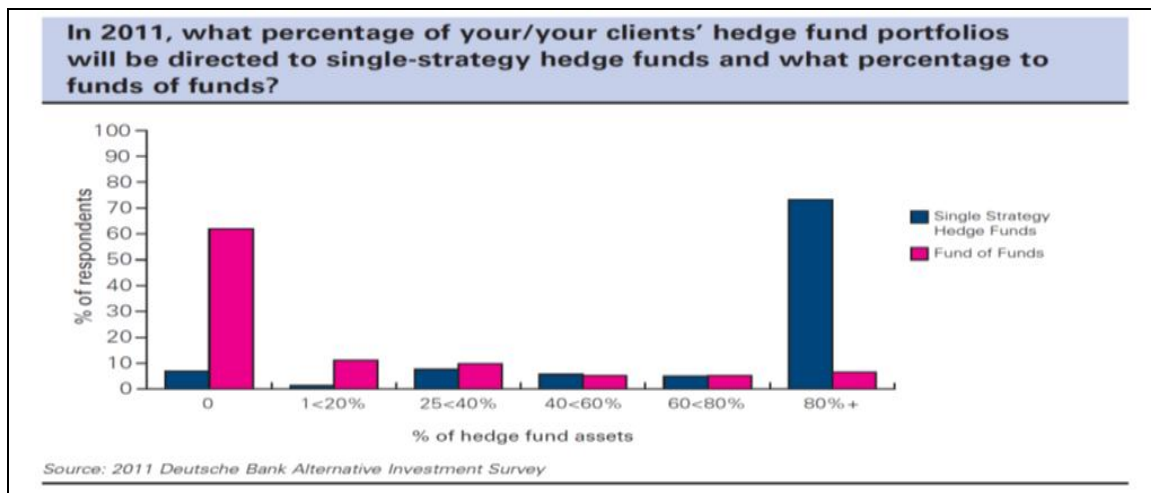
Embedded in the above phenomenon are three trends:

- 1) FOHFs have lost assets mainly due to large-scale redemptions from European FOHFs that are widely known to have relied heavily upon high-net-worth individual clients, likely the first to show signs of panic in both a financial crisis and when exposed to frauds (e.g., Madoff)
- 2) Investors in FOHFs with a smaller institutional client base have gradually migrated to direct hedge funds
- 3) However, FOHFs with a larger institutional focus have continued to attract assets, a reflection of both a flight to safety (as most large institutionally oriented FOHFs were not exposed to fraudsters like Madoff) and a continued endorsement of the preliminary reasons why investors invested with these (large) FOHFs to begin with

While most of these reasons still remain valid, confidence in FOHFs with a smaller institutional focus seems to have been shaken. In summary, the big institutional FOHFs have continued to grow bigger while the smaller institutional FOHFs have continued to shrink.

#### Emerging Trends and Underlying Reasons

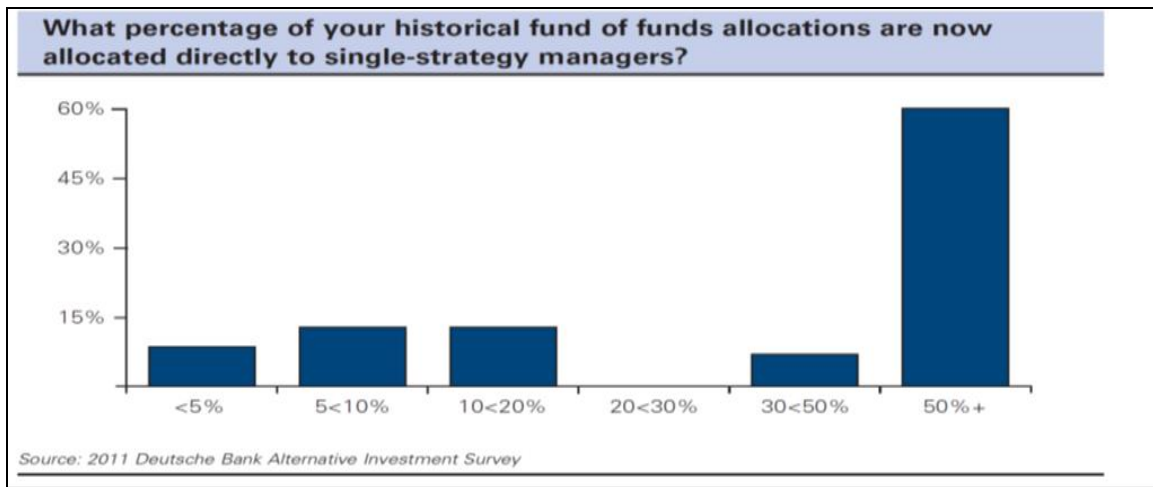
Going forward, the overall FOHF industry faces a threat of migration to direct hedge funds. According to The 2011 Deutsche Bank Alternative Investment Survey, almost 75% of institutional investors plan to allocate 80%–100% of their hedge fund assets to single-strategy hedge funds, and more than 60% plan to allocate 50% of their historical FOHF allocation (existing FOHF investments) directly to single-strategy hedge funds.



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The shift in sentiments is attributable to one or more of the following reasons:

- 1) i) Investors doubt the performance-generation capabilities of FOHFs, especially when returns overall are challenged by a persistently difficult investing environment.  
ii) In addition, investors now also question the extra layer of fees charged by FOHFs (generally 1% management fee plus 10% incentive fee in addition to 1.5%-2% management fee and 20% incentive fee charged by underlying managers).
- 2) Investors desire better control over their hedge fund portfolios.
- 3) Investors have matured over time (sophistication/skill of institutional investors has increased, thus encouraging more do-it-yourself investors<sup>1</sup>).

Let's pause to examine these reasons individually.

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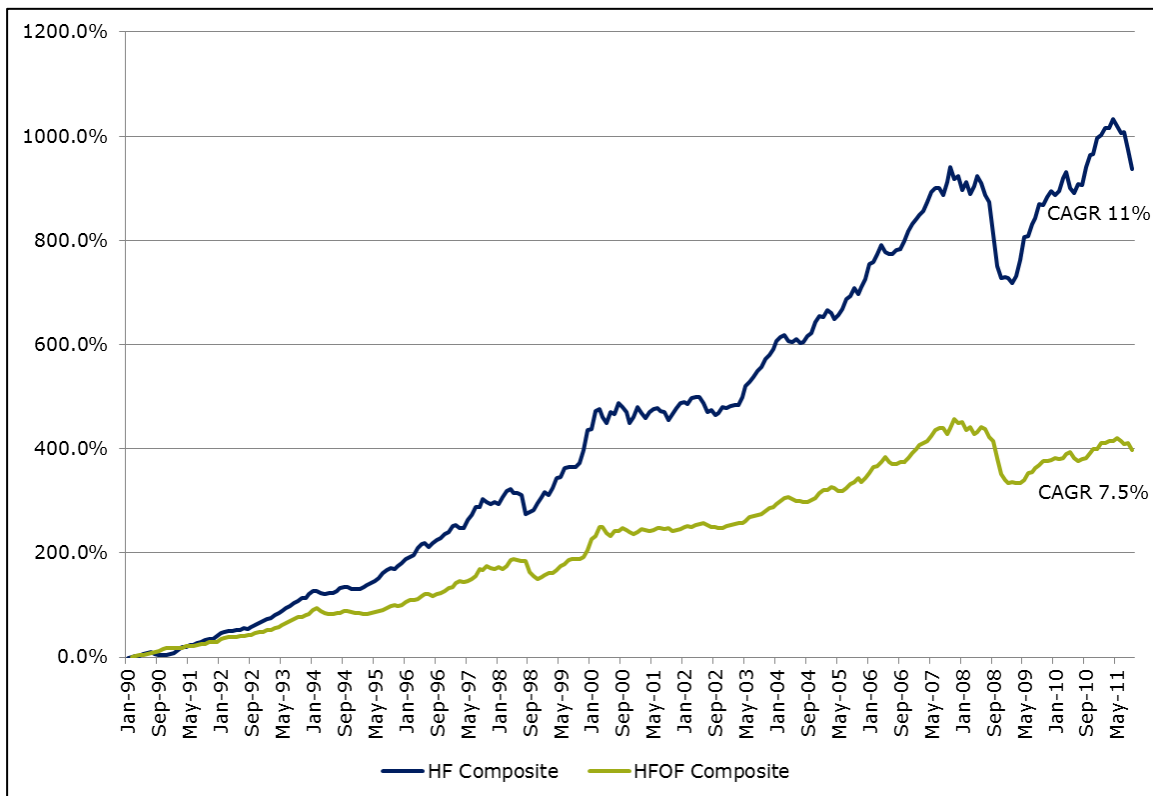
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#### Perceived Issues with FOHFs

##### a) Performance Measurement

To gauge their performance expectations from FOHFs, most institutional investors default to measuring historical investment performance of FOHFs vs. direct hedge funds. This is illustrated below:



Source: NEPC

The chart above depicts a 7.5% annualized return with a 6% volatility for FOHFs vs. 11% and 7%, respectively, for the composite of single-strategy hedge funds as measured by the HFRI. Put another way, investors are disappointed that FOHFs have captured only 70% of hedge fund returns while underappreciating their ability to do so for 15% less volatility. This then leads them to question the double layer of fees. The validity of this concern is examined below under *True Measure of Value: Analyzing FOHFs*.

##### b) Better Control

Better control does not seem to be the real issue because of the increased use of customized formats (separate accounts/managed accounts,) that FOHFs offer to clients, which are all geared for better control and oversight.

##### c) Maturation of Investors

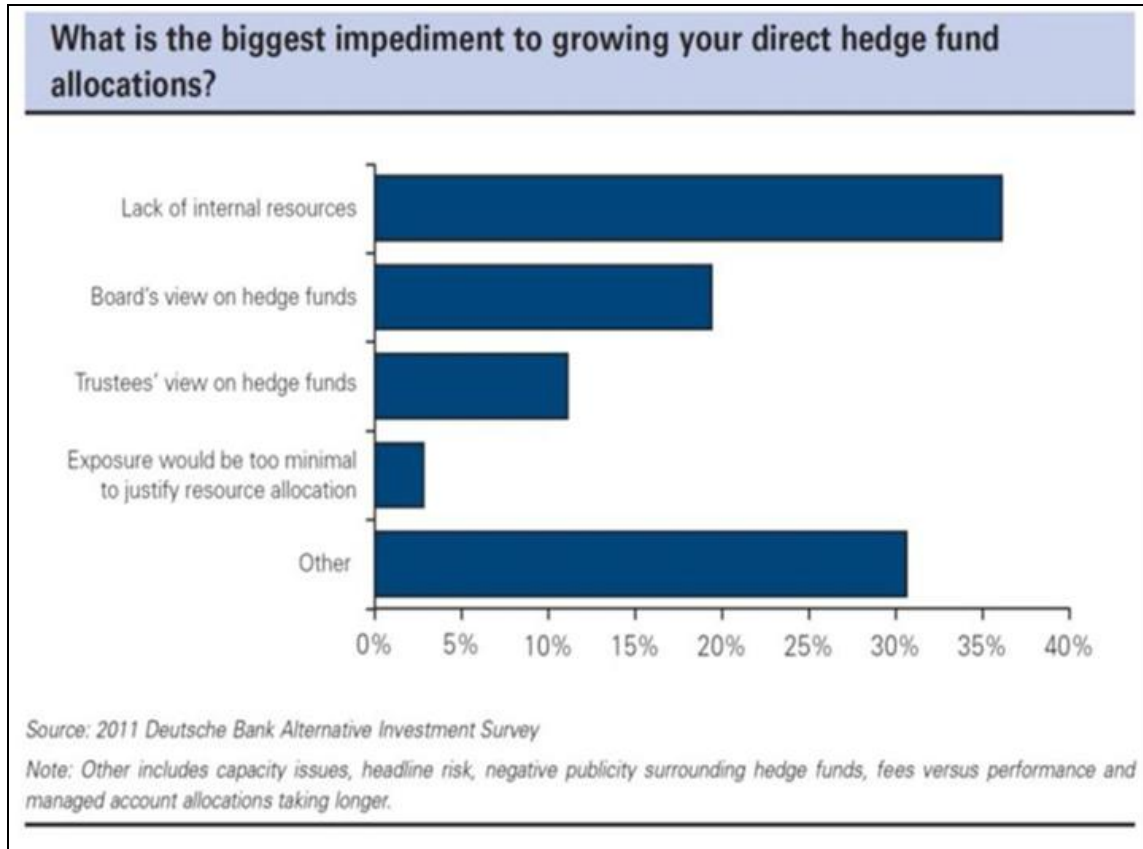
With the passage of time, one might say that some investors (though not all) would have acquired the confidence to run a hedge fund portfolio on their own. However, when asked of institutional investors their ability to implement a direct hedge fund program, a vast majority (65%) of institutional investors surveyed were still unsure of their ability to manage a hedge

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fund portfolio on their own for two main reasons: lack of internal resources (skills) and aversion to assuming risk directly (classified under “other”).



This presents a disconnect—while a vast majority wish to allocate/migrate to direct hedge funds, an equally large majority express their practical inability to do so. Therefore, only a minority can claim to have come of age (or matured) to pursue a direct hedge fund program. All the same, the vast majority are questioning the value proposition of FOHFs and their justification for an extra layer of fees.

At first glance, the urge to save on a double layer of fees is understandable. Post-crisis, the hedge fund industry finds itself in a low-return environment beset with macro concerns of gargantuan proportions that spur volatility. Starved for returns, investors are naturally inclined to become more fee conscious and look for ways to save on fees, if possible, to boost their bottom line. Acting on this, investors default to comparing the HFOF Composite to the HF Composite and cynically ask “what are we getting for our fees?”

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#### **True Measure of Value: Analyzing FOHFs**

To evaluate this, we take guidance from a study<sup>2</sup> conducted in November 2005 (long before migratory trends developed). The researchers argue that comparing the performance of FOHFs to direct hedge funds is faulty and misleading—essentially because the HF Composite is afflicted with a survivorship bias as it depicts a far superior performance of hedge funds that have survived through time, whereas the performance of FOHF (as captured by the FOHF index) also captures the tainted performance by investing in those failed hedge funds.

Other reasons supporting this argument are:

- 1) FOHF performance is weighed down further by the extra layer of fees that FOHFs charge, which are not present in the HFRI Composite performance.
- 2) The HFRI Composite is an equal weighted index of disparate underlying funds (currently 2,000), whereas the HFRI Fund of Fund Composite shows the performance of reporting FOHFs (currently 650), *each constructed differently*—the very essence of FOHFs (please see *Style Classification* of multi-strategy FOHF). The HFRI Composite thus does not reflect the portfolio construction attributes of the FOHF index, which is the single most differentiating feature of FOHFs.

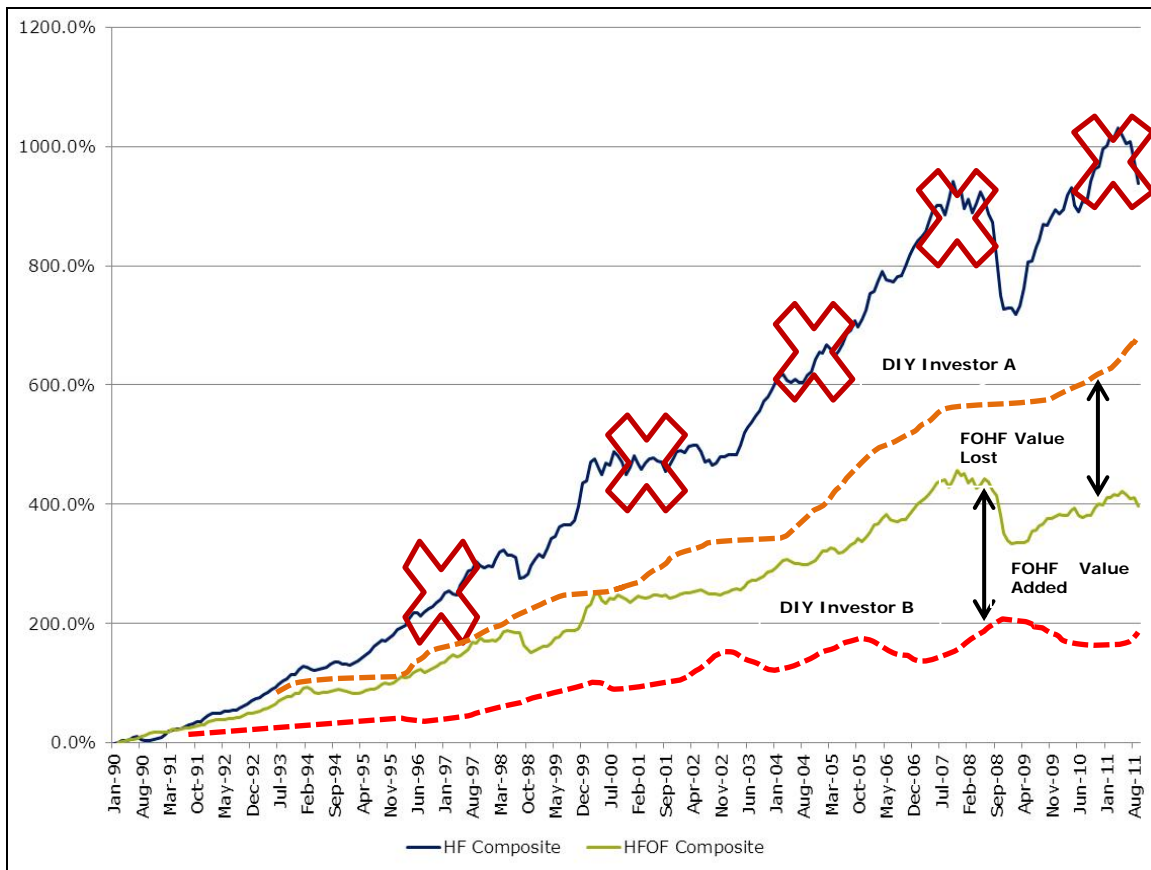
In other words, comparing the HFRI FOF composite to the HFRI Hedge Fund Composite to evaluate the relative performance of FOHFs is like comparing apples to oranges.

According to the authors, a more realistic method for comparing the effectiveness and performance of FOHFs should be based on comparing the performance of a FOHF with an investor's own experience in constructing a portfolio of hedge funds selected from a large universe of 7,000+ hedge funds—both good and not so good. In other words, how a FOHF stacks up against an investor's own experience (*expected* risk-adjusted performance of a do-it-yourselfer) in replicating a FOHF is a true measure of whether the FOHF added or lost value. This should then provide a better yardstick for evaluating if the extra layer of fees to the FOHF is justified or not. The concept is graphically illustrated below:

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Source: NEPC

### Value Creation by FOHFs

As mentioned earlier, the intrinsic value (or lack thereof) of FOHFs lies in their portfolio construction. The art and science of portfolio management manifests itself in one or more forms:

- Strategic asset allocation: defining the strategies that the FOHF wishes to invest in over the mid- to longer-term course of the portfolio
- Dynamic asset allocation: making tactical adjustments (shifting weights of the selected strategies) in response to changing market dynamics
- Astute manager selection

Intuitively, the need for strategic asset allocation arises from the plethora of strategies (please see *Hedge Fund Strategies* in the Introduction) available to a FOHF, each with its own risk and reward profile. Tactical allocation assumes importance due to the erratic behavior of the various hedge fund strategies, as can be observed from the performance of individual hedge fund strategies on the next page:

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**HFRI Indices Annual Investment Returns (1998 – YTD Q3 2011)**

1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	YTD Q3 2011
S&P 500 28.59%	HFRI Emerging Markets 55.86%	HFRI ED: Merger Arb 18.02%	HFRI RV: ConvertArb 13.37%	Barclays Gov's/Credit 12.10%	HFRI Emerging Markets 39.36%	HFRI ED: Distressed 18.89%	HFRI Emerging Markets 21.04%	HFRI Emerging Markets 24.26%	HFRI Emerging Markets 24.92%	Barclays Gov's/Credit 6.09%	HFRI RV: ConvertArb 60.17%	S&P 500 15.08%	Barclays Gov's/Credit 7.90%
HFRI Equity Hedge 15.98%	HFRI Equity Hedge 44.22%	HFRI EH: Eq Mkt Nrt 14.56%	HFRI ED: ConvertArb 13.28%	HFRI ED: ConvertArb 9.05%	HFRI ED: Distressed 29.56%	HFRI Emerging Markets 18.42%	HFRI Equity Hedge 10.60%	HFRI ED: Distressed 15.94%	HFRI Macro 11.11%	HFRI Macro 4.83%	HFRI Emerging Markets 40.24%	HFRI RV: ConvertArb 13.07%	HFRI ED: Merger Arb -0.07%
Barclays Gov's/Credit 12.00%	HFRI Fund Wghtd Comp 31.29%	HFRI RV: ConvertArb 14.50%	HFRI Event-Driven 12.18%	HFRI Macro 7.44%	S&P 500 28.87%	HFRI Event-Driven 15.01%	HFRI Fund Wghtd Comp 9.30%	S&P 500 15.78%	HFRI Equity Hedge 10.48%	HFRI ED: Merger Arb -5.36%	HFRI ED: Distressed 26.13%	HFRI Emerging Markets 11.98%	HFRI Relative Value -0.35%
HFRI EH: Eq Mkt Nrt 9.30%	HFRI FOF Composite 26.47%	HFRI Relative Value 13.41%	HFRI Emerging Markets 10.36%	HFRI Relative Value 5.44%	HFRI Event-Driven 29.33%	S&P 500 10.86%	HFRI ED: Distressed 8.27%	HFRI Event-Driven 19.33%	HFRI FOF Composite 10.25%	HFRI EH: Eq Mkt Nrt -5.93%	S&P 500 26.47%	HFRI Relative Value 11.73%	HFRI Macro -1.67%
HFRI RV: ConvertArb 7.77%	HFRI Event-Driven 24.33%	Barclays Gov's/Credit 13.27%	Barclays Gov's/Credit 9.40%	HFRI ED: Distressed 5.28%	HFRI Macro 21.42%	HFRI Fund Wghtd Comp 9.03%	HFRI FOF Composite 7.49%	HFRI ED: Merger Arb 14.24%	HFRI Fund Wghtd Comp 9.66%	HFRI Relative Value -18.04%	HFRI Relative Value 25.80%	HFRI Event-Driven 11.63%	HFRI EH: Eq Mkt Nrt -1.76%
HFRI ED: Merger Arb 7.23%	S&P 500 21.03%	HFRI Equity Hedge 9.09%	HFRI Relative Value 8.92%	HFRI Emerging Markets 3.70%	HFRI Equity Hedge 20.54%	HFRI Equity Hedge 7.68%	HFRI Event-Driven 7.29%	HFRI Fund Wghtd Comp 12.89%	HFRI Relative Value 8.94%	HFRI Fund Wghtd Comp -19.02%	HFRI Event-Driven 25.04%	HFRI ED: Distressed 11.26%	HFRI ED: Distressed -3.54%
HFRI Macro 6.19%	HFRI Macro 17.62%	HFRI Event-Driven 6.74%	HFRI Macro 6.87%	HFRI FOF Composite 1.02%	HFRI Fund Wghtd Comp 19.55%	HFRI FOF Composite 6.86%	HFRI Macro 6.79%	HFRI Relative Value 12.37%	Barclays Gov's/Credit 7.75%	HFRI FOF Composite -21.36%	HFRI Equity Hedge 24.55%	HFRI Equity Hedge 10.58%	HFRI ED: Distressed -4.44%
HFRI Relative Value 2.81%	HFRI ED: Distressed 16.94%	HFRI Fund Wghtd Comp 4.98%	HFRI EH: Eq Mkt Nrt 6.71%	HFRI EH: Eq Mkt Nrt 0.98%	HFRI FOF Composite 11.61%	HFRI Relative Value 5.58%	HFRI ED: Merger Arb 6.25%	HFRI RV: ConvertArb 12.17%	HFRI ED: Merger Arb 7.05%	HFRI Event-Driven -21.82%	HFRI Fund Wghtd Comp 19.98%	HFRI Fund Wghtd Comp 10.49%	HFRI FOF Composite -5.26%
HFRI Fund Wghtd Comp 2.62%	HFRI Relative Value 14.73%	HFRI FOF Composite 4.07%	HFRI Fund Wghtd Comp 6.07%	HFRI ED: Merger Arb -0.87%	HFRI RV: ConvertArb 9.93%	HFRI Macro 4.63%	HFRI EH: Eq Mkt Nrt 6.22%	HFRI Equity Hedge 11.71%	HFRI Event-Driven 6.61%	HFRI ED: Distressed -25.20%	HFRI ED: Merger Arb 11.63%	HFRI Macro 8.61%	HFRI Fund Wghtd Comp -5.44%
HFRI Event-Driven 1.70%	HFRI RV: ConvertArb 14.41%	HFRI ED: Distressed 2.78%	HFRI FOF Composite 2.80%	HFRI Fund Wghtd Comp -1.45%	HFRI Relative Value 9.72%	Barclays Gov's/Credit 4.54%	HFRI Relative Value 6.02%	HFRI FOF Composite 10.39%	S&P 500 5.49%	HFRI Equity Hedge -26.65%	HFRI FOF Composite 11.46%	Barclays Gov's/Credit 6.99%	HFRI RV: ConvertArb -5.86%
HFRI ED: Distressed -4.23%	HFRI ED: Merger Arb 14.34%	HFRI Macro 1.97%	HFRI ED: Merger Arb 2.76%	HFRI Event-Driven -4.30%	HFRI ED: Merger Arb 7.47%	HFRI EH: Eq Mkt Nrt 4.15%	S&P 500 4.91%	HFRI Macro 8.15%	HFRI RV: ConvertArb 5.33%	HFRI RV: ConvertArb -33.71%	Barclays Gov's/Credit 4.81%	HFRI FOF Composite 5.60%	S&P 500 -8.69%
HFRI FOF Composite -5.11%	HFRI EH: Eq Mkt Nrt 7.09%	S&P 500 -0.09%	HFRI Equity Hedge 0.40%	HFRI Equity Hedge -4.71%	Barclays Gov's/Credit 5.07%	HFRI ED: Merger Arb 4.08%	Barclays Gov's/Credit 2.55%	HFRI EH: Eq Mkt Nrt 7.32%	HFRI EH: Eq Mkt Nrt 5.29%	S&P 500 -36.99%	HFRI Macro 4.37%	HFRI ED: Merger Arb 4.60%	HFRI Equity Hedge -9.53%
HFRI Emerging Markets -32.98%	Barclays Gov's/Credit -2.40%	HFRI Emerging Markets -10.71%	S&P 500 -11.85%	S&P 500 -22.09%	HFRI EH: Eq Mkt Nrt 2.44%	HFRI RV: ConvertArb 1.18%	HFRI RV: ConvertArb -1.86%	Barclays Gov's/Credit 4.07%	HFRI ED: Distressed 5.08%	HFRI Emerging Markets -37.26%	HFRI EH: Eq Mkt Nrt 1.43%	HFRI EH: Eq Mkt Nrt 3.16%	HFRI Emerging Markets -12.81%

**HFRI** HFRI Global Hedge Fund Industry Report – Third Quarter 2011  
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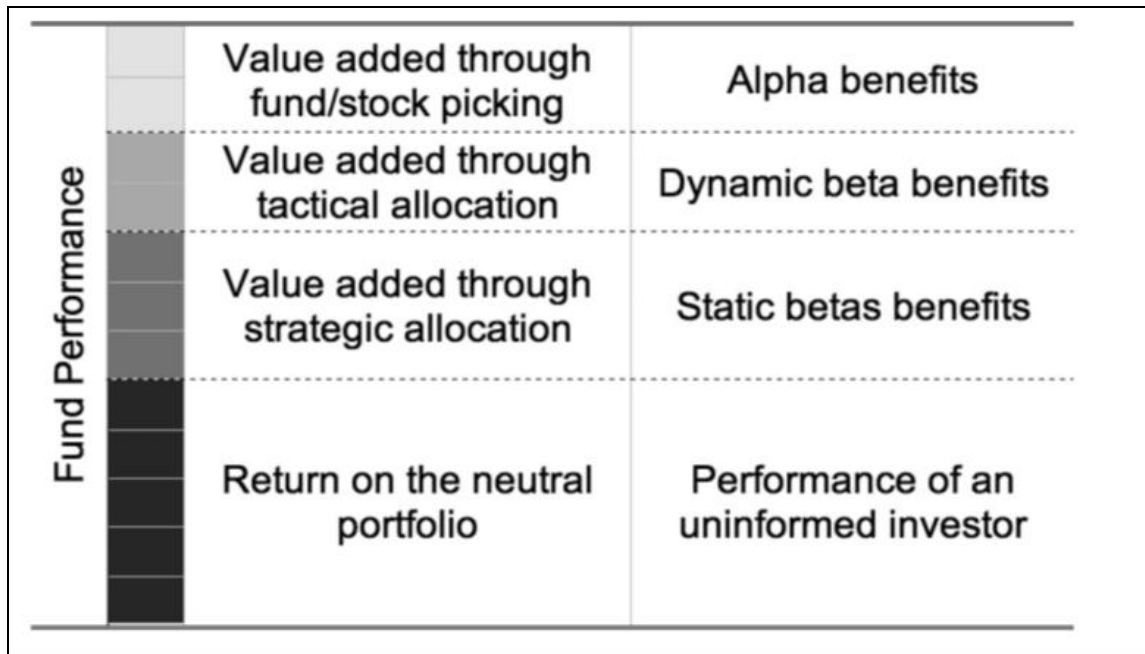
A quick look at this quilt chart suggests that both allocation functions—strategic and tactical—rest with the FOHF manager (and any investor looking to build a hedge fund portfolio on his/her own).

Last but not least, the investor (FOHF or investor wishing to go direct) is faced with the daunting task of identifying managers (from a universe of both good and not-so-good hedge funds) who he/she thinks would be best suited to express the strategy/tactical views of the investor. To select managers, the FOHF is expected to carefully weigh one or more characteristics of underlying managers, as outlined below:

- Size (AUM)
- Age/experience
- Team
- Focus: generalist vs. specialist
- Liquidity
- Geography
- Investment structure: commingled vehicles, separate accounts, etc.

In a September 2010 study<sup>3</sup>, researchers at the EDHEC Risk Institute arrived at a performance attribution model allowing for a full decomposition of FOHF returns. This is depicted on the next page:

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Source: EDHEC-Risk Institute

The researchers studied more than 1,000 FOHFs from the HFR and Lipper TASS databases from January 2000 to 2009 to extract 184 less-correlated FOHFs that showed a continuous track record through this period. They applied the performance attribution model depicted above to all the various FOHFs and performed a return-based analysis over the full length of their study, segmenting it further over two economic regimes: normal market conditions ranging from January 2000 through June 2007 and stressed market conditions spanning from June 2007 to July 2009. The results of their study are presented below:

Value Added over Normal Market Conditions

Percentiles	Total	Strategic	Tactical	Fund picking
Mean	4.21%	0.41%	0.32%	3.48%
Volatility		1.51%	2.24%	2.50%
Skewness		1.56	5.82	-0.19
Kurtosis		2.04	60.39	3.38
% > 0		48.4%	60.9%	92.9%
Mean (> 0)		1.54%	1.24%	3.89%
% < 0		51.6%	39.1%	7.1%
Mean (< 0)		-0.64%	-1.08%	-2.11%

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Value Added over Stressed Market Conditions				
Percentiles	Total	Strategic	Tactical	Funds picking
Mean	0.72%	2.50%	-1.69%	-0.09%
Volatility		3.60%	3.31%	6.79%
Skewness		1.37	-0.77	0.44
Kurtosis		1.74	2.30	13.73
% > 0		77.7%	30.9%	48.4%
Mean (> 0)		3.50%	1.86%	4.19%
% < 0		22.3%	69.1%	51.6%
Mean (< 0)		-0.99%	-3.13%	-4.30%

Source: EDHEC-Risk Institute

The first table above suggests that, over a normal period, the vast majority (93%) of the funds added significant value from manager selection, while a small minority lost significantly. Hence, manager selection is a major driving force for most FOHFs in normal periods. However, when the environment is stressed (see the second table), the ability to select managers was no longer universal; only about half of the funds were able to add value through fund picking, while those who got it wrong lost almost as much. Therefore, fund picking or manager selection is a greater force in both normal and stress environments but is also a double-edged sword, especially in stress periods.

Strategic asset allocation seems to be a safer bet in both normal and stress periods. Almost half the sample added value modestly during normal conditions, while those who missed it paid a relatively smaller penalty. However, for most FOHFs, strategic asset allocation assumes greater significance in stress periods, as 78% of the funds added 3.5%/year on average during a stressful phase.

Through tactical allocation decisions, 61% of the FOHFs added a small value, while the rest detracted (-1.00%). In stress conditions, only 31% managed to do so (although with greater value addition than in normal periods) while a majority detracted a great deal of value (-3%). This shows that tactical asset allocation is not everyone's forte and is clearly a differentiator for those who can make good market calls.

In summary, manager selection is of greatest importance in normal periods and is clearly a differentiator in stress periods. FOHFs thus help investors gain access to a better skill set of discovering, evaluating, selecting, and monitoring hedge funds. Getting strategic allocation right is a smaller contributor in normal periods but trumps manager selection for most FOHFs in stress periods. Accurately timing tactical shifts is not a universal trait. In aggregate, all three forces can potentially drive the performance of FOHFs in varying degrees across different economic regimes and the ability to harness one or more forces is tangible evidence of value creation.

In practice, we find institutional investors acknowledging the value of FOHFs in making key asset allocation and manager selection decisions as much as they express their incipient desire to go direct. Many institutional investors who have gone direct have leveraged the skills, acumen, and experience of FOHFs to build out direct hedge fund programs or in making their first forays in that direction.

Hence, we would argue that the value creation/addition by FOHFs is not dubious. However, the question remains whether this value is ubiquitous. Is every FOHF a value creator and as deserving as the next?

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#### **The Real Issue with FOHFs: A Scarcity of Value Creators**

To study if value addition/creation is ubiquitous or confined to a select few, we draw upon the findings of a very recent study<sup>4</sup> published in October 2011.

The authors examined 1,315 active and defunct FOHFs from January 1994 through August 2009, to resolve two questions:

- 1) Whether FOHF managers deliver, or channel, after-fees alpha from single-manager hedge funds
- 2) Whether FOHFs can produce any alpha from superior manager selection

The results of the study indicated that:

- 1) 21% of FOHFs showed alpha channeling skills
- 2) 5% (approximately) added value through superior manager selection

In other words, not all FOHFs transfer/channel value from the aggregation of underlying hedge fund managers. Only one in five proved to be good conduits of value created by underlying managers and only far fewer were able to layer that with added value through good manager selection. Considering the paucity of value creators, most investors default to painting all FOHFs with one broad brush and dismissing the entire class of FOHFs.

But this study also reinforces the case that aggregating managers and harnessing their alpha is a tall order—let alone adding value through good manager selection, a trait successfully demonstrated by only a few FOHFs. Therefore, those investors aspiring to construct their own hedge fund portfolio face a big challenge in distinguishing themselves from a select few FOHFs that have proven themselves as good conduits and creators of value.

The real issue with FOHFs, therefore, is not one of fees or performance but discovering the select few from a universe of 2,000+ FOHFs who can claim to be true value creators.

#### **Search for Value Creators: A 6Ps Approach**

Identifying a value-creating FOHF takes a lot of effort. That said, good quality managers that can have a positive impact on a hedge fund allocation do exist. A FOHF is likely hired to perform a certain role in a hedge fund portfolio in the context of the overall objectives of the portfolio and client preferences. Thus, it is important to understand the role a FOHF manager is likely to play and then evaluate how effective it may prove in fulfilling that role and how does it rank against its peers similar in philosophy and style.

At NEPC, we strive to understand the manager's philosophy and resulting behavior as a guide to assessing the role a FOHF might play in an investment portfolio. To further establish the FOHF's potential to effectively fulfill its role, we take a holistic view of the FOHF. Both of these functions form the basis of our due diligence of FOHF managers and are reflected through our 6Ps approach, which consists of:

- **P**eople
- **P**hilosophy
- **P**rocess
- **P**erformance
- **P**rice
- **P**erpetuity

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Each element of our 6Ps approach is described in detail below. Note that is highly unlikely to find one perfect FOHF that has “all” the note-worthy features listed below. Those that have most of the desirable ingredients present a more attractive picture among their peer group.

#### **People**

To state the obvious, people drive decisions and processes at a FOHF, just as they do anywhere else. Investors, rightfully so, seek stewards of capital—well intentioned people who can make good investment decisions and execute consistently through a well-defined process. Ideally, well-rounded teams with diverse skill sets are more effective than those that exhibit strength in one or two areas (strategies), but often a “key person” is deemed the single biggest driving force.

In any event it is important to assess the integrity of decision makers *and* their capabilities to deliver consistently. In this regard, motivations of people provide valuable insights into how trustworthy they might be. If a FOHF team consists of people with successful pedigrees who came together to capitalize on their passion and knowledge of strategies and hedge fund managers accessible through their networks, they are more likely to be successful FOHF managers and businesses than those who are driven by the one-sided desire to build and grow a successful FOHF business on merely establishing an institutional infrastructure that gives investors the comfort of perceived safety. The twin objectives of building a successful FOHF and business have to go hand in hand.

#### **Philosophy**

While performance cannot be predicted, there is a greater chance that peoples’ investment beliefs resonate through time. Investment tenets serve as good indicators of manager behavior to understand “what can the FOHF do *to* my portfolio and what can the manager do *for* my portfolio.” To carefully appreciate both of these propositions, it is paramount to get behind the numbers to understand the psyche of the FOHF manager in managing the portfolio through various market cycles. In other words, one must assess what motivations have consistently guided the FOHF manager in the past in managing the portfolio. Does the manager pursue above-average returns and is he/she willing to take risks that this entails, or does the manager seek only the returns that are commensurate with the risks he/she is willing to take? While both of these questions call for balancing risk and reward, each defines a different mind set. Philosophies influence styles (see *Style Classification*) that FOHFs adopt, which in turn drive portfolio construction and risk management processes. When a philosophy guides a FOHF’s thinking and has a pervasive influence on its processes, it can be easily articulated. This distills a manager with clarity of purpose from those who are less thoughtful about their portfolios.

#### **Process**

Processes, in our opinion, are three-fold:

- I. Investment research
- II. Portfolio construction and
- III. Risk management

##### **I. Investment Research**

Research capabilities are defined by who is doing the research, what is the subject of the research, and how the research function is executed.

##### *i) Research Team*

Adequacy of research personnel and breadth and depth of experience are both valuable. A well-staffed research unit is a reflection of the quality and depth of investment due diligence

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that can be expected of a FOHF. Teams that are spread too thin are unlikely to devote time and attention to underlying managers and perhaps too stretched to discover new ideas that then run the risk of being “married” to proven names. By the same token, past experience with strategies and manager selection are equally important to oversee underlying managers and uncover new talent. Some teams are empowered by people who have traded some hedge fund strategies before; others consist of people with years of experience in selecting good quality hedge funds. Principal strategy trading experience is not universal, hence an important differentiator across FOHFs.

#### *ii) Research Agenda*

A good research team is discerning in its choice of managers, knows what to expect out of each underlying manager, and can increase/decrease allocations when appropriate. By extension, these FOHFs know the type of manager they seek in each strategy (e.g., small nimble managers in equity long/short and large established managers in global macro). Well-defined research criteria impart discipline to the research process and are likely to be well integrated with the FOHF’s investment philosophy.

As stated before, hedge fund investing is a search for investing talent and that is supported further by the overarching influence of manager selection on portfolio performance for a FOHF. The search for talent is an ongoing endeavor at a good quality FOHF, which is constantly looking beyond proven names for the next rising star. In this regard, many academic studies support the choice of newer and smaller managers over more established and larger hedge funds.

For example, in a study<sup>5</sup> of hedge funds over 11 years (January 1996–December 2007), small/young funds posted superior returns due to their:

- Ability to select only from their best investment ideas
- Ability to easily maneuver while simultaneously attracting less attention (as position sizes are also smaller) to their strategic moves, particularly in volatile markets
- Ability to exploit small market inefficiencies and opportunities that larger funds may have to ignore due to limited capacity, which might prove inconsequential to overall returns

Larger funds, on the other hand, may suffer from “size is the enemy of performance” syndrome due to:

- A bigger focus on running/maintaining their franchise
- Presence of large and perhaps more conservative investors who might be less demanding of performance, leading to a concentration in staid investment ideas combined with some extraneous investment ideas outside the FOHF’s core competency to overcome capacity constraints and keep capital in play

The quests for idiosyncratic performance in a low-return environment, combined with rising correlations, is turning “emerging managers” into a catch phrase among investors and FOHFs alike. Some large institutional investors and FOHFs are running seeding platforms as new talent becomes available from proprietary desks in the wake of the Volker Rule. Despite the apparent need and desire to incorporate new talent in FOHF portfolios, the ability to conduct due diligence on such unproven talent requires both fortitude and capability. A FOHF investing in small managers has to accurately assess the higher risk of failure (for operational reasons) associated with these managers. Right-sizing such allocations is also important to diversify concentration risk in a hedge fund manager’s AUM and limit losses/markdowns in the portfolio, if any. Assessing asymmetric payoffs and knowing when to pull the plug is a valuable trait of a good quality FOHF that is well positioned to avoid headline risk associated with such failures that some direct investors might face. As a result, for some direct investors this could act as a deterrent to investing with new talent and, therefore, might restrict the portfolio from participating in the upside potential of small managers.

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Apart from size, a good FOHF is conscious about its choice of specialists versus generalists. In the case of region-specific managers (e.g., Asia), the ability to source and evaluate local talent is very important. On-the-ground research (not marketing) presence staffed with local talent and well-entrenched local networks are privileges enjoyed by only a few FOHFs. Equally important is the ability to negotiate investment structures (e.g., separate accounts, fund of ones) and fee arrangements that afford better transparency, allow greater control, maintain good liquidity, and grant fee concessions to the benefit of FOHF investors.

#### *iii) Continuing Research*

Monitoring managers on an ongoing basis is a function of both adequate resources and the ability of the FOHF to command respect and accountability from underlying managers. Some FOHFs are better in their processes and can gain valuable insights through constant dialogue and frequent interactions with the underlying managers beyond what periodic reports from managers and risk aggregators (e.g., Risk Metrics, Measurisk) might enable. Concurrently, seeking new managers is again a distinguishing trait of proactive FOHFs that maintain a robust pipeline of new ideas to keep their portfolios current in response to a rapidly changing opportunity set.

Embedded in the research process is operational due diligence that's almost indispensable to verifying the soundness of business operations. A rare but notable differentiator for some FOHFs is the existence of risk due diligence that evaluates the inherent risk of investing strategies and business operations beyond simply running conventional risk analytics (stress test, scenario analysis, Value-At-Risk, etc.). Independent risk due diligence speaks to the risk culture of the FOHF and affords an additional layer of oversight of the underlying managers.

## II. Portfolio Construction

Portfolio construction is the holy grail of FOHF investing. It is both an art and a science. At its very core it consists of strategic asset allocation, dynamic/tactical allocation, and good manager selection. As discussed earlier, all three play an integral role in determining the performance of a FOHF and how it distinguishes itself from its peers. Taking it a step further, manager sizing within a sub strategy allocation is an important step both from portfolio construction and risk management standpoints.

#### *a) Top Down vs. Bottom Up*

Recognizing the power of manager selection as the strongest driving force in normal periods, some FOHFs adopt a "bottom-up" portfolio construction approach with a "manager-first" mindset. Others follow a more conventional strategic allocation: top-down followed by bottom-up manager selection, since strategic asset allocation is the safest bet in both normal and stressed periods. However, a third (almost exclusive) league of FOHFs are those that differentiate themselves with timely market calls reflected in tactical shifts and changes in manager selection in sub-strategies that warrant attention. Market timing, as proven earlier, is a small but differentiating contributor and (on average) successfully practiced by only a few. Some might consider this a high-turnover-inducing exercise, sometimes even at the expense of losing capacity with underlying managers. However, good FOHFs are not afraid of expressing their convictions and exiting on terms that leave them still welcomed by redeeming managers when the tide turns.

#### *b) Diversification*

At the heart of portfolio construction is the proven tenet of diversification, often regarded as the only free lunch in portfolio management. The age-old reasons that underpin diversification, especially in the FOHF context, are:

- Defraying of business and headline risk
- Tapping into diverse talent and style
- Gaining exposure to various strategies, sectors, and geographies
- Above all, reducing intra-exposure/position correlation to lower overall portfolio volatility

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In the post-crisis period, any attempt to lower correlations is challenged by the all-pervasive macro influences that have come to dominate economies and capital markets. On the contrary, correlations are swept from side to side by erratic waves of risk-off and risk-on sentiments of investors. Hence, there is a growing chorus among investors to go beyond the conventional parameters of diversification mentioned above to understand how underlying exposures—both current and new additions—are likely to react to various economic regimes, systemic shocks, and, above all, different states of solvency. While conventional scenario analysis has meant to address some of these considerations, there is a growing accent on varying solvency states given the all-round uncertainty questioning the survival of sovereigns and corporations.

At the individual manager level, the question facing most FOHFs is “how much diversification is enough?” Some old-school FOHFs follow a kitchen-sink approach and construct portfolios with a slew (e.g., 70+) of managers. While academicians are still researching the reasons for over-diversification despite inherent disadvantages (see *Best-Ideas Portfolio* below), one might speculate that this could be a function of a FOHF’s size where capacity with underlying managers becomes an issue and FOHFs then begin seeking newer capacity to put their money to work. While this may give the impression of seeking newer managers at first glance, the real motive is search for capacity. In other words, the manager count goes up, not the drive to discover new ideas. Another reason could be a conservative client base looking to diversify away headline and business risk with less emphasis on performance, encouraging a FOHF to invest with more proven (brand) names.

#### *c) Best-Ideas Portfolios*

However, more contemporary FOHFs are slanting toward building more compact portfolios concentrated in their highest conviction ideas. Intuitively, this is plausible given that investors’ desire for idiosyncratic risk is greater than ever before, and over-diversification diversifies away that risk leaving behind pure market risk, which is the antithesis of hedge fund investing. Academic studies also lend credence to this phenomenon for a host of other reasons.

- The greater the number of underlying hedge funds, the more exposed the FOHF is to hedge fund contagion arising out of liquidity shocks—deemed the most severe of conditions resulting in hedge fund failure. While FOHFs efficiently diversify away business risk, excess diversification concentrates common factor risk<sup>6</sup>.
- The higher the number of funds in a FOHF, the larger the accumulation of incentive fees at the fund level that are passed through the FOHF’s vehicle. These fund-level incentive fees then become a fixed charge payable by the investor whether or not the FOHFs does well or poorly<sup>7</sup>.
- Due diligence on underlying managers is expensive and the sheer volume of managers could compound that expense, quickly consuming a big chunk of the management fees. This could deter the FOHF from conducting initial and continuing due diligence in a thorough and timely, manner thus increasing operational and investment risk to the portfolio<sup>8</sup>.

From the evidence above, one may conclude that having an excessive number of hedge fund managers in a FOHF may be counter-productive.

#### *d) How much diversification is enough?*

One recent study<sup>9</sup> suggests that variance-reducing effects of diversification diminish once FOHFs hold more than 20 underlying hedge funds. Another study<sup>10</sup> suggests 10–15 funds for adequate diversification while a 2008 study<sup>14</sup> concluded that a diversified portfolio of approximately 40 funds is optimal for a FOHF’s portfolio. The results vary due to the universe considered and the simulation methodology applied in the various studies.

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Suffice is to say that there is no precise number to suggest adequate diversification. Diversification for the sake of diversification is a meaningless exercise. A best-ideas portfolio in high conviction names mindful of both downside protection and upside participation is a differentiator. Given that there is wide dispersion between top and bottom quartile performance within each hedge fund strategy<sup>11</sup>, good quality FOHFs artfully blend top performers within each strategy (not necessarily brand names but those most suited to respond proactively to the prevailing opportunity set) with some high-conviction newer names.

#### III. Risk Management

##### *a) Risk Mitigating Strategies*

In its simplest form, risk management is a preemptive measure to protect from the risk of permanent loss of capital. The risk of drawdowns or capital losses is fresh on the minds of investors coming out of the financial crisis. Systemic shocks and frauds (e.g., Madoff) both contributed to investor losses in recent times. Risk management aims to address the former while operational due diligence is geared toward developing early warning signs to prevent potential frauds. In the aftermath of the financial crisis, many FOHFs have become extremely risk averse and portfolio management has transformed into a more risk management practice. This is partly driven by investors who flocked to large FOHFs (see *Recent Trends in Fund of Hedge Funds*) seeking capital preservation as their primary objective. Therefore, FOHFs that espoused “sleep well at night” by attempting to smooth out interim volatility have joined others that claim low correlation as their mantra in their search for uncorrelated/low-correlated sources of return. In their attempt to do so, many FOHFs are actively seeking opportunities in Global Macro and CTAs in addition to managing market exposures and pursuing low-volatility strategies. Some also have increased appetite for volatility arbitrage and tail risk strategies that aim to both protect in adverse conditions and profit from heightened volatility. Some FOHFs have adopted overlay hedges through derivatives to augment/supplement risk-mitigation efforts by the underlying managers. While all the above-mentioned efforts are valid responses to volatile market conditions, experience and a track record of successfully implementing these techniques distinguishes a FOHF from those that might have to prove themselves in the use of such defensive tactics.

##### *b) Underlying Exposure Management*

To successfully deploy such strategies, an understanding of underlying exposures is critical. Hence there is an increased emphasis on transparency and risk aggregators. The large FOHFs that command the resources and clout open managed account (separate accounts, fund of ones) with underlying managers where they get complete security-level transparency and can select/deselect exposures. Others that do not/cannot obtain such terms either leverage their strong relationships with managers to gain insights into the portfolio ahead of what risk exposures might suggest or compensate for lack of position-level details with a higher frequency of manager interactions and onsite visits to get a good read into portfolios.

##### *c) Technology and Risk Analytics*

To assist in the slicing and dicing of data, risk management technology has advanced leaps and bounds with significant dollars committed to enhance technological infrastructure in terms of both resource personnel and hardware/software. Value creating FOHFs use technology to their advantage, purposefully knowing what to look for in the mountains of position-level/exposure data obtained from underlying managers and overlaying that with intuition and common sense. Merely exhibiting state-of-the art technology and staffing up do not compensate for the lack of analytical skills and tantamount to good marketing at best.

##### *d) Liquidity Management*

Having learned hard lessons from the financial crisis, among the most common uses of these risk tools is an increased focus on liquidity to prevent a liquidity mismatch between terms offered to investors and liquidity afforded by underlying managers. Almost as a consequence of this, liquidity-conscious FOHF managers are averse to incorporating strategies promising

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illiquidity premiums for longer lock-ups and thus deploy these in separate hybrid structures that resemble private equity deals.

Coexisting with this need to maintain good liquidity and avoid a potential liquidity mismatch is the pressing need to remain nimble and opportunistic to respond to rapidly changing market dynamics. A lock-up deprives an FOHF from redeeming from a less attractive opportunity in a timely manner and reinvesting in successful ones. The value lost is the expected premium for committing to the lock-up. FOHFs can therefore enhance their returns by redeeming their investment in sick funds whenever the lock-up period ends and reinvesting with good funds<sup>12</sup>. This lack of liquidity was cited as the debilitating factor preventing timely tactical decisions, especially in stressed conditions, which left only a few to add value through dynamic allocation in rough times<sup>3</sup>.

#### *e) Concentration Risk*

Thoughtful FOHFs are also conscious about concentration of positions through underlying managers. For example, it is quite likely that distressed managers are likely to have exposure to the same post-reorganized equities as dealer inventories are typically low and these are traded by and large within the hedge fund community. Concentrations in an underlying manager's business/AUM or exposure to multiple products from the same underlying manager are other issues that good quality FOHFs seek to avoid.

#### *f) Correlations*

While managing correlations to traditional markets is important, a valuable risk consideration is lowering inter-manager correlations that can help reduce the risk of systemic shocks. Creating alternative streams of return (i.e. difference between the returns of different assets<sup>15</sup>) is the true measure of real diversification.

#### *g) Leverage*

Varying gross exposures i.e. leverage through underlying managers is a risk tool that some FOHFs employ especially in uncertain market environments. This shows in their preference for underlying managers who can alter their gross exposures dynamically while maintaining low net exposures. A look through gross notional exposure (including derivatives) is valuable in this regard. Some FOHFs are more focused on net exposures to assess their exposure to market risk. Others prefer a low net exposure but a higher gross exposure, indicating deployment of both longs and shorts to capture upside and protect and profit on the downside.

### **Performance**

Performance, while important, is best understood in the context of the character of the FOHF: What role did the investor expect the FOHF to perform in a prevailing market environment? This takes us back to emphasizing the importance of gaining a good understanding of the investment philosophy of the FOHF. For example, in a highly volatile environment, one would expect a "low-volatility-focused" FOHF to do far better than a "return-seeking" FOHF. On the other hand, the opposite is likely to be true in normal to up markets. Thus, performance is a test of a FOHF's character and relative performance is a measure of its success or failure compared to *its own peer group*. This is a more meaningful assessment of performance than broad comparisons to the HFRI FOF, which is a mix of hedge funds that vary in character and style. As discussed under "*True Measure of Value*," comparing a FOHF to the HFRI Composite has many shortcomings and, therefore, is not a meaningful yardstick.

Besides relative performance, it is equally important to measure absolute performance. In this regard, good quality FOHFs display consistency of performance in market cycles best suited to a FOHF's character, led by consistent contribution from the principal performance drivers. Peer-leading FOHFs display superiority of their performance drivers vis-à-vis other FOHFs that also employ the same drivers with similar emphasis. Attribution for good quality FOHFs also show parity in performance contributors and allocation weights suggesting that the "strategy

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bets are paying off.”

Another valuable performance measurement exercise is to compare a FOFH to the HFRX (investible index) individual strategy indices weighted by the fund-specific strategy allocation (see *Value-Creation Illustrated*, below). This is a reflection of a manager’s value addition/detraction through active portfolio management, mainly attributable to manager selection.

#### **Price**

Some FOHFs fearing flight of assets to direct hedge funds have buckled under pressure to reduce fees by waiving incentive fees and offering concessions on management fees (avg. ranges 0.9%–1.25%) in their bid to retain and win larger clients. Some have used their heft to their advantage to bargain for fee breaks from their underlying managers. In some ways, the fee concessions suggest that maintaining and growing market share is an important priority for them to maintain their competitive advantage. Some of these FOHFs have also started offering advisory services to enable investors to go-direct, thus offsetting some revenue loss from managing discretionary assets.

On the other hand, there are others who have managed to maintain their fees. Included in this group are those who continue to enjoy favor (and assets) on the strength of their institutional framework and project an image of “safety” that many clients seek with a preservation-first mindset in a persistently volatile environment.

But then there are also those who have maintained their fees because they firmly believe in their continued ability to create value and have retained and won new clients in the face of adversity. It is for such value creators that investors are inclined to pay incentive fees (avg. 5%–10%) to align the FOHF’s economic interests with their own. For others, fee compression is inevitable when performance (reflected in preserving and growing portfolios) becomes a bigger consideration than “perceived” safety.

Hence, pricing power will rest with those FOHFs that can deliver on this dual mandate, either in commingled vehicles or in customized/bespoke mandates. This is often a better opportunity for a FOHF to display its portfolio construction capabilities.

#### **Perpetuity**

Last but not least, longevity of a business is as important as continuation of a successful track record. Investors seek stability both in terms of performance and the team that delivers it. Thus, compensation and incentive structures that foster the building of a legacy into the future are confidence enhancing. In private FOHF firms, periodic admission of new partners and/or broad-based equity ownership is a good indicator of building toward the future. FOHFs that are part of large corporations indirectly inherit both the stability and the balance sheet support of their parent companies; however, autonomous functioning of such subsidiaries also helps engender the entrepreneurial culture that is more typical of smaller firms.

“Sticky” capital is another sign of a stable business—hence the penchant for the less-fickle institutional investor among FOHFs. However, some FOHFs that historically have managed high-net-worth (more than institutional capital) assets show equally good stability of capital if the latter represents long-standing private clients/family offices who have stuck with the firm over the long haul. Capital garnered from private banking platforms is less encouraging as also evidenced by the massive redemptions (ATM effect) faced by FOHFs (especially private client-focused European FOHFs) in the recent past.

With the passage of time, it is expected that FOHFs get more seasoned, perform better, and increase their clientele (and thus their AUM). This should afford better economies of scale and

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lower risk of failure, which are often distractions for a newer FOHF. However, with size, capacity constraint is an impending threat for large FOHFs that could be detrimental to future performance<sup>13</sup>. Therefore, while size is an advantage, it begins to wear off after some time and becomes an obstacle to superior performance.

To address this, good quality, large FOHFs leverage their size advantage to negotiate better terms with underlying managers and use their superior infrastructure to discover and evaluate newer hedge fund managers that have the potential to tap creatively into niche market segments and generate superior returns (see the discussion under *Research Agenda*). Together, the size advantage of a large FOHF and the nimbleness and superior performance potential of smaller hedge fund managers form a potent combination.

#### **6Ps Summarized**

In summary, a method akin to NEPC's 6Ps approach helps to explain the DNA of a FOHF and the role that it is likely to perform in a portfolio. It further helps gauge the effectiveness of the FOHF in performing its designated role and also helps to verify (through performance analysis) if the FOHF was successful in delivering on its mandate and how. While past is not necessarily prologue, consistency of character and conduct bodes well for the future and acts as a fair indicator of sustainability of a FOHF's value creation. Again, it cannot be emphasized enough that value creation should be assessed in the context of the role a FOHF is expected to play. For example, a FOHF that espouses low volatility should be evaluated for consistency of behavior (through a 6P process) and success in delivering on that mandate versus others in its peer group.

Investors who aspire to go direct can use such value creators as benchmarks for themselves to evaluate their success in fulfilling various functions of a FOHF and above all in constructing a responsive portfolio with best-in-class managers. For those FOHF investors who cannot go direct, such value creators in respective peer groups are viable alternatives to their existing FOHFs should the latter pale in comparison. Again, it is highly unlikely that a FOHF will display "all" the desirable characteristics discussed under each "P" above. The objective is to discover the most attractive candidate in a peer group that presents a balanced picture consisting of most, if not all, desirable features.

#### **Value-Creation Illustrated**

In our search for value creation, NEPC has identified a select group of FOHFs that score high in aggregate on our scorecard based on the 6Ps discussed above. While they differ by philosophy, style, and processes, they are all value creators.

Presented below is the attribution (see *Appendix 2* for a description of the methodology for calculating value attribution) of value creation—How did the manager create value: through asset allocation or manager selection?—of some of NEPC's highest-conviction FOHFs. We have grouped them by their underlying philosophies:

**Core** FOHFs espouse stability of returns and adopt the "sleep well at night" approach to attempt more modest returns with lower volatility. Core FOHFs aim to protect on the downside and participate quite modestly on the upside.

**Enhanced Core** FOHFs follow a dual philosophy of providing good downside protection in bad market environments and seeking above-average returns in normal to up markets. In aggregate, they tend to deliver returns higher than core FOHFs but lower than their return-seeking brethren.

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**Return-Seeking** FOHFs strive for above-average returns. They are less concerned about interim volatility and focus more on downside protection as their risk-management tool. Return-seeking FOHFs aim to generate superior returns in normal to up markets.

Below is a sample of value-creating FOHFs on NEPC's platform.

		2005	2006	2007	2008	2009	2010	CAGR
<b>Core</b>	<b>FOHF Manager S</b>	6.8%	8.9%	8.1%	-14.7%	11.0%	6.1%	4.0%
	Fund Wtd HFRX Sub Strategy Returns	3.6%	9.5%	3.9%	-23.7%	11.3%	6.5%	1.1%
	<b>Manager Selection Value Add</b>	<b>3.3%</b>	<b>-0.6%</b>	<b>4.2%</b>	<b>9.1%</b>	<b>-0.4%</b>	<b>-0.5%</b>	<b>2.9%</b>
	HFRI FOF- Diversified Index	7.5%	10.2%	9.7%	-20.9%	11.5%	5.5%	
	<b>Asset Allocation Value Add(HFRX-HFRI)</b>	<b>-3.9%</b>	<b>-0.7%</b>	<b>-5.8%</b>	<b>-2.9%</b>	<b>-0.1%</b>	<b>1.0%</b>	<b>-2.1%</b>
	<b>Total Value Add (Manager Select+ Asset Allocation)</b>	<b>-0.6%</b>	<b>-1.3%</b>	<b>-1.6%</b>	<b>6.2%</b>	<b>-0.5%</b>	<b>0.6%</b>	<b>0.8%</b>
	<b>FOHF Manager W</b>	5.3%	9.8%	8.8%	-15.7%	18.3%	4.7%	4.6%
	Fund Wtd HFRX Sub Strategy Returns	9.0%	14.3%	9.8%	-13.7%	16.4%	7.0%	6.6%
	<b>Manager Selection Value Add</b>	<b>-3.7%</b>	<b>-4.5%</b>	<b>-1.0%</b>	<b>-2.0%</b>	<b>1.9%</b>	<b>-2.3%</b>	<b>-2.0%</b>
	HFRI FOF- Diversified Index	7.5%	10.2%	9.7%	-20.9%	11.5%	5.5%	
<b>Asset Allocation Value Add(HFRX-HFRI)</b>	<b>1.5%</b>	<b>4.1%</b>	<b>0.0%</b>	<b>7.2%</b>	<b>4.9%</b>	<b>1.6%</b>	<b>3.2%</b>	
<b>Total Value Add (Manager Select+ Asset Allocation)</b>	<b>-2.2%</b>	<b>-0.4%</b>	<b>-0.9%</b>	<b>5.2%</b>	<b>6.8%</b>	<b>-0.8%</b>	<b>1.2%</b>	

Source: NEPC

While most core managers rely more on the power of strategic asset allocation (as the safer bet) as can be observed from the attribution of Manager W, Manager S is an exception and sources its alpha or value add from manager selection. In fact, during stress periods (e.g., 2008) when manager selection is challenged, Manager S stands out across all camps—core, enhanced core, and return seeking.

		2005	2006	2007	2008	2009	2010	CAGR
<b>Enhanced Core</b>	<b>FOHF Manager A</b>	10.4%	9.2%	15.4%	-15.6%	18.0%	7.4%	6.8%
	Fund Wtd HFRX Sub Strategy Returns	5.9%	7.8%	6.6%	-18.3%	8.9%	4.9%	2.1%
	<b>Manager Selection Value Add</b>	<b>4.5%</b>	<b>1.4%</b>	<b>8.8%</b>	<b>2.7%</b>	<b>9.1%</b>	<b>2.5%</b>	<b>4.7%</b>
	HFRI FOF- Diversified Index	7.5%	10.2%	9.7%	-20.9%	11.5%	5.5%	
	<b>Asset Allocation Value Add(HFRX-HFRI)</b>	<b>-1.6%</b>	<b>-2.4%</b>	<b>-3.1%</b>	<b>2.5%</b>	<b>-2.5%</b>	<b>-0.5%</b>	<b>-1.3%</b>
	<b>Total Value Add (Manager Select+ Asset Allocation)</b>	<b>2.9%</b>	<b>-1.0%</b>	<b>5.7%</b>	<b>5.3%</b>	<b>6.5%</b>	<b>1.9%</b>	<b>3.5%</b>

Source: NEPC

With a dual philosophy of above-average returns and good downside protection, Manager A, in the enhanced core category, creates good value through manager selection consistently, losing a little through asset allocation though successfully harvesting it during a stress period.

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Return Seeking								
	<b>FOHF Manager O</b>	2005	2006	2007	2008	2009	2010	CAGR
		4.8%	10.3%	16.6%	-22.0%	18.6%	6.1%	4.8%
	Fund Wtd HFRX Sub Strategy Returns	1.9%	8.9%	2.5%	-24.7%	16.9%	8.8%	1.4%
	<b>Manager Selection Value Add</b>	<b>2.9%</b>	<b>1.4%</b>	<b>14.1%</b>	<b>2.7%</b>	<b>1.7%</b>	<b>-2.7%</b>	<b>3.4%</b>
	HFRI FOF- Strategic Index	10.3%	11.8%	12.8%	-25.2%	13.2%	6.3%	
	<b>Asset Allocation Value Add(HFRX-HFRI)</b>	<b>-8.4%</b>	<b>-2.9%</b>	<b>-10.3%</b>	<b>0.5%</b>	<b>3.7%</b>	<b>2.5%</b>	<b>-2.6%</b>
	<b>Total Value Add (Manager Select+ Asset Allocation)</b>	<b>-5.5%</b>	<b>-1.5%</b>	<b>3.8%</b>	<b>3.2%</b>	<b>5.4%</b>	<b>-0.2%</b>	<b>0.8%</b>
		2005	2006	2007	2008	2009	2010	CAGR
	<b>FOHF Manager U</b>	9.5%	11.0%	13.1%	-21.7%	21.3%	7.3%	5.8%
	Fund Wtd HFRX Sub Strategy Returns	4.1%	9.2%	6.9%	-13.8%	7.0%	3.4%	2.5%
	<b>Manager Selection Value Add</b>	<b>5.4%</b>	<b>1.8%</b>	<b>6.2%</b>	<b>-7.9%</b>	<b>14.3%</b>	<b>-1.0%</b>	<b>3.3%</b>
	HFRI FOF- Strategic Index	10.3%	11.8%	12.8%	-25.2%	13.2%	6.3%	
<b>Asset Allocation Value Add(HFRX-HFRI)</b>	<b>-6.1%</b>	<b>-2.5%</b>	<b>-5.9%</b>	<b>11.4%</b>	<b>-6.2%</b>	<b>-2.9%</b>	<b>-2.2%</b>	
<b>Total Value Add (Manager Select+ Asset Allocation)</b>	<b>-0.8%</b>	<b>-0.8%</b>	<b>0.3%</b>	<b>3.5%</b>	<b>8.1%</b>	<b>-3.9%</b>	<b>1.1%</b>	
	2005	2006	2007	2008	2009	2010	CAGR	
<b>FOHF Manager L</b>	8.8%	11.6%	9.6%	-17.5%	28.6%	11.5%	7.9%	
Fund Wtd HFRX Sub Strategy Returns	6.5%	9.0%	7.1%	-22.0%	10.6%	8.1%	2.5%	
<b>Manager Selection Value Add</b>	<b>2.3%</b>	<b>2.6%</b>	<b>2.5%</b>	<b>4.5%</b>	<b>18.0%</b>	<b>3.4%</b>	<b>5.4%</b>	
HFRI FOF- Strategic Index	10.3%	11.8%	12.8%	-25.2%	13.2%	6.3%		
<b>Asset Allocation Value Add(HFRX-HFRI)</b>	<b>-3.8%</b>	<b>-2.7%</b>	<b>-5.7%</b>	<b>3.1%</b>	<b>-2.6%</b>	<b>1.8%</b>	<b>-1.7%</b>	
<b>Total Value Add (Manager Select+ Asset Allocation)</b>	<b>-1.5%</b>	<b>-0.2%</b>	<b>-3.2%</b>	<b>7.7%</b>	<b>15.4%</b>	<b>5.2%</b>	<b>3.7%</b>	

Source: NEPC

In the return-seeking category, manager selection is the biggest driving force, with some support if any from asset allocation except in a stress period like 2008. Manager L in the above sample is the most successful in creating value through manager selection. Manager O has been successful more often than Manager U and Manager L in creating value through asset allocation, but has also detracted more when wrong.

As one may observe from the tables above, the greater the penchant for superior performance, the greater the influence of manager selection on performance. Also, note that , in the crisis period of 2008, asset allocation reasserted itself as the dominant force even for those managers that otherwise depend more on manager selection to seek above-average returns (e.g., Managers A, U, and L).

In a volatile period such as 2010, again asset allocation was a greater additive force for two-thirds of our sample above, although Managers A and L also continued to extract value from good manager selection. In this regard, Manager S finds asset allocation benefits outweighing manager selection.

Therefore, Managers A and L differentiate themselves in their ability to dynamically move their portfolios and invest with appropriate managers that can help protect downside in a crisis period while continuing to capture the upside through manager selection in up markets and volatile periods.

This proves that, although discovering value-creating FOHFs is like "finding a needle in a haystack," such FOHFs do exist. It takes a thorough 360-degree due diligence effort to discover them. NEPC's FOHF research is founded upon and guided by this conviction.

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#### **Market Opportunity**

In a new era where confidence is waning, the FOHF industry has to rise to face the challenge by clearly demonstrating its value proposition—either through superior manager selection or responsive portfolio construction or both. The future would likely belong to those FOHFs that can demonstrate their true ability to be not only valuable conduits/channels for underlying manager performance but also value enhancers through astute manager selection and/or portfolio construction.

At the end of the day, today's investors—more than ever before—are concerned about both capital preservation and growth of capital given the ongoing turmoil in the markets. FOHFs that can opportunistically respond to this urgent need will find themselves ranked among the select few that have distinguished themselves as good channels of underlying manager performance and value enhancers.

Despite the overall increase in macro driven factors spurring higher volatility, most institutional investors are maintaining their openness toward hedge funds and looking to increase their allocations when most investment classes remain challenged in this environment. Anticipating inflows of money, some traditional investors are likely to migrate to the hedge fund world lured by a better compensation structure. Higher inflows of money and influx of talent could see greater exploitation of market inefficiencies and a further compression of returns. The unfolding of an even more challenging environment for returns will further distill the good from the not-so-good managers. Hence, manager selection for FOHFs will assume even greater importance and, in turn, constrict the universe of top-quality FOHFs.

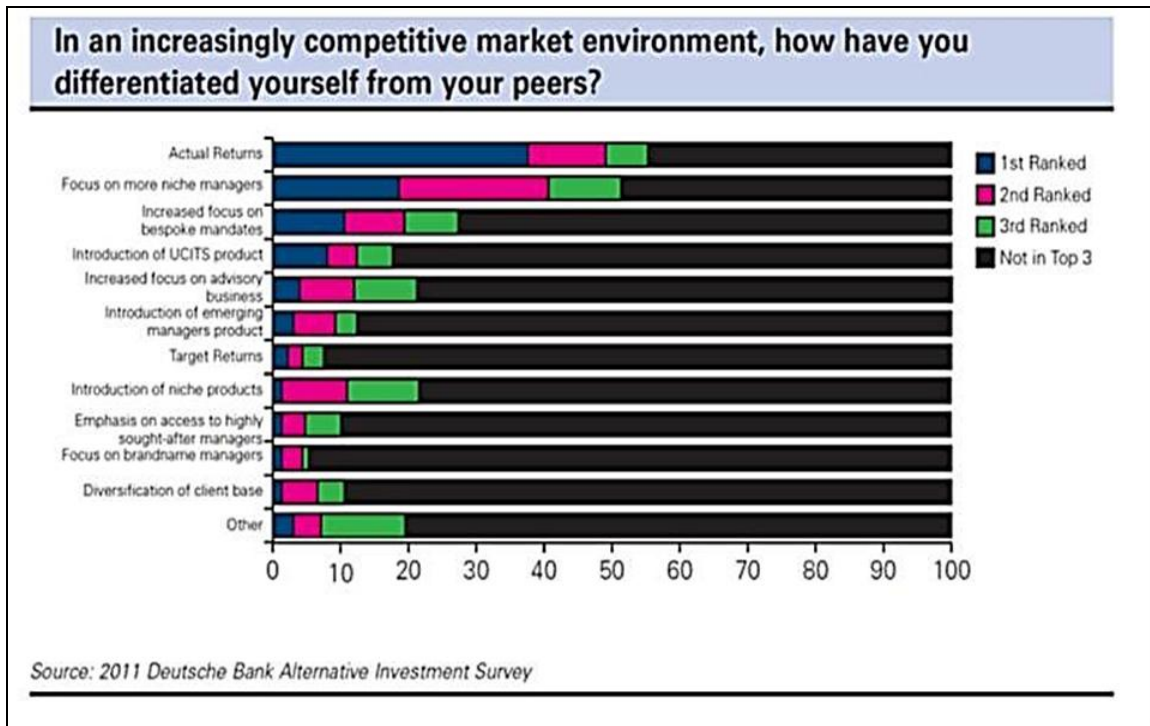
As discussed earlier, there are a few FOHFs that consistently demonstrate their ability to add value through asset allocation, tactical shifts, and careful manager selection. Sensitivity to investor demands but confident of their ability to create value, these FOHFs have responded by enhancing their roster of services (their value proposition). This has manifested itself in more frequent client interaction, more detailed and transparent reports, more client education, and, above all, customized portfolio construction and acting as the clients' de facto CIO. Rational clients continue to perceive additional value as evident in the growing institutionalization of some FOHFs even when they have not offered fee concessions.

However, some FOHFs continue to gain client favor more on the strength of their institutional frameworks that offer a timely response to investors' penchant for safety and avoidance of headline risk. As a result some FOHFs i.e. the large institutional shops are getting larger.

Proactive FOHFs, who aim to deliver beyond their institutional persona, are by their own admission already responding to a changed marketplace to differentiate themselves.

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As one might observe from the Deutsche Bank Alternative Survey, the yesteryear “emphasis on access to highly sought after managers” and “focus on brand name managers” have given way to “actual returns,” “focus on more niche managers,” and “increased focus on bespoke mandates.” Acting merely as concierges to provide access to brand name hedge funds is a scene fading in the background and FOHFs of tomorrow have to deliver on manager selection, customized portfolio construction, and generating real returns. This will lead to a survival of the fittest and impose higher barriers to entry.

To deliver on this mandate, we envision three forms in which FOHFs are likely to prevail going forward:

- FOHFs with high-conviction ideas and dynamic portfolio allocation capabilities adopting an “all weather” portfolio style will continue to attract first-time hedge fund investors (less resourceful and more risk-averse investors<sup>3</sup>).
- FOHFs with high-conviction “niche” ideas and dynamic portfolio allocation capabilities will likely complement core allocations of single-strategy hedge funds in client portfolios.
- FOHFs will increasingly customize portfolios in bespoke mandates to supplement/complement other portfolio/single-strategy hedge fund allocations.

In addition to the above, there is a new breed of FOHFs that are attempting to distinguish themselves by practicing some high-conviction trades in conjunction with investing in underlying managers. Direct trades are a reflection of a FOHF’s own insights into the marketplace and help corner those segments of the market that a FOHF views to be untapped by underlying managers. However, this does run the risk of a (perceived) conflict of interests and front-running and thus has to be hemmed into the portfolio carefully.

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#### **Conclusion**

In a low-return environment, investors are becoming increasingly fee conscious and are assessing the intrinsic value of fees through performance more closely than ever before. In evaluating performance of FOHFs, investors often default to comparing performance to the HFRI Composite to arrive at the wrong conclusion that FOHFs have not added any value. This comparison is faulty because the HFRI Composite represents only funds that have survived over time, while the HFRI FOHF also includes the history of investing with failed firms. The HFRI Composite is an aggregation of the performance of various hedge fund strategies but not a representation of *how* a FOHF aggregates the underlying strategies. In other words, the HFRI Composite fails to capture the biggest differentiator for FOHFs: their ability to construct portfolios in myriad ways.

Industry research and NEPC Hedge Fund Research affirm that investors should compare FOHFs to their own experience in constructing a hedge fund portfolio. Any shortfall in one's own experience (typical of first-time do-it-yourselfers and more risk-averse investors) is likely attributable to a FOHF's value addition through a combination of strategic asset allocation, dynamic/tactical shifts in allocation, and astute manager selection from a universe of both good and not-so-good hedge funds.

However, the attribution of value creation varies by FOHF and studies suggest that only a small universe of FOHFs prove to be value creators overall. These best-in-class FOHFs, in and of themselves, offer both a viable choice for hedge fund investors and a benchmark for those investors looking to build their own FOHF. The challenge is to find such value creators among a multitude of 2,000 plus FOHFs.

Adopting a holistic approach—as demonstrated by NEPC Hedge Fund Research's 6P due diligence criteria—investors can identify such value-creating FOHFs as further illustrated by NEPC's own experience is building its own platform of high-conviction value-creating FOHFs.

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### Appendix 1: List of the Largest (by Assets Under Management) FOHFs

THE 2011 FUND OF FUNDS 50					THE 2011 FUND OF FUNDS 50				
RANK 2011	RANK 2010	FIRM	FIRM CAPITAL (\$ MILLIONS)		RANK 2011	RANK 2010	FIRM	FIRM CAPITAL (\$ MILLIONS)	
			2011	2010				2011	2010
1	2	HSBC Alt. Investments Ltd (London, U.K.)	\$36,800	\$30,600	32	32	Banca del Ceresio (Lugano, Switzerland)	\$6,300 <sup>2</sup>	\$5,790 <sup>3</sup>
2	3	Blackstone Alt. Asset Mgmt (New York, NY)	34,061 <sup>1</sup>	27,874	33	33	Hall Capital Partners (San Francisco, CA)	6,292	5,604 <sup>3</sup>
3	1	All. and Quantitative Investments, UBS (New York, NY)	27,548	32,286	34	30	Aberdeen Asset Mgmt <sup>9</sup> (London, U.K.)	6,284	6,293 <sup>3</sup>
4	4	Grosvenor Capital Mgmt (Chicago, IL)	24,022 <sup>2</sup>	22,532 <sup>3</sup>	35	34	Crestline Investors (Fort Worth, TX)	5,997	5,200
5	5	Permal Group (New York, NY)	21,600	19,400	36	—	AXA Investment Managers (Paris, France)	5,700	—
6	6	Goldman Sachs Hedge Fund Strategies (New York, NY)	20,800 <sup>2</sup>	19,080 <sup>3</sup>	37	38	EnTrust Capital (New York, NY)	5,550 <sup>10</sup>	4,576 <sup>11</sup>
7	12	BlackRock Alt. Advisors (Seattle, WA)	18,910	16,100	38	37	Aetos Alt. Mgmt (New York, NY)	5,475	4,676
8	11	Pacific Alt. Asset Mgmt Co. (Irvine, CA)	16,704	16,315	39	45	Prisma Capital Partners (New York, NY)	5,400	4,090
9	8	Lyxor Asset Mgmt <sup>4</sup> (Paris La Defense, France)	16,133	17,700	40	—	Diversified Global Asset Mgmt Corp. (Toronto, Canada)	5,323	2,312
10	7	Union Bancaire Privée (Geneva, Switzerland)	15,000	18,792 <sup>3</sup>	41	40	Harcourt Inv. Consulting (Zurich, Switzerland)	4,700 <sup>12</sup>	4,500
11	9	Man Investments (London, U.K.)	14,700 <sup>2</sup>	17,100 <sup>3</sup>	41	40	LGT Capital Partners (Pfäffikon, Switzerland)	4,700	4,500
12	10	GAM (London, U.K.)	14,500	17,000 <sup>3</sup>	43	44	Archstone Partnerships <sup>13</sup> (New York, NY)	4,678 <sup>2</sup>	4,353 <sup>3</sup>
13	15	Mesirow Advanced Strategies (Chicago, IL)	13,628	12,082	44	36	Lighthouse Partners (Palm Beach Gardens, FL)	4,500	4,700
14	16	Morgan Stanley Alt. Inv. Partners (West Conshohocken, PA)	11,905	11,149	45	—	Evanston Capital Mgmt (Evanston, IL)	4,240	—
15	14	Amundi Alt. Investments <sup>5</sup> (Paris, France)	10,734	12,800	46	—	Brummer & Partners (Stockholm, Sweden)	4,078	—
16	18	Aurora Inv. Mgmt (Chicago, IL)	10,468	9,542	47	—	Schroders NewFinance Capital <sup>14</sup> (London, U.K.)	3,900 <sup>2</sup>	2,500 <sup>3</sup>
17	13	Credit Suisse Asset Mgmt <sup>6</sup> (New York, NY)	10,400	13,000	48	49	Sciens Capital <sup>15</sup> (New York, NY)	3,765	2,800
18	23	K2 Advisors (Stamford, CT)	9,394	7,986	49	17	BNY Mellon Asset Mgmt <sup>16</sup> (New York, NY)	3,746	10,277
19	20	Financial Risk Mgmt (London, U.K.)	9,277	8,473	50	—	NB Alt. Inv. Mgmt (New York, NY)	3,710	—
20	21	Pictet Alt. Investments (Geneva, Switzerland)	8,800	8,347					
21	25	J.P. Morgan Alt. Asset Mgmt (New York, NY)	8,600	7,500					
22	31	LCF Edmond de Rothschild Asset Mgmt (London, U.K.)	8,489	6,200					
23	—	BlueCrest Capital Mgmt (London, U.K.)	8,353 <sup>2</sup>	—					
24	22	Gottex Fund Mgmt (Lausanne, Switzerland)	8,255 <sup>7</sup>	8,130					
25	27	Fauchier Partners (London, U.K.)	7,858	7,200					
26	19	E.I.M. (Nyon, Switzerland)	7,500	8,700					
27	29	SkyBridge Capital II <sup>8</sup> (New York, NY)	7,440	6,708					
28	24	Arden Asset Mgmt (New York, NY)	7,340 <sup>2</sup>	7,943					
29	34	Rock Creek Group (Washington, D.C.)	7,200	5,200 <sup>3</sup>					
30	25	Notz, Stucki & Cie (Geneva, Switzerland)	7,000	7,500					
31	28	Silver Creek Capital Mgmt (Seattle, WA)	6,774	7,192					

Unless otherwise specified, 2011 assets are as of January 3, 2011, and 2010 assets are as of January 4, 2010.  
<sup>1</sup>Estimate, unaudited.  
<sup>2</sup>As of December 31, 2010.  
<sup>3</sup>As of December 31, 2009.  
<sup>4</sup>Lyxor Asset Management is a subsidiary of Société Générale.  
<sup>5</sup>Amundi Alternative Investments is a joint venture of Crédit Agricole and Société Générale.  
<sup>6</sup>Previously listed as Credit Suisse Funds and Alt. Solutions.  
<sup>7</sup>Total fee-earning assets as of December 31, 2010; includes advisory and Gottex Solutions Services assets under management.  
<sup>8</sup>Rank and capital last year were for Citi Alternative Investments, which SkyBridge Capital II acquired in June 2010.  
<sup>9</sup>Royal Bank of Scotland Group sold the Investment Strategies division of RBS Asset Management to Aberdeen Asset Management in January 2010.  
<sup>10</sup>Estimated as of December 31, 2010.  
<sup>11</sup>As of January 1, 2010.  
<sup>12</sup>As of June 30, 2010.  
<sup>13</sup>Previously listed as Archstone Management Co.  
<sup>14</sup>Previously listed as NewFinance Capital; NewFinance Capital has been a wholly owned subsidiary of Schroders since 2006, and Schroders changed the name of the subsidiary to Schroders NewFinance Capital in July 2010.  
<sup>15</sup>Previously listed as Sciens Fund of Funds Management.  
<sup>16</sup>EACM Advisors is the sole BNY Mellon Asset Management fund-of-hedge-funds business.

Source: Institutional Investor, April 2011

# **NEPC Hedge Fund Research**

## **Assessing the Value of Multi-Strategy Fund of Hedge Funds**

### **A Market Survey: 2011**

#### **Appendix 2: Methodology to Compute Attribution of Value Added by NEPC Approved FOHFs**

To compute the attribution of value creation, we followed the following steps:

- 1) We matched the FOHF to the appropriate FOHF sub-index (conservative, diversified, strategic) closest in description to the manager's philosophy.
- 2) We next computed the FOHF annual returns based on the manager's actual asset allocation for a particular year and multiplied it with the HFRX sub-strategy index (investable index). The aggregate of all strategies gave us the fund-weighted HFRX sub-strategy returns for the FOHF.
- 3) The difference between an equal-weighted HFRI sub-strategy index (1) and the aggregate of the FOHF specific weighted sub-strategy performance (2) is indicative of the manager's value addition/detraction from strategic asset allocation.
- 4) Finally, we subtracted the aggregate of the FOHF specific weighted sub-strategy returns (2) from the FOHF's actual performance for the year to determine the value addition/detraction from manager selection. *This might be biased slightly upward, given differences in the profile of managers that constitute the HFRX index and those available to a FOHF. However, comparison on this basis still affords a relative measure of value added/detracted from manager selection.*

Note: We have preferred the HFRX investable indexes over The DJCS sub-strategy investable indexes due to the following reasons:

- a) The HFRX investable index is constructed using quantitative and qualitative considerations that select funds having the highest statistical likelihood of producing a return series that is most representative of the reference universe of strategies.
- b) The DJCS sub-strategy indexes are constructed in a manner where the weight of each member fund is calculated per its AUM. This is likely to result in the index being skewed to reflect the performance of larger funds in the index, which tend to control the bulk of the assets in the respective categories.

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#### **Disclaimer**

- Past performance is no guarantee of future results.
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In addition, it is important that investors understand the following characteristics of non-traditional investment strategies including hedge funds, real estate, and private equity:

1. Performance can be volatile and investors could lose all or a substantial portion of their investment.
2. Leverage and other speculative practices may increase the risk of loss.
3. Past performance may be revised due to the revaluation of investments.
4. Investments can be illiquid, and investors may be subject to lock-ups or lengthy redemption terms.
5. A secondary market may not be available for all funds, and any sales that occur may take place at a discount to value.
6. Funds are not subject to the same regulatory requirements as registered investment vehicles.
7. Managers are not required to provide periodic pricing or valuation information to investors.
8. Funds may have complex tax structures and delays in distributing important tax information.
9. Funds often charge high fees.
10. Limited partnership agreements often give the manager authority to trade in securities, markets, or currencies that are not within the manager's realm of expertise or contemplated investment strategy.