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## Special Report

December 2005

### Hedge Fund of Funds: Death of a Salesman

by Rich Kleinbauer  
with James A. Bianco

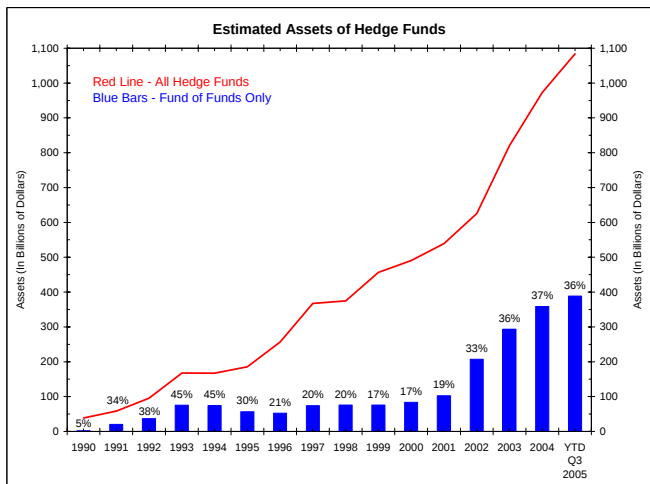
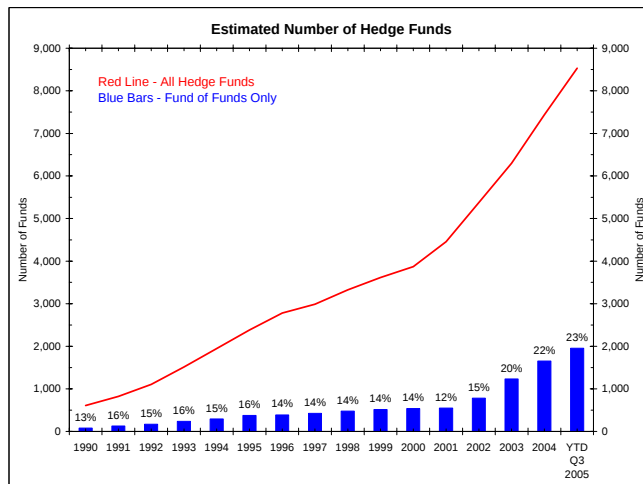
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Hedge funds are a popular topic for the financial press. Their every move is tracked with a combination of envy and interest. While they are usually lumped into a single entity when studied, a distinction between two different categories of hedge funds exists. One group, the fund of funds, is also known as an active hedge fund. The other category of hedge fund is labeled passive.

Since fund of fund managers are employed to select regular hedge fund managers to invest their money,

they are more active in moving money around among different hedge funds in hopes of finding the right combination that will produce the best possible results. The investor in passive hedge funds, after he has done his homework, puts his money in a hedge fund and “passively” watches it.

Fund-of-fund managers get very little press. They are the focus of this report. First, how big are fund of funds hedge funds? The following graphs offer some perspective.



Source: Hedge Fund Research, Chicago IL ([www.hedgefundresearch.com](http://www.hedgefundresearch.com))

As of September 30 (latest data) fund of funds numbered nearly 2,000 with just less than \$400 billion in assets. As the charts above show, their percentage of the overall hedge fund universe has been growing in recent years. It's amazing that while the financial press is obsessed with hedge funds, the fund of funds are generally ignored.

## Changing Roles with Asset Allocation

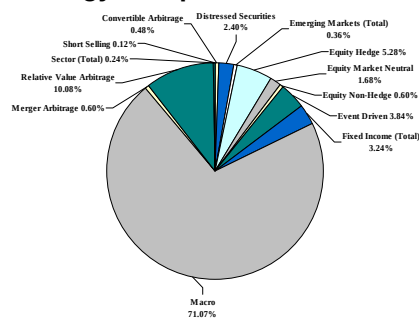
Several years ago, the hedge fund industry began to segment management styles into roughly 10 sub-strategies. Since hedge fund investing is a method of applying correlations and arbitrage to market opportunities using borrowed money, the segmentation process provided fund of fund managers with an entry point into the role of asset allocation.

In the ancient era of hedge funds (prior to 1997 AD), an investor would hand their money to one manager, say a global macro manager such as Julian Robertson of Tiger Management, and they were done. Since his fund was not specific to style or securities, the investor's money would then be spread across different asset classes and themes.

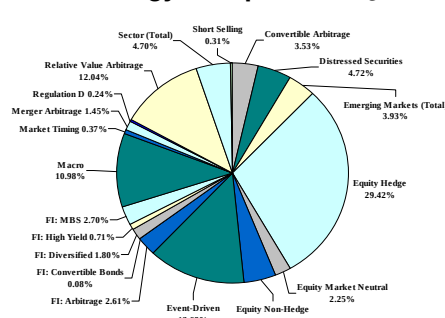
When it came time to change allocation, Julian would just direct his managers to buy and sell various securities and it was done.

Once fund of funds managers became popular, this model offered a different way of investing in hedge funds. Now the investor can give his money to a fund of funds manager, who in turn spreads the money across a variety of hedge funds to include a diverse portfolio of securities. As a result, asset allocation has moved downstream from those following markets and looking forward (i.e., the global macro manager) to those reviewing historical results (i.e., the fund of funds manager). This change can be seen in the following charts.

**Strategy Composition 1990**



**Strategy Composition Q3 2003**



Source: Hedge Fund Research, Chicago IL ([www.hedgefundresearch.com](http://www.hedgefundresearch.com))

Most studies of investing show that 90% of investment performance is asset allocation -- choosing how much to invest in stocks, bonds, distressed, etc. Avoiding an oncoming train such as getting out of technology in 2000, or jumping on a departing train, such as natural resources in 2004 is more important than finding a manager good at picking technology stocks or playing the roll in crude oil futures. Yet too many fund of funds managers offer little more than the benefits of monitoring and examining past performance and historic decision making of a manager. These skills offer little in the critical decision of deciding which train is going next.

## The Problems of Active Management

The active management style of fund of funds which invest among the various segments of the hedge fund industry and the requisite reallocation is fraught with operational problems. For instance, the **assets** of a fund of funds (i.e. regular hedge funds) are themselves illiquid. Not only is the exact sale price unknown on the trade date and sometimes not known for two or three weeks after the trade date, but also the cash proceeds from the sale are unavailable for delivery within the time frame typical for stocks, bonds, mutual funds or most real estate.

Regular hedge funds themselves incorporate this redemption delay into their funds, partly because some over-the-counter positions are difficult to price. This built-in delay encumbers asset allocation decisions to such a degree that fund of funds may pass up some decisions because they take too long to implement.

In addition, the administrative process of buying and selling hedge funds -- let alone shorting -- is non-uniform. Depending on the hedge fund, notification of redemption can range from a week to a month, and depending on the sub-strategy, trade dates can range from monthly to quarterly. A client's liquidity is impinged by so-called "gate provisions" which limit the size of redemption per month or per quarter.

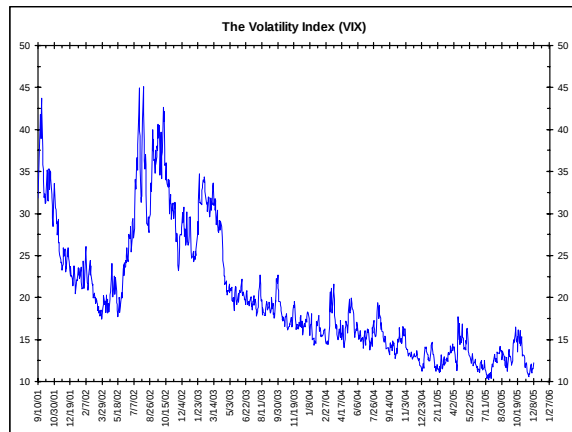
By contrast, a regular hedge fund manager himself, notably global macro managers and multi-strategy managers, can switch exposure immediately simply by re-distributing assets between different in-house portfolio managers/traders in the case of a multi-strategy fund or in the case of a global macro fund by trading into new positions.

Lastly, illiquidity penalizes a fund of funds' ability to exploit market volatility and medium term market trends. When a new trend emerges such as Asian

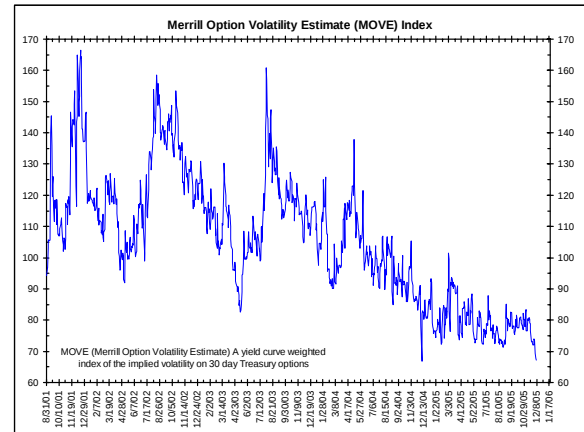
managers in 2002 or natural resource managers in 2004, the amount of time necessary for a fund of funds to identify competent managers, complete a requisite manager due diligence, and liberate assets from existing strategies in order to get in may result in missing much, if not all, of the move.

### Lower Volatility Hurts Fund of Funds

The charts below illustrate how stock and bond market volatility has been declining for several years.



Declining volatility or falling risk premia takes many forms: lower credit spreads, lower real yields, or convergent P/E ratios to name a few. Volatility is an important part of the performance profile sought-out by fund of funds analysts. The typical funds of funds pursue regular hedge fund managers that generate a steady +1% per-month/12% per-year return coupled with little or no drawdown.



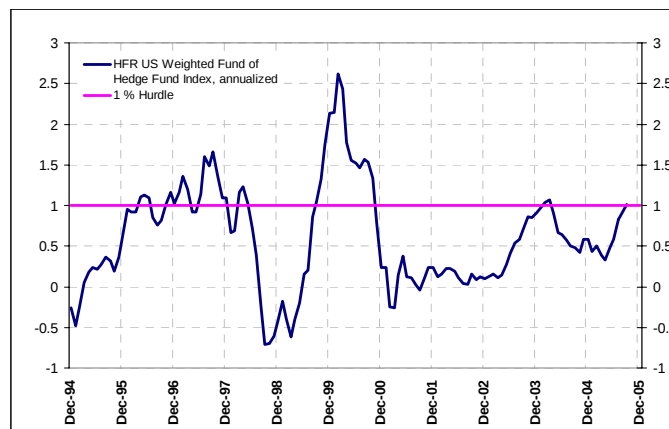
This means fund of funds try to avoid investing in a manager generating 0% performance for 11 months, then a 12% December. Instead, the preferred regular hedge fund is one with steady month-over-month performance with minimal downside.

This selection bias effectively limits what the underlying regular hedge fund manager can employ as a trading strategy to obtain the desired results. Strategies which pay a steady stream of cash flow such as selling short volatility, collecting premiums from writing credit default protection or equity option buy/write strategies pay when volatility continues to fall. Leveraging relative value trades pay when the

yield curve remains positively sloped. Convertible arbitrage strategies reduce volatility because the arbitrageur needs to continuously trade against the stock trend in order to generate cash flow, a tactic which has been all but exhausted this year.

As long as volatility declines and the yield curve's shape allows for positive carry, these strategies will work. But with Ben Bernanke replacing not only Alan Greenspan as Fed Chairman but also his risk-management approach to monetary policy, generating these consistent returns will be all the more difficult.

### 1% Per Month – A Rare Occurrence since the NASDAQ's Collapse



## Alpha Fatigue

What better place than the hedge fund conference circuit to find new catch phrases. Lately, weak results have prompted forensic specialists to describe hedge fund manager performance as suffering from "*alpha fatigue*." Most of us might just say that making money is difficult.

Converging credit spreads, low volatility levels, a flattening yield curve, the lack of P/E dispersion, and too much money chasing too few distressed deals have sucked the life out of all hedge fund returns.

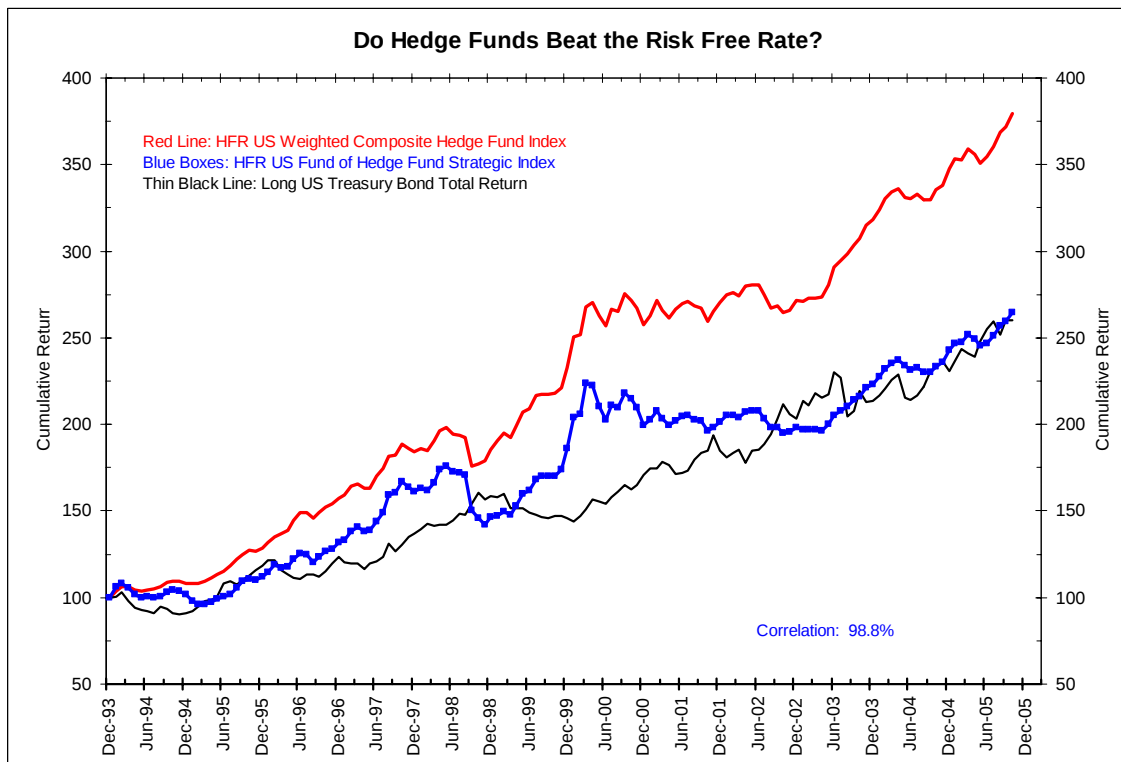
Alpha, aka a manager's ability to outperform a benchmark index, has always been difficult to obtain, particularly when alpha is measured against an appropriate objective. The graph below compares two indices from Hedge Fund Research:

- a) The Composite index of regular hedge funds or passive managers (thick red line)

- b) The active, or strategic, fund of funds index (blue squares).

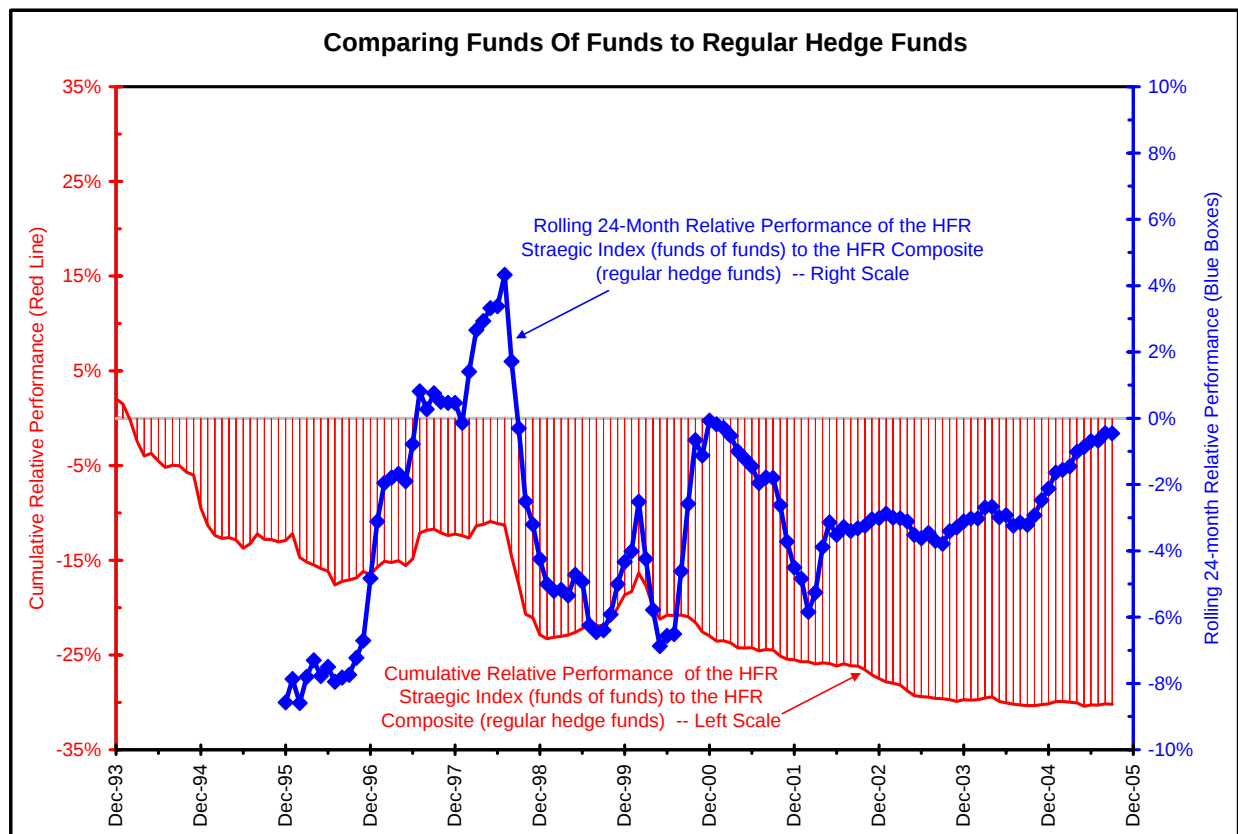
Both of these indices are then compared to the total return of long-dated US Treasury bonds (thin black line) as they provide a fair representation of the "risk free" rate of return on capital for institutional investors. Moreover, friends of a fixed income's term structure of volatility would argue that long-dated Treasuries are less volatile than cash, therefore a lower-risk "risk-free" rate.

The chart below shows that passive fund of funds (thick red line) generate substantially more positive "alpha" over Treasuries when measured over a long time horizon. The active fund of funds, however, not only consistently and dramatically underperform the passive hedge funds but has also failed to provide any out-performance (alpha) over the risk free rate in the past 12 years.



The oft-cited explanation for fund of funds underperformance is fees, typically around 1% of assets as a management fee plus a 5% incentive fee paid above a high watermark (when the fund's net-asset-value makes a new high). This is the additional charge incurred for the manager selection process, asset allocation, administration and monitoring. For this additional fee to adequately reconcile the underperformance argument, the performance lag would

need to be steady and uniform. The chart on the next page shows the cumulative (red bars) and relative performance (blue line) of the passive versus active hedge funds. These results indicate a high level of variation between active and passive management, particularly prior to 2002. Clearly, factors beyond the incurrence of additional fees have played a role in generating this -30% cumulative relative underperformance.



## Conclusion

In the "ancient era" of the hedge fund industry, before 1997 AD, the typical sophisticated and qualified investor (net worth more than \$1 million, net income more than \$200,000) could name maybe five regular hedge funds. Most of these were probably global macro funds as the industry offered little more than that. Back then the fund of funds industry served a valuable purpose as a gateway to these investment vehicles. Now that the hedge fund industry is much more transparent and hedge fund managers are offering investment advice and throwing chairs on TV this gateway is not as necessary.

Fund of funds also suffer from managing a portfolio of illiquid hedge funds, low volatility, and high fees. The results have been poor performance versus both regular hedge funds and a benchmark (e.g., Alpha-Fatigue).

What can fund of funds do? Remember these funds number near 2,000 funds and have almost \$400 billion in assets.

As we mentioned before, the asset allocation decision is critically important. It can account for as much as 90% of a fund's returns. So, if these managers can get this right, they can not only pay

for themselves but generate substantial alpha for their investors.

The problem with this strategy is most fund of funds are not asset allocators. They have sold themselves on their ability to vet regular hedge fund managers, administration and reporting. They would have to hire people experienced in this field and add infrastructure. Even if they did this, they would be allocating among illiquid investment (hedge funds) and always be at a competitive disadvantage to hedge funds that asset allocate now - global macro and/or multi-strategy. These funds have a wide variety of liquid and transparent investments which include Exchange-Traded Funds or ETFs (one just opened this week that allows you to bet on the Euro), futures, and other liquid derivatives (interest rate swaps) which make switch allocations easier while lowering costs.

As with Arthur Miller's book, *Death of a Salesman*, the struggle with reality versus illusion eventually brings about the downfall to the story's main character. The financial press has been looking for the Willy Lomans in the hedge fund industry for years. We might have one, and it could be in the place few reporters have bothered to look, the \$400 billion 2,000 strong fund of funds segment of the hedge fund industry.

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