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Funds of Hedge Funds: Portfolio Construction, Risk Budgeting and the Prudent Use of Leverage

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During 2000, two years after the sale of my former firm, PMC International (portfolio management consultants), I began focusing extensively on the hedge fund industry, with particular emphasis on diversified Funds of Hedge Funds ("FoHF"). Hedge funds were enticing, they were attracting substantial attention, and several high profile investment managers and analysts were leaving traditional firms to launch new funds. To gain a better understanding of the industry, I spent several months visiting many of the larger and more prominent FoHF companies, meeting with their management, learning about their businesses, the demand for their products, their approach to portfolio construction, their views on risk management and other such issues that a veteran investment consultant might find of interest.

What I found was a bifurcated industry in its early stages of development, largely dominated by the 80/20 rules. First, 80% of the FoHF money seemed to be concentrated with approximately 20% of the firms. Next, and probably of most concern, only 20% of the FoHFs (at best) seemed to employ a disciplined and repeatable investment process – an approach to portfolio construction and risk management that could be clearly articulated and repeated.

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Funds of Funds: The First Generation

To-date, the majority of FoHFs have had a single value proposition. Generally, they boast "a secret list of superior managers that are closed to new investors." They suggest that the only way to gain access to those individual hedge funds is through investment in their FoHF. Although somewhat accurate in some cases, the historic performance and success of many of these FoHFs can be closely correlated to the 1990s bull market, and their underlying hedge fund selections represented a virtual "who's who" of funds that performed exceptionally well during this "bubble period." By in large, the majority of these FoHFs were formed by prominent sell-side analysts, bankers, brokers, wealthy private investors and even service providers such as attorneys and accountants who had little experience with the disciplines of portfolio construction and investment consulting.

The result of this "approach," which in many ways represented the classic pursuit of the "hot dot," was that many of the FoHFs that performed well during the past decade, on both a relative and absolute basis, have experienced disappointing results in recent years. To be sure, the majority of these FoHFs have not experienced the large losses of the equity markets, but to some extent, they have also failed to deliver on their promises of absolute, uncorrelated returns." Instead, these funds now boast excellent relative performance versus equity indices that are, in most cases, poor comparative benchmarks (remember that most diversified FoHFs are not largely invested in equity strategies).

The problem was not that hedge fund strategies weren't working; some strategies have recently been experiencing their best performance in recent years. Instead, the issue has been the approach of the FoHF managers to the fundamental issues such as asset allocation and strategy diversification. Simply, many funds have been inadequately diversified among the primary hedge fund strategies, and little was being done by many of these FoHF managers to closely monitor or change the underlying strategy mix, or even the specific hedge funds. In a bull market, investors considered themselves "lucky" to gain access to certain hedge funds, many of which were experiencing legitimate capacity concerns; but in an effort to gain access to all the great names, something quite elementary and very important was being overlooked by much of the FoHF industry: The Investment Process!

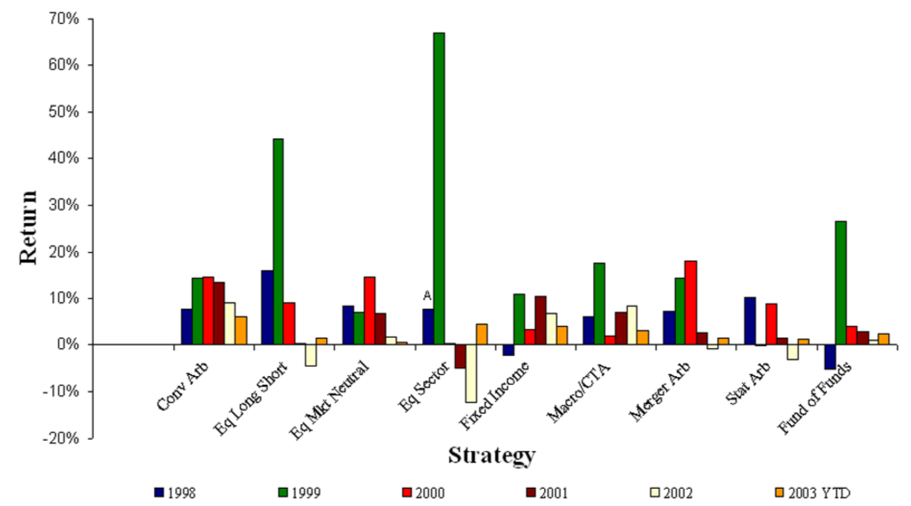
Academic Research

Tom Schneewiess has published extensively about hedge funds and the many hedge funds strategies, and most of his work is extremely useful and should be read by serious consultants and investors. His work reveals that all hedge fund strategies are not as "skill based" as their managers might like you to think. Or, perhaps said another way, not all the hedge fund managers are as skillful as they would like you to think.

Although hedge funds in general employ "absolute return" strategies, it is not true that they absolutely always perform at all times. An analysis of hedge fund performance, on a monthly or quarterly basis, reveals significant strategy and style influences. Simply, there are times that each strategy seems to perform exceptionally well and, unfortunately, there are times that this same strategy will not – irrespective of manager skill. Merger Arbitrage is one obvious example. Very little merger activity in the public markets results in very little action for the merger arbitrage desk – so it's not surprising that the returns of most strategy-specific merger arbitrage funds resemble cash, that's what most of the funds have been holding! To be sure, the returns are positive. But clearly, the "passive" (or what we might also call the "carry trade") return for this strategy has been virtually zero.

Global Macro had a similar experience several years ago, and several of the largest and most respected names in the macro field shut their doors and returned all the capital to their investors. Unfortunately, a FoHF without adequate recent exposure to Global Macro in 2002 could barely eek out an interesting (let alone positive) return, since most macro funds experienced excellent returns in 2002. (Many were up more than 30%.) As a result, a 15% FoHF allocation to Global Macro in 2002 would have added 4.5% to its annual return. In hindsight we now understand the under-weighting to Marco, e.g., in 1999, with the equity bull raging, Global Macro returned a paltry 7.3% (based on HFRI Index returns, see Figure 1). An allocation to Macro seemed unnecessary during the bull market of the '90s, and most FoHFs focused on the hot dots instead, not bothering with such pedestrian issues as asset allocation.

Figure 1.
HFRI Annual Returns



Funds of Funds: The Second Generation

Fortunately, not all FoHFs are currently being managed on such a naïve basis. In fact, many FoHF managers have long and successful backgrounds in the construction and management of diversified portfolios for institutional and high net worth clients. Often, these managers come from the investment consulting industry and understand the portfolio construction process. They know the value of a clear investment policy and a thoughtful approach to asset allocation and portfolio diversification. They have a rigorous process for evaluating hedge fund performance and differentiating luck from skill. They have an on-going view towards the portfolio management process, including periodic rebalancing, overweighting and underweighting strategies, hiring new managers and terminating old ones. And they have a well thought-out approach to risk management, whether it be through portfolio transparency policies, VaR calculations or some another set of metrics.

These FoHF managers tend to build diversified portfolios, employing numerous investment strategies and, potentially diversifying extensively even at the strategy-specific level. One fund I like employs nine different strategies in its diversified fund and within each strategy, further allocates between three and five different underlying funds. This helps them achieve two levels of diversification. First, they diversify by strategy to address systemic risk. Next, they diversify by manager within each strategy to address non-systemic risk. This strategy of "diversification layered upon diversification" does not "over-diversify" the fund. Instead, it helps ensure the consistent "absolute return" qualities they seek which, in turn, allows them to implement other risk and return enhancement strategies that we will talk about later in this article.

Portfolio Construction

We believe the optimal approach to FoHF portfolio construction should begin with a rigorous quantitative exercise. Specifically, one should initially start with strategy-specific hedge fund index returns (HFRI, for example). At such an early time in the policy development process, one can select the investment strategies they consider most appropriate, eliminating strategies with unfavorable characteristics or tendencies. Then, after determining (1) monthly performance, (2) standard deviation of returns and (3) correlations, a mean variance optimization can create an efficient frontier, showing the risk and return trade-offs of various strategy mix scenarios. Of course, as with a "long only" optimization, you will have to develop portfolio constraints and limitations.

But over time one understands these issues and knows where many of the risks are hiding. In the end, you will have an initial asset allocation scenario and will be ready for the hedge fund selection process.

The second step involves the notion of "populating" the asset allocation with actual hedge funds and managers. This step can be more than a bit challenging in hedge fund land because databases are incomplete, funds are unable to advertise and performance attribution information is difficult to get. Such portfolio management tools as leverage, derivatives, and short and long positions only begin to reveal the many complex issues surrounding hedge fund performance and risk evaluation, making it virtually impossible to use return-based style analyses tools that rely upon regression. Additionally, specific issues often found buried in a funds' private placement memorandum, along with legitimate capacity constraints and the unwillingness of many funds to even consider certain types of new investors, further exacerbates the challenges of the search process. Yet, a full-time effort must be maintained. One solution is to maintain access to New York. Although all good ideas do not necessarily originate there, all those with good ideas seem to come through the city from time to time; and with the help of a network of friends, prime brokers and capital introduction groups, one can be regularly exposed to interesting names and ideas. After all, the selection of superior hedge funds is an important aspect of the portfolio construction process, and good funds are not easy to find.

Once the optimal asset allocation and diversification policy has been implemented, and good underlying funds selected, there is outstanding potential for very consistent, absolute returns that will have a very low correlation, if any, with the traditional markets. The historic returns experienced by various hedge fund strategies during the 1990s bull market may be difficult to replicate, but excellent consistent future returns are probable. ■

About the Author

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