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Investing in a Hedge Fund of Funds: What Really Matters

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Recent pricing scandals at well-known hedge funds like the Clinton Group, Lipper and Beacon Hill underscore the need for hedge fund of fund (FOF) investors to demand that FOF managers obtain increased transparency, independently verified valuations and increased liquidity from their underlying investments. For FOF managers to effectively monitor and manage risk in a multi-manager portfolio they need to be far more demanding of the hedge fund managers with whom they invest.

According to a recent study by CapCo, a London-based hedge fund consultancy, about 35% of recent hedge fund failures have stemmed from valuation problems, whether regarding inaccurate pricing or poor controls. (See Tables 1 and 2 for a list of prominent recent examples.) These failures have been costly with asset markdowns of more than 40% on some highly publicized hedge fund failures. More and more investors are turning to diversified, professionally managed fund of funds to outsource their risk management – but unfortunately, most FOF risk controls are not as sophisticated as they should be.

Caveat emptor. Simply investing via FOFs does not sufficiently mitigate the structural risks inherent to hedge fund investing. Investors need to exercise additional due diligence by selecting FOF managers who invest exclusively via separate account vehicles and utilize third-party pricing services to obtain independent valuations of the hedge fund portfolio's holdings.

FOF vehicles that exclusively require separate accounts for the underlying managers provide ultimate transparency: the ability for fund of fund managers to monitor holdings at the position level on a daily basis. Yet, transparency alone is of limited use in protecting against loss. The Clinton Group learned in late October that fund values were likely to be significantly lower than reported, but customary limited partnership redemption constraints prevented them from liquidating assets until the end of the quarter. Without adequate liquidity and the ability to immediately respond to problems revealed from their transparency, they were forced to watch helplessly as the value of their portfolios declined over the next three months.

**Table 1.
Recent Hedge Fund Blow-Ups Involving Valuation and Performance-Reporting**

Case	Strategy	Date	Loss	What Went Wrong?
Manhattan Investment Fund	Long/short equity	1999	$400 million	Fictitious statements sent by manager
Princeton Economics International	Macro	1999	$950 million	Market losses Fraudulent sale of notes and misrepresentation of assets
Maricopa Investment Corp. (David M. Mobley)	Long/short equity (quantitative)	2000	$59 million	Market losses Reporting of false performance figures Fraudulent misrepresentation of assets Ponzi scheme, paying distributions with new investor assets.
Cambridge Partners, LLC (John C. Natale)	Long/short equity	2000	$45 million	False audits, tax documents and monthly statements. Overstatement of performance. Pleaded guilty to securities fraud, theft and misappropriation of property.
Lipper	Convertible arbitrage	2001	$700 million	Market losses. Mispricing of convertible bonds.
Beacon	Fixed income arbitrage	2002	$500 million	Failure to properly mark-to-market the book of mortgage derivatives
Lancer	Long/short	2003	$600	False valuations and fictitious statements

Source: PlusFunds Group, Inc.

There is a way for FOF managers to obtain a higher degree of control over their hedge fund investments and to ensure full transparency, fair pricing and nearly instantaneous liquidity – consequently achieving ultimate levels of risk monitoring. FOFs that exclusively invest via separate accounts and utilize third-party pricing services provide all these benefits while reducing investor exposure to adverse events. Essentially, these FOF structures provide their risk managers with three important benefits: transparency, independent pricing and the liquidity necessary to effectively manage and mitigate risk.

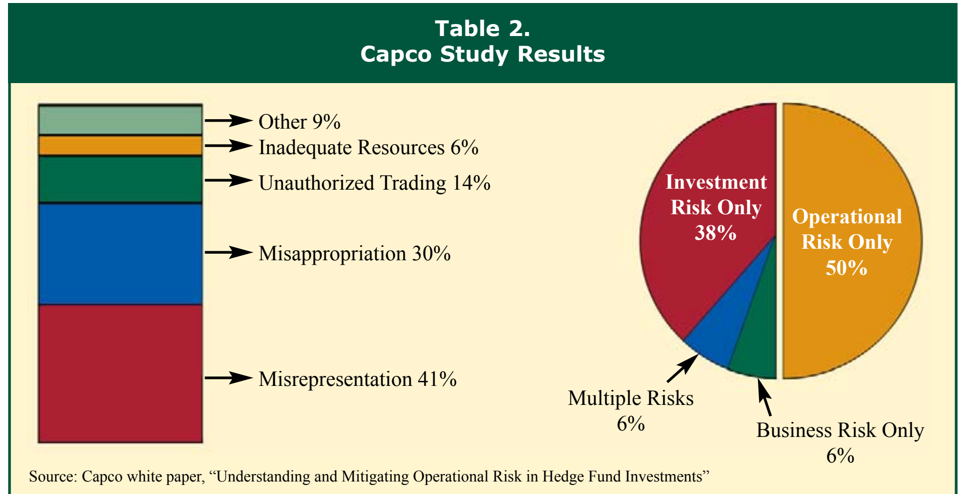
Enhanced Transparency for Fund of Funds Managers

Lack of transparency (that is, the ability to periodically view the underlying holdings of a hedge fund) has traditionally been among the biggest obstacles to more effective FOF risk management and greater investor participation in hedge funds. In fact, a recent survey by the Alternative Investment Management Association found that 64% of investors had declined to invest in hedge funds because of lack of transparency.

Separate account vehicles solve the transparency problem automatically. By investing through a separate account structure rather than investing in a hedge fund manager's commingled private placement vehicle, FOF managers gain access to daily positions and performance. This allows them to monitor assets for style adherence, asset allocation, leverage and concentration on a continuous basis. What's more, it allows for regular, if not daily, aggregate performance reporting – enabling the FOF manager to fully account for all of the portfolio's underlying risks.

But even full transparency – without the liquidity of a separate account – provides only limited value to the risk manager. Transparency does allow the risk manager of a FOF the ability to identify specific and aggregate exposures, but it is the separate account structure that allows the FOF manager to immediately react to unwanted exposure by reducing the manager's allocation or firing the manager.

Table 2.
Capco Study Results



Source: Capco white paper, "Understanding and Mitigating Operational Risk in Hedge Fund Investments"

Heightened Control Through Separate Accounts

The critical advantage of FOFs that invest via separately managed accounts is the heightened control that results from the liquidity inherent to the separate account structure. Unlike limited partners, separate account investors own the assets in their portfolio directly and can revoke the hedge fund manager's discretionary power of attorney over their account at any time. There is no need to wait until the next notice and redemption period to terminate a manager, as is the case in a limited partnership or limited liability corporation.

To illustrate, consider the recent Clinton Group controversy. Senior trader Anthony S. Barkan resigned from the Clinton Group, Inc. on October 29, 2003, citing disagreements with Clinton managers about the accuracy of the valuations that were being reported to investors with respect to the asset-backed securities in their limited partnership portfolios. Immediately after the story broke, Clinton's partnerships were hit with redemption requests reported to exceed $2.2 billion, but limited partners were unable to liquidate assets until three months later (January 2004) by which time their value had been driven down considerably. Moreover, limited partners were forced to liquidate all at the same time, creating further downward price pressure. If they had been investing with Clinton through separate accounts, these investors could have liquidated assets immediately at the first hint of trouble, before large-scale liquidations drove prices down.

Independent Analysis Highlights Critical Issues

Transparency is necessary to identify a manager's style drift, securities mispricing or faulty performance reporting. Yet, simply knowing a portfolio's holdings may not be enough, without some means of independently analyzing them.

Gabriel Bousbib, CEO of PlusFunds, a New York-based company offering an investment platform that tracks the S&P Hedge Fund Index, says that many FOF managers are not prepared to deal with the amount of information complete transparency would provide. "Let's say you invest in a large hedge fund with $100 million under management and that every day you want to receive all the positions in your fund," he explains. "If I send you a file with 8,000 positions every day, you won't be able to do much with it. It's not just the data that's important, but also what you do with it." Bousbib adds that technology now provides elegant infrastructures through which risk, return and holdings data can be monitored and valued independently.

Third-party pricing is a critical part of the equation, offering hedge fund investors "a separate, independent set of eyes determining the value of the portfolio," notes Bob Aaron, CEO of Derivatives Portfolio Management, a New Jersey-based hedge fund administrator. "Third-

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party pricing provides protection if a trader or manager is involved in long-term manipulation of prices in a large number of holdings." Aaron also explains that his firm analyzes valuations from managers – from its own models and from outside parties such as trading desks – in determining fair value of non-listed assets. He adds that in most cases the values reported by managers are very close to what his company determines as fair; however, there are some red flags. "If we see a manager booking all the profits on a trade during the first day of the trade, we will often question that, since it generally takes time for the market to recognize mispricing," he says. "In the same way, we look hard at firms that wait to book all profits until a position is liquidated." The goal is to keep reported prices continuously in line with market valuations so that if the trade fails to work out as expected, results won't have to be restated abruptly.

A Solution for Today's Market Environment

The separate account structure for fund of fund investments provides solutions to the structural risk concerns financial advisors and their clients have about hedge funds. Most importantly, by ensuring complete transparency, accurate valuation and liquidity, the FOF manager has the ability to immediately identify and react to problems that can limit the investors' exposure to risk.

Presently, only a handful of the estimated 1,200 FOFs available can claim to exclusively require separate accounts for each of the hedge fund managers with whom they invest. But sophisticated hedge fund investors are enthusiastically embracing these preferred product structures (with billions in assets). Due to their unprecedented risk management, FOFs will be able to answer yes to the ultimate FOF due diligence question, "Do you require separate accounts of all of your underlying hedge fund managers?" ■

About the Author

Jeff Joseph is Managing Director of Rydex Capital Partners and is responsible for the Rydex SPhinX fund, which invests in the S&P Hedge Fund Index. Jeff is also responsible for the development and distribution of additional absolute return investment products. For more information, visit their web site at http://www.rydexinvestments.com.

Note

The opinions expressed are those of Jeff Joseph. This information should not be construed as a recommendation of any specific security.

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