Multi-Strategy Funds vs. Funds of Funds:

The Future of Multimanager Hedge Funds

BY SCOTT WELCH, CIMA®

Hedge funds are here to stay. Survey results from the Institute of Private Investors (IPI), a New York-based consortium of high-net-worth families and their advisers, indicate that hedge funds now constitute about 22 percent of the average IPI member's portfolio, and alternative investments including real estate, private equity, etc., constitute about 40 percent of the average portfolio—more than the average 36 percent allocated to traditional long-only equity. IPI members represent the ultra-wealthy segment of the market; more than 40 percent of IPI members have investable assets in excess of $200 million. But history shows that investment trends exhibit a strong trickle-down effect. What the ultra-wealthy are investing in today is what the affluent investor will be demanding tomorrow.

In addition to the cachet associated with hedge fund investing (which should never be underestimated in terms of driving investor demand), macro market forces also are fueling the growth of hedge funds. Advances in quantitative/analytical tools as well as the growth of various passive or beta-driven investment strategies (e.g., index funds, exchange-traded funds, swaps, futures, etc.) increasingly allow investors to segment the alpha and beta components of their portfolios.

This is a significant challenge for traditional long-only active managers, who face fierce fee pressure from investors increasingly unwilling to pay active management fees for beta-driven performance. At the same time, this trend has been a boon to alpha-oriented strategies such as hedge funds. Rather than investing in a diversified combination of active long-only managers, sophisticated investors increasingly are building core-satellite portfolios with a core of cheap-beta passive investment strategies and alpha-chasing satellite investments consisting of hedge funds and other alternatives.

This trend, combined with the portfolio-saving performance of hedge funds from 2000–2003 following the tech-bubble burst, has hedge fund popularity and demand soaring despite hefty fees, relative illiquidity, and a lack of transparency into the underlying strategies.

As 2006 draws to a close, however, the landscape may be shifting yet again. Volatility, which is the life-blood of many hedge fund strategies, has fallen significantly over the past two years and shows no real sign of increasing. The general consensus for the equity markets is for low overall equity risk premia and subsequently mid–high single-digit nominal gross returns for the foreseeable future.

Likewise, while interest rates have increased (at least for shorter maturities),a stabilizing real estate market and overall economic sluggishness does not suggest significant further increases going forward.

So what will happen to hedge funds? Specifically, how will the *structure* of hedge fund investing evolve as a result of the anticipated continued growth in demand and the expected difficulty in replicating historical performance? What will the hedge funds of the future look like?

Definitions and Market Share

The term "hedge fund" is used liberally to describe a variety of investment strategies. In this article hedge funds are assumed to be nothing more than legal entities in which various investment trading strategies are implemented. These strategies may include the use of leverage, short-selling, quantitative black boxes, different forms of arbitrage, market timing, relative value, long/short, market neutral, and so forth.

These entities usually are in the form of limited partnerships created as either 3c1 partnerships (limited to 99 partners and eligible to accredited investors with net worth in excess of $1 million each or adjusted gross incomes in excess of $200,000 per year for the previous two years) or 3c7 partnerships (limited to 499 partners and eligible only to investors with investments in excess of $5 million). In the past three years, however, the number of registered hedge funds, which look and act more like mutual funds, also has grown.

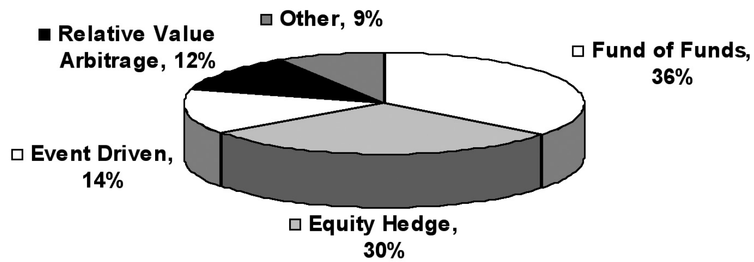
In terms of investment structure, hedge funds typically take one of three forms:

Single Strategy Fund. These are funds in which one manager or one management team focuses on one particular trading strategy, e.g., a fund dedicated only to long/short equity or to merger arbitrage. At a recent IPI presentation, Albourne Partners (http://www.albourne.com) estimated that roughly 8,000 single-strategy managers are active in the market today.

Multi-Strategy Fund. This fund typically is owned and managed by one investment company or a large institutional investment firm and employs several strategies under a common organizational umbrella. Historically, multi-strategy funds (MSFs) represented multiple investment teams pursuing a similar trading strategy (e.g., a collection of long/short managers), but diversified MSFs (funds employing different trading strategies) are gaining in number and popularity. Albourne Partners estimates there are roughly 500 MSFs active today. The Hennessee Hedge Fund Advisory Group of New York (http://www.hennesseegroup.com) estimates that MSFs control about $216 billion or roughly 18 percent of the overall hedge fund investment assets of about $1.13 trillion.

Fund of Funds. This is an investment management firm that makes multiple investments in (typically) nonaffiliated third-party single-strategy managers or MSFs. Most funds of funds (FoFs) pursue a diversified absolute return strategy as they seek to generate stable, consistent returns with low volatility. Albourne Partners estimates there are roughly 2,000 FoFs in today's marketplace. Hedge Fund Research (http://www.hedgefundresearch.com) estimates that roughly 36 percent, or about $400 billion, of all hedge fund assets are controlled by FoFs.

FIGURE 1 Percent Market Share Year-End 2005



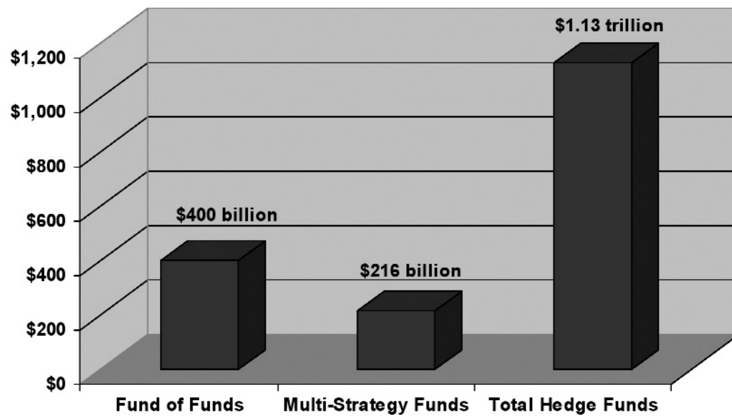
Source: Hedge Fund Research

FoFs represent the largest market share in the hedge fund industry in terms of dollars invested (though there is some double counting because the FoFs themselves invest in underlying single-strategy funds and MSFs), for the following reasons:

1. Many if not most single-strategy managers have very high minimum investment requirements (e.g., $1 million or more), which means access is limited to a small percentage of the investor population. More to the point, it would be imprudent for most investors to invest a significant percentage of net worth with a single-strategy manager. Research from FAME (The Swiss-based International Center for Financial Asset Management and Engineering, http://www.fame.ch) suggests that investors need to allocate funds to at least five to 10 single-strategy managers to achieve an appropriate level of diversification. The FAME research also found that analysis focused primarily on statistical considerations (i.e., optimizing expected return, standard deviation, skew, and kurtosis) did not seem to consider the very real risk of manager blow up (which would push up the number of managers needed for appropriate diversification). So to achieve the necessary level of diversification across single-strategy managers, investors would need to invest at least $10 million or more in hedge funds (i.e., $1 million with each of 10 single-strategy managers). Given that hedge fund investments typically represent only a portion of an overall portfolio, this single-strategy solution is beyond the means of most individuals.
2. FoFs offers several advantages to most investors:
   - a layer of professional management, due diligence, and risk monitoring in selecting the underlying managers,
   - lower minimum investment requirements (frequently $250,000–$500,000), and
   - appropriate diversification within a single fund structure.
3. Diversified MSFs are a relatively new development, while FoFs have been around for much longer. More specifically, many MSFs do not offer the same degree of diversification as most FoFs because they focus on a common underlying trading strategy (e.g., multiple long/short managers). Diversified MSFs would be a more appropriate comparative alternative to diversified FoFs, but they do not represent a significant percentage of the overall MSF market.

Both FoFs and MSFs developed in response to growing demand for hedge fund exposure within portfolios. Typically a FoF is created with the specific intent of gathering multiple third-party managers in an

FIGURE 2 Assets under Management of FOFs vs. MSFs
Year-End 2005



Sources: Hennessee Group; Hedge Fund Research; International Financial Service, London

TABLE 1 Fee Structure of a Hypothetical FoF

Gross Underlying Managers Return:	**12.00%**
Less: Underlying Manager Fees (2%):	–2.00%
Gross Pre-Performance Fee Return:	**10.00%**
Less: Underlying Manager Performance Fees (20%):	–2.00%
After-Fee Underlying Manager Performance:	**8.00%**
Less: Fund of Fund Management Fee (1%):	–1.00%
Gross Pre-Performance Fund of Fund Return:	**7.00%**
Less: Fund of Fund Performance Fee (10%):	–0.70%
Net Pre-Tax Return to Investor:	**6.30%**

Note: Calculation assumes no hurdle rate for calculating performance fees.

investment entity designed to deliver specific risk and return characteristics and to be more accessible to a wider array of potential investors. KPMG International (http://www.kpmg.com), in its 2005 survey of the hedge fund industry, estimated that FoFs, because of their multi-manager, multi-strategy approach, are scalable up to $15 billion in assets under management.

MSFs usually develop along a different path. A successful long/short equity manager, for example, may reach capacity. Rather than closing to new investors, this long/short manager may look to acquire or form a strategic partnership with other long/short managers that can provide additional capacity. Or the manager may look to affiliate itself with a larger institutional organization that can offload much of the back office and administrative burden, allowing the manager to focus on its trading strategy. Another possible evolution is a long/short manager who specializes in a particular market (e.g., U.S. equity) but is looking to branch out into other long/short markets (e.g., Europe, Australia, and the Far East (EAFE) or other emerging markets). However it comes about, the result is a collection of formerly independent managers now trading within a common multi-strategy structure.

KPMG International estimates that most single-strategy managers prefer to evolve to a multi-strategy or multi-product approach once they reach $1 billion–$4 billion in assets under management (AUM).

Pricing

The historical high risk-adjusted performance of hedge funds has allowed for a lucrative fee structure for most strategies. A successful single-strategy manager may charge 1 percent to 3 percent in annual management fees and anywhere from 10 percent to 50 percent in performance-based fees, often pegged to some specified hurdle rate (e.g., 20 percent of all performance in excess of Treasuries + 5 percent).

A typical FoF overlays an additional layer of fees on top of the underlying manager fees. A 1-percent management fee and a 10-percent performance fee are not uncommon. Table 1 illustrates the hypothetical after-fee results of a “1 and 10” FoF overseeing a collection of “2 and 20” underlying managers.

MSFs typically charge only a single layer of fees that incorporates all of the underlying manager fees, which does not necessarily mean that the MSF fee will be lower than a FoF overall fee. Typical management fees on an MSF are 1 percent to 4 percent and typical performance fees are 0 percent to 40 percent.

Some MSFs offer a netting feature that distinguishes them from most FoFs. If the MSF offers a netting feature, the performance of all underlying funds will be “netted” before calculating the excess performance fee, which could save the investor money if one or more of the underlying funds underperforms in a given year.

Comparing Funds of Funds to Multi-Strategy Funds

Because investing directly into single-strategy funds is beyond the prudent reach of most individuals, FoFs and MSFs (whether structured as 3c1s, 3c7s, or registered products) will remain the primary access vehicles for most non-institutional investors. So the question naturally arises: “Which is better?” The

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answer, of course, is, "It depends." The following is a summary of the potential strengths and weaknesses of each structure.

TABLE 2 Comparing FoFs with MSFs

	FUNDS OF FUNDS	MULTI-STRATEGY FUNDS
POTENTIAL STRENGTHS	• Lower minimums/ highly accessible • Immediate diversification • Professional management • Access and negotiated fees • Lack of conflicts • Reduced individual manager blow-up risk	• Potential for reduced fees • More flexibility and nimbleness in reallocating capital • Improved transparency and liquidity • Netting feature on excess performance • Increased institutionalization of hedge fund investment process
POTENTIAL WEAKNESSES	• Additional layer of fees • Relative lack of liquidity and transparency • Inability to re-allocate quickly	• Increased manager or firm risk • Potential for conflicts and sub-par manager inclusion • Talent retention risk • Potential hidden fees

Note: Calculation assumes no hurdle rate for calculating performance fees.

Fund of Funds: Potential Strengths

Accessibility. FoFs offer investment minimums of $100,000–$1 million, so they are accessible to many high-net-worth investors.

Diversification. Because most FoFs shoot for consistent, low-volatility return through the use of multiple managers and multiple strategies, investors can achieve a satisfactory level of diversification within a single fund. It is not uncommon for a FoF to employ 20–25 underlying managers within a given fund.

Professional management. Many FoF managers have significant experience in the field and provide a professional level of due diligence, manager selection, asset allocation, and risk management that individual investors achieve themselves.

Access and negotiated fees. Many FoFs have successfully negotiated access to managers otherwise closed to new investors, sometimes at reduced fees. The power of the collective assets of the FoF gives it a negotiating ability beyond the capabilities of most individual investors.

Lack of conflicts. Because most FoF managers are independent of the underlying managers they select, they have the ability to pick and choose the best underlying managers or an appropriate mix of managers to generate a specified risk/return profile.

Reduced blow-up risk. Because of their diversified (and typically unrelated) underlying managers, the blow up of any given individual manager, or serious underperformance of any particular strategy, typically will not bring down the overall FoF (though it may hurt performance for some period of time).

Fund of Funds: Potential Weaknesses

Additional layer of fees. Many FoFs were generating double-digit returns in the turbulent bear market of 2000–2003 and investors gladly paid the double layer of FoF fees. Today, however, many if not most FoFs are anticipating mid–high single-digit returns into the foreseeable future. In this environment investors may pay more attention to fees as they consider the appropriate way to invest in hedge funds.

Lack of liquidity and transparency. Many FoFs distinctly lack transparency into the strategies underlying the overall fund. This mix of managers represents the "special sauce" the FoF manager is bringing to the table, and many managers are reluctant to reveal its ingredients. In addition, because the underlying managers may have strict redemption or liquidity terms (e.g., annually with significant advance notice), many FoFs must offer similarly strict liquidity terms to their investors.

Inability to reallocate quickly. Most FoFs have core holdings in a relatively small number of underlying managers supplemented by smaller satellite holdings. In addition, the underlying managers frequently have restrictive liquidity and redemption terms, as noted above. As such, FoF managers typically do not engage in frequent reallocation of their underlying funds, and they may be unable to react to changing market trends.

Multi-Strategy Funds: Potential Strengths

The potential for reduced fees. Because MSFs typically charge only a single layer of fees that incorporates the cost of the underlying managers, there is the potential for an overall reduced fee structure for investors, especially if the fund offers a netting arrangement on performance fees. Albourne Partners, citing research from Prisma Capital Partners (http://www.prismapartners.com), estimates that netting could save about 16 basis points (0.16 percent) in performance fees for a typical MSF.

Flexibility and nimbleness. Because the underlying funds in an MSF are owned and controlled by a single firm, they may have the ability to more quickly reallocate investments within the various funds, and they also may have more control over the overall investment profile of the fund.

Improved transparency and liquidity. Because of the common ownership structure, MSFs typically will offer improved transparency into the make-up of the underlying strategies (because the "special sauce" offered by the MSF is not the underlying managers as it is with a typical FoF

but rather the allocation between the various strategies), and they can better manage and control liquidity as well.

Diversified MSFs present competition for FoFs. Historically most MSFs pursued multiple strategies within a specified market space (i.e., convertible arbitrage or relative value) and as such were not really an apples-to-apples alternative to a diversified FoF (i.e., within a typical MSF the investor received diversification of managers but not diversification of strategies). In the past one to two years, however, many large institutional firms (banks, insurance companies, etc.) have formed or purchased multiple single-strategy hedge funds for the purpose of being able to offer a diversified MSF to investors. These firms are responding, in part, to the rapid growth in institutional demand for hedge funds, particularly among pension plans. International Financial Services of London (http://www.ifsl.org.uk), citing research from The Bank of New York, estimates that institutions will represent about 50 percent of hedge fund asset flow by 2008, up from about 10 percent in 2002. Most of this growth will come from pension plans, endowments, and foundations. These institutional investors most likely will prefer a diversified MSF structure to a more traditional FoF structure because of the increased ability to reallocate capital more quickly and to reduce overall fees.

Multi-Strategy Funds: Potential Weaknesses

Increased manager risk. With an MSF, the investor may get diversification of underlying strategies but he/she is still placing a large bet on a single hedge fund shop, because all of the underlying funds are owned or controlled by that shop. Lack or loss of risk control within that single firm could have severe negative consequences for the investor.

Potential for subpar managers. As with any closed architecture investment offering, once a particular hedge fund is owned or controlled by the firm offering the MSF, that firm now is conflicted with respect to the underlying funds. There is a disincentive and perhaps an inability to fire an underperforming manager. This typically is less the case with an independent FoF manager. Furthermore, expertise in a particular strategy does not necessarily translate into expertise in other strategies, so a single-strategy fund that evolves into a more diversified MSF may or may not be selecting the "best of breed" managers along the way. This can be viewed as similar in nature to the risk of style drift for a long-only manager.

Talent retention. Successful hedge fund managers by nature tend to be idiosyncratic and independent, and they frequently are ex-proprietary traders from large investment houses who struck out on their own to pursue a particular trading strategy or shake free of a corporate environment. These managers are not threatened by FoFs, which merely are large investors in their funds, but becoming part of an institutionally-owned MSF may not be something many of the better managers seek.

Hidden fees. Both FoFs and MSFs have operational costs associated with running their respective offerings, and these fees may or may not be passed through to the end investor. MSFs, however, may have an additional cost not readily apparent to the investor—the internal cost of capital allocated to the fund by the sponsoring investment firm. For example, an investment bank needs to make resource allocation decisions between competing areas of the firm, and those decisions will be based in part on the expected return on allocated capital. Investors should find out whether or not that cost of capital is being passed through to them before deciding that a given MSF really is the less expensive alternative.

And the winner is . . .

There is no clear-cut best choice when deciding between a diversified FoF and a diversified MSF; both structures have strengths and weaknesses and both will continue to grow as the demand grows for accessible hedge investments. One can, however, make some defensible predictions about the evolution of the marketplace.

MSFs will grow at a faster pace than FoFs. This is a function of the respective numbers of the two structures (FoFs are far more numerous) and the corresponding difficulty in maintaining comparable growth as size increases, as well as the changing nature and demands of the investor. As discussed above, institutional asset flows into hedge funds are expected to match or exceed private investor asset flows within the next few years. This represents a fundamentally new type of money for managers, with different risk–return expectations, different tax status, different requirements on corporate governance and institutionalization of operations, and different expectations with respect to fees. In addition, more large institutional investment firms are entering the hedge fund game, and they will be targeting a wider array of potential investors. These trends favor the growth of MSFs over FoFs.

FoF fees will come down. Pressure to lower FoF fees will come primarily from two sources: (a) increased competition and (b) lower expected returns. As more MSFs enter the market offering a single layer of fees (and, increasingly, charging only a management fee, with no associated performance fee), FoFs will be forced to follow suit or risk pricing themselves out of the market.

Secondly, for many FoF managers, the days of double-digit returns are history due to increased efficiency and less excess return potential in the underlying markets as well as lower volatility and lower expected-risk premia. In a world of 7-percent to 10-percent gross returns, investors increasingly will be unwilling to pay

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high management and performance based fees. As a simple example, a research report by AllianceBernstein (http://www.bernstein.com) estimates that a typical "1 and 10" FoF manager would need to generate a gross return of 10.9 percent to generate a 4-percent net after-fee, after-tax return—a return well within the reach of a competent municipal bond manager, with comparable diversification benefits to the equity portion of the overall portfolio. One easily can envision the day within the next three to five years when the standard FoF fee structure is 0.50 percent to 0.75 percent (not including the fees of the underlying managers, which will face less downward pressure), with no performance fee. MSF fees may be higher but already will incorporate the underlying manager fees (perhaps 1.50 percent to 2.00 percent) with no performance fee.

In a highly competitive marketplace that is not anticipating especially stellar overall returns, investors may turn from "performance alpha" to "fee alpha" (admittedly this takes significant poetic license with the classical definition of alpha). Again, if one believes in the maxim that "the average investor generates average results," then many investors may not have confidence that a FoF can generate sufficient performance alpha (in the true sense) to justify a higher fee structure. Under this scenario, an MSF offering comparable market returns at a lower cost will look very attractive. Put a different way, investment consultants know they cannot control market performance, but they can control fees and, to a certain degree, taxes. In a low-return environment, it will be tempting for these consultants to control fees rather than chase performance.

In a different light, the decision between FoFs and MSFs is analogous to the decision between active versus passive management. If one believes active management can add value, then that active management justifies a higher fee. Consultants who believe in their ability to identify and employ successful FoF managers will prefer this route, because they will believe they can generate superior performance and show a differentiated offering to existing and prospective clients. Consultants who want to show a competitive offering but not spend their time trying to find "the best" fund in an increasingly efficient industry may opt for the MSF route. At the end of the day, both strategies can play a role in a well-designed portfolio. M

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The Aftermath of Amaranth

In mid-September 2006, news broke about the implosion of the Amaranth Multi-Strategy Hedge Fund. Information known so far indicates that the fund made a leveraged directional bet on natural gas prices that went dramatically wrong, resulting in a loss of about 66 percent of the fund's overall NAV within a short period of time.

We eventually will know what happened within Amaranth, but in the context of this article the following question naturally arises: "Will Amaranth's implosion affect the growth and popularity of hedge funds generally and multi-strategy funds specifically?

At least so far, the answer to both questions appears to be "no," though Amaranth's implosion underscores the importance of both diversification and stringent risk control.

General market reaction (in contrast to the attention and reaction from the media) seems fairly muted, and many other MSFs benefited from being on the other side of Amaranth's underlying energy trades (remember that alpha is a zero-sum game; when someone loses, someone else wins).

Also, it is helpful to take a look at what Amaranth had become by the time it imploded. It is somewhat of a misnomer to call Amaranth a multi-strategy fund. It may have started that way, but by the time of its implosion it essentially had become, in fact if not in name, a highly leveraged single-strategy fund (although the fund lost only two-thirds of its net asset value when the energy trades collapsed, indicating that there was at least some degree of diversification remaining).

The mild market reaction seems to imply that most investors realize (and accept) that investing in what amounts to a single-strategy manager means accepting manager blow-up risk.

Also, it should not be implied that what happened at Amaranth means funds of funds are, therefore, better. There are some very high-quality FoF managers that held positions in Amaranth. The primary difference is that the position typically represented a small percentage of the overall portfolio, so the impact was largely muted.

Given the size of the hedge fund market, the diversification benefits of most MSFs and FoFs (still the largest investors in hedge funds in dollar terms), and the typically relatively small allocation to hedge funds within most client portfolios, the actual performance impact of Amaranth's implosion is likely to be fairly insignificant and in no way proportional to the media coverage it engendered.

Overall, not too much should be read into the Amaranth situation regarding FoFs versus MSFs. As more institutions invest more capital into hedge funds, there still should be significant growth in MSFs, for the reasons cited in the main article: more transparency, greater institutionalization of the investment process, and potentially lower fees. At the individual investor level, FoFs should continue to be very popular, despite the added layer of fees, because of the access, diversification, and professional oversight they provide.

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to most people, but what about the QPFC or the CIMA®? The Certified Investment Management Analyst, or CIMA, focuses on 'asset allocation, manager search and selection, investment policy and performance measurement,' according to the Investment Management Consultants Association."

November 1, *Investment Advisor*—A news brief noted that IMCA announced a call for nominations for the 2007 Richard J. Davis Ethics Award. The Davis Award is given each year to the author of an article "that has made a significant contribution to increasing the awareness of the investment management consulting profession in the area of ethics, or on legal and regulatory issues that affect the profession."

November 1, *Investment Advisor*—The article "At A Conference Near You," features Olivia Mellan: "Members of our extended Investment Advisor family will be speaking at several venues across the country during conference season this fall. For example, our 'Psychology of Advice' columnist, therapist and money coach Olivia Mellan, will be appearing on a panel called 'Living Your Legacy' at a November 13th gathering in Sarasota, Florida, sponsored by Wachovia Corp. Following her appearance at the Investment Advisor/Moss Adams Advisor Summit November 30 in Las Vegas, Olivia will be traveling on to Beaver Creek, Colorado, to present a keynote speech on December 4 at an IMCA-sponsored event. Her topic? 'Money Personality Types and Gender Differences.'"

IMCA® PRNEWSWIRE PRESS RELEASES

September 19—"Investment Management Consultants Association (IMCA®) Presents 2006 Stephen L. Kessler Writing Award."

IMCA MEMBERS IN THE NEWS

August 14, *Business Wire Press Release*—"Phoenix Investment Partners Names David N. Wadley National Sales Director, Retail Distribution." "Phoenix Investment Partners, Ltd., the investment management subsidiary of The Phoenix Companies, Inc. (NYSE: PNX), has appointed David N. Wadley, senior vice president and regional investment consultant for the south central states, as national sales director of its U.S. wholesaling operation. Prior to joining Phoenix, Wadley was president of CAI Securities . . . Earlier he was president of Geodyne Securities in Houston, Texas, and held senior positions with other securities firms. He earned the designation of Certified Investment Management Consultant from the Investment Management Consultants Association in 2002, and became a

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