Accessing hedge funds: how 'solutions' are the new FoHFs

The roles of consultants and funds of hedge funds (FoHFs) have increasingly converged over the years, with significant ramifications for both fund managers and investors

By Niki Natarajan

Consolidation and ever greater concentration of assets among a small group of the biggest players has been an ongoing story in the funds of hedge funds world ever since the financial crisis of 2008. During the crisis, there was a rapid shrinkage in the FoHF sector, and there has since been a recovery of sorts – though much more muted than in the underlying hedge fund industry itself.

The result has been that FoHFs have accounted for a declining proportion of the industry's assets, though by most measures they still today represent more than 20% of the total. Over the same period, the number of bigger FoHF groups that manage hedge fund assets of $1 billion or more – the *InvestHedge* Billion Dollar Club – has declined from about 150 separate firms to under 100 following a long series of mergers and acquisitions as well as the disappearance of a number of groups.

The fund of funds world has been continuing to concentrate, with more than 40% of its assets now in the hands of just the 10 largest players – no less than three of which also happen to be investment consultants, according to the 2014 *InvestHedge* multi-manager survey. This has created a situation that has many in the traditional FoHF community up in arms – because of what they see as potential conflicts of interest that arise (despite whatever Chinese walls are in place) when the consultant is also the provider of the solution, as so often happens in implemented consulting or fiduciary management.

While implemented consulting and fiduciary management services are likely to be offered across all asset classes, not just hedge funds, the KPMG 2014 Fiduciary Management Survey highlighted some statistics that are likely to be relevant when applied to the selection of hedge funds. The first is the 44% growth in the number of full delegation of fiduciary mandates over the year, a number that is likely to include assets to hedge funds. The second is that of the 92 new mandates, 75% of them were won on an uncontested basis — in other words: in eight out of 10 cases a quote was only provided by the ultimate mandate winner.

This raises the question: How many pension funds are hiring hedge advisers or allocators without the appropriate tender process?

Without a competitive tender process, trustees risk not getting the delegation solution that best matches their needs, KPMG states — an issue that is likely to also be reflected in the selection of hedge funds. The KPMG survey also highlights the absence of investment performance in the fiduciary management industry. In a similar fashion, there is no transparent standardised measurement of the performance of bespoke and customised portfolios, which makes assessing the skills of providers that do not have a commingled track record to show, much harder.

The long term damage to the global FoHF industry of not having audited performance for customised and bespoke portfolio included in the indices is that, as more assets flow into the customised solutions, the worse the performance of FoHF indices become, thereby perpetuating the notion that funds of hedge funds are just 'funds of fees' with no inherent added value.

Offering bespoke and customised solutions is a relatively new phenomenon in the 45 year timeline of funds of hedge funds. But a couple of firms – Pacific Alternative Asset Management Company, with heritage is in the consulting world, and the former EIM, now Gottex Fund Management – have offered this form of tailoring since their inception. In fact one of the synergies between Gottex and EIM was the product centric focus of Gottex and bespoke forte of EIM that combined with EIM's Luma managed account platform – now giving the firm a full set of services to offer clients.

This new age of transparency, liquidity and control means that managed account infrastructures allow investors access to a wide variety of hedge funds that would once not be seen dead on a platform. In turn, this has helped the change in how hedge funds have been defined over the last six or seven years, as they have moved away from being seen as an asset class and towards being used as more of a tool for better overall portfolio management.

In the UK, the Cornwall Pension Fund gave FRM a $180 million hedge fund mandate to manage via its managed account platform. Meanwhile, the advisory services that come with many of the platforms allow investors like California State Teachers' Employee Retirement System, which uses the Lyxor Asset Management platform, to go direct but with a little assistance if required.

Just by looking at the performance dispersion across the 1,414 FoHFs run by 404 management companies in the InvestHedge database it is clear to see that not all FoHFs are the same. Despite the poor perception of FoHFs in the mainstream media, the industry has a role in the hedge fund allocation food chain. This conclusion is supported by the fact assets grew by 8% in 2014, according to InvestHedge, driven more by inflows than performance as investors looked for more yield in low interest rate environments and protection from the inevitable but

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unpredictable likelihood of a spike in volatility.

While the composition of who is winning the race for hedge fund assets may be changing with the entrance of consultants as viable providers, the need for professional hedge fund allocation services is clearly not in question.

Collectively the top three investment consultants now manage some $100 billion in hedge fund assets, making up 13% of the total $767 billion in the InvestHedge multi-manager survey. And while not all three of the investment consultants offer commingled funds, the phenomenon is not new – Russell Investments and Stamford Associates were among the first to do so.

Whether the multi-manager fund is onshore, offshore, a fund of UCITS funds or managed by the independent arm of a major pension fund such as ABP's New Holland Capital, is a different question. But the demise of the humble commingled product has been exaggerated for the simple reason that a single multi-manager vehicle is a far more cost effective way to manage hedge fund assets than the many and varied bespoke portfolios

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with lots of moving parts and objectives.

The irony, however, is that as consultants move towards offering commingled funds, FoHFs are expanding their advisory and consulting remit in a bid to retain clients and win new ones. For many FoHFs offering advice is the main areas of business growth and for others it is already the biggest part of their business. While it is well known that advisory fees are low, many FoHFs have employed this strategy to make their mark as – due to their depth and breadth of resources – most FoHFs are well placed to offer solid advice on manager selection based on an existing track record.

Offering low-fee advisory services put Blackstone Alternative Asset Management on the institutional hedge fund map back in 2003 when it won the advisory mandate for California Public Employees' Retirement System's hedge fund portfolio – one that is now being wound down more than a decade later. But with more than $60 billion in assets that make up 8.2% of the entire universe of multi-manager assets, many look at Blackstone's solution-based model as one to emulate, offering: commingled hedge fund portfolios in all flavours; best ideas funds; a range of liquidity spectrums from illiquid opportunities funds to liquid alternatives; portfolio advisory; and a host of other ways to make sure that client needs are taken care of.

Solution providers

Solving problems is the new FoHF because the real challenge facing the industry is not who offers what hedge fund product, but who can offer clients what they need. A current example of this is K2 Advisors, which started as a pure FoHF. Since it was bought by Franklin Templeton, a successful long-only mutual fund giant, it has become a solutions provider offering access to hedge funds, other asset classes and beta strategies, all in a wrapper to suit the client.

The winners are going to be groups that can translate the needs of the clients into solutions that work. On top of the consultant offering implemented consulting, a new threat to the traditional FoHF may come from the long-only asset management brand that has the client base and an army of client relations people but not yet enough alternative products.

An example of this may be seen in the 2015 acquisition of Arden Asset Management by Aberdeen Asset Management. Aberdeen has the clients and the support infrastructure, what it needed was bigger footprint in the US and a deeper hedge fund team. The fact that Arden is adviser to the $6 billion hedge fund portfolio at Massachusetts Pension Reserves Investment Management and that it has more than $1 billion in liquid alternative assets from Fidelity made it a desirable 'catch'.

With hedge funds and FoHFs also looking for exit strategies – selling their business or stakes in it – deals such as the one between Texas Teachers' and Bridgewater are also going be potentially attractive options for investors wanting to access alternatives. Teaming up with a US mutual fund group is the quickest way for a FoHF willing to enter the liquid alternatives space to help stabilise its business with new asset flows and a new client base. M&A in the FoHF space is likely to continue to access skills, distribution or assets and while the FoHF industry is likely to continue to shrink in number of groups it will grow in assets as the solutions mind-set that started in the wake of gating, suspensions, frauds and general lacklustre performance in the hedge fund industry, continues.

How investors access hedge funds' return streams is changing. As investors look for solutions to enhance returns and protect portfolios, in a regulatory environment that challenges fees and makes the cost of capital expensive, even hedge funds themselves are under threat by the cheaper replicators, alternative betas, risk premia, factor models, investable indices and in fact anything that purports to offer hedge fund-like returns, cheaply.

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The asset manager, hedge fund, fund of funds, or long-only player that can mix and match all the options so the investor gets what they need in a single cost-effective way will be the winner in terms of assets under management. All of this is not to say that the multi-manager culture is dead. Indeed, far from it.

As hedge fund investing enters the 'retail' space with liquid alternatives, access to diversified hedge fund strategies will be key. Players in this space such as K2, Arden and Blackstone are those that can access mutual funds distribution channels and offer the solutions in 'plain English' language. Hence, to succeed in raising assets with a liquid alternatives brand will become increasingly important.

In addition to liquid alternatives, access to new alpha and talent in the form of smaller managers is another way FoHFs are distinguishing themselves from the consultants. The latter have typically, but not exclusively, allocated to the larger better known brands. The downside of size is that big allocators can only allocate to big funds to make a difference, leaving the smaller manager market to smaller investors and family offices where performance is more important than anything else. Tages Capital, Larch Lane Advisors and Aurora Investment Management are among the FoHFs that actively seed new managers, while others such as ABS Investment Management are enthusiastic day one investors.

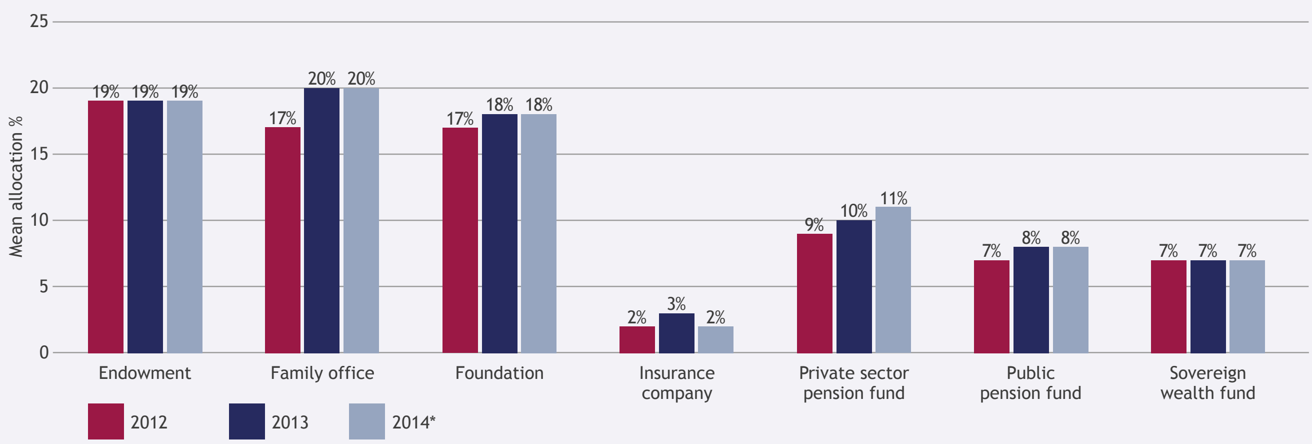
While much of what can be called hedge fund alternative return streams are not proven in dire markets, the real challenge for investors today is to make sure they know who has fiduciary responsibility for their hedge fund allocations when the markets turn sour or a fraud rears its ugly head.

As the multi-manager industry moves beyond product-driven commingled funds to solution-driven alternatives businesses, investors need to start asking:

- "Who is in charge of lining up the hedge fund advisers if the consultants are now also the potential provider?"
- "How do you measure the performance of 'bespoke' solutions?" and:
- "Who is responsible for my hedge fund allocation during times of market stress?"

FoHFs were once deemed 'fast money' by some hedge funds. But one of the greatest lessons hedge funds can learn from the long-only world is that consultant concentration risk can be just as dangerous. •

Mean allocation to hedge funds by investor type, 2011 — 2014



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