DEMYSTIFYING HEDGE FUNDS II
‘A safe investment is an investment whose dangers are not at that moment apparent.’
- Lord Bauer

In 2001, Presidio Financial Partners LLC wrote a white paper on hedge funds in an attempt to educate our clients on the highly topical subject. At the time of that writing, little had been published on hedge funds and investors were still relatively limited to very wealthy families. While these investment vehicles have been around since 1949, their growth really exploded this decade. Now it seems that every investor has jumped on the hedge fund bandwagon, perhaps without fully understanding what they are, how they work, and most importantly, what to expect. Given the proliferation of product, the fast evolution of strategies, and their prominence in the media, hedge fund research must likewise stay current and relevant. For a refresher on what constitutes a hedge fund and the nuances of the major strategies, we refer you to our 2001 paper.

With zero barriers to entry to forming a hedge fund the most common investment styles have been replicated by thousands of funds recently. Most of these new funds have little assets and little experience but plenty of optimism and ambition. What is one getting by investing in a basket of these funds? Presidio’s research group compared the performance of a diversified portfolio of traditional asset classes to the HFRI Fund of Funds Composite Index, an industry benchmark for hedge fund-of-funds. The analysis found the following:

- From April 2000 to March 2006, a diversified portfolio generated an average annualized return of 6.3%, compared to 5.2% for the HFRI Index. The analysis period starts at the height of the bull market in April 2000 and included the bear market of 2000 to 2003 when many investors poured money into hedge funds.

- Over a longer period, from January 1990 to March 2006, the same pattern of investment returns was repeated. The diversified portfolio of investments generated an average annualized return of 10.6% compared to 10.1% for the HFRI Index. January 1990 is the inception of the HFRI Index.

Such results call into question the efficacy of the hedge fund industry broadly speaking. This white paper provides statistical updates and qualitative reviews of the major hedge fund strategies and concludes with our position on how to effectively use hedge funds within an investment program.

We are not suggesting that hedge funds and/or hedge fund-of-funds serve no purpose in a diversified investment program. Quite the contrary, in fact. The industry contains a number of extremely talented investment professionals that can add value over time. If they can be identified amidst the more mediocre providers (and at a reasonable price) such alpha is immensely valuable to portfolio construction. One must use nontraditional methods to uncover whether a hedge fund manager is delivering Beta (market returns), Alpha (excess risk-adjusted returns), or some combination of the two. Unfortunately, most hedge fund managers deliver too much Beta – simply providing market exposure that can be replicated far more cheaply through traditional means. Others that do generate alpha keep far too much of it for themselves after debiting management and incentive fees. If you are fortunate to locate and gain access to the small number of funds that can provide alpha net of fees, consider them closely as an investment (and don’t tell anyone about your discovery!)

**STATE OF THE INDUSTRY**

Alfred W. Jones, who developed the first hedge fund in 1949, probably never envisioned that there would be thousands of imitators managing over a trillion dollars in equity. The growth of assets flowing into hedge funds has been exceptional (figure 1).

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1 As an example, Business Week, July 3, 2006 issue writes about recent college graduates creating their own hedge fund.

2 40% taxable bonds (Lehman Aggregate Index), 20% US large cap (S&P 500), 10% high yield bonds (ML Lynch High Yield Master II), 15% international equity (MSCI EAFE), 10% US small cap (Russell 2000), and 5% emerging market equity (MSCI EMF index).
Some data providers put the current number of hedge funds at 8,000, managing $1 trillion as of June 2005. While the absolute dollar figures seem astonishing, the concentration of these funds is downright astounding. The top 100 largest hedge fund operators manage $568 billion\(^4\). In addition, the top 10 hedge funds ranked by assets controlled $111 billion of the total hedge fund assets under management. Assuming the $1 trillion in asset figure for the industry is reasonably accurate, 1% of hedge fund managers control 57% of estimated hedge funds assets and 0.1% of hedge funds control 11% of assets. As we will see later when we look at the problems with hedge fund indices, many of the largest hedge funds do not report their performance to the major databases. This calls into question the relevancy of hedge fund indices as well as the associated analysis by academics that draw conclusions predicated on perhaps misleading data. It would be like looking at the US stock market while ignoring the presence of General Electric, Microsoft, Walmart, ExxonMobil, and Citigroup. Of course, all of these hedge fund data providers ignore the biggest and most successful hedge funds of all time including Berkshire Hathaway, GE, AIG, JP Morgan Chase, Goldman Sachs, etc.

Previously, we defined a hedge fund as a private investment partnership fund that can take long and short positions in various markets and are accessible only to wealthier investors. We believe that the original hedge fund managers were merely looking to hedge out the unpredictable nature of the “markets” in order to obtain a more stable, consistent pattern of returns. In our opinion, the whole concept of absolute return investing should be geared toward hedging out the more random components of risk in favor of risk controlled upside return. Later, we look at the efficacy of hedge funds ability to hedge out systematic risk and truly extract positive, controlled alpha.

**Asset Class or Investment Strategy?**

Strictly defined, we do not believe that hedge funds constitute a separate asset class given the heterogeneity of strategies and dispersion of returns amongst hedge funds that purport to employ similar strategies\(^5\). While, hedge funds, unlike traditional asset classes, have no economic theory justifying a positive expected

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\(^1\) Source: UBS (1990-2004 from Hedge Fund Research, 1982-1989 from Quellos, prior to 1982 from Elden [2001] and Caldwell [1995]

\(^2\) Statistics provided by Institutional Investor, June 2005

\(^3\) In our own asset-liability modeling we do technically define hedge funds as an asset class to the extent that we have confidence in implementing an absolute return-based program that may look decidedly different from the hedge fund universe at large.
performance, there are many anecdotal and qualitative theories on the subject. Their entire rationale for being is predicated on the managers' ability to exploit inefficiencies left behind by other investors in what is largely considered a zero or negative sum game. It is quite ironic then to see investors who employ a large allocation to hedge funds and ignore many traditional asset classes. There may be debate on the size of the risk premium of equities, but there is near universal agreement among academics and practitioners that stocks and bonds have a positive expected return in the long run.

Figure 2 compares and contrasts traditional long-only stocks and bonds to hedge funds. With traditional investments, an active manager is mostly capturing the inherent risk and return characteristics of the asset class. A good active, long-only manager will seek a return in excess of what can be achieved in a passive strategy, i.e. index funds.

The owner of stocks, bonds, cash, private equity and the like will be subject to changing macroeconomic conditions and investor behavior in the short-term. Over the long term, these beta risks should reward investors positively though volatility can be quite significant in the short run. Conversely, a good hedge fund operator tends to dislike this short-term volatility and will seek to eliminate such risk factors instead looking to exploit some small inefficiency. As such, as depicted in the illustration, the good hedge fund manager tries to limit their beta exposure and maximize their alpha exposure. Hedge fund performance should, then, be attributed to the manager's skill at discovering and executing on its search for alpha. With the explosive growth in hedge funds, however, media pundits are debating whether this alpha component has shrunk to minute levels.

FIGURE 2

WHAT INFLUENCES HEDGE FUND RETURNS?
It is our experience that the long-term positive expected returns for traditional asset classes make it a difficult proposition, psychologically, for most hedge fund managers to fully hedge out "market" risks. The thinking goes something like this: “Markets tend to go up over time, so why shouldn’t I have a long-bias when constructing my fund?” To varying degrees, investors then pay hedge fund managers very expensive fees for the privilege of “beta” or market exposure. As a simple thought experiment, if one were to pay the typical hedge fund fee (1% management and 20% incentive fee) to a manager replicating the Wilshire 5000 Total Stock Market index over the 12-months ending June 30, 2005, the net of fee return would have been approximately 6% versus 8.4% for the index. Perhaps not too surprisingly, the HFRI Fund-of-Funds index achieved a 6.4% return over the same period.

To the extent that a manager or strategy is truly offering Beta rather than absolute returns (“alpha”), investors may be sorely disappointed with their hedge fund experience. In fact, there is historical precedence for this prediction. At the end of the 1960's bull market, hedge funds were long and levered. During the two subsequent bear markets (1969-1970 and 1973-1974), roughly two-thirds closed down and assets under management declined 70% due to losses and withdrawals as experienced by the 28 largest hedge funds in a SEC survey. While we do not expect current hedge fund investors to experience such a phenomenon, we do believe that many investors...
will become disillusioned over the next several years with the mediocrity of returns. Much of the remainder of this white paper explains our rationale.

**AlphaBet(a) Soup**

Part of the allure of hedge funds is rationalized by the general perception that they are providing alpha (excess returns) with little to no beta (systematic risk). Betas are easy to capture either through traditional money managers or inexpensive passive investments such as ETFs or index mutual funds. Alpha is difficult to find and can be very expensive. In truth, many hedge funds are packaging up beta and selling it at alpha prices. Statistical evidence of this can be confirmed by the high correlation of hedge funds within “strategies”. A highly regarded research firm that also manages hedge funds examined over 1,600 hedge funds and looked at the typical correlation of managers within different hedge fund strategies (table 1). The authors conclude that these high correlations are evidence that many hedge fund managers are employing similar strategies to take in risk premiums and not creating “alpha” by outsmarting other market participants.

<table>
<thead>
<tr>
<th>Strategy</th>
<th>Average Correlation of Return Above Cash</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible Arb.</td>
<td>60%</td>
</tr>
<tr>
<td>Short Bias</td>
<td>51%</td>
</tr>
<tr>
<td>Market Neutral</td>
<td>42%</td>
</tr>
<tr>
<td>Event Driven</td>
<td>66%</td>
</tr>
<tr>
<td>Hedge Equity</td>
<td>63%</td>
</tr>
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Just as with the traditional asset classes, the vast majority of hedge funds can be explained by four main factors including:

1. **Equities**- S&P 500, Russell 3000
2. **Fixed Income**- Lehman Aggregate, Term Structure
3. **Volatility**- VIX, MOVE
4. **Credit**- Merrill Lynch High Yield II, CDS Spreads

Since most investors already have these embedded risks within their traditional money managers and asset classes, it makes little sense to employ strategies and hedge fund managers that might be duplicating these risks. The next few sections illustrate where there might be systematic risk exposures present in many of the more popular hedge fund strategies.

**Hedge Equity or Long/Short Equity**

This strategy is currently the most popular strategy employed both in terms of assets and number of managers. Very simply, the hedge fund buys or goes long undervalued stocks and shorts overvalued stocks. It is our experience that most such funds maintain a consistent long bias (more longs than shorts). In fact, the standard marketing materials offered by long/short managers suggest that they will maintain a net long position between -20% to +80%. In reality, such managers rarely go below 0%, generally vacillating between 20% - 50%. Further, they are systematically long small cap stocks and short large cap stocks. We tested this thesis by running a regression of the HFRI Equity Hedge Index vs. a naïve index constructed by being long the Russell 2500 and short the S&P 500 and maintaining a 50% net long book. Figure 3 illustrates the consistently high correlation between
the median long/short hedge fund manager and our custom index\(^7\). Since this naïve index can be cheaply replicated using ETFs, we are dismayed that so many investors are willing to pay exorbitant fees for an investment strategy that offers little to no diversification benefits.

\(^7\) Average correlation of 0.81 with t-stat of 14.4.
FIGURE 3: ROLLING 24-MONTH CORRELATION OF THE HFRI EQUITY HEDGE VS. CUSTOM INDEX

Merger Arbitrage
Merger arbitrage is one of the most understood hedge fund strategies and perhaps the easiest to replicate. At its core it involves going long a company that is being acquired in a merger and short the equivalent units of stock in the acquirer. Because there is typically a spread in value between the two stocks, the payoff is predicated on the two stock prices converging once the deal is consummated. The payoff is dependent on the spread in prices and the time it takes for the merger to close. The risk is that if the deal fails the hedge fund often loses on both sides of the trade. This strategy is often portrayed as “picking up nickels in front of a steam roller” because success results in modest returns but failure results in very poor returns. To test this, we regressed the HFRI Merger Arbitrage index against the S&P 500 index. Rather than a simple linear regression, we ran a multi-regression analysis. Our thesis is that merger deals tend to “fail” when the stock markets do poorly - much like a naive investment strategy of writing put options on the market. Figure 4 illustrates this short put option payout. When the stock market is positive, merger deals tend to be successful and the hedge fund gets its nickel. However, when the stock market falls, the deal often collapses (or is delayed) causing big to losses occur. In essence the upside is limited while the downside is not. Such a payout can be replicated quite cheaply by writing put options on the S&P 500 index. We believe that most investors, when presented with such a scheme, would probably pass.

FIGURE 4: MULTI-REGRESSION OF HFRI MERGER ARBITRAGE VS. S&P 500 INDEX
Commodity Trading Advisors (CTAs)
As reported in our white paper on CTA strategies (2005), roughly 90% of CTA managers employ a trend following process investing in commodities, financial futures, and currencies. They utilize computer algorithms to identify short, medium or long-term trends in a number of markets and measure the ability to exploit those movements. The primary factor employed in their computer models is trends in price. The major differentiation between the models is typically the trailing time period that the modeler believes is critical, e.g. 1 day, 1 week, 200-day moving averages. The programs tell a trader when to initiate and when to close out the trade.

Historical performance of systematic CTAs has been attractive. Figure 5 illustrates how such active strategies have fared versus the S&P 500 index. Systematic CTAs have positive correlation to the stock market when it is gaining, but strong negative correlation when it is falling. Such performance behavior is very attractive for long-only or long-biased investment programs that have a lot of market risk. While this is an attractive performance feature, it is also highly illustrative of an option straddle strategy whereby the investor could buy at the money calls and puts on the stock market. To the extent that the markets’ volatility increases in dramatically rising and falling markets, one could recreate the trend and follow CTA strategy without paying the 2% management fee and 20% incentive fee often demanded by such managers.

Figure 5: Multi-Regression of CTAs vs. S&P 500 Index

Other Strategies
Most other common hedge fund strategies require more complicated analytics to parse out its beta from alpha. Without providing the quantitative proofs, we offer a summary of the academic findings for many of the other significant strategies that reveal their major source of returns:

- **Fixed Income Arbitrage**: For a number of years, there was a mystery as to why fixed income arbitrage managers were able to consistently generate 1% returns each month with very little volatility. Three theories were postulated: (1) they are capturing true mispricings, (2) they are acting as market makers in providing liquidity, or (3) they sell economic disaster insurance. After the trauma in 1998, it became apparent that #3 was the explanation. In essence, fixed income arbitrage managers were collecting their premiums in low volatility, economically stable environments but had to pay large costs during market meltdowns. This short volatility strategy is similar to what insurance and re-insurance companies do.
  - A study by money manager and hedge fund shop, Bridgewater Associates, found that fixed income arbitrage managers were 59% correlated to a naïve strategy of being long a simple combo of mortgages, short-term corporates, emerging market debt, and euro dollars relative to treasuries.
Such short-volatility strategies have performed exceedingly well over the past few years as volatility has diminished and spread product (all those bonds that these hedge fund managers purchase) has been in favor. Not surprisingly, many brokerage houses are now advocating fixed income arbitrage strategies.

**Statistical Arbitrage:** For most of its history, statistical arbitrage was simply a form of paired trading strategy where two stocks which are close substitutes (like Coca-Cola and Pepsi) are employed with the manager going long the cheaper stock and short the more expensive company. While larger statistical arbitrage shops are certainly employing more elegant and sophisticated nuances, a significant portion of these strategies can be explained by the spread between small and large cap stocks, between value and growth stocks, the spread between high grade and intermediate grade corporate bonds, and shifts in the yield curve. Because much has been studied and written up in the academic literature on the common statistical arbitrage sub-strategies, it is not too surprising that returns have truncated over the past few years. Our theory is that unless you can find and invest in the top 3-5 statistical arbitrage shops, it is very difficult to make money.

**Convertible Bond Arbitrage:** This strategy, which became very unpopular this year, is a bit more difficult to model into its beta components. The majority of convertible bond arbitrage managers are either trying to extract returns from one or both of two sources: (1) improving credit quality or (2) volatility trading. The former sub-strategy does well when company fundamentals are doing well and credit spreads contract. The latter sub-strategy does well when there is higher realized volatility than is implied by the market. The credit strategy has performed reasonably well given the credit environment we have been in while the volatility strategy has done very poorly. Volatility in the markets has hit multi-year lows. In the aggregate, one can characterize this popular investment strategy as a variation of being long credit and long volatility.

Much like the risk in the merger arbitrage business, what was once a niche strategy employed by only a small handful of hedge fund managers and investment banking proprietary trading desks, the number of managers and assets in the space has grown tremendously- the majority in the past few years. While many critics were concerned about the collective universe ratcheting up leverage, the reality was that leverage in the space has come down over the past few years. Consequently, when dislocations occurred during April-May of 2005 (result of the GM and Ford credit downgrades), the universe of managers did poorly though losses were kept within reasonable boundaries. Many reputable shops closed down and/or returned capital to investors even as many large multi-strategy shops dramatically took down their exposure to the trade.

While the number and assets in the convertible bond arbitrage universe has downshifted back to more reasonable levels, there are still too many players (and potential assets) that can almost immediately flood back into the space if opportunities are attractive. Therefore, while there may be cyclical periods where the strategy can add “alpha”, from a strategic perspective we believe that convertible bond arbitrage is unattractive and should be obtained only within the context of a multi-strategy hedge fund manager that can play it tactically.

**Hedge Fund Performance, or Lack Thereof...**

We learned in Economics 101 that supply and demand can explain almost all of economic theory. The same can be applied to the hedge fund industry. Arbitrage strategies, other than the ongoing pursuit of singular idiosyncratic mispricings, tend to lose power as the skills and information needed to exploit them become widespread. Given the proliferation of hedge fund managers, size of assets in the industry, and the concentration of assets in similar strategies, we would expect a contraction of returns. Figure 6 seems to confirm this theory as most of the common hedge fund strategies have experienced a decline in realized returns. The news is not all bad. While returns from 2000-2005 did decline from the previous five-year period, in most instances, volatility did as well (illustrated by the diamond, 1995-2000, to the square, 2000-2005). We believe that advancement of risk management techniques and greater sensitivity of hedge fund managers to unwanted risk resulted in lower

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8 “Pairs Trading: the performance of a Relative Value arbitrage rule”, Gatev, Goetzmann, and Rouwenhorst, 1999
volatility and that this trend will continue. Of course, there are other factors that contributed to bringing down returns and volatility aside from the popularity of hedge funds - not the least of which has been more muted returns with traditional asset classes. With returns of bonds and stocks below historical levels, it is not surprising that hedge fund returns have been significantly impacted. As many hedge fund shops are just long-biased managers dressed as hedge funds in order to charge a 1% and 20% fee, a smaller market return will absolutely diminish the opportunities for the average hedge fund.


![Graph showing 5-year performance of HFRI Index](image)

**WHAT DOES THE "DATA" TELL US?**
Unlike mutual funds that have strict reporting criteria or investable indices like the S&P 500, Russell 2000, or MSCI EAFE, there are many problems with arriving at any definitive conclusions on the hedge fund universe when looking at the available data. The issue is data integrity. Because all hedge fund indices and databases used by academics and practitioners are based on the voluntary contribution of information from hedge fund managers, there is a real strong argument for survivorship bias. In fact, researchers question whether hedge fund index returns, periodically published by Hedge Fund Research (HFR), Van Hedge Advisors, and CSFB/Tremont Hedge Fund Index, are a reliable representation of hedge fund industry performance. The problem is twofold: (1) hedge funds will often “backfill” their history only if they have good performance and (2) many successful hedge funds will stop reporting to databases because they do not need to tout their performance. Obviously the former makes the indices look more attractive while the latter influences the indices to look worse than the total universe of hedge fund managers actually is. Several studies have looked at the “backfill” issue and calculate that the indices exaggerated performance by 446 bps from 1995-2003. However, Robert Schulman, CEO of Tremont Capital, rebuts the studies claiming that “there are two parts to our database: the public database, and the proprietary portion that we use for our advisory business and Tremont hedge fund clients. We have empirical evidence that more dollars stop reporting because they’re doing well than stop reporting because they’re doing poorly. That leads me to the statement it is ‘preposterous’ to assume survivorship bias is negative.”

If Schulman’s insights are correct there are some interesting conclusions we might draw including dispelling the myth that size is an absolute detriment to future performance. In fact, some studies have concluded that both

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10 Ibid
very small firms and very large hedge fund shops in most strategies have offered superior risk-adjusted performance. The explanation hypothesized is that smaller firms are more nimble, can execute on their best ideas without constraint, and whose interests are most aligned with their investors. Conversely, larger firms may be large because they are very good at what they do and the innate skill and experience is only marginally impeded by size. In fact, it is often the mid-sized hedge fund shop that is disadvantaged in that they might be too big to fully execute, large enough that they do not need to perform, and in the aggregate not good enough to overcome the burden of a larger asset base.

**IS MANAGER SELECTION IMPORTANT?**

We uncovered only a single study that looked to answer whether manager selection is more or less important than strategy selection. While the data examined only managers in the MAR and HFR databases from 1995-1999, the results were interesting. Figure 7 below reflects the dispersion of manager performance after accounting for each strategy's beta factors. The analysis implies that there is a lot to be gained by finding top quartile managers (universe shaded in Blue). This study also tells us that while top managers really outperform, the penalties for selecting average to bottom quartile managers did not hurt that much.

**FIGURE 7: RANGE OF MONTHLY EXCESS RETURNS ASSOCIATED WITH MANAGER SELECTION**

That said, we feel that if the survivorship bias was properly accounted to include good managers that stopped reporting and poor managers that do not report, combined with all of the newer, less seasoned hedge funds, that dispersion of results would be significantly greater today. If this is indeed the case, then manager selection will be even more important than it ever was in the past. This leads us to the next section which addresses the role of hedge fund-of-funds.

**FEES ON FEES ON FEES ON...**

Like everything in life, if you can get similar quality at cheaper prices, the decision becomes an easy one. The problem with hedge fund-of-funds (“HFOF”) versus going direct to hedge fund managers and saving on the middle man is usually not an either-or decision. It is our proposition that the risks in hedge fund land (those that can and cannot be quantified) are too great to have only a small handful of hedge funds as one’s entire hedge fund program. Therefore, a general rule of thumb is that one should allocate no less than $7-8m directly to hedge fund managers in order to get appropriate diversification. In the absence of this allocation, hedge fund-of-funds is the only other option. The $64,000 question is whether hedge fund-of-funds are worth it. Our opinion is that the vast majority of HFOF operators are not. Through interviews with dozens of HFOFs, we've found a deplorable lack of

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value-added relative to the high level of fees. There are a small handful of HFOFs which are worth their fees. Below we list some key factors that a perspective HFOF should embody in order to justify their fees:

- **Top down management**: A surprising number of HFOFs either have no view on the various hedge fund strategies or, if they do, they do not act on such insight. As a result, such firms have a fixed weighting by strategy that is almost always based on historical numbers. We find such simple, naïve assumptions promotes a suboptimal if not dangerous “past as prologue” philosophy.

- **Access to top tier talent**: A good percentage of HFOFs will have a couple of flagship hedge funds as anchor managers. Usually, these are name brand firms with which the HFOF either fortuitously or co-incidentally established a good relationship early on. The depth and quality of hedge fund managers beyond these flagship firms is often mediocre to poor. Providing “access” to a couple of strong hedge fund managers is a poor rationale for hiring a HFOF if this is all they offer.

- **Strong pipeline of prospective managers**: Similar to the “access” issue, the HFOF must be prepared to put capital to work and be constantly looking to upgrade the quality of the investment program. There are a number of large HFOFs that would be unable to fire their larger managers because there is not enough talent in the pipeline to replace them.

- **Deep knowledge of hedge fund industry/strategies**: There is a reason that most of the money being invested today is flowing to long/short equity strategies. The strategy is easy to understand, does not suffer from capacity constraints (in the aggregate) and is readily explainable to an investment committee in 100 words or less. Likewise, merger arbitrage and convertible bond arbitrage became well understood strategies over time until eventually the alpha disappeared. Almost universally, the greater the barrier to entry (e.g. sophistication of the strategy) the better the opportunities. The converse is typically true as well. The easier the strategy is to understand the more likely that someone has already extracted the low-risk profits.

- **Sophisticated risk management systems**: There is a real dichotomy and litmus test that one can apply to most HFOFs. The sophisticated shops place a strong emphasis on risk management both qualitatively and quantitatively. The hedge fund world is not a simple one; strategies are getting more complex and risks are constantly evolving. HFOFs need to understand and manage the risks in the portfolio appropriately. Most HFOFs have little to no risk management systems though there are a small handful of operators that have very robust systems.

- **Ongoing due diligence and monitoring**: This is where the universe of HFOFs spend almost all of their time. However, too many HFOFs become wedded to hedge funds that they have employed for a long time often well past their prime. HFOFs need to stay fresh and while not necessarily churn their managers should be open to replacing a manager when warranted.

- **Willingness to stay small**: It is the rare HFOF that, when successful, is willing to slow or stop taking in new assets. As with any capacity constrained industry more money will eventually result in mediocre to poor results.

While there is no HFOF that absolutely embodies all of the above attributes perfectly, it is our position that any HFOF that we recommend will strongly emulate them to varying degrees. Of course, this has limited the universe of “acceptable” HFOFs to an extremely small number (we can count them on one hand). It is only by adopting these seven core philosophies that a HFOF can justify the extra layer of fees.

**ARE LOCKUPS JUSTIFIED?**

There has been a frightening shift in momentum by hedge fund players to employ long lock ups of their client capital. Some of this was driven by the Security and Exchange Commission’s mandate to get hedge funds to register as Registered Investment Advisors. Because they left an out for hedge funds that had at least a 2-year lockup, it is no surprise that many hedge funds took the SEC up on its exclusion.

If 1998 taught hedge fund managers anything (at least those that were around back then) it was that human emotion in a very bad market makes for irrational investors. These irrational investors often want their money and they want it yesterday. Of course, this is usually at exactly the wrong time, forcing managers to liquidate
positions at the worst possible time exacerbating an already tenuous circumstance. This “run on the bank” syndrome is one of the single greatest risks to the hedge fund industry. While no one can accurately predict what might cause such a systemic event, many hedge fund managers have used lockups in a judicious manner to minimize its impact on their ability to manage through it. They have done this not to lock up money in order to captivate the client's assets and have guaranteed fees, but to mitigate being forced to liquidate potentially illiquid securities when there is no liquidity to be had.

There are certain strategies that make all the sense in the world to require a lock up period. After all, direct real estate managers, venture capitalists, and private equity firms have lockups from 8-12 years due to the nature of the investments. A distressed debt or activist microcap manager is justified in imposing a reasonable lock up, whereas a large cap long/short equity manager has almost no economic rationale for employing a 3-year lock.

**WHERE DOES THIS LEAVE US?**

One might think that after reading the above that one should not walk but run away from any hedge fund manager. In the absence of really understanding the universe and having an ability to conduct extremely deep due diligence on a prospective manager, such a prescription is apropos. Like everything, however, when used intelligently and with moderation investments in certain hedge funds can be extraordinarily beneficial to one’s investment program. While there are no absolutes in investing, there are a couple of overarching philosophies and themes that we subscribe to when advising our clients in hedge fund land:

- **Who?** Only a small minority of hedge fund managers truly have the experience, skill set, aptitude, and motivation to deliver superior returns. Even with these requisite qualifications, there are still no guarantees of success. The structure of the hedge fund, especially the compensation system, really does attract the best and brightest. It also attracts the riff-raff, the also-rans, the day trader, and the charlatan. One has to be very good at separating the “wheat from the chaff”.

- **Why?** There has always been a small band of extremely talented investors who have special skill and an innate ability to find interesting ideas or strategies. While the long-only mutual fund world is too restrictive in allowing such special managers to operate, the hedge fund structure is perfect for such managers to execute on their good ideas and rewards them for their success.

There are many investment techniques available to hedge funds that are not part of a long-only manager’s arsenal. As an example, the only option for a long-only manager that believes a company is overvalued or subject to fraud (Enron, Adelphia, MCI Worldcom) is to not own the stock. A hedge fund manager can capitalize on their insight by shorting the stock and profiting from its eventual decline in stock price. Also, long-only managers cannot take advantage of true arbitrage opportunities, whereas a hedge fund can. One example of this was found when 3Com spun off Palm in the late 1990’s. At the time, despite 3Com’s 100% ownership of Palm at the time of the spin-off, Palm was valued greater than 3Com, a mathematical impossibility. Hedge fund managers that could purchase 3Com and short the appropriate number of shares of Palm were guaranteed a good profit. Long-only managers by definition could not implement such a strategy.

- **What?** Strategies that become popular, have little or no barriers to entry, and are easy to execute will eventually lose any alpha potential. Top hedge fund managers will always be looking for new, undiscovered opportunities. One should be much more interested in the difficult to understand investment strategy or trade that no one has ever heard of. It is usually these opportunities that high risk-adjusted profits can be had. The minute “everyone is doing it” should be the time to exit such a strategy. While a lot of money is entering the hedge fund space, much of it is coming from institutions (pensions, endowments, foundations) selecting strategies that they understand (long/short equity) and/or strategies that have looked strong over the past few years (convertible arbitrage, CTAs, global macro).

- **Alpha or Beta?** Most investors have plenty of beta exposure. Hedge fund managers should provide the opportunity to deliver alpha returns with minimal market exposure. Additionally, hedge fund managers should look for alpha in complementary fields which will not all be exposed to similar risk factors. A well diversified pool of hedge fund managers can offer greater consistency of returns in the aggregate even
though any single or small group of managers may be in or out of favor over the short-term.

- **Fees?** It is important to verify that the general partner is adding significant value to justify the added layer of fees. If the HFOF manager is only focusing on a couple of activities, poor performance will likely result. If the manager can avoid poorly performing strategies, select superior managers, negotiate better terms, offer good diversification, and manage portfolio level risks, than the extra layer of fees may be justified.

- **Size?** All else equal, too large of assets will eventually become a detriment. However, many large firms allocate substantial revenue to research and development of new ideas and strategies, improvement of internal controls and risk management, as well as the hiring of top talent. Small and mid-sized firms often do not have the resources to compete to the same degree and can be disadvantaged; however, most have other attributes that can work in their favor.

Remember all the new dotcoms that were going to revolutionize the world and make millions (or billions) for all of those young entrepreneurs? While most went bust, a handful of them went on to create incredibly useful products or services that made their investors and employees good money. For every Amazon, Ebay, Yahoo and Google there were three Webvans, Pets.com, and etoys.com. A similar phenomenon is playing out in hedge funds. The goal is to find the Ebays and skip the Webvans.