



Change in the Air for Fund of Funds Fee Structures

*Brad Balter, Portfolio Manager and Managing Partner
Balter Capital Management*

Funds of hedge funds (FoHFs) have been and will continue to be an integral part of hedge fund investing. While many investors can and have chosen to bypass FoHF structures in order to invest "direct", for the past ten years assets under management (AuM) under the FoHF structure grew faster than AUM for all hedge funds combined.

The reasons for this impressive growth are obvious. FoHFs provide diversity among managers, reduce risk and hold out the promise of net returns higher than the average hedge fund. The long list of casualties in the hedge fund industry and recent high-profile hedge fund losses have also driven investors toward the security provided by a FoHF.

Investors are now more willing than ever to invest in FoHFs for the benefits provided by the pooled investment structure and professional supervision. On the other hand, as the FoHF industry matures, FoHFs are having a harder time beating the average return for all hedge funds. Concurrent with this trend, investors are beginning to demand that the FoHF fee structure makes economic sense.

Do Fund of Hedge Funds Managers Add Value?

Hedge funds are now viewed less as an alternative and more as an integral part of portfolio management and asset allocation. Awareness and knowledge of the industry has grown significantly, both among investment professionals and high net worth investors alike. "Brand-name" hedge funds are frequently mentioned in the press and an investor who can afford the minimums may choose to invest directly in these larger funds. This approach can work if the investor hires a professional consultant or has the wherewithal to perform due diligence, but such an approach is not for everyone.

According to Alexander Ineichen of UBS, "manager review is a dynamic and iterative process. The due diligence never ends. What we find amazing is the value added of a FoHF manager is often put in doubt (or the extra layer of fees determined, as excessive and/or unnecessary). This is, in our opinion, a paradox: on the one hand, investors agree that seeing hundreds of hedge fund managers on a regular basis is important; yet on the other, they postulate that FoHF managers do not add value. Who else is in the position of doing the due diligence other than experienced and prudent investment professionals, who are in the loop of information flow? The industry itself is opaque, ie, information does not flow efficiently and so scarce resources must be expended to find and analyse the information. We doubt that the information advantage of a top-quartile FoHFs manager, over a less informed investor, will deteriorate."

FoHFs Here to Stay

The list of investors who utilise FoHFs continues to grow; currently including pension funds, foundations and endowments, charitable organisations, insurance companies and government entities. According to data provided by Hedge Fund Research, hedge fund industry assets in 2000 were estimated at US\$490 billion and FoHFs managed around 17% of this amount.

Today the industry is estimated at US\$1.8 trillion and FoHFs represent 43% of that total. This trend has continued as FoHFs attracted half of the US\$45 billion in total net inflows for all hedge funds in the third quarter of 2007. Beyond the evidence of asset flows, a recent poll by Mercer Consulting of 181 institutional users around the world found that 33% already use FoHFs and another 19% intend to do so within the next two years.

Analysing the past decade, the average performance spread (defined as the difference between the HFRI HF Index and the HFRI FoF Index) has declined from 3.5% in 2000 to 2.8% in 2006. This data demonstrates that FoHFs are making profitable investment decisions to the benefit of clients as the performance spread is shrinking. As FoHFs garner an increasing percentage of the average HF's AuM, the average FoHF's return must get closer and closer to the average return for all hedge funds, before fees. This is a mathematical certainty and the implication for investors is that selecting the right FoHF, as well as the right fee structure, is critical to achieving superior returns.



The question on whether to use a FoHF product, comes down to the question of whether there is truly value added? In their working paper, "Fees on Fees in FoHFs", Stern School's Brown, William Goetzmann of the Yale School of Management and Bing Liang of the University of Massachusetts, reported that not only do FoHFs reduce the standard deviation of the monthly return by more than a third but they also significantly reduce the value at risk ie, the probabilities of potential losses in a specific time period, of hedge fund investing.

Chris Aldous of Absolute Fund Management says that, "in single hedge fund strategies there is clearly an opportunity to generate stronger returns simply because it is a more focused type of strategy. On the other hand, there is more risk involved. Furthermore, FoHFs are supposed to have a high level of expertise as well as the ability to spread large amounts of assets over a number of hedge funds, which limits risk. So in exchange for slightly lower returns, you are getting an entirely different risk profile."

Due diligence is the single most important aspect of the investment process for any hedge fund investor. Past performance is generally not the best predictor of future results. What distinguishes leading Offs from the pack is superior qualitative judgment. A top-tier FoHF team must identify skilled managers, determine which managers can generate true alpha, analyse if a manager is able to shift strategy opportunistically while avoiding style drift and perform meticulous operational and business practice due diligence. The best FoHF managers have a ubiquitous informational network, an instinct for selecting the "right" managers and a philosophy to avoid following the crowd.

Fee Structure Changes Imminent

A 2002 FoHF fee structure study by UBS stated that the most common FoHF fee structure is a management fee of 1% and an incentive fee of 10%. Hurdle rates are almost non-existent. The second most common structure was a 1% management fee and a 15% incentive fee, with a hurdle rate ranging from T-Bills to S&P 500 returns. Our industry observations indicate that the fee structures for FoHFs remain largely unchanged for the present. While FoHFs continue to grow and the performance gap declines, pressure on FoHF fees is inevitable.

We suggest that both individual and institutional investors should look for two specific characteristics for their future FoHFs investments: fee structure differentiation and strategy differentiation. While there is an almost infinite variety of structures that can be created, we favour a "simpler is better" approach.

Thus, we propose a bifurcation of the two components of traditional FoHF fee structures as follows: investor pays for oversight (a fixed percentage management fee with no incentive fee); investor pays for performance (an incentive fee with no management fee). Some variant of the two structures will most likely be adopted by many FoHFs in the future.

The choice of which structure is best for an investor will depend on the investor's expected return assumptions. We believe that the simplest fee structure is the key for investor comfort and ease in making a decision to invest in a FoHF product. Investors should also evaluate whether the strategy used by a prospective FoHF will likely lead to superior returns.

"Institutional investors are moving (away) from investing in three or four core hedge FoHFs (because of the) overlap in their underlying portfolios. Institutions are replacing one or two of these core managers with specialty niche managers in order to diversify and improve performance." Boutique FoHFs avoid following the crowd and seek out differentiated investment strategies.

One such strategy is to invest in funds whose returns are not strongly correlated. Another differentiated strategy is to select funds early on, when they are able to be more flexible in their investment decisions. Boutique shops are also willing to explore creative fee structures.

Increasing numbers of investors are gravitating toward FoHFs because of their professional oversight, initial and ongoing due diligence and the potential for attractive risk adjusted net returns, compared to investing in single strategy hedge funds directly.

However, as FoHFs continue to control a larger share of HF dollars, the performance gap is narrowing. In this environment, it is logical to expect that tomorrow's FoHF investor will gravitate towards a new breed of



FoHFs, where the fee structure relates to the value added. In selecting a FoHF, investors should take into account their objectives and risk tolerance and seek FoHFs that have differentiated investment criteria and fee structures along with top-tier operational due diligence and manager selection.

Bradley Balter is a portfolio manager and a managing partner at Balter Capital Management. Prior to founding Balter Capital Management, Balter was a managing director in the institutional investor group at Citigroup, where he was responsible for hedge fund relationships including support of fund formation, capital seeding, prime brokerage and research requirements.

This article first appeared in www.finalternatives.com on 15 August 2008.