



Alternative Investment
Management Association



HELPING TRUSTEES NAVIGATE
THE HEDGE FUND SECTOR

PAPER 1: The way ahead

By AIMA and the CAIA Association



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Introduction

Hedge funds have become part of the mainstream. Approximately one in every four dollars¹ managed by hedge funds today are invested by public and private sector pension funds. This means that hedge funds are managing more than \$700 billion on behalf of pension funds. For institutional investors as a whole, that figure rises to roughly three in every four dollars managed by hedge funds – over \$2 trillion.

The change in investor demographic reflects a gradual shift in sentiment towards hedge funds over the course of the last 10-20 years. Just as stocks and shares were once considered too “risky” for pension funds and other institutional investors, so investing in hedge funds used to be thought of as a highly speculative pursuit for all but the wealthiest, and least risk-averse, in society. Hedge fund products have evolved however, the industry has matured, and gradually, almost imperceptibly, investor attitudes towards hedge funds have changed. Today, many hedge funds are legitimately known for their risk-management, not their riskiness. A recent institutional investor survey asked what impact a withdrawal from hedge funds would have on their portfolio; 80% responded that such an occurrence would increase, not decrease, their exposure to risk.²

Significant inflows from pension plans and other investors during 2014 have pushed the assets managed by the global hedge fund industry to record high levels. Investors are looking for a variety of benefits when they choose to allocate to hedge funds including downside protection and diversification. Such has been the change that has taken place that versions of certain hedge fund products are now being developed for retail investors. As the hedge fund industry has become institutionalised, hedge funds have become more open and transparent and less complex and opaque.

It has not been a story of unbroken growth or success. 2008 stands out as being the industry’s most challenging year to date. Performance losses exceeded \$300 billion. During the fourth quarter alone, more than 750 hedge funds were liquidated and investors withdrew more than \$150 billion,

¹ Source: Preqin

² Source: Preqin

according to Hedge Fund Research. As markets seized up, some hedge funds imposed significant restrictions on investor withdrawals.

Since 2008, discussions have continued to persist about the pace of progress on issues like portfolio transparency, fund governance, fee levels and other issues. Many pension fund trustees and fiduciaries at institutional investors have begun to ask questions about their existing or prospective hedge fund allocations. Rarely has there been such demand for a realistic assessment of the benefits – and also the risks – associated with hedge fund investing.

With that in mind, the Alternative Investment Management Association (AIMA), the global hedge fund industry body, and the Chartered Alternative Investment Analyst (CAIA) Association, the global leader in alternative investment education, have launched a new initiative in which we will seek to help trustees and other fiduciaries better understand, and manage, these risks and opportunities.

In this, the first of a series of papers that we will publish about hedge funds, we will set out the main benefits and challenges associated with investing in hedge funds. We will discuss the significant investment discretion and latitude typically granted to hedge fund managers, and how this can be both an advantage and a challenge to investors. We will show how much investors have earned from hedge funds and will discuss performance, risk, volatility and other factors related to hedge fund investments. At the same time, we will give practical guidance about how investors have managed issues and risks involved with investing in hedge funds.

CAIA and AIMA have a proud shared history. AIMA is committed to developing industry skills and education standards and is a co-founder of the CAIA designation, the industry's only specialised educational standard for alternative investment specialists. Established in 2002, the CAIA Association's mission has been and remains to promote excellence in alternative investment education in a global arena. The alternatives

market continues to grow at a rapid pace intensifying the need for a broad and content-rich curriculum. With the creation of the Fundamentals of Alternative Investments Certificate, CAIA programs, including the CAIA Charter designation, ensure financial professionals at all levels stay current and relevant.

Our organisations believe that as the landscape for hedge funds and other alternative investments has changed in recent years, it has become vital that those professionals charged with managing, analysing, distributing, and regulating these products keep pace with a focus that has knowledge and education as its central tenet. This is particularly true of trustees and other non-investment professionals who perform a fiduciary role at institutions. They are the primary audience for this series of papers.

Special thanks are due to AIMA's Investor Steering Committee for its support in the production of this series of papers. We hope that these publications will help to improve understanding of hedge funds, provide practical guidance on issues to consider, and ultimately be considered a trusted source for trustees and other fiduciaries wishing to learn more about this important area of finance.



Jack Inglis, CEO,
AIMA



William Kelly, CEO,
CAIA Association

Executive summary



Most hedge fund investors are pension funds and other institutional investors.

Approximately one in every four dollars managed by hedge funds worldwide is invested by public and private sector pension funds, while roughly three out of every four dollars invested in hedge funds come from institutional investors worldwide. In the UK, over half of all defined benefit (final salary) pension schemes allocate to hedge funds or other alpha-seeking strategies.



Investors' earnings from hedge funds top \$1.5 trillion in the last decade.

According to new research commissioned for this paper from Hedge Fund Research Inc, investors have earned about \$1.5 trillion from hedge funds, after all fees have been deducted, over the last 10 years. That is despite the performance losses of \$306 billion in 2008, by far the industry's worst year.



Pension funds would often rather have steadier returns with lower volatility than a higher return with greater volatility.

This is why risk-adjusted returns are often as highly valued as the headline figures. Moreover, the hedge fund industry's risk-adjusted returns are competitive with traditional asset classes such as stocks and bonds partly because those returns tend to be less volatile – meaning they are generally steadier and more consistent over time.



Hedge funds are designed to provide greater protection against the large drawdowns or peak-to-trough losses that the main asset classes sometimes experience.

Hedge funds (as measured by the performance of the HFRI composite index) experienced a maximum drawdown in the last 10 years of only 21.4% (between November 2007 and February 2009). Only bonds experienced a smaller drawdown (10%) in this 10-year period, while real estate suffered a drawdown of 35%, the S&P 500 a 57% drawdown and commodities a 54% drawdown.



The challenge of finding the right fund or funds is one of the reasons that the hedge fund due diligence process is deeper and longer-lasting than it has ever been.

The most commonly used method for tackling due diligence and manager selection challenges is to outsource at least part of these processes to a specialist third party – either a fund of hedge funds manager (FoF) or a hedge fund consultant.



Hedge fund strategies can seem complex or difficult to understand.

But changes in regulations since the financial crisis and the growing influence of institutional investors has improved transparency and public openness. In addition, the on-going “institutionalisation” of the hedge fund industry has resulted in the level of portfolio transparency provided by the fund manager to the investor being higher than in the past.



Reputational or headline risk is increasingly at the forefront of trustees’ considerations when evaluating any investment program.

In recent years, some hedge fund managers have been charged with insider trading and theft of client assets. Such publicity can be worrying for an investor but is certainly not representative of the global hedge fund industry. Recent regulation and adherence to industry sound practices have considerably strengthened investor protection and provided for greater transparency. Carrying out thorough operational due diligence (including background checks) will greatly mitigate headline risks. Finally, structuring investments in a particular manner can reduce investor exposure to operational risks associated with hedge funds to levels below those faced in retail fund products.



The fact that hedge funds charge higher fees than long-only managers or mutual funds means there will always be a debate as to whether hedge funds offer value for money.

It is more costly to manage investment portfolios in an active manner, especially if sophisticated and flexible strategies seeking absolute returns are

employed. Investors in hedge funds should always consider whether the quality of potential or actual returns is worth the fees. Tools such as hurdle rates and high watermarks assist in properly aligning manager incentives aimed at obtaining and rewarding performance.



Hedge funds are commonly (but erroneously) referred to as an asset class in their own right.

Instead, investing in hedge funds is a method for accessing particular asset classes, and many hedge fund strategies trade across multiple asset classes such as stocks, commodities, fixed income and foreign exchange. As investors become more knowledgeable of the hedge fund industry and their role in today’s investment portfolios, they are deploying hedge fund strategies to act as a buffer or as a risk mitigation tool.



For an institution investing in hedge funds, issues around capacity and scale can be significant headwinds to any proposed allocation.

Some investors may allocate small amounts to a large number of managers, while another approach is to secure capacity with managers early on in their investment lifecycle. As the hedge fund industry grows assets to \$3 trillion and beyond, investors should include discussions of capacity and scalability with their managers in order to determine whether the assets under management in any strategy or market sector are too large to predictably earn alpha, especially in smaller investment markets, such as small capitalisation emerging markets stocks.



Managers of hedge funds have a set of tools at their disposal – including lock-ups, gates and side pockets – to prohibit or restrict withdrawals.

These are often designed to ensure that investment strategies are capable of being carried out as intended. Certain restrictions are designed to avoid mismatches between liquidity offered to investors and that of the underlying assets in the fund. Others exist to allow managers to withstand periods of significant market stress. It is vital for investors to understand the methods that may be used and their implications.

1 Who invests in hedge funds and how much have they earned?



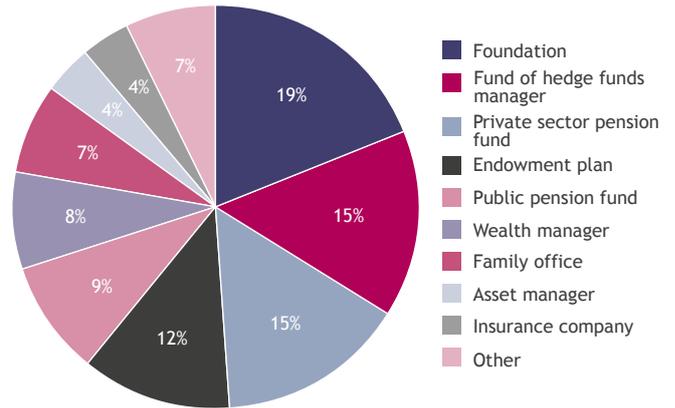
Hedge fund investor demographic

Today, pension funds, endowments, sovereign wealth funds, insurance companies and charities are the source of the majority of capital managed by the hedge fund industry today.

Approximately one in every four dollars³ managed by hedge funds worldwide is invested by public and private sector pension funds. Foundations and endowments also continue to remain significant sources of investment into hedge funds. We estimate that three out of every four dollars invested in hedge funds come from institutional investors worldwide. In the UK, over half of defined benefit (DB) schemes in the UK allocate to hedge funds or other alpha-seeking strategies.⁴

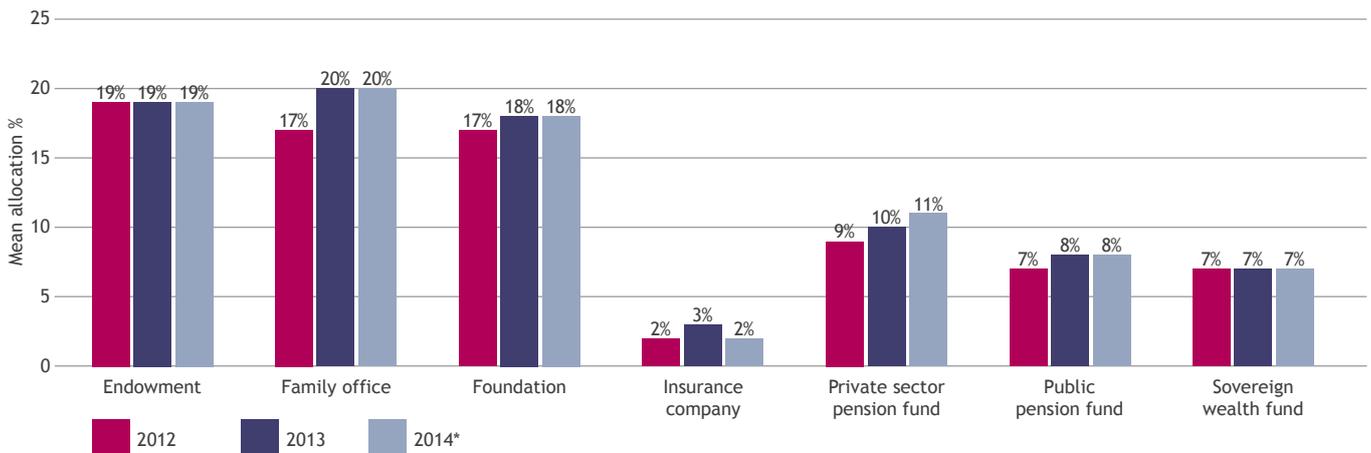
The changed investor demographic – from private individuals to predominantly institutional base – has had far-reaching implications for the hedge fund industry. Increased demands for transparency, whether during the initial due diligence process or as an on-going feature of being an investor in the fund, have meant that hedge fund management firms have had to invest significantly in systems, technology and people. Increased regulation since the 2008 financial crisis has also had a significant impact on the industry and its infrastructure. In short, the process of “institutionalisation” has been a game-changer for the industry.

Figure 1: Breakdown of investors in hedge funds by investor type



Source: Preqin

Figure 2: Mean allocation to hedge funds by investor type, 2011 – 2014*



Source: Preqin

³ Source: Preqin

⁴ Aberdeen Asset Management research, 2014.

How much have investors earned from hedge funds?

According to new research commissioned for this paper from Hedge Fund Research Inc, investors have earned about \$1.5 trillion from hedge funds, *after all fees have been deducted, over the last 10 years.*⁵ That is despite the performance losses of \$306 billion in 2008, by far the industry’s worst year.

However, those 2008 losses wiped out “only” approximately the previous 18 months of gains – for the 2006-2008 period, hedge funds still returned a net \$136 billion to their investors. The new data also shows that the industry’s post-crisis growth can be attributed to performance gains far more than capital-raising or so-called “asset-gathering”.

Table 1: Annual earnings by hedge fund investors

Year	Net asset flows (\$bn)	Performance-based AUM change (\$bn)
2005	\$46.9	\$85.9
2006	\$126.5	\$232.7
2007	\$194.5	\$209.4
2008	(\$154.5)	(\$306.9)
2009	(\$131.2)	\$324.2
2010	\$55.5	\$261.8
2011	\$70.6	\$20.1
2012	\$34.4	\$209.9
2013	\$63.7	\$312.2
2014	\$76.4	\$140.3
Total change since 2005	\$382.9	\$1,489.5

Source: Hedge Fund Research

Note

The estimates contained in the above table and this report are based upon the Hedge Fund Research Database, which tracks the hedge fund industry (including funds of hedge funds). The majority of fund information in the Database is distributed to Hedge Fund Research subscribers, with permission of the fund managers. Funds that decline to be included in the distributed hedge fund database are tracked internally by Hedge Fund Research. Asset size and performance for a subset of internally-tracked funds are determined by internal company estimates and a variety of other sources. In order to arrive at the total assets and asset flows by strategy, Hedge Fund Research uses total assets from all funds contained in the Hedge Fund Research Database as well as all funds tracked internally. Funds of funds are not included in the overall Industry estimates to avoid double-counting.

Funds in the Hedge Fund Research Database submit assets under management consistent with conventional reporting methods which specify investor capital under management, net performance fees.

⁵ January 2005 – Q3 2014. Source: Hedge Fund Research.

2 Why do investors allocate to hedge funds?

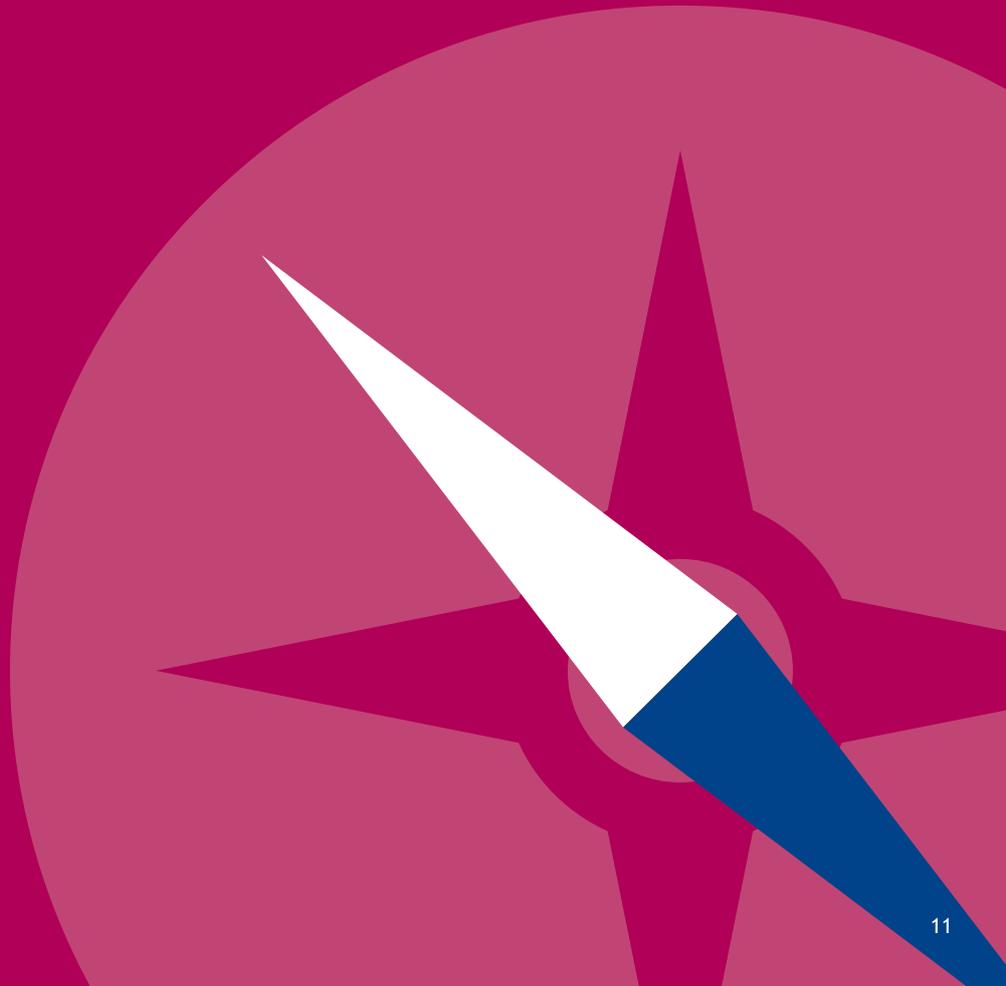
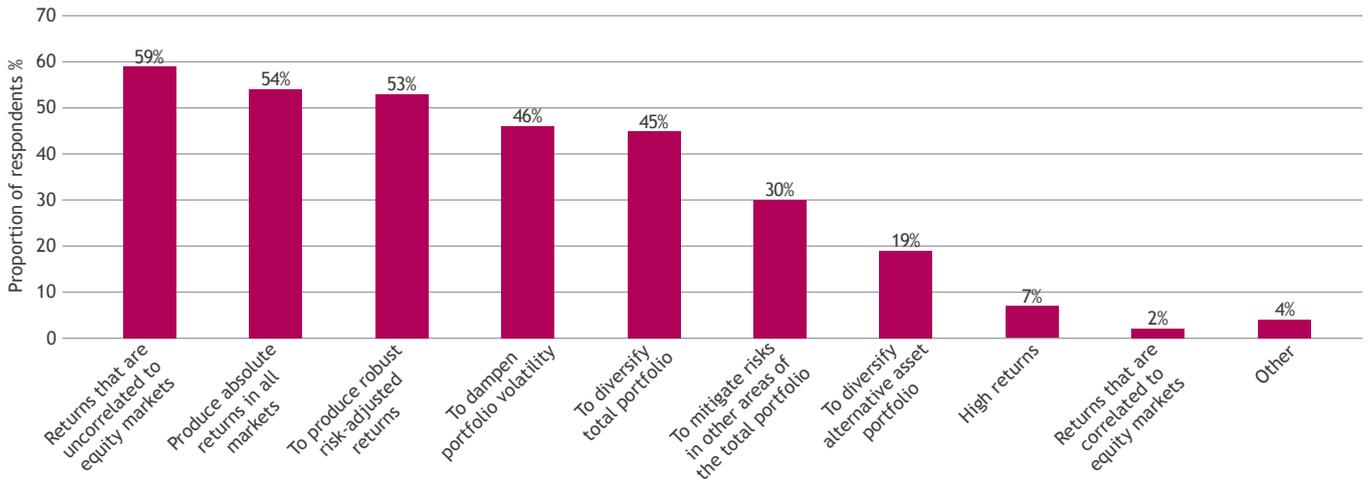


Figure 3: Key objectives of institutional investors from their hedge fund portfolios



Source: Preqin

Risk-adjusted returns

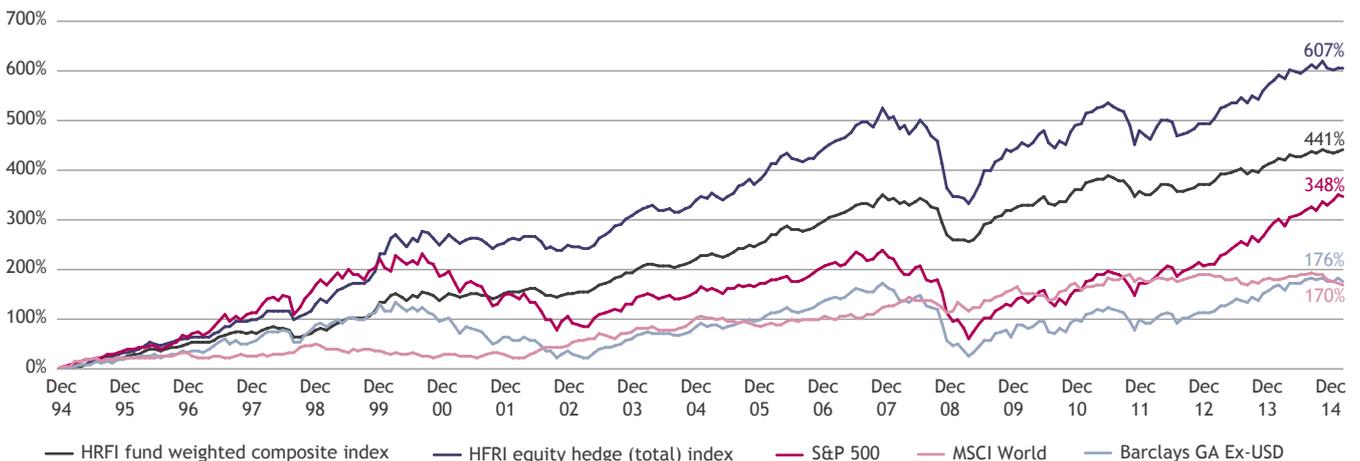
Hedge funds have outperformed the traditional asset classes over the last 20 years as figure 4 shows.

However, many investors do not only look at such headline return figures. They often also look at the risk adjusted returns – a way of measuring the value of the return in terms of the degree of risk taken. Investors such as pension funds would often rather have steadier returns with lower volatility than a higher return with greater volatility because of the risk of potential loss that higher volatility brings (as in 2008 when equity markets witnessed an almost unprecedented collapse).

The table below shows that hedge funds outperformed equities and bonds on a risk-adjusted basis (as represented by the Sharpe ratio) over the last 10 years, and also on a 20-year basis. This return was achieved despite the scale of the post-financial crisis equity bull market. Over the shorter time frame of five years, hedge funds outperformed global equities and bonds on a risk-adjusted basis.

Risk-adjusted returns are calculated by using the volatility of the returns using standard deviation, which considers the scale of fluctuation in a particular period of time. In effect, the lower the value of standard deviation, the lower the volatility. Standard deviation is a key metric for investors seeking smoother and more stable returns over the long term.

Figure 4: Hedge funds versus main asset class cumulative returns: Jan 1995 – Dec 2014



Source: AIMA research, Hedge Fund Research Inc, S&P, MSCI, Barclays

Table 2: Comparison of both annualised ‘headline’ returns and risk-adjusted returns for hedge funds as a whole, equity hedge funds, bonds and equities, for various periods to 2014.

Index	5 year			10 year			20 year		
	Annualised return	Annualised standard deviation	Sharpe ratio*	Annualised return	Annualised standard deviation	Sharpe ratio*	Annualised return	Annualised standard deviation	Sharpe ratio*
HFRI fund weighted composite	4.66%	5.19%	0.63	5.17%	6.33%	0.29	8.81%	6.96%	0.55
HFRI equity hedge (total)	4.90%	7.55%	0.46	4.71%	8.66%	0.16	10.27%	2.65%	0.58
S&P 500	13.05%	13.01%	0.89	5.44%	14.67%	0.14	7.79%	15.13%	0.19
MSCI World	7.91%	14.35%	0.45	3.87%	16.41%	0.03	5.21%	15.46%	0.02
Barclays Global Aggregate ex-USD	1.38%	7.19%	0.00	2.81%	8.05%	-0.07	5.08%	8.22%	0.02

* Sharpe Ratio calculations assume an annual risk free rate of 1.41%, 3.33% and 4.95% over the 5, 10 and 20-year periods respectively. The risk free rate is calculated as the average rate of a US treasury security during the relevant period for a security of the same maturity as the period in question (eg. for the 5 year period, the risk free rate is the average rate of a 5 year treasury note over the Jan 2010 – Dec 2014 period).

Source: AIMA research, Hedge Fund Research Inc, S&P, MSCI, Barclays

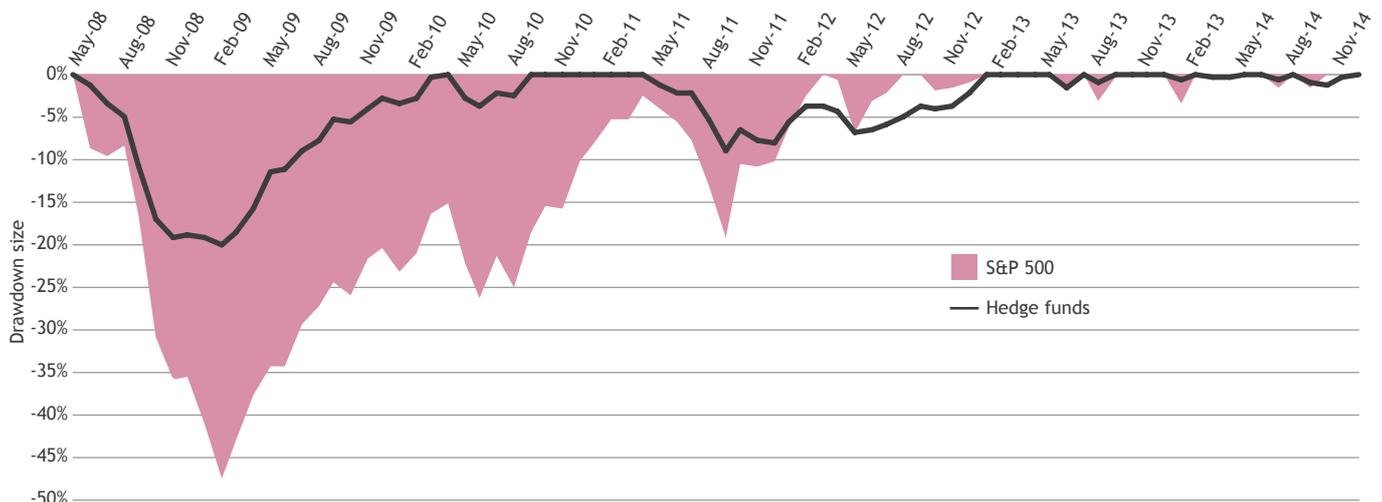
Downside protection

Hedge funds are designed to provide greater protection against the large drawdowns or peak-to-trough losses that the main asset classes sometimes experience. Hedge funds (as measured by the performance of the HFRI composite index) outperformed the main standalone asset classes over the 10 years to the end of 2014 with a cumulative return of 74% in the period. This return was accomplished with a maximum drawdown of only 21.4% (between November 2007 and February 2009). Only bonds experienced a smaller drawdown (10%) in this 10-year period than hedge funds. In comparison, real estate suffered a

drawdown of 35%, the S&P 500 experienced a 57% drawdown while commodities saw a 54% drawdown.

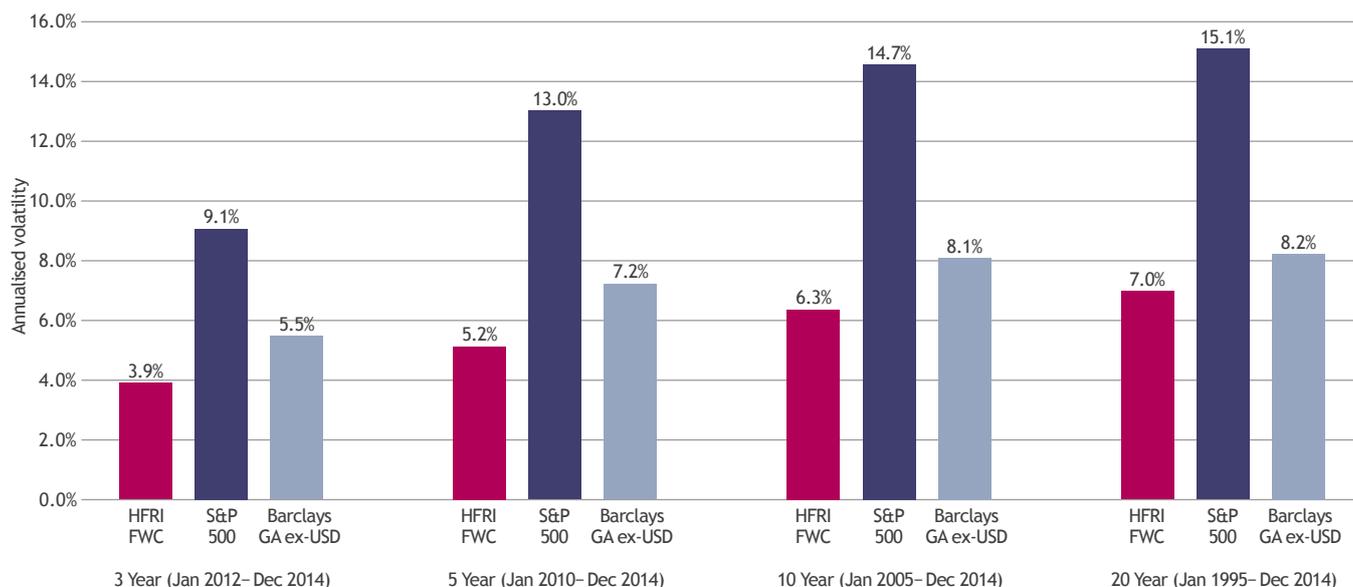
Many hedge funds are equipped to manage risk through hedged portfolio management and having a greater ability to go both long and short in markets that are expected to continue to be volatile. The best hedge fund managers can maximise risk-adjusted returns and make this an integral part of their investment plan. Given the current environment of historically low interest rates, the use of hedge funds can help mitigate some risks if and when interest rates start to increase.

Figure 5: Drawdowns of hedge funds vs. S&P 500, May 2008 – December 2014



Source: AIMA

Figure 6: Comparison of annualised volatility of hedge funds, S&P 500 and global bonds



Source: AIMA research

Low volatility

Hedge funds’ risk-adjusted returns are competitive with traditional asset classes such as stocks and bonds partly because those returns tend to be less volatile – meaning they are generally steadier and more consistent over time – as the chart above shows.

Flexible investment strategy

Hedge funds usually have a flexible investment strategy/mandate. Depending on the strategy, they may apply leverage, invest in private securities, invest in real assets, actively trade derivative instruments, establish short positions, invest in structured products, and hold relatively concentrated positions.

Hedge funds can move rapidly when opportunities appear. This dynamic asset allocation capability helps them to improve market timing – buying and selling assets at more opportune moments.

An investor that is allocated to a number of hedge funds can tactically adjust its strategy allocations to help navigate and take advantage of investment opportunities as they arise. A diversified portfolio of hedge funds can also help to protect the downside.

Hedge fund strategies are sometimes considered opportunistic. This involves identifying investment opportunities that may only exist for a short period of time, and that may involve taking a sizeable position. Traditional investment managers such as mutual funds, by contrast, tend to hold longer-term positions and generally prefer to spread their exposure across a market.

Additionally given the flexibility of the hedge fund structure, hedge fund firms can develop customised products for their investors. For example, a pension plan may request that a hedge fund manager hold securities only in a specific market sector or request a reduction or increase in the level of leverage.

Hedge fund managers often aim to add value by specialising in a sector or market strategy. These managers seek to contribute above-market returns through the application of skill or knowledge of a narrow market or underlying strategy.

Low correlation

Since hedge funds are broad and varied in nature, hedge fund investments tend to exhibit a low correlation to other more traditional investments in the portfolio. The correlation between hedge funds and traditional markets has been thoroughly assessed in academic research with a broad

consensus that the insertion of hedge funds in a diversified investment portfolio (of equities and bonds) could significantly improve its risk-return profile.⁶

Customised tools

Institutional investors increasingly are moving away from the traditional 60% equities and 40% bonds portfolio structure, and using alternatives in general, and hedge funds in particular, as tools to customise their portfolios.⁷ Many investors allocate to hedge funds to help them meet their individual portfolio objectives in terms of risk-adjusted returns, diversification, lower correlations, lower volatility and downside protection. Hedge funds are also often regarded by investors as a means to access opportunities and tailor portfolios.

Diversification

Hedge funds deliver risk-adjusted performance that provides investors with diversification benefits, even during difficult

macro-economic environments – for example, the performance of some hedge fund strategies (notably CTAs and macro funds) can be counter-cyclical in nature. Institutional investors continue to allocate to hedge funds because the logic of a broadly diversified allocation still holds over time. To maximise diversification potential, investors will consider the correlation of returns of an individual hedge fund to their stock and bond holdings including during times of market crises.

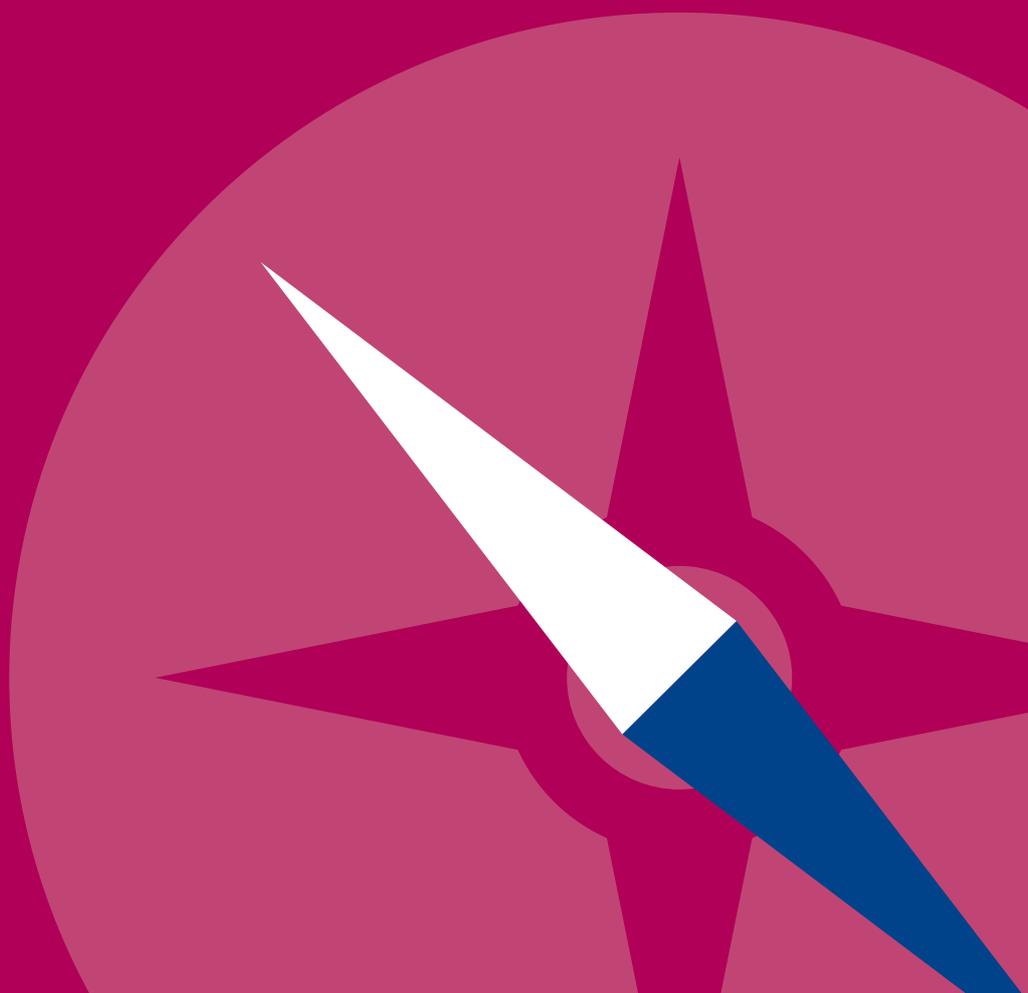
New opportunities

Hedge funds produce co-investment opportunities for investors by exploiting capital supply imbalances brought about by the post-crisis deleveraging of the financial system (in particular the impact being felt within the European banking sector). As traditional lenders and the proprietary trading desks of banks reduce their market participation in response to changing regulatory rules, there are fewer lending participants across many different capital markets. This may mean less efficient markets and better opportunities to outperform, with hedge funds well placed to take advantage.

⁶ Evidence of superior performance persistence in hedge funds, an empirical comment, by T Schneeweis *Journal of Alternative Investments*. Vol.1 No. 2: 76-80

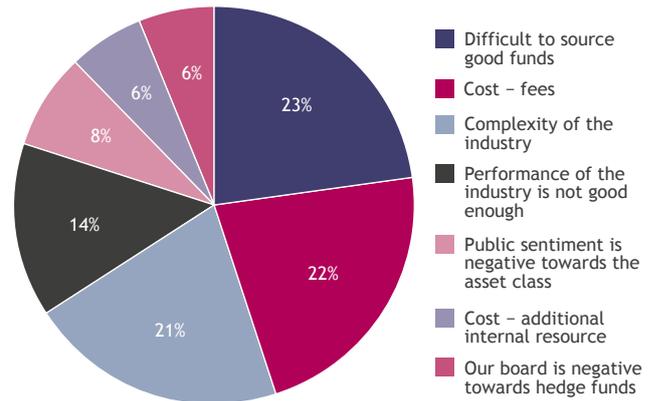
⁷ See 'Beyond 60/40: The evolving role of hedge funds in institutional investor portfolios', AIMA, May 2013. <http://www.aima.org/download.cfm/docid/77A589A0-3BEA-4559-B0F0EE38CF21B1CF>

3 Key considerations when investing in hedge funds



There are many issues to consider before implementing a hedge fund program. This section of the paper will discuss some of these issues and will offer practical guidance on methods that many investors use to overcome or mitigate those issues.

Figure 7: Single largest impediment to investing in hedge funds



Source: Preqin



Difficulty in sourcing the best hedge funds

Arguably the most important strategy for success when allocating to hedge funds is the identification and evaluation of the appropriate hedge fund(s) for the portfolio. This is not only about accessing those funds with the best historic performance. It is also about understanding the objectives of a hedge fund investment and finding the funds that best fit the investor’s goals and constraints.

The challenge of finding the right fund or funds is one of the reasons that the hedge fund due diligence process is deeper and longer-lasting than it has ever been. Given the breadth of the industry, it is likely that some investors seek broad exposure while others might wish to specialise in a certain investment strategy. Ultimately, investors’ objectives vary, which is why it is necessary to consider how different funds and strategies provide varying characteristics, benefits and risk and reward profiles.

Key considerations

Not all pension plans or other investors have the internal resources or experience to make the best informed decision about which fund(s) are most appropriate to meet their risk and return requirements. Scale can also play a part – some plans may be concerned that their mandates may be too large for certain smaller funds. Then there is the fact that some of the most established and successful hedge funds have reached their capacity and no longer accept new investors.

The most commonly used method for tackling due diligence and manager selection challenges is to outsource at least part of these processes to a specialist third party – either a fund of hedge funds manager (FoF) or a hedge fund consultant.

Both of these parties provide a variety of investment support ranging from manager sourcing and selection, portfolio construction, investment due diligence, operational due diligence, fee negotiations, structuring, and ongoing monitoring/reporting. These services add an extra layer of fees, but they provide additional benefits in the form of expediency, knowledge transfer, and scalability around the hedge fund product.

The case for using a consultant or FoF is often strongest among smaller institutions that do not have the internal investment staff to properly manage a portfolio of hedge funds. Many larger institutions also find it practical to start with a consultant or FoF, before eventually graduating to a programme of investing directly in a hedge fund. Indeed, many investors continue to employ the services of a consultant or FoF long after their initial allocation, mostly in an advisory capacity.



Complexity and opacity

Consider a long-only mutual fund, which in general invests only in stocks or bonds, and buys and sells those securities relatively infrequently (it is said to have a low turnover). Hedge funds, in contrast, have the ability to vary market exposure, invest in a variety of derivative securities and short positions, and may trade more or less frequently. Indeed, certain strategies exhibit longer holding periods than traditional asset managers. To many people, hedge fund strategies can seem complex or difficult to understand. Hedge funds' hesitancy to speak openly about their businesses was often based on regulatory reasons – funds were not at liberty to publicly discuss details related to their funds or strategies due to the prohibitions on general solicitation and advertising they were subject to. At other times, given the proprietary nature of their investment ideas, managers were reluctant to share core information for fear of that information spreading into the market and potentially hurting investor returns.

Hedge fund managers are not legally required to disclose trading positions with investors. Without adequate disclosure, it can be difficult for investors to understand their risk exposures, whether the manager is skilled and has appropriate risk controls.

Key considerations

Changes in regulations and the growing influence of institutional investors since the financial crisis has improved transparency and public openness. In the US, the Dodd-Frank Act requires most advisers to hedge funds to register with the Securities and Exchange Commission, resulting in the public reporting of the basic operations of the fund and any conflicts of interest that it might have. The JOBS Act in the US has also created the potential for managers to be more ambitious in terms of their engagement with investors and the public.

In Europe, the recently introduced Alternative Investment Fund Managers Directive is also increasing transparency. Funds under its scope must report their hedge fund positions on either a quarterly or annual basis to their investors and as well as their national regulator.

In addition, the on-going “institutionalisation” of the hedge fund industry has resulted in the level of portfolio transparency provided by the fund manager to the investor being higher than in the past.

Investors are increasingly asking for (and receiving) greater transparency and control of their portfolio, and are turning to managed accounts to do so. The characteristics of a managed account structure differs from direct investments in several key respects, offering improved liquidity, transparency and investor control. They also allow clients (investors) to segregate their investments in vehicles separate from the manager's main hedge fund, meaning investors retain control over their assets, usually with the ability to redeem much more frequently than the main fund.⁸

Of course while increased levels of transparency being provided by hedge funds is to be welcomed, there are often good reasons for hedge funds not to reveal some of the individual positions they hold. This is the manager's IP, its proprietary trading strategy, and some level of confidentiality would be expected. Sensitivities about disclosure are likely to vary depending on the strategy of the fund.

Furthermore, not all fund data that investors are receiving is considered useful or relevant to them. Being able to make effective use of what may amount to “information overload” from the surplus of data being provided is certainly something that needs to be considered in terms of what investors can realistically do with the increased level of transparency that is sometimes on offer to them.

Using professional risk aggregating and reporting platforms, or working with a fund of hedge funds can help investors to better understand and aggregate their risk exposures across their diverse hedge fund portfolios as well as manage complexity.

⁸ To read more about managed accounts, please refer to pages 92-94 of AIMA's Roadmap to hedge funds, 2012 edition; <http://www.aima.org/en/education/aimas-roadmap-to-hedge-funds.cfm>



Reputational risk

Reputational or headline risk is increasingly at the forefront of trustees' considerations when evaluating any investment program. In recent years, some hedge fund managers have been charged with insider trading and theft of client assets. Such publicity can be worrying for an investor – but is certainly not representative of the global hedge fund industry.

Key considerations

Recent regulation and adherence to industry sound practices have considerably strengthened investor protection and provided for greater transparency.

Hedge funds must be authorised and supervised in all major financial jurisdictions, including the UK and Europe. They are subject to strict operational standards and organisational requirements such as conflicts of interest and conduct rules, protection of client assets as well as prudential regulations on liquidity and risk management.

Carrying out thorough operational due diligence (including background checks) will greatly mitigate headline risks. Furthermore, structuring investments in a particular manner can reduce investor exposure to operational risks associated with hedge funds to levels below those faced in retail fund products.

Investing via such a managed account structure greatly mitigates the fund's operational risk since the investor controls the cash and assets and the valuation of the portfolio.⁹

In addition, partnering with consultants or FoFs who have invested with the manager for a long time can provide further reassurance.

More broadly, the industry continues to make efforts to foster greater understanding and acceptance of certain hedge fund strategies and activities which can attract additional scrutiny, including short-selling, activism and distressed debt investing.

⁹ To understand more about managed accounts, please refer to page 92 of AIMA's Roadmap to hedge funds 2012 edition at <http://www.aima.org/en/education/aimas-roadmap-to-hedge-funds.cfm>



The fact that hedge funds charge higher fees than long-only managers or mutual funds means there will always be a debate as to whether hedge funds offer value for money.

Hedge fund management firms typically charge their investors both a management fee and a performance fee. Management fees are calculated as a percentage of the fund's total net asset value and typically range from 1% to 2% per annum. Management fees are charged to cover the operating costs of the manager, and are usually paid monthly or quarterly (on a pro-rata basis).

There is little doubt that the cost of running a hedge fund has increased since the financial crisis, as management firms invest in people and technology to enable them to comply with new regulatory requirements and increased regulatory demands. Many hedge fund managers – particularly those managing smaller sums (i.e. less than \$1 billion) – argue that an annual management fee of approximately 2% of the fund's total assets is necessary in order to allow it to continue to operate and remain competitive.

Many investors have argued that hedge fund management fees ought to decline as managers grow to a point where they are better able to benefit from economies of scale. While some managers do offer reductions as they expand, they often point out that skill-based returns (known as alpha) are scarce and require significant on-going investments in staff, data and infrastructure. The management fee can be critical in sustaining a firm since, unlike the performance fee, it is charged each year regardless of performance.

There are various forms of protection for investors regarding performance fees being charged by hedge fund managers. Most hedge funds have what is called a high watermark and, in some cases, a hurdle rate. The basic premise of the high watermark is that if the fund drops in value, investors do not pay the performance fee again until the fund's value reaches its previous peak value. Similarly, a hurdle rate (sometimes called a preferred return or benchmark) means the fund is not allowed to charge a performance fee until a certain minimum return is achieved.

Key considerations

Investors in hedge funds must always consider whether the quality of potential returns is worth the fees. Many investors argue they should not pay hedge fund fees in full when they only receive market-driven performance or have risk exposures that can be accessed internally at a lower cost.

Many investors are successful in securing fee reductions. The amount of room for negotiating depends on various factors including the demand/supply of a hedge fund manager, the size of the investment being made, the time for which investors are willing to 'lock-up' their investments, and the perceived "qualities" of the investor (pension plans, for example, are generally viewed by hedge funds as providing longer-term investments).

There is little doubt that fees have gradually declined since the financial crisis. Average management fees range from 1.26% to 1.62%, depending on the investment strategy of the hedge fund. Average performance fees vary from 16.04% to 19.09%.

Other arrangements and partnerships are also becoming more common. Co-investment between managers and investors has become increasingly popular, while some investors have taken equity stakes in hedge fund management firms.¹⁰

A final point to consider is that any hedge fund portfolio analysis should use returns that are net of fees. If the hedge fund's risk-adjusted net returns consistently meet the portfolio requirements, then the question of fees may be less of a concern – assuming that the quality of returns is such that they cannot be accessed or replicated cheaper elsewhere. While some investors may not be able to accept the high levels of fees charged by some hedge funds, other investors find the fee levels acceptable and appropriate if the net of fee returns satisfy the investor's return objectives.

¹⁰ To read more about these trends, and the partnership dynamic between managers and investors, see 'The Extra Mile: Partnerships between hedge funds and investors', AIMA/Barclays, June 2014. <http://www.aima.org/download.cfm/docid/C2EC4BE7-D014-49A0-8195917E4849C81D>



Asset allocation

We observe a change in the way hedge funds are being used by institutional investors. As well as regarding hedge funds as providers of diversification, many investors are also recognising that hedge funds could enable them to access expertise in specific or esoteric investment opportunities that may not be readily available to them otherwise (e.g. investing in emerging markets, distressed debt, so-called special situations and many others).¹¹ It is not always a simple task for an investor to decide where to place a hedge fund program in the overall portfolio. Hedge funds are commonly (but erroneously) referred to as an asset class in their own right; instead, investing in hedge funds is a method for accessing particular asset classes, and many hedge fund strategies trade across multiple asset classes such as stocks, commodities, fixed income and foreign exchange.

Key considerations

Some investors do not necessarily regard their allocations to hedge funds as being part of a separate “pot” within their investment portfolio. As investors become more knowledgeable of the hedge fund industry and their role in today’s investment portfolios, they are deploying hedge fund strategies to act as a buffer or as a risk mitigation tool. For example, an allocation to an equity long/short fund or systematic equity fund would be included within the equity allocation or other products that share a similar exposure to the portfolio’s equity risk to help reduce the volatility and protect the portfolio against downside risks (as referred to earlier). We will be exploring this theme further in future papers of this series.

Investors need to consider more sophisticated risk measures when investing in hedge funds, as some strategies may lose money more quickly than anticipated in crisis markets. Investors who believe that markets will exhibit increasing uncertainty and increasing dispersion should consider making allocations to strategies such as hedge funds. Of course, investors need to consider the levels of leverage employed and use sophisticated risk models that realise the asymmetric risks and returns of each of these. These topics will be addressed in further detail in the next paper of this series which explores how investors allocate to hedge funds and their rationale for doing so. The size of the allocation is also key. We are often asked what the optimum share of an overall portfolio should be invested in hedge funds. There is no easy answer as it usually depends on the investor’s objectives. For example, it is not uncommon for investors who wish to either reduce the volatility of their entire portfolio or protect the downside of a greater share of their portfolio to do this by increasing the size of the hedge fund allocation – the logic being that it may not be particularly effective to do this if, say, only 2%-5% of the entire portfolio is allocated to hedge funds.

These topics will be addressed in further detail in the next paper of this series which explores how investors allocate to hedge funds and their rationale for doing so.

¹¹ To read more about this, see ‘Beyond 60/40: The evolving role of hedge funds in institutional investor portfolios’, AIMA, 2013. <http://www.aima.org/en/document-summary/index.cfm/docid/77A589A0-3BEA-4559-B0F0EE38CF21B1CF>



Scalability

Skill-based returns (sometimes referred to as “alpha”) are not nearly as scalable as market returns (“beta”), which is why many hedge funds eventually become “closed” to new investments. What this means is that investors are prevented from investing in a particular fund.

For an institution investing in hedge funds, issues around capacity and scale can be significant headwinds to any proposed allocation. Smaller institutions have the advantage over larger institutions in this instance, since a \$5bn pension plan, for example, could easily achieve a 50% allocation to hedge funds (i.e. \$2.5bn) whereas a \$200bn pension plan would be hard pressed to achieve even a 10% allocation (i.e. \$20bn).

Key considerations

Investors consider a number of ways to tackle this issue. Although many closed hedge funds only accept allocations directly from institutions, some investors have been successful accessing closed funds via other routes. Partnering with a FoF who has access to closed funds on its particular platform is one such avenue. An institutional investor’s capital may be efficiently deployed into a portfolio of existing managers in which the FoF is already invested. This has a potential secondary benefit of producing diversification across a portfolio of managers and strategies.

Alternatively, investors may allocate small amounts to a large number of managers. However, this may not be practicable in terms of the commensurate monitoring effort that would be required.

Another approach is to secure capacity with managers early on in their investment lifecycle. This requires investing in newer managers that may not have a long track record. This approach can be a more risky proposition for those who are not adept and experienced in manager selection.

Investors must ultimately judge the capability of an individual hedge fund to earn alpha. As the hedge fund industry grows assets to \$3 trillion and beyond, investors should include discussions of capacity and scalability with their managers in order to determine whether the assets under management in any strategy or market sector are too large to predictably earn alpha, especially in smaller investment markets, such as small capitalisation emerging markets stocks.



Lock-ups, gates and side pockets

Like other investment types, hedge funds have a set of tools at their disposal to restrict or prohibit withdrawals under certain conditions. These are often designed to ensure that investment strategies are capable of being carried out as intended. Certain restrictions are designed to avoid mismatches between liquidity offered to investors and that of the underlying assets in the fund. Others exist to allow managers to withstand periods of significant market stress. They can be used by hedge funds and it is vital for investors to understand the methods that may be used and their implications.

These tools include lock-ups, gates and side pockets. Lock-ups prohibit withdrawals during a period after the initial investment is made. This period is generally between one and two years but can be longer in duration.

Gates and side pockets grew in prominence – and controversy – during the 2008 financial crisis. The liquidity that some hedge funds had been able to offer to investors under normal conditions was not available in times of severe market stress. Unable to meet a wave of redemption orders, some hedge funds imposed gates or separated illiquid or hard-to-value assets into side pockets.

While gates put a limit on investor withdrawals, they do not prohibit them altogether. The nature of the restriction imposed by a gate also varies, including restrictions on the amount that can be withdrawn as a proportion of: the investor's capital in the fund; the fund's total net asset value; or the funds held under a particular class of shares.

Side pocket arrangements segregate illiquid or hard-to-value positions from the main pool of assets in a fund until such time as they are realised or are no longer difficult to price. Side pockets can be intentionally created also as a part of an investment strategy, for example if a hedge fund manager and investors wish to pursue investment opportunities in illiquid assets. But they are most often utilised during crises, when illiquidity levels can rise.

Key considerations

Many investors have argued that the capability to use gates and side pockets, or the circumstances under which those tools would be utilised, was not made sufficiently clear in some hedge funds' articles of incorporation or other documentation prior to the financial crisis.

However, gates and side pockets are not necessarily harmful to investors. They can protect the interests of those investors who choose not to redeem, given that a fund may have been forced into a fire-sale of its assets if a run for the exit were to be allowed. Similarly, side pockets can help to ensure that assets are realised (sold) at fair value once markets have stabilised.

It is important to clarify and understand any arrangements relating to fund liquidity during the due diligence process. The AIMA Due Diligence Questionnaire (DDQ) for the Selection of Hedge Fund Managers (2014 Edition)¹² contains questions relating to the liquidity of the underlying assets in the fund's portfolio and how quickly the fund could be liquidated. The DDQ also includes questions as to whether gates and side pockets have been utilised in the past, and if so, under what circumstances.

Once an allocation is made, on-going transparency relating to redemption restrictions by the hedge fund to its investors is paramount. There should be clear documentation that defines a side pocket, and the fund should provide investors with a description of assets which have been side pocketed and the pricing at the point of being side pocketed. Some investors also believe that performance fees should only be charged to the investor once the manager has realised (sold) the asset(s) that were held within the side pocket.

Since the crisis, some hedge funds have reduced or removed the most illiquid parts of their portfolio and have begun to offer managed accounts, whereby investors have more control over liquidity, custody arrangements and other aspects of their own investments. For those strategies that are inherently illiquid, and which therefore may not lend themselves to managed accounts, some hedge funds are now offered as closed-ended or fixed-term vehicles (i.e. investors may not redeem until the end of the period).

¹² The AIMA DDQs are available to AIMA members – <http://www.aima.org/en/members/Industry-standard-ddqs.cfm>

Key takeaways for trustees and other fiduciaries

- 1 The majority of hedge fund investors today are pension funds and other institutional investors.
- 2 Hedge funds are designed to provide greater protection against the large “drawdowns” or peak-to-trough losses that the traditional asset classes sometimes experience.
- 3 By co-investing alongside their clients, hedge fund managers have skin in the game which aligns their interests and incentivises prudent risk management practices.
- 4 Hedge funds are more transparent today, offering a range of risk reporting services, and investors have greater access to managed accounts that allow for full transparency and control.
- 5 Institutional investors increasingly are using alternatives in general, and hedge funds in particular, as tools to customise their portfolios and manage specific risks.
- 6 Working with experienced and knowledgeable partners such as consultants and funds of hedge funds can assist with manager selection and help to reduce hedge fund complexity.
- 7 A variety of risks associated with hedge fund investments can be mitigated by carrying out thorough due diligence (including background checks) prior to making an allocation.
- 8 Investors must always consider whether the type and quality of hedge fund returns is consistent with the fee and understand the costs associated with sophisticated asset management.
- 9 Skill-based returns are not as scalable as market returns, which is why many hedge funds eventually “close” to new investments.
- 10 Fund redemption restrictions such as gates and side pockets and the conditions under which they can be employed should be properly understood before making investments.

Looking ahead

The second paper in our series will focus on the role of hedge funds in a portfolio and will show how different hedge fund styles have their own return distribution profiles.

Appendix

What is a hedge fund?

The original hedge funds sought to minimise risks by “hedging” their investments so that they could deliver positive returns for their investors regardless of whether the market went up or down (to use the jargon, the returns were “uncorrelated”). To this day hedge funds employ highly sophisticated risk-management techniques and continue to deliver uncorrelated returns, which is why many big institutional investors like pension funds are increasingly investing in them. In fact a majority of all investment in hedge funds now comes from institutional investors. Hedge funds employ a very diverse range of different strategies and trade a variety of asset classes, from bonds and equities to fine wine and contemporary art. Analysts have hailed the diversity of hedge funds and think they are useful to markets.

Hedge funds are now widely used by most large institutional investors. More important is that the changes demanded by institutional investors after 2008 pushed hedge funds to become more institutional in regards to the levels of improved transparency, increased frequency of reporting to investors, more detailed reporting on the portfolio and better governance. The result is that hedge funds are becoming more accessible to smaller investors, both institutional and retail. So what is a hedge fund and how do they differ from a traditional investment or mutual fund structure?

How hedge funds differ from mutual funds

Hedge funds (and private equity) represent the most visible categories of alternative investments. While it is impossible to have a precise and yet encompassing definition¹³ of a hedge fund, they differ from mutual funds¹⁴ and traditional long-only asset managers in several respects:

- Hedge funds are predominately private organised firms and generally unlisted investment vehicles that pool the capital of investors and invest in opportunities not readily available through traditional pools of investment such as mutual funds.
- Hedge funds are typically designed to be private by utilising one or more “safe harbour”¹⁵ provisions. In the United States, for example, hedge funds are specifically exempt from the disclosure requirements of the Investment Company Act of 1940 through one of two exemptions or safe harbours that are available to funds. As a result, hedge funds place various restrictions on potential investors such as a minimum investment size and being an accredited investor, which implies the investor has a certain level of investment knowledge to understand the risks associated with investing in hedge funds.
- Most hedge funds are not benchmarked to a broad securities index. One reason is that most hedge fund managers claim their style of investing is “skill based” and cannot be measured relative to a public markets index. Hedge funds tend to have narrower investment strategies, often focusing on only one or a few economic sectors. Therefore hedge funds should not be compared to a benchmark but viewed as a structure that seeks to generate absolute returns in most market environments which are purposefully not correlated to a traditional investment index. In this way, hedge funds can offer investors risk-adjusted returns unrelated to the performance of the traditional asset management universe.
- Hedge funds tend to use more derivative investments than mutual funds. This provides the opportunity to short securities and use leverage to add to or mitigate risk in its portfolio.
- Mutual funds can accept as many investors as they like, while hedge funds typically have to limit their number of investors as specified by a regulatory agency. The median hedge fund requires a minimum investment of \$500,000. In regulated European countries, the constraints are of the same order, but the minimum investments tend to be significantly lower at €125k or €250k. A new trend emerging is hedge fund managers launching mutual funds that invest in hedge fund like strategies. While mutual fund rules place limits on leverage and concentration while demanding greater liquidity and transparency than typical hedge funds, hedge fund managers may launch these structures to access opportunities from the retail investor. These liquid alternative investments can be accessed with much smaller levels of net worth and minimum investments. Liquid alternative investments will be discussed in detail in a future paper.
- Significant investment by the manager (“eat their own cooking”) is more typical in hedge funds compared to mutual funds.
- Some hedge fund strategies invest in non-public securities (securities that have been issued to investors without the support of a prospectus).
- Finally hedge funds tend to be more actively managed than traditional investment vehicles, with more complex strategies and more dynamic risk management. Since hedge funds do not track a broad market index and are not forced into holding a diversified portfolio of securities, they tend to have more concentrated portfolios compared to long-only funds that are compared to a market index. The disadvantage is that the portfolio may suffer significant losses if the portfolio’s risk is not properly managed. Risk management is by definition an active undertaking. An argument can be made that what we call active risk management is actually the opposite of traditional asset management, which is built on the premise of benchmarking, indexation, and that a passive strategy will do just fine in the long-term.¹⁶

¹³ Reference to AIMA stating that no clear definition has been pronounced for hedge funds.

¹⁴ The complete guide to hedge funds & hedge fund strategies, Capocci, page 516.

¹⁵ A safe harbour denotes an area that is explicitly protected by one set of regulations from another set of regulations.

¹⁶ AIMA Roadmap to hedge funds, 2012, pages 11- 23.



Alternative Investment
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About AIMA

The Alternative Investment Management Association (AIMA) is the global hedge fund industry association, with over 1,500 corporate members (and over 8,000 individual contacts) in over 50 countries. Members include hedge fund managers, fund of hedge funds managers, prime brokers, legal and accounting firms, investors, fund administrators and independent fund directors. AIMA's manager members manage a combined \$1.5 trillion in assets (as of March 2014). All AIMA members benefit from AIMA's active influence in policy development, its leadership in industry initiatives, including education and sound practice manuals, and its excellent reputation with regulators worldwide. AIMA is a dynamic organisation that reflects its members' interests and provides them with a vibrant global network. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists. For further information, please visit AIMA's website, www.aima.org.



About the CAIA Association

The CAIA Association, a non-profit organisation founded in 2002, is the world leader and authority in alternative investment education. The CAIA Association is best known for the CAIA Charter®, an internationally recognised credential granted upon successful completion of a rigorous two-level exam series, combined with relevant work experience. Earning the CAIA Charter is the gateway to becoming a member of the CAIA Association, a global network of over 7,000 alternative investment leaders located in 80+ countries, who have demonstrated a deep and thorough understanding of alternative investing. Having grown rapidly, the CAIA Association now supports vibrant chapters located in financial centres around the world and sponsors more than 120 educational and networking events each year. The CAIA Association also offers a continuing education program, where trustees can learn the Fundamentals of Alternative Investments in a 20 hour, video-based program. For more information, please visit CAIA.org.



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