Funds of Funds and the “Either/Or” Fallacy

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Editor’s Note: The information below applies to both taxable and tax-exempt accounts.

Some investors consider funds of hedge funds (FoHFs) and multi-strategy hedge funds (multi-strats) mutually exclusive options. Yet FoHFs themselves often invest in multi-strats, a fact that suggests the two types of vehicles are complementary rather than adversary. FoHFs and multi-strats are like shopping malls and department stores. Both formats offer variety, but a mall may operate with or without a department store tenant. The success of one format does not impugn the appeal of the other.

Then again, if you were a village planner and could pick only one retail format, the mall might be the better choice. A mall typically offers several advantages over a single store even if that one store is, say, Target or Sears. Malls typically 1) offer a broader range of merchandise; 2) have better selection within the categories offered (because specialty stores are usually deeper than specialty departments); 3) can more easily replace formats that lose their appeal; 4) can more easily introduce attractive new formats; 5) can more readily adjust capacity to respond to traffic; and 6) depend less on a single management.

Each of these advantages finds a parallel with an advantage typically offered by FoHFs over multi-strategy hedge funds. I examine each parallel advantage below, but none of this discussion is an indictment of multi-strategy funds as a class. Multi-strats have their place.

Broader array of strategies. A well-diversified multi-strategy fund might invest in five strategies. Convertible arbitrage and event-driven strategies (such as risk arbitrage and distressed) often are core elements, but equity long-short strategies of various sorts frequently are components of multi-strats, too. These strategies collectively make up a large portion of the hedge fund universe. Omitted from the collection, however, are important diversifiers such as managed futures, fixed income arbitrage, and emerging market hedge funds. Some multi-strats do use these strategies, but the multi-strats that use all of the components listed are rare. The want of managed futures in multi-strategy funds is especially limiting considering the extremely low or negative historical correlation between commodity trading advisors and other hedge fund strategies. Many funds of funds, on the other hand, routinely provide exposure to all of these.

An investor choosing between a single FoHF and a single multi-strategy fund should, therefore, choose a high quality version of the former to get broader alternatives exposure. Many investors, however, have pre-existing allocations to alternatives. Some FoHF families allow the investor to select among strategy components so that exposures can be tailored to complement existing exposures.

Better selection within strategies. The best convertible arbitrage hedge fund, for example, is bound to be better run than the best convertible arbitrage desk in a multi-strategy firm. The best single strategy funds will of necessity have greater commitment to the area of expertise than the multi-strat, will often draw on broader and deeper talent, and will have had longer experience in the specialty area. A FoHF, of course, can hire the specialist while the multi-strat has what it has in-house. What’s more, a FoHF may well employ more than one manager in a category to capture various sources of strategy return. Equity market-neutral strategies, for example, embrace many noncorrelated approaches. Some of these strategies are industry specialized, some are broadly fundamental, some are based on quantitative systems. A multi-strat that employs an equity market-neutral component is unlikely to employ more than one of these. A fund of funds might well use five equity market-neutral funds, each with a different approach, to provide diversification and capacity. Similar arguments might be made about the range of fixed income arbitrage strategies (encompassing mortgage-backed securities, basis arbitrage, corporate credit arbitrage, etc.), risk arbitrage (in which regional expertise often provides diversification benefits), and other strategies. Multi-strategy funds often employ very talented and versatile individuals and even entire disciplines within a discipline. But no desk has all of the best talent. And even if the best, let us say, convertible arbitrage portfolio manager happened to start out in a multi-strategy environment, he or she might well eventually leave to start an independent firm focusing on the manager’s expertise.

Greater flexibility in replacing strategies or managers that lose appeal. Multi-strategy portfolio managers often emphasize their flexibility in deploying capital. A multi-strat manager is typically closer to the market than a fund of funds manager and is not constrained by liquidity terms that may prevent cash flows until the end of a month or quarter. On the other hand, multi-strats can allocate only to managers...
they have in-house. (Occasionally a multi-strat will hire out-
side managers to exploit a new opportunity, but in so doing
the firm will not be deploying capital faster than a FoHF
could.) Deploying capital is one side of a two-sided decision.
Money moving into one strategy usually has to come out of
another. But multi-strategy firms may be reluctant to idle
employees whose opportunities have ebbed, or who have
turned out to be less talented than expected, or who have lost
whatever edge they once had. Let us stipulate that neither
managers of FoHFs nor managers of multi-strats enjoy firing
people. But FoHFs and their underlying investees understand
that eventual redemptions are not unlikely. In contrast to a
FoHF, the multi-strat may have contractual obligations to
employees and typically has greater costs sunk in an in-house
strategy, which may require specialized infrastructure to sup-
port a desk. So the multi-strat may pull back assets from an
unappealing strategy but will have incentives to keep the desk
employed. Once a multi-strat does let go of a strategy or a
portfolio manager, it becomes difficult to reverse the decision
in a timely manner.

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Participation in attractive new strategies or managers.
The better FoHFs attend conferences, listen to pitches, and
talk to people at funds that are just starting up. FoHFs are
attuned to finding opportunities that are not already reflected
in existing portfolio line-ups. In 2007, for example, some
hedge funds were talking to investors about the potential
of shorting mortgage-backed securities. Some hedge funds
famously went on to make triple-digit returns in 2008, when
almost every strategy was suffering double-digits losses.
FoHFs were systematically introduced to the trade as the
hedge funds that came up with the idea sought investors.
Some FoHFs invested, and others passed. But multi-strats
were left to discover the trade on their own. Few multi-strats
had the resources or in-house expertise even to contemplate
such investments. Even if they had recognized the opportu-
nity, few multi-strats would have been able to develop effective
to participate.

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has an advantage over multi-strats, which typically focus on
allocating capital among managers and strategies already
in-house. Worse for multi-strats—and to the benefit of their
FoHF cousins—promising new talent frequently emerges
from multi-strategy firms.

Deeper capacity. Both FoHFs and multi-strategy funds
are better-equipped than single-strategy funds to deploy
large amounts of capital. Diversified FoHFs, however, tap
more strategies, can absorb more capital, and can do both
more quickly than multi-strats. At any given time most of
the hedge funds underlying most FoHFs have more capacity.
And if a given fund does not have capacity, the FoHF usually
can find similar managers to round out an allocation. FoHFs
usually find more attractive managers than they can use.
So, even when a favorite manager no longer can accept new
subscriptions, a second or third favorite usually is available.
The depth of the hedge fund universe is prodigious. There are
more than 75 long-biased health-care specialized hedge funds
alone. FoHFs can tap any of those. Multi-strats can tap none
of them. Finally, if capacity constraints were especially tight, a
FoHF also could deploy to multi-strats that have room.

Less exposure to organizational risk. Manager-level
risk perhaps belongs at the top of the list of multi-strategy
fund disadvantages. Regardless of the number of individual
portfolio managers employed in-house by a firm, the firm
itself is vulnerable to risks that are impossible to diversify
away within the organization. Organizational vulnerabilities
are almost countless. A firm can suffer problems related to
fraud, portfolio-wide leverage, portfolio-level counterparty
agreements, allocation misjudgments, system malfunctions,
legal vulnerabilities (deserved or not), natural disaster, terror-
ism, abandonment by large clients (again, deserved or not).
This last is a problem for any type of firm, but multi-strats
typically require more expensive infrastructures than other
sorts of hedge funds. Quality FoHFs are not cheap to run
either, but they generally do not require the often-expensive
trading apparatus, the clearing and reconciliation facilities,
and the number of highly paid portfolio managers that multi-
strats do.

FoHFs are vulnerable to many of the other risks as well,
but FoHFs’ firms are rarely so imperiled as to prevent return
of most client assets. Even FoHFs caught with disastrous
allocations, such as to Madoff, typically return much or
most client assets even as the FoHF is wound down. A
multi-strat that harbors a rogue trader, however, might
go the way of Amaranth. The investments that underlie a
FoHF face organizational risks that are independent of one another. If one of the underlying goes down, the others are not likely to be affected, barring unusual cases such as Long Term Capital Management that shake the foundations of almost all hedge funds.

None of the foregoing indicates that multi-strategy hedge funds are bad investments. As noted, some FoHFs allocate money to multi-strats. Multi-strat funds boast some excellent investment talent. They probably respond more quickly to some fleeting investment opportunities than FoHFs can. They are also usually cheaper than FoHFs, which charge a separate fee on top of underlying hedge fund fees.

The fee differences, however, are easy to overstate. Multi-strategy funds tend to be the most expensive stand-alone hedge funds, rarely charging less than 2 percent management fees and 20 percent performance fees. Moreover, multi-strats frequently have even more charges imbedded in their structures. Non-fee expenses sometimes include infrastructure and trading costs, which can add another 100 basis points or more. Common press coverage notwithstanding, most non-multi-strategy hedge funds charge less than 2 percent and 20 percent, and FoHFs sometimes are able to negotiate better-than-published terms. Also, FoHF performance fees, if any, are charged net of all other fees. A FoHF that charges 1 percent and 10 percent of performance (sometimes over a hurdle return) is not at as much of a fee disadvantage as many assume.

All in, FoHFs are still usually more expensive than multi-strategy funds. The question is whether a FoHF can generate enough extra return or reduce risk enough or offer other characteristics to justify an additional fee. How much is the additional cost? A plausible estimate is 90–110 basis points.¹

To judge whether the additional costs are worthwhile, returns should be risk-adjusted. Unfortunately, standard risk-adjusted metrics such as the Sharpe ratio do not easily capture catastrophic, organization-ending risks. Other measures such as information ratios may be useful, although hedge fund investors—especially those interested in multi-strategy funds and FoHFs—rarely think of risk in terms of tracking error.

Unfortunately, the benchmarks widely used to track hedge fund returns all have composition challenges. Credit Suisse/Tremont, for example, publishes two indexes that are both supposed to represent multi-strategy hedge fund returns. One index is investable, and the other is not. Over the past 10 years the investable version has produced an annualized return of 3.7 percent, while the noninvestable has produced annualized returns almost as high, at 7.0 percent. FoHF indexes over the same period also vary widely. HFR publishes five FoHF indexes, which over the 10-year period have produced annualized returns of between 3.5 percent and 7.6 percent. The EDHEC Fund of Fund Index compounded at 4.5 percent. Note that all of these returns are supposedly net of all fees.

Conclusion

This article forces generalizations about FoHFs and multi-strats. There are hundreds of multi-strategy hedge funds and hundreds more FoHFs. Both types vary widely in quality and character. To say that one type is better than the other is as unhelpful as saying that boats with sails are better than boats with motors. For what purpose? Some self-described multi-strategy hedge funds would be better described as event-driven. Some FoHFs, too, focus only on a narrow sliver of a strategy, such as energy equity long-short. Narrowness is right or wrong only relative to a given investor’s needs.

Any advantages a FoHF may claim over a multi-strategy hedge fund in potential return, flexibility, or diversification depend on the FoHF and the multi-strat under examination. And the value of a given fund depends equally on what the investor asking the question values.

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Endnote

¹ These figures assume the following: a) a multi-strat that charges a 2-percent management fee and a 20-percent performance fee, and b) a FoHF with underlying managers that charge an average of 1.5 percent and 20 percent and FoHF fees that are 1 percent and 10 percent of performance over a 5-percent hurdle. A 10-percent gross return at the hedge fund level translates into 89 basis points less for the FoHF investor than the same gross return leaves for the multi-strat investor. At a 15-percent gross return, the additional cost for the FoHF is 109 basis points.