What Should an Investment Management Consultant Ask a Fund-of-hedge-funds Manager?

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The year 2007 was a banner growth year for hedge funds. According to Hedge Fund Research, the industry attracted $194.5 billion in new money, and year-end assets soared to $1.87 trillion. Funds of hedge funds enjoyed similar blistering growth, taking in $59.2 billion in net flows. Fund-of-fund assets now make up $798.6 billion, almost half the industry total.

The 2007–2008 Russell Survey on Alternative Investing (A Survey of Organizations in North America, Europe, Australia, and Japan) analyzed trends in several popular alternative investment types, including hedge funds and private equity, through an institutional investor survey of public and corporate pensions, endowments and foundations, Taft Hartley, religious organizations, pensions, and life insurance companies. The survey noted that globally hedge funds “matured as an investment tool for diversifying portfolios and reducing risk.” Further, over the next three years survey respondents expect to increase their strategic allocations in nearly all global markets. Among the 167 North American (United States and Canada) respondents, the commitment to hedge funds of $40 billion represented a sharp uptick from the $25 billion reported only two years earlier, and their mean strategic allocation is expected to increase from 7.5 percent to 8.9 percent of assets over the next two years (up from only 2.5 percent in 2001).

The Russell Survey noted that funds of funds remained the most popular method for accessing hedge fund strategies. Funds of funds were utilized by 71 percent of North American respondents, compared with 50 percent of respondents who said they were in single-fund strategies. Those figures remained unchanged from the 2005 survey.

Although alternatives have an indisputably important role in client portfolios, consultants must consider the challenges of such investments. Because funds of hedge funds are a preferred nontraditional investment choice for institutions and affluent investors, this article focuses on questions that consultants need answers to before advising clients to invest in any fund of hedge funds.

Analysis of Fund-of-hedge-funds Managers

The analyses of fund-of-hedge-funds managers and traditional long-only managers require different approaches. Hedge funds have limited transparency into securities holdings, securities that do not always have readily available valuations, leverage, complex derivative strategies, and limited liquidity of holdings, and many alternatives managers lack long track records.

On the other hand, the investigation and due diligence for both types of managers remains the same: to achieve a thorough understanding of how a manager makes investments and to realistically assess the risks involved. This article suggests some questions to ask a fund of hedge funds manager. It’s not exhaustive; it serves as a starting point. The questions are categorized, and comments explain the questions’ relevance to fund-of-hedge-fund manager analysis. These questions may be equally helpful when considering an investment in a hedge fund.

Investment Strategy and Philosophy

What is your investment strategy and philosophy?

It is important to understand the fund-of-funds manager’s philosophy. At the fund-of-funds level, do you use a top-down or bottom-up approach or a combination of the two? At the underlying manager level, do you look for a top-down or bottom-up approach, or do you look for both? What is the philosophy behind the selection of the managers, and what is the common denominator in that selection process?

Has the strategy changed since the fund’s inception?

The consultant should gain a historical perspective on how the portfolio strategy has evolved over time. Has the number of underlying managers increased or decreased? If so, why? Has the fund-of-funds manager added new strategies or removed strategies from consideration? If so, why? In general, what has the manager learned, and how has the manager altered the strategy over time?

What are your target returns and volatility?

Most fund-of-funds managers have a target return and estimates of volatility. A consultant should go into some detail as to the performance expectations for each manager to attain a performance goal. In addition, the fund-of-funds manager should explain how a volatility target is reached.

It is worthwhile for the consultant to “deconstruct” a fund-of-funds portfolio.

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That is, the consultant should independently determine and assess the qualitative and quantitative characteristics of the underlying managers and then make an internal assessment of the projected volatility. Does this internal assessment coincide with the manager’s stated risk-and-return targets?

**What is your competitive edge?**
What does the fund-of-funds manager do that distinguishes the fund from other funds of funds? Do the members of the team have a particular approach that is unlike others, or have they developed a proprietary methodology?

**How does your strategy affect capacity with your managers?**
Hedge funds have capacity restraints in terms of how much money they can manage. It is important to go into some detail with the fund-of-funds manager regarding how much money each underlying hedge fund can manage based upon strategies.

**Will new money be accepted from current investors after capacity is reached?**
Some hedge funds accept new money from existing accounts even though they are closed to new business (sometimes referred to as a "soft close"). A consultant should know what the soft-close dollar figure is and ask if there is a "hard close" number as well—that is, at what point the manager will accept no new money, even from existing clients.

**State all potential conflicts of interest that might arise between the fund of funds and the underlying hedge fund managers.**
Some funds of funds have a small group of managers and retention partners in underlying hedge funds in which they are invested. While this may allow the fund-of-funds manager to gain more transparency and potential oversight, there is no longer an arm’s-length arrangement with the hedge fund manager. Will the fund of funds terminate the manager if he or she has an ownership interest and how might it affect the objective decision-making process?

Some funds of funds rely on prime brokers’ capital introduction groups to identify hedge fund managers. The consultant should ask the fund-of-funds manager what conflicts of interest might arise within that prime brokerage relationship, such as the use of soft dollars or other arrangements between the hedge fund and its prime broker.

The consultant should determine if any of the underlying hedge funds pay the fund of funds for any services (and if so, what services?) and whether there is any kind of fee-sharing arrangement between the two entities. This would be a significant potential conflict of interest.

Another potential conflict may arise with hedge fund affiliates. Will the fund of funds invest in underlying funds that have affiliates, such as a broker-dealer? If yes, how does the fund-of-funds manager assure that the relationship is at arm’s length?

**Manager Selection, Research, and Portfolio Construction**

**What criteria do you use to select underlying managers?**
The consultant should be able to map out the process by which managers are selected. What specific criteria and characteristics are required for a manager to be considered for the portfolio? How are managers and strategies excluded from consideration? What are common characteristics of managers included in the portfolio?

**How do you source your managers — personal contacts, databases, prime brokers?**
Is the fund-of-funds’ sourcing process more quantitative or qualitative in nature? Does the manager rely on databases and third parties for introduction to managers? How much research is done internally to find managers, and how much is reliance upon prime brokers and capital introduction groups? Does the fund of funds have a “farm team” of potential hedge fund investment candidates in the event that a) an existing holding has a hard close and will not accept additional funds, or b) the underlying fund must be replaced due to performance issues or other factors ascertained during ongoing due diligence?

**How is your research team structured, and what are the individual responsibilities and contributions/specialties of each team member?**
Some funds of funds have a small group or committee of managers/analysts who evaluate managers. Having each member of the team looking at the same managers is advantageous. The disadvantage may be that there is no specialist in a particular area.

Other funds of funds have analysts who specialize in industry or geographic sectors or particular strategies, providing a skill advantage. The disadvantage may be an overreliance on one particular opinion.

The consultant also must understand the operational due diligence process. Does a designated analyst or team evaluate the adequacy of each under-

"Having each member of the team looking at the same managers is advantageous. The disadvantage may be that there is no specialist in a particular area."
lying fund’s physical and operational infrastructure? Are the same teams responsible for ongoing due diligence? How frequently, and to what extent, is each underlying fund re-evaluated for suitability in the fund of funds?

**What is your firm’s business plan? How big do you want to get, and do you have a maximum asset size based upon your capacity?**

It is important to know the business and personal goals of the principals of the firm. How long do they intend to own and manage the business? Are they cultivating a middle management team to take over? Are the principals providing equity (or other) incentives to ensure stability of the successor team? How big can the firm get, based upon the capacity restraints of the strategies?

**Manager Monitoring and Risk Management**

**What risks are inherent in your portfolio? What can go wrong?**

Volatility risk, credit risk, liquidity risk, geopolitical risk, and risks associated with leverage and derivatives must be assessed in the portfolio. The potential for fraud also has been a risk in a few cases. The consultant—and the client—must be satisfied that these risks are manageable. It is a good idea for the consultant to ask for an itemized assessment of these risks and an explanation on how these risks are addressed.

In short, the consultant must ask the following: What can go wrong and how is the fund-of-funds manager protecting portfolios against the known risks, as well as the unknown risks? Often, these risks are outlined in the private placement memorandum, and this section can serve as a starting point for the discussion.

**How much leverage do you typically use, and how is it monitored?**

How often does the fund-of-funds manager determine the amount of leverage employed by the underlying managers?

Is there an independent check on this leverage? Some funds of funds ask their managers for permission to receive statements from the prime broker verifying the amount of leverage used.

Does the fund-of-funds manager ever use leverage at the fund-of-funds level? If so, what are the parameters, and is there a maximum amount that can be used? Is the use of leverage limited to a redemption line of credit so that the fund of funds can satisfy redemption requests in advance of receiving proceeds from one or more underlying funds?

**How much derivative exposure is allowed, and how is it monitored?**

How does the fund-of-funds manager monitor derivatives positions and assess strategies using derivatives? What information is available from the hedge fund manager and/or the prime broker as to these positions?

**Describe the transparency you have with regard to underlying managers and their investments.**

What type of access, if any, does the fund-of-funds manager have with respect to the securities holdings of the underlying managers? Do you receive a top-five or top-10 holdings long and/or short securities list from managers? Does the manager receive reports of aggregate holdings by sector or geographic region to ensure that the fund of funds does not have an unintended concentration? Does the manager feel that this is satisfactory information for oversight? Is there any third-party check, such as prime broker’s records, regarding the securities holdings? If there is a level of transparency, how does the fund-of-funds manager evaluate this information and process the data?

Hedge funds differ on what information they disclose regarding their securities holdings. Most will provide the top-five or top-10 long positions to the fund-of-funds manager. However, with respect to short positions, hedge fund managers are understandably reluctant to provide current data. Some hedge fund managers will provide the information verbally to the fund-of-funds manager but may not provide online access. Others may provide the information through an e-mail or in written form, but with a time lag.

As a result, there is little consistency in the area of transparency among hedge fund managers. The fund-of-funds manager could establish his or her own criteria to get the data. That is, if the manager does not provide the required data, then the fund of funds will not invest in that hedge fund.

However, the fund-of-funds manager must balance what he or she needs to know in terms of individual securities holdings versus the hedge fund’s proprietary “edge” in stock selection and the understandable reluctance to give away this perceived “edge.”

**What is your diversification policy with regard to number of managers, sector, industry, and geographic distribution?**

How does the fund diversify among managers and construct an appropriate allocation to the managers? Does the manager compare the allocation to a benchmark index or other baseline? If so, what are the parameters used to manage the portfolio’s allocation versus the baseline allocation?

**What are the criteria for manager termination?**

There should be specific reasons for manager termination. The manager should clearly articulate the circumstances under which a manager is terminated from the portfolio.

**What is the average turnover of the portfolio?**

How often does the fund of funds hire and fire managers, and what criteria are used? Get examples of particular instances in which managers were hired and terminated and the reasons.
Do you provide performance attribution information and reports? How much of the portfolio return is due to long positions or short positions at the fund-of-funds level as well as at the manager level? Does the manager receive individual hedge fund manager information on performance attribution and in what detail—sector, industry group, capitalization, geographic? How often is this provided, and how does the fund of funds process and report the data? Does the fund of funds use external software systems to process the data, or is there a proprietary model?

What types of risk-management tools are used, and are they internal, external, or both? There are a number of risk-management programs available that perform value-at-risk (VaR) analyses, correlation, Monte Carlo simulations, etc. The consultant should learn about the tools the fund-of-funds manager uses to monitor portfolio risk.

Performance and Fees
Do you report performance on a net or gross basis? Most funds of funds report performance net of all fees. A gross number is an extra. A gross number is an extra. If the fund of funds provides performance data on underlying managers to the consultant, it should be determined if the data are net or gross of fees.

Do you publish estimates of the fund’s performance? How often? Funds of funds generally may provide a performance estimate at month-end; some also may offer more-frequent estimates. The consultant should know the release dates of estimates/performance updates and should consider if the manager is diligent in meeting those dates as well as the means by which the data are communicated.

Do you charge a performance fee? Is there a hurdle rate? Is there a high-water mark? The consultant should be aware of the terms by which the fund-of-funds manager is paid. Fees range from only an investment management fee to management and performance fees; the latter can be based on a simple percentage of profits, meeting or exceeding a particular absolute or relative benchmark, or satisfying a high-water mark. Of late, some larger hedge funds are requiring a performance fee (or a portion thereof) even if the hedge fund manager fails to meet the high-water requirement.

The consultant also should be aware of the terms by which the underlying hedge fund managers are paid. How does the fund-of-funds manager assess the appropriateness of management and incentive fees charged by an underlying fund—relative to competing funds, relative to absolute performance, or by other methodologies?

Do you charge an up-front placement fee? Many funds of funds charge an up-front placement fee. Determine how much this is and whether it can be negotiated or, in some cases, waived.

What are your fees (other than management and performance) and how do they compare with those of comparable fund-of-funds investments? Funds of funds often have servicing fees and internal expenses in addition to the investment fees that are charged to the fund. Is there a cap on these internal expenses or are they open-ended? Estimates of servicing fees should be disclosed in the offering memorandum, and actual expenses may be provided in the annual report or in an investor’s tax documents, depending on the structure of the fund of funds.

Compliance and Client Reporting
With which regulatory authorities are you registered? The consultant should know all of the governing bodies that regulate the fund of funds under consideration. If the manager of the fund of funds is registered under the Investment Advisers Act of 1940, in addition to receiving Part II of Form ADV, the consultant should inquire about the manager’s policies in areas such as personal trading, trade allocation/rotation, and other potential conflicts of interest.

Has the Securities and Exchange Commission, Commodity Futures Trading Commission, or any other regulator ever audited your firm? The consultant should inquire about significant findings from regulatory examinations and corrective steps the manager has taken. In addition, the consultant should obtain copies of recent audit reports (including opinion letters) of the fund of funds. If the auditor is not a firm familiar to the consultant, he should make himself comfortable with the expertise and experience of the firm in the hedge fund arena before approving an investment by his client.

What is the timing of K-1s, 1099s, or other tax reporting for U.S. investors? Most funds of funds issue K-1s. Because the fund of funds must itself compile K-1s from the underlying managers, the fund of funds’ K-1 often comes out just before (or even later than) the April 15 filing deadline. A consultant must manage a client’s expectations by offering a realistic view of this reporting, including the need for requesting an IRS filing extension.
Personnel

What is your remuneration and incentive policy? How do you retain good employees?
A consultant should know how key employees are compensated and what incentives—bonuses, equity ownership, etc.—keep them at the firm. This is particularly important because many hedge funds are managed and/or owned by a relatively small and close-knit senior team of professionals. The resignation of one person may have a huge impact on the investment process. There is a relatively high turnover of personnel in the hedge fund business. How does the fund-of-funds manager manage staffing and personnel in this type of environment?

What has been your personnel turnover?
The consultant should have knowledge of all employees who were hired or terminated as well as those who resigned in the past five years and the reasons for these changes.

Have any principals of the firm been subject to regulatory action? Do any of the principals have a criminal or civil record?
The consultant should make sure that all information and data regarding regulatory action and criminal or litigation activity have been asked for and collected.

What background checks does the fund of funds perform on the underlying managers?
It is important that the fund-of-funds manager has a thorough knowledge of the underlying managers and their backgrounds with respect to credit history, regulatory, criminal, and civil issues. Because the hedge fund industry has been largely unregulated, it is important for the consultant to provide clients with a level of comfort that every effort has been made to assess the character and background of the principals of the hedge fund.

Operations and Administration

When can investments be redeemed or tendered? Please describe the redemption process.
Hedge funds have varying degrees of liquidity and varying rules about how investments are redeemed and money withdrawn. Often, a percentage of the account balance is paid upon redemption, and the remainder is due after a period of a month (or more). Sometimes a percentage is held back pending the final annual audit. Thus, liquidity for hedge funds and funds of funds is very different than that for traditional long-only managers.

Registered investment companies generally are subject to a tender offer process. This means that the fund of funds tenders for shares. If the amount tendered exceeds the amount stated in the offer, investors may be unable to withdraw the amount requested. The consultant should fully understand the redemption and tender features and process and make sure that the client is aware of the risks. If the fund of funds is not a registered investment company, the consultant should determine if there are any gates (redemption restrictions that are disclosed in the offering documents) that would similarly delay receipt of the entirety of the redemption proceeds.

What is the manager’s policy on side letters?
A side letter is an agreement between the manager and an investor that provides a specific benefit to that investor. (This is a moot point for registered investment companies, which must treat all investors alike.) Those benefits might include perks such as more-favorable management or performance fees, or greater flexibility in the timing of additional investments or redemptions. The consultant should become comfortable that other investors are not disadvantaged to the detriment of his client in the redemption process.

Are side pocket investments permitted, and what is the effect on redemptions?
Hedge funds investing in illiquid, private-equity-like assets may place those assets in so-called side pockets. When an investor requests a redemption, he will receive the full amount of the marketable portion in a timely manner but will not receive his pro rata share of the side pocket for an extended period (which may be measured in years). The consultant should determine the manager’s view on investing in hedge funds that use side pockets and the impact on the timing of receipt of redemption proceeds.

Do you have a lock-up period?
Some funds of funds have a one-year (or longer) lock-up period—that is, a period during which the investor cannot gain access to the invested money. Some charge an exit fee if this lock-up period is violated, and others specifically deny an investor the possibility of early withdrawal. Some funds of funds require an exit fee any time money is withdrawn from the account.

How often are the underlying funds valued? Do you check if they employ fair valuation methodology?
Valuation of portfolios can be a major risk. Hedge fund managers generally attempt to take advantage of inefficiency in the markets, and inefficiencies often are coupled with decreased liquidity. Therefore, the consultant should understand the strategies and the underlying securities necessary for those strategies and ascertain how the securities are valued (for example, in accordance with SFAS 157)—and by whom. Some securities valuations are not available daily and are priced on a periodic basis only. Does the fund-of-funds manager obtain fair valuation methodology—that is, independent verification by a third party or multiple valuations by several broker–dealers—in order to arrive at the valuations? What is the fund-of-funds’ policy on these valuations?
Do you have a disaster recovery program and other emergency procedures?

What are the manager’s emergency contingency plans in case the main office and its computer systems and/or hard-copy files and data are compromised? Are the data backed up at another location, and if so, how often are the data downloaded to that location? Can employees manage the money from another location if that becomes necessary? How does the fund of funds manager access the emergency plans of its underlying managers?

Does the fund of funds utilize a third-party administrator?

Does the fund of funds utilize a third-party administrator for accounting, shareholder, and administration services? While most funds of funds utilize external administrators, the consultant should not be surprised if the administrator is not a “household” name. Size and reputation are far less important for this audience than the level of service provided.

Does the fund-of-funds manager require that all underlying funds also use third-party administrators? If not, what is the due-diligence process for ensuring the adequacy of the underlying fund’s controls?

Taxes

Do any of the underlying managers use strategies to reduce the tax impact of the investment style?

While hedge funds are not usually tax-efficient vehicles, some managers attempt to minimize taxes by employing strategies to offset gains and losses. It is important to know if there are underlying managers doing this and to what extent, if any, the fund of funds itself uses strategies at the fund level to minimize taxes.

Also, some strategies lend themselves to more tax efficiency. Because many hedge fund managers have their own money in the fund, it is often to their personal advantage to achieve long-term capital gains where possible. A long-short equity manager may attempt to hold long positions for long-term capital gains, for example.

What percent of your gains historically have been long-term?

Does the fund of funds have an estimate of its historical breakdown of long-term versus short-term gains? How has that varied year by year, and why?

Do you offer estimated after-tax returns for taxable clients?

Estimating after-tax returns during the taxable year may be an added plus for investors who may be able to do some tax planning. What information is available from the fund of funds, and when is it available?

What provisions has the fund of funds made for avoiding unrelated business taxable income (UBTI) for its tax-exempt clients?

If a tax-exempt entity’s investment in a fund of funds includes investment income that is considered unrelated by the Internal Revenue Service, such as margin interest, then the entity may have to file a tax return to account for that income, despite the entity’s tax-exempt status. In an extreme case where there is significant UBTI, the entity’s tax-exempt status may be jeopardized. It is therefore important for the consultant to determine the likelihood and extent of UBTI in a fund-of-funds portfolio for a tax-exempt client and inform the client of the implications and options.

Many funds of funds have set up offshore versions of their fund of funds portfolios. These funds are open only to those investors who are not required to file a U.S. income tax return—tax-exempt entities such as pension funds, endowments and foundations, individual retirement accounts, and nonresident aliens. The offshore vehicle itself is not subject to U.S. tax, and therefore the issue of UBTI does not arise.

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Endnotes

1 Read the executive summary to the survey at http://www.russell.com/Public/pdfs/Alternatives_Survey/AltSurveyExecutiveSummary_2007.pdf.

2 Some fund-of-hedge-fund managers, for example, select managers that use a purely bottom-up stock picking strategy. However, in their portfolio construction process they may use a top-down overlay based upon their economic forecast to allocate weightings to the managers. It is important to understand how the bottom-up and top-down approaches work together, if the manager employs both strategies.

3 According to the Financial Accounting Standards Board, SFAS 157 defines fair value, establishes a framework for measuring fair value in generally accepted accounting principles, and expands disclosures about fair value measurements. Prior to SFAS 157, there were different definitions of fair value. SFAS 157 emphasizes that fair value is a market-based measurement, not an entity-specific measurement, is determined based on the assumptions that market participants would use in pricing the asset or liability, and utilizes a hierarchy methodology. The highest level, Level 1, applies to quoted prices in active markets for identical assets or liabilities and the lowest level is Level 3, which includes unobservable inputs for the asset and liability (i.e., the company’s own data and assumptions).