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COURSE
82157A

Special Considerations for Hedge Funds

Rounding out the series, this course takes a closer look at niche hedge fund categories, when and how to bring in a consultant, and what thorough due diligence actually involves. Real-world cautionary tales highlight the risks of skipping critical evaluation steps. For CPAs and advisors who may be called on to vet fund managers or guide clients through the selection process, this course provides a practical framework for asking the right questions and spotting potential red flags before they become costly mistakes.

CREDIT HOURS 2 | FIELD OF STUDY BUSINESS | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recall the primary goal of a multi-manager fund of funds in hedge fund investing.
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Recognize the purpose of sending out a Request for Proposal (RFP) when investing in hedge funds.

- Recall the details of various hedge fund horror stories.

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Chapter 1: HOOKING ONTO OTHER TYPES OF HEDGE FUNDS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the primary goal of a multi-manager fund of funds in hedge fund investing.

One problem with fund strategies is that they're sometimes too specialized for a hedge fund investor. Even an accredited investor — one with a net worth of $1 million or an annual income of at least $200,000 ($300,000 with a spouse; see Chapter 2 of course 82151B) — may not have the resources to take advantage of a diversified range of hedge fund strategies. Likewise, some hedge fund managers don't like to limit themselves to a single investment strategy when one strategy is temporarily out of market fashion. Other hedge fund managers like to diversify their market approaches so that they can have even performance no matter how the market is doing.

In this chapter, I introduce several types of hedge funds that cover a range of investment strategies. I examine the aptly named multi-strategy fund, and I present the world of fund of funds investing; I also look at some niche hedge funds and related investments to show you what your options are. If you're interested in hedge funds that invest in a range of investment styles, you can use the options I present in this chapter to discover more about them.

MULTI-STRATEGY FUNDS: PURSUING A RANGE OF INVESTMENT STRATEGIES

The problem with any investment strategy is that it will work better in some years than in others. It can be really hard to sit through a down year, no matter how much the manager believes in the strategy. A lot of smart people identified the real estate bubble and predicted its collapse, but most of them were way too early in their predictions. They lost investors who thought they were out of touch — wasn't it obvious that real estate always went up in price so everyone should buy the biggest and most expensive house?

To circumvent the bad years, some managers want the right to change their strategies. Others, especially those with very large funds, handle several investment strategies in-house, with different staff members getting different amounts of money to manage based on market conditions. Multi-strategy funds are hedge funds that pursue several different investment strategies instead of focusing on any one investment style. In the following sections, you find out more about multi-strategy funds.

The advantage of a multi-strategy fund is that a variety of different investment styles all mesh under one roof. The hedge fund investor has more diversification benefits and more consistent performance than with hedge funds that are organized to follow a single investment strategy.

Warning

A multi-strategy focus may be just an excuse for posting mediocre performances year in and year out. The best hedge fund managers tend to be disciplined, even when the markets are turned against them; they know that buying low is the best assurance of some day selling high. Other hedge fund managers drift from strategy to strategy, hoping that something will stick for this year, instead of generating value for investors. If a fund you're interested in pursues multiple strategies, find out how the manager determines those strategies and how the fund moves money among them (see Chapter 3 for more on due diligence). A multi-strategy fund is still a hedge fund, so buying into it calls for the same research as any other hedge fund.

Determining the strategies

A multi-strategy hedge fund is usually set up in one of two ways. First, you have the top-down strategy:

1. The hedge fund manager starts with a top-down analysis of market conditions and expectations. (For an in-depth discussion of top-down analysis, see Chapter 2 of course 82152B.)
2. The manager works out what sectors and strategies are likely to do well.
3. The manager uses the sector and strategy information to guide the fund's allocation of money.

This may well be a messy process, with plenty of smart people arguing over what these investment traders, analysts, and portfolio managers see ahead in the markets. The goal of the process for the traders, analysts, and portfolio managers involved isn't to get a consensus; the goal is to be right about the direction of the market, or at least make enough of a case to get an allocation of capital to invest. The advantage is that members of the hedge fund's staff have to think through their arguments in order to get them past everyone else, so the best ideas survive. As a result, multi-strategy funds may have some internal tensions and employee turnover. These factors don't necessarily make for a bad fund, although internal turmoil can be disconcerting to hedge fund investors.

The second setup involves diverse strategies. At many multi-strategy funds, the hedge fund manager hires sub-managers who concentrate on specific market sectors, derivatives, arbitrage, or other trading strategies (see Part 3 for discussions of these strategies). Each sub-manager starts with a set amount of money to manage. If a sub-manager does well, he or she will receive more money. If the

sub-manager doesn't do well, he or she may see the money cut — or may lose his or her job. This setup can be a great way to ensure that sub-managers who can make money get to make a lot of it for the fund. However, markets run in cycles. If the hedge fund manager isn't careful, he or she may give a sub-manager too large a percentage of the fund just as the sub-manager's investing style falls out of favor, while he or she asks other sub-managers to give up money just as their investment styles come back in fashion.

Dividing in-house responsibilities

After the hedge fund manager(s) determines the allocation of the money (see the previous section), he or she gives the money to different people in the firm to manage. In essence, a multi-strategy hedge fund is a group of little hedge funds clustered under one roof. Two traders may handle the currency; two analysts may work on emerging market equities; three analysts may specialize in risk arbitrage (see Chapter 2 of course 82153B); and one analyst may do nothing but highly leveraged fixed income trading (see Chapter 1 of course 82154B for more on leverage).

The goal of all involved is to post as great a return as possible, given the amount of money allocated. (You can find out more about the different jobs of hedge fund staff members in Chapter 1 of course 82151B.)

Managers usually assign risk-management responsibilities to those who determine the investment strategies. Someone at the top needs to make sure that the strategies mesh and that the fund takes on only as much risk as its investors want and its prime broker is prepared to accept. If a fund has too much risk, it may not be able to borrow money for leverage strategies, borrow securities for short-selling, or even get its trades executed (see Chapter 1 of course 82154B for more information).

Warning

What does this mean for you? In a situation where a fund has too much risk, it may take money away from a trader who's doing well because his or her success may be increasing the fund's exposure to one specific strategy.

Scoping the pitfalls of working with a broad portfolio

A multi-strategy fund is often a very large hedge fund — one with a few billion dollars under management; after all, it's expensive to do the research and have the staff members execute a variety of strategies well. A small hedge fund would have a hard time justifying the costs of managing different investment styles under one roof. Some trading strategies utilized by a multi-strategy fund require large commitments of the firm's capital as collateral, which alone may limit the number of strategies that a small hedge fund can try.

Multi-strategy funds face another interesting problem: keeping top employees happy. All hedge funds — actually, all employers — have this problem, but a multi-strategy fund has some unique issues. If the fund as a whole doesn't do well one year, for instance, it may not be able to collect the performance fee (see Chapter 2 of course 82151B). No performance fee means the fund may not have money to pay bonuses, even to employees who had great performances in their parts of the portfolio. And, with so many people in the firm, it may be tough for anyone to be a star.

Technical Stuff

People in the investment business make a lot of money, but that doesn't mean they don't want more! In 2019, the CFA Institute — the trade organization for investment analysts and money managers — reported that the median compensation for members working at hedge funds was $200,000. This is before bonuses, which may be considerable, to say the least.

So, what happens to the disgruntled fund workers? An analyst with a good track record for his or her part of the fund will quit, possibly starting his or her own hedge fund that focuses only on his or her chosen investment technique. The multi-strategy fund then has to replace the analyst, with the fund's performance suffering during the transition.

FUNDS OF FUNDS: INVESTING IN A VARIETY OF HEDGE FUNDS

An alternative to traditional hedge funds is a fund of funds, which is an investment that pools money from several different investors — who may be individuals or institutions like pensions, foundations, or endowments — and puts it into a handful of different hedge funds.

A fund of funds is usually set up as an investment pool registered with the U.S. Securities and Exchange Commission (SEC; see Chapter 2 of course 82151B for more information on registration), although it doesn't necessarily have to be registered. The process for buying into most funds of funds is the same as for other hedge funds (see Chapter 3 of course 82151B).

Remember

A registered hedge fund, including a registered fund of funds, may offer the people or institutions that invest more protections if the fund turns out to be mismanaged or a fraud, but registration is no assurance that the hedge fund or fund of funds is a good one.

Funds of funds have unique characteristics you need to consider. Not only do you have to decide if a hedge fund is the right investment for you (see the chapters of Part 1) and what kinds of hedge funds are the right investments for you (see the chapters of Part 2), but also whether a fund of funds is the right way for you to buy into a hedge fund.

In the following sections, we outline different types of funds of funds, list the advantages and disadvantages of funds of funds, and enter the realm of funds of funds of funds (not a typo!).

Surveying fund of funds types

Hedge funds themselves fall into many different categories. Some funds invest in growth equities, almost the same way that a mutual fund might. Others do some very fancy risk arbitrage transactions involving emerging country debt. (The chapters of Part 2 describe the different strategies that funds follow.) When it comes to funds of funds, some are diversified across many investment styles, and others are designed to capture the best hedge funds working in a specific investment style.

But, although funds of funds may follow different strategies, they fall into only two distinct types: multi- manager and multi-strategy.

Multi-strategy funds of funds

Like a multi-strategy hedge fund (see the first section of this chapter), a multi-strategy fund of funds pursues different investment strategies to achieve the goal of increased return for a given level of risk. The fund of funds manager chooses funds that complement each other and that usually have a directional market return (in other words, they have some market risk, unlike a traditional hedge fund, which is designed to remove market exposure; see Chapter 1 of course 82153B). The goal is to give investors diversified exposure to an array of hedge funds in order to generate a steady annual return.

Multi-manager funds of funds

A multi-manager fund of funds puts its money into several hedge funds that follow a similar strategy. The manager may look for absolute-return funds, which are hedge funds that follow a traditional strategy with no market exposure (see Chapter 1 of course 82151B), or he or she may concentrate on a single aggressive strategy. Investing in several funds within the same strategy eliminates (or minimizes) the manager risk, which is the value that the manager adds or subtracts (also called alpha; see Chapter 1 of course 82153B). After all, in any strategy and in any year, some people do a lot better than others. The goal of the multi-manager fund is to combine the expertise of many different money managers following the same strategy in order to get a more consistent return for investors than they may get by investing in just one fund.

Highlighting the advantages of funds of funds

Funds of funds have some neat benefits for investors, hedge fund managers, and the banks, brokers, and consultants who put hedge funds together.

First off, no matter who's investing, funds of funds have two distinct advantages you can take to the bank: