

The Challenges of Investing An Institutional Investor

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In the light of reduced equity and bond return expectations, institutional investors have shown an increasing interest for alternative investments. This article explores the main challenges that institutional investors face when investing in hedge funds. The central question of asset allocation is addressed in preamble to the discussion to invest either directly in hedge funds or by means of an investment in funds of hedge funds, investable hedge fund indices or structured products.

The general preference for alternative investment solutions where guidance is provided from an independent source is a distinctive character of institutional investors. After a discussion about the practical considerations of investing in hedge funds, the article outlines the importance of an effective financial and operational due diligence process that goes far beyond a “ticking-the-box” approach on a due diligence questionnaire. Finally, the limitations of some popular risk monitoring tools as well as style drift are briefly analyzed. While the discussion around asset allocation broadens the scope to the full spectrum of alternative asset classes, the focus is more on direct or indirect hedge fund investing thereafter.

Institutional asset allocation to alternative investments

After the exceptional bull market of the 1990s and the subsequent bear market led by the NASDAQ in March 2000, current expectations of returns on developed equity markets have been lowered. Consequently, most institutional investors have acknowledged the benefits of adding alternative investments to

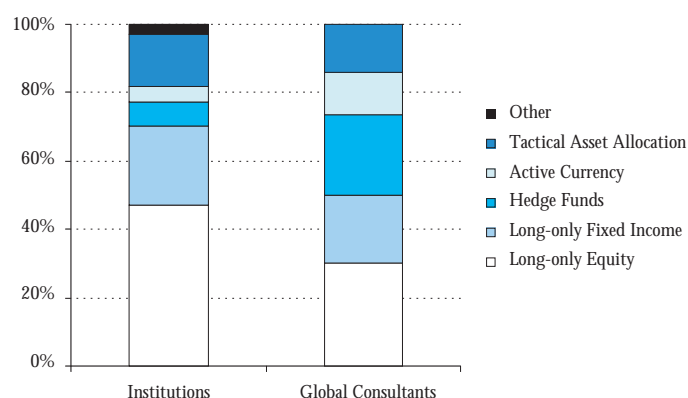
a conventional long-only portfolio of equities and bonds. The unique risk and return characteristics of alternative investments and the diversification benefits of adding a broad range of alternative investments to a traditional portfolio have also been supported by an abundant academic research and empirical evidence. A recent survey², conducted by IPM, First Quadrant and with the cooperation of AIMA, about large European institutions and global consultants' views on alternative investments offers fresh evidence on the diversification benefits as, according to that survey, the vast majority (87%) of European institutions have an allocation to alternative investments. Interestingly, the same survey analyzed the actual and recommended risk allocations of institutions. The results reproduced in Figure 1, hereafter, indicate that global consultants recommend a more balanced risk allocation across the various asset classes and a reallocation of part of the long only equity asset class to hedge funds.

Overall, the current debate among the asset management community tends to crystallize between beta and alpha strategies. While beta strategies provide an expected return commensurate with the risk taken on the markets, alpha may be defined as excess expected return due to a manager's skill. The vast majority of alternative investment strategies are in the latter category, although the true ability of the alternative investment fund managers to generate excess returns needs to be carefully scrutinized. Regarding to beta strategies, one may also question one part of the traditional long-only fund industry charging 'active' fees while delivering performance in line or below a passive market benchmark. The rising success of exchange traded funds (ETFs) charging low or 'passive' fees and delivering performance in line with their passive benchmark may bring significant changes to the institutional investors long-only portfolios provided they have a solid strategic and tactical asset allocation process.

The decision to shift the overall asset allocation more towards alternative investments poses a number of challenges for determining the appropriate allocation to alternative investments as traditional optimization tools and methods based on historical data are generally ineffective when combining both asset classes. Simulations will generally work best for determining the appropriate allocation for conventional and alternative investments. Note that while most investors have been looking at hedge funds as a separate asset class, many practitioners prefer to refer to alternative investment strategies.

Investing in Hedge Funds – The Investor's Perspective

Figure 1: Active Risk Distribution - Actual institutions Allocation vs. Global Consultants Recommendations



Source: Lars Ericsson and Paul Roberts, IPM Informed Portfolio Management AB. Hedge Funds and Currency Management Biggest Gainers as Institutions Increase Alternative Investments. *AIMA Journal*, December 2004.

Structural and regulatory constraints

Some institutional investors are also constrained by their own liability structure and regulatory restrictions when investing in alternative investments. Taxation impacts also need to be carefully considered.

Pension funds have a statutory obligation to seek advice in some jurisdictions. They generally face specific investment restrictions and have a liquidity constraint in relation to the payment of pensions and benefits. In the US and other jurisdictions, hedge fund managers may end up as fiduciaries if they exceed a specific limit (25%).

Life and non life insurance companies likewise face a number of regulatory constraints both in terms of the nature and maximum holding percentage of specific instruments. The UK regulators (FSA) have issued for example an Interim Prudential Sourcebook outlining the specific rules to be followed by UK insurance companies.

Alternative investment products or solutions?

A number of conferences and recent studies about institutional investors' attitude towards hedge funds have revealed a gap between the institutional investors' expectations and hedge

fund managers' marketing and selling strategies. Pension funds and insurance companies, in particular, are generally more interested in alternative investment solutions that will meet their needs instead of merely acquiring hedge fund products. The selection of the most appropriate products will generally depend on the expectations of the institutional investors. Key questions will include: does the institutional investor need a return enhancer? What part of the traditional portfolio will be reallocated to alternative investments? What are the minimum liquidity requirements? What is the maximum acceptable leverage? Is diversification a primary objective?

Not surprisingly, many institutional investors have gained initial exposure to hedge funds by means of investing in funds of hedge funds (FoHF) as FoHF generally act as advisors on hedge funds selection, strategic and tactical asset allocation, risk manage-

regulation and

transparency are simply a

cost of business

ment and reporting, i.e. they come up with a solution. However, with falling returns, FoHF are facing competition from independent consultants and index linked products which offer a cost effective solution to an increasing number of investors. The growth of investable hedge fund indices has been considerable over the past few years as they grew rapidly to an estimated US\$8 to US\$10 billion³. The primary motive of some of the largest institutional investors when investing in passive hedge fund index funds is to avoid impacting the market given the large size of their investment portfolio. This concern seems to be shared by the world largest pension fund, The Japanese Government Pension Fund (GPIF), as GPIF has recently announced that they will allocate part of their \$460 billion investment portfolio to hedge funds primarily by means of an exposure to a passive hedge fund index. The emergence of a number of specialized boutique alternative investment specialists covering the entire alternative investment spectrum, including hedge funds, private equity,

venture capital, commodities, real estate, energy and other alternative asset classes may also provide a valuable alternative solution to institutional investors seeking a sole entry point for diversifying across all alternative asset classes. Investment clubs or communities dedicated to institutional investors with a focus on alternative investments have also gained in popularity.

Are structured hedge fund products suitable to an institutional investor's portfolio?

Structured hedge fund products have gained significant traction on the market in the recent past. These structured products provide risk reduction by means of a combination of the following: institutional due diligence, strict investment restrictions, institutional risk oversight, and a risk transfer or capital protection mechanism.

Collateralized Fund Obligations (CFOs) and Constant Proportion Portfolio Insurance (CPPI) are among the most popular structured products. CFOs are sold to investors in various tranches which may be investment grade. The funds raised by the sale of CFO tranches are invested by FoHF managers. Such structures allow some institutional investors to gain exposure to hedge funds while they are in theory restricted to conventional asset classes. With a CPPI, the portfolio is dynamically rebalanced between a risky asset (a hedge fund or FoHF portfolio) and a risk-free asset (generally a zero-coupon bond) depending on the difference between the net asset value (NAV) of the fund and a risk-free benchmark (the zero-coupon bond). When the fund's NAV moves closer to the risk-free benchmark, the allocation to the risky asset is reduced and vice versa. CPPI is thus a form of capital protection.

Before investing in a structured product, an institutional investor should examine the suitability of the structured product relative to his needs, especially in terms of liquidity, transparency and leverage. Frequently the detailed structure of such products is insufficiently documented in the prospectus. The investor should be prepared with a battery of questions to the distributor to understand the fundamentals of the product and under which circumstances it may or may not be an appropriate fit for the entire portfolio. Understanding the terms between the product manager and the guarantor bank will generally provide invaluable clues. How valuation issues are dealt with, in particular in relation to OTC options, must also be addressed. Finally, capital protection always comes at a cost. An in-depth understanding of direct and indirect costs of participating to such structures should be a prerequisite.

Practical considerations when investing in hedge funds vs. funds of hedge funds

Many of the large institutional investors with a long history of investing in alternative investments, such as the California Public Employees' Retirement System (CalPERS), have dedicated resources to actively manage and monitor their exposure to alternative assets. Some of these institutions have developed in-house expertise while others seek the assistance of a FoHF manager or a consultant to invest directly in hedge funds. But for the majority of institutions, the question to invest directly in hedge funds or in FoHF, generally depends on the following criteria: are staff resources limited at managing the overall portfolio? Is the objective merely to gain exposure to a diversified

portfolio of hedge funds? Is there a primary focus on asset allocation? When the answers are positive to all of the above questions, a FoHF approach is generally preferable. Otherwise, direct investment in a diversified portfolio of hedge funds may be considered depending on a long term assessment of the merits of investing directly in hedge funds (in terms of liquidity requirements, resources constraints, risk management capabilities, development objectives, etc.).

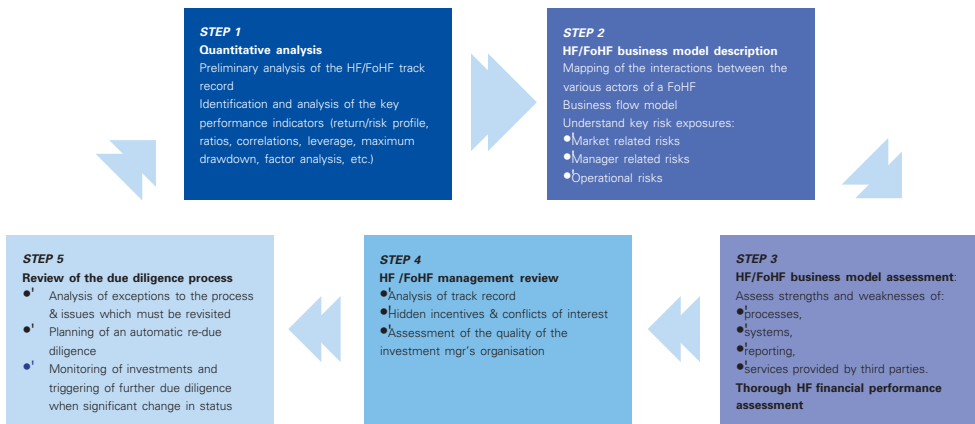
Vital importance of an effective financial and operational due diligence process

The hedge fund industry has grown tremendously over the past 10 years to reach global asset under management in excess of US\$ 1 trillion. The key challenges for the institutional investor are: hedge funds are mostly unregulated, they generally offer poor liquidity and limited transparency to their investors, and last but not least, many of the best hedge funds are closed. In addition, many of the well publicized hedge fund collapses have revealed that operational failures were frequently the root causes of these collapses. As a result, some industry experts have claimed that only 5 to 10% of hedge funds are worth investing.

Consequently, a rigorously quantitative and qualitative due diligence process must be implemented to separate the wheat from the chaff. Due to the complexity of some of the hedge fund strategies and to the wide range of risks, the due diligence approach must be holistic in nature. This means that only the combination of analyses about a hedge fund business model, performance and relevant risk parameters, including operational risk, will allow drawing a conclusion about the merits of investing in a hedge fund under review.

Figure 2 hereafter, outlines a HF/FoHF financial and operational due diligence process. Typically, a short list of potential candidates corresponding to the investor's focus is established after a quantitative screening of the hedge fund universe from multiple sources. Step 1 is a preliminary analysis of the HF/FoHF consisting of an in depth analysis of the strategies and approach, initial assessment of risks and review of performance. If the candidate passes the initial test, a second level of diligence may be conducted and comprises an analysis of risk at the portfolio level, a comparison of performance and fees relative to peers and an analysis of leverage and liquidity. Step 2 focuses primarily on the business model description. It includes an overview of all interactions between investors, the HF, the prime brokers, the administrative function (or fund administrator if outsourced), services providers, including brokers, Electronic Communication Networks (ECNs), Depository Trust Clearing Corporation (DTCC), custodians and sub-custodians. Step 3 is a comprehensive assessment of the business model. It consists of a thorough analysis of the HF/FoHF financial performance and of an analysis of operational risk at the level of processes, systems, reporting and relations with service providers. Serious shortcomings of the investment policies or operational bottlenecks should be clearly identified at the end of this step. Step 4 focuses primarily on corporate governance and on the fund manager track record. Background checks and verification of conflicts of interests are carefully performed. Finally, Step 5 is a general review of the due diligence process upon which the decision to invest or sell the investment is made. Step 5 aims at identifying the yellow flags that will trigger a partial re-due diligence sometime in the future once predefined parameters have been exceeded. For example, a rising star hedge fund

Figure 2: Process for HF/FoHF financial and operational due diligence



Source: Yves Courtois, KPMG Advisory

manager may be extremely talented at managing his portfolio. However, as he is attracting more money, the size of his operations is growing, i.e. he is running a business, not just a portfolio. A partial re-due diligence may be needed to ascertain that the hedge fund manager is adequately managing properly his operations. Step 5 forms thus an integral part of the ongoing risk monitoring of the investment portfolio.

Some risk monitoring considerations

A broad array of risk measurement tools are used to monitor hedge fund risk. These tools include Value-at-Risk (VaR), stress testing and scenario analysis, the Sharpe ratio, option exposure (Greeks), drawdown, concentration measures, leverage, etc. Depending on the hedge fund strategies, some of these tools will be more relevant than others and are subject to limitations.

VaR has been gaining importance and is best described with an example. A VaR with a 99% confidence interval of -5.5% tells us to expect a loss of at least -5.5% with a frequency of 1 in 100 days. However, VaR in a hedge fund context has a number of significant shortcomings. First, it does not provide us information on the magnitude of a loss. Second, it is based on the assumption of a normal distribution of returns (bell shape). Most hedge funds exhibit, however, skewness and fat tails in the distribution of their returns. VaR may thus significantly underestimate the exposure to significant losses. Third, the possibility of rare but catastrophic events (such as sovereign default, geopolitical crisis, and terrorist events) tend to happen more often than we think! The collapse of the Long Term Capital Management (LTCM) fund is one of the most prominent examples⁴ where VaR proved unsuccessful in an extreme market environment.

With stress testing, on the other hand, focus is on the worse case scenarios for the risk factors governing the portfolio. They may be conducted at the level of specific risk factors or at the level of correlations. We may assume, for example, that correlations between markets approaches 1 during market turmoil, i.e. there is no diversification possible. Scenario analysis is a technique aiming at building worse case but still realistic scenarios. Both techniques have generally been recognized among the most effective, but they also need much input.

A compromise may be to apply VaR during “normal” market environments but to switch to scenario analysis and stress testing during “extreme” market events.

In light of the above, the selection of an appropriate risk management platform and the recruitment or training of qualified staff are essential to conduct an ongoing risk monitoring of the hedge fund exposure. Risk monitoring procedures also need to be implemented.

Style drift: is it an issue to the institutional investor?

Style drift may be defined as the hedge fund manager departing from the stated style or strategy. Style drift may come in one of the following two forms: either a drift in the exposure to risk factors relevant to the stated style or strategy or a change in the quantity of risk (increase of leverage for example).

Some argue that style drift is not always undesirable, but it should always be clearly understood by the investor. A detection of unexpected style drift should generally trigger a redemption of the investment. A talented hedge fund manager in merger arbitrage, for example, may find his strategy out of favor at times when the mergers and acquisitions deal flow is drying up. He may be tempted to change the risk profile of the fund in an attempt to remain at the top of the league tables.

An interesting recent development relates to the increasing appetite from the cash rich hedge fund managers for private equity deals. While some alternative investment management groups may well have the expertise both in hedge funds and private equity, such development by pure play hedge funds should be treated with caution as private equity are long term and illiquid in nature. ●

Notes

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- 2 Lars Ericsson and Paul Roberts, IPM Informed Portfolio Management AB. Hedge Funds and Currency Management Biggest Gainers as Institutions Increase Alternative Investments. AIMA Journal, December 2004.
- 3 Why pension funds cannot ignore investable indices. Hedge Fund Review, October 2004.
- 4 Jorion, P., (2000). Risk Management Lessons from the Long Term Capital Management, European Financial Management, Vol 6 pp. 277-300.