



# BEYOND 60/40

The evolving role of hedge funds in institutional investor portfolios

An AIMA Investor Steering Committee publication – May 2013

## Foreword

I am delighted to introduce on behalf of the AIMA Investor Steering Committee (ISC) our new paper, *Beyond 60/40: The evolving role of hedge funds in institutional investor portfolios*.

The paper is based on a survey of some of the most influential institutional investors in hedge funds globally. It sets out to explain why traditional portfolio construction techniques have been revisited by many investors since the crisis and what some of the new thinking in that space involves, including the role of alternatives in general and hedge funds in particular in the portfolios of tomorrow. It also seeks to dispel some common misconceptions about hedge funds and hedge fund investing.

In the paper, we wanted to hear directly from the hedge fund investors. One of the things that they explain in their detailed responses – which are quoted from liberally throughout the paper – is why they have invested in hedge funds. Many of them have either invested in hedge funds since the crisis for the first time, or have increased their allocations. Many spoke of their desire to apportion more of their overall portfolios to hedge funds in the coming years. Where the investors were somewhat critical – whether over fees, say, or governance – it was important that these criticisms also be included.

Although the sub-title of the paper refers to the “role” (singular) that hedge funds play in the investors’ portfolios, one of the key findings of our survey is that hedge funds continue to perform a variety of different roles (plural). Superior risk-adjusted returns are still, and always will be, essential. But our fellow investors also spoke of their desire to tap into other potential benefits, including capital preservation, reduced portfolio volatility and increased diversification.

The lengths that institutional investors methodically take in reaching their investment decisions are also acknowledged in the paper. Investors devote enormous amounts of time and resources to researching new investment opportunities, risk profiles and strategies, and in undertaking the subsequent due diligence.

I would like to express our gratitude to the investors for devoting so much of their time to this initiative.

I would like to thank AIMA, on behalf of the ISC, for their continued commitment to investor-engagement. Particular thanks are also due to Théodore Economou, CEO & Co-CIO, CERN Pension Fund; Sajal Jagdish Heda, Investment Manager, Al Omran Group; Elizabeth M. Hewitt, Director of Public Investments, Robert Wood Johnson Foundation; David Morehead, Director of Investments, Baylor University; and Andrew Waring, Chief Executive, MNOFF; for their help and support.

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**The paper sets out to explain why traditional portfolio construction techniques have been revisited by many investors since the crisis and what some of the new thinking in that space involves, including the role of alternatives in general and hedge funds in particular in the portfolios of tomorrow.**

The ISC has been responsible for a number of useful publications in recent years, including the *Roadmap to Hedge Funds*, the world’s first educational guide for institutional investors in hedge funds, and the *Guide to Institutional Investors’ Views and Preferences Regarding Hedge Fund Operational Infrastructures*, which set out investors’ views, expectations and preferences on a variety of important operational and organisational issues.

We hope that you enjoy reading this paper and find it to be as useful a reference tool as those earlier ISC publications.

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### DISCLAIMER

This paper is not to be taken or treated as a substitute for specific advice, whether legal advice or otherwise. It does not seek to provide advice on any of the issues herein. The views expressed in this paper do not necessarily reflect the views of the AIMA Investor Steering Committee, AIMA itself or any of its members.

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## Executive Summary

This paper, by AIMA's Investor Steering Committee (ISC), is based on a survey of institutional investors worldwide about their hedge fund investments.

The investors provided detailed responses to a range of questions about their investment decisions and processes, and excerpts from those responses appear throughout the paper. The questions themselves are included in the appendix.

The respondents included North American, Asian and European pension funds, endowments, foundations and family offices. Their combined assets are more than **\$400 billion**.

The main findings of the survey include:

- Institutional investors are moving away from the traditional 60/40 portfolio structure and increasingly using alternatives in general and hedge funds in particular as **tools to customise their portfolios**.
- Hedge funds are increasingly regarded as a means to **access opportunities and tailor portfolios**, rather than as a separate asset class.
- Investors are using hedge funds to enable them to meet **individual objectives** in terms of risk-adjusted returns, diversification, lower correlations, lower volatility and downside protection.
- Most investor respondents said they had **increased their allocations** to hedge funds since the financial crisis, with some reporting a **doubling** of their allocations.
- Most of the respondents plan to continue to increase their allocations to hedge funds in the **future**.
- Hedge fund **due diligence** is taking longer, with one investor respondent saying it now can take up to two years to complete.
- The increasing emphasis placed by hedge funds on **transparency** since the crisis was generally welcomed. Investors said however that they did not want to be swamped with unnecessary information.
- Many of the investors welcome the increased **regulation** of the hedge fund industry since the crisis, including the additional reporting requirements to regulators. But some spoke of worries that the reforms could be onerous or restrict their ability to allocate to certain managers in certain jurisdictions.
- Asked what steps the hedge fund industry could take in order to attract new or increased investments, the investors cited **lower fees**, further **transparency**, additional changes to **governance** and further improvements to **operational infrastructure**.
- Larger hedge fund managers were generally attracting most of the institutional investment, but some investors were starting to explore ways of allocating to smaller, **emerging managers**.
- Investors would like to see hedge funds willing to take fewer clients and build stronger **strategic partnerships** with them.

## Introduction

Institutional investors face an almost **unprecedented set of challenges**. The post-crisis period has been one of slow economic growth, low or effectively even negative interest rates, volatile markets and increasing geo-political pressures.

This set of conditions is threatening to undermine the viability of the traditional Markowitz portfolio model – the “60/40” model of a 60% allocation to domestic equities and 40% to high-grade corporate or government bonds. Equities may have been performing well recently, but investors have not forgotten the stock market falls of 40% in 2008, while some sovereign bonds are not yielding in real terms – indeed many investors effectively are paying governments for the privilege of lending them money. Put another way, assets that were once regarded as “risk-free” are now characterised in some quarters as “return-free”.

Institutional investors have been compelled to move away from the 60/40 structure and consider non-traditional approaches to investing. Faced with managing investment portfolio risk while at the same time identifying solutions that will generate sufficient portfolio returns to support their future liabilities, the need to employ **diverse investment strategies** is more important than ever.

Many investors now regard alternatives in general and hedge funds in particular as **tools to customise their portfolios** and enable them to achieve individual objectives in terms of risk-adjusted returns, lower correlations, lower volatility, greater diversification and more downside protection.

Hedge funds in general have recovered fairly well from the financial crisis. Total assets under management reached \$2.4 trillion, a new record level, by the end of the first quarter of 2013.<sup>1</sup> New research in 2012 was able to demonstrate how hedge funds outperformed

equities or fixed income over the long term.<sup>2</sup>

Institutional investors have been the main source of the industry’s asset growth since the crisis.<sup>3</sup> But why has so much money flowed into the industry at a time of relatively **modest returns** for many hedge funds?

This paper, by the members of AIMA’s Investor Steering Committee (ISC), sets out to answer this broad question.

We, the ISC, are a group of institutional investors in hedge funds globally. Our paper is the product of a survey of many leading institutional investors in hedge funds worldwide. The respondents include North American, Asian and European pension funds, endowments, foundations and family offices. We regard them as being **among the most influential institutional investors in**

**Hedge funds are increasingly being seen as tools to customise portfolios to enable investors to achieve individual objectives in terms of risk-adjusted returns, correlations, volatility, diversification and downside protection.**

**hedge funds**, with combined assets of more than \$400 billion. They were asked a series of questions about their hedge fund investments, including the size of their allocations and the role that hedge funds play in their portfolios.

We questioned them about the processes that they follow in making those allocations, including their due diligence and risk management requirements. And we invited them to suggest changes that the industry could make to encourage further increases in allocations.

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### NOTE

<sup>1</sup> Hedge Fund Research, ‘HFR Global Hedge Fund Industry Report’, 19 April 2013

<sup>2</sup> The Centre for Hedge Fund Research, Imperial College, ‘The value of the hedge fund industry to investors, markets and the broader economy’, April 2012 (AIMA/KPMG)

<sup>3</sup> KPMG and AIMA, ‘The evolution of an industry’, May 2012

## Section I

# The Investment Portfolio

**Investors regard hedge funds increasingly as tools to customise their portfolios and enable them to achieve individual objectives in terms of risk-adjusted returns, correlations, volatility, diversification and downside protection.**

**Most respondents have increased their allocations to hedge funds since the financial crisis, with some reporting a doubling of their allocations.**

**Investors do not consider hedge funds as a separate asset class but as a means to access opportunities and tailor portfolios.**

Our survey began by asking the institutional hedge fund investors about their portfolios: the overall risk and return objectives; the size of their allocations; and the role that hedge funds play in them.

A number of significant findings emerged. There were clear signs that the investors we spoke to had chosen to step back from the more traditional approach to portfolio construction in favour of a more **dynamic approach**, and that they were not deterred by hedge funds' sometimes modest returns during the post-crisis period.

There was also recognition that lessons from past experiences had been learned. "If we look at the classic approach of **60% equities/40% bonds**, the portfolio was too focused on assets and not focused enough on risk," said an investor from the Middle East.

"If that same portfolio were viewed in terms of risk, the result was extremely skewed towards equities. Ninety per cent of the portfolio's overall risk was seen coming from the equity holdings and only 10% from the bond allocation. We thought the best way to approach this task was to identify the existing risk exposures in

a portfolio and select hedge funds that have **similar volatility and return profiles with non-correlated risks.**"

For all the investors we spoke to, hedge funds had become an integral part of their investment approach. As a large US endowment put it: "The hedge fund portfolio is a **core allocation** in the overall endowment portfolio, and we have no near-term plans to decrease it in size. We believe that hedge funds can continue to generate equity-like returns with one-third to one-half the risk of equities. We think that the hedge fund allocation balances our private equity portfolio, which targets returns higher than public market equities, but with the same risk as equities."

These remarks underscore the growing awareness among institutional investors that the traditional static approach to asset allocation may not always protect their fundamental interest – that is, to ensure steady **risk-adjusted returns** over time for their investment as well as best **preserve the capital investment** of the same.

Historically, pension scheme investment portfolios, for example, consisted of an allocation to equities, bonds and cash with a heavy investment bias towards equity weightings (as per the classic market portfolio theory/Cap M approach). As recent years have shown, an over-reliance on this model of investing can leave investors exposed to the volatility of equity markets while even the traditional safe haven investing via fixed income type investing has come under pressure.

### Hedge fund allocations

Some respondents said they had **doubled their investment allocation to hedge funds** over the past five years. The average allocation to hedge funds by our pension fund respondents was approximately 8% of their total investment portfolio. The same metric from our sample of endowment and foundation institutional investors was closer to 25%. "We only started allocating [to hedge funds] post-crisis," said one US public pension fund. "We hired a consultant in 2010 and the first allocation was approved in 2011. In this way, we were able to **learn the lessons from the crisis.**"

“We have benefited from what happened in 2008,” said another large US investor. “**Transparency and fund lock-ups** are so much better.”

“Until 2010, our allocation to alternatives was zero,” admitted a large European pension fund. “The decision was taken in 2011 to build a test portfolio with the aim of demonstrating that alternatives can achieve strong **protection against market downturns**, while capturing sufficient upside to deliver high efficiency (as measured by the Sharpe ratio). We were able to do this due to our prior investing experience in alternatives at other employers. The August 2011 downturn allowed our test portfolio to demonstrate exactly what we had promised, giving us the green light to boost the allocation.”

Not all of the respondents said they had a dedicated hedge fund allocation. “We do not view hedge funds as a separate **asset class**,” said a US public pension fund, “and thus do not have a set hedge fund allocation. We view hedge funds as a structure to access talent and opportunities.”

Another pension fund said: “I believe hedge funds serve the following purposes: to provide **diversification** to long only strategies, to provide access to **hard to access strategies/deals**, and to provide access to strategies that require **leverage**. I do not believe that hedge funds should be viewed as an asset class.”

A UK-based pension fund made a similar point: “There is no specific allocation to hedge funds within the overall asset allocation. We do not consider hedge funds to be an asset class per se, as they cover a variety of strategies, many of which are highly correlated (such as equity long short) to other assets in the fund. Where they do exist in the alternatives portfolio, hedge funds represent an **opportunistic investment**.”

A US investor said that if it had a particular “idea”, it often turned to hedge funds to put the theory into practice. “We use hedge fund managers

opportunistically to **execute specific themes and trades**,” this investor said. “In these instances, we are singularly focused on the **risk-adjusted return** of an ‘idea’.”

## Choice of strategy

Any allocation to hedge fund strategies needs to be taken in the context of the risk/return preference of the respective investor. Across the responses we received, the most popular hedge fund investment strategy being employed against the current market conditions was “directional-trading”.<sup>4</sup>

The public pension fund managers we spoke to in particular said they wanted to blend a larger share of their equity portfolio allocation with directional hedge fund managers, particularly equity long/short-focused hedge fund managers. Employing this strategy was seen as offering the investors a way to reduce their portfolio **volatility** while maintaining their returns.

“We have benefited from what happened in 2008,” said a large US investor. “**Transparency and lock-ups are so much better.**”

Many of the respondents also said they were allocating to macro-focused hedge funds, a reflection of the strong performance of such funds over the past five years. Non-directional hedge fund strategies such as relative value strategies (event driven strategies and convertible/fixed income arbitrage) were also popular among the investors. Allocations to these hedge fund strategies have become more common in the past year, with assistance being provided to the allocator via the use of funds of hedge funds and/or investment consultants.

Indeed, the use of funds of hedge funds are to the fore, providing access to other hedge fund strategies previously not considered by the institutional investor. The majority of our respondents said

## NOTE

<sup>4</sup> Strategies that tend to perform best from the direction that the market takes, they include the original hedge fund strategy – long/short equity that can be invested in either developed markets or emerging markets. Funds can also be directional credit while macro funds and managed futures investing are also considered to be directional.

they preferred to invest through the traditional **commingled** hedge fund product, as most investors ideally prefer to be invested in the flagship fund of the hedge fund manager (where, generally speaking, the principal has made its investment).

That said, a number of investors we spoke to said they recognised the merit of investing via a **managed account and/or “fund of one”**, in particular in certain strategies which may deem the need for closer inspection/monitoring from a due diligence perspective. Across our sample, our pension fund respondents in particular said they preferred the “fund of one” product offering over managed accounts, since such an offering provides the same level of transparency and risk-reporting as a managed account solution but with less of the administrative burden.

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**A US-based charitable foundation said it viewed its hedge fund investments as playing an “important anchor role” and a “volatility dampener”.**

## Benefits to investors

After an extended period of poor returns in equity markets, hedge fund performance remains an important factor in these investment decisions. Many of the respondents to our survey identified outperformance based on a manager’s skill as still being very influential.

They said that an allocation to hedge funds (as part of a diversified portfolio of otherwise traditional investments) was considered to be the best investment strategy to generate absolute returns (on a net-of-fee basis) while having a low correlation to various markets that the portfolio was invested in.

Absolute return managers consider not only the long-term compounded returns on their investments but also how the value of their investment changes during the period under consideration. In other words, an absolute return manager tries to increase its wealth by balancing opportunities with risk and employing portfolios that are diversified and/or hedged against strong

market fluctuations on the downside.

“In our absolute return portfolio,” said a US pension fund that holds about 15% of its assets in hedge fund strategies, “we look for hedge funds to generate **high absolute returns with a low correlation to equity and credit markets**. We accomplish this by identifying managers we believe execute a strategy that is diversifying against our existing portfolio of risks and can be executed with consistency going forward.”

Many of the pension funds we spoke to said they considered their investment in equity long/short as primarily being a method to **reduce volatility** within their public equity allocation, not to generate excess returns.

This reflects a change in the expectation of many hedge fund investors. By virtue of the variety of hedge fund strategies that can be invested in and the low correlation to markets that investing in these strategies provides, an allocation to a particular hedge fund strategy is considered the most likely strategy to potentially **smooth out volatility** which could impact negatively on the relevant fund’s portfolio returns and ultimately its portfolio worth.

This is a very different investment mandate to that pursued by many high-net worth individuals (who accounted for the absolute majority of capital investment in hedge funds prior to 2008); namely to achieve out-performance with high returns.

The importance of having an effective asset allocation process was highlighted in the recent financial crisis where even mature pension schemes encountered rising fund deficit levels due to a high allocation to “risky assets” such as equities.

This “volatility” risk can be efficiently managed throughout the life span of the investment, both in the growth and maturing stages by an asset-allocation strategy.

Ultimately employing a diversified approach to allocating to the investment portfolio should provide greater protection for growth and should lock in any gains made, closer to the investment’s maturity. As if to underscore the different

expectations of institutional investors, a global pension fund we surveyed said that “achieving **uncorrelated returns** to other investments together with preserving capital are the two chief reasons for investing in hedge funds”.

**Capital preservation** was also cited by a US pension fund. “We are generally looking for funds that have less downside risk,” said this investor, which aims to return 8% a year from its hedge fund allocation. “We want funds that exceed our target, although in some circumstances we are willing to take on more beta risk. Generally, we are looking for more attractive risk-adjusted returns.”

“Hedge funds benefit from more flexible mandates and less constrained use of financial instruments to execute their strategies (e.g., managers have the ability to short, use leverage, trade derivatives, and build more concentrated positions).”

Another investor, a US-based charitable foundation, told us that it viewed its hedge fund investments as playing an “important anchor role” and a “**volatility dampener**”. Added another US investor: “Our primary goal [in investing in hedge funds] is to reduce volatility to public equity markets... We have bounced around with the stock market too much.” An Asian pension fund agreed. “We use hedge funds to **dampen the volatility of the portfolio** and we still continue to adopt such an approach in the future,” it said.

By virtue of the variety of hedge fund strategies that can be invested in, and the low correlation to the markets that investing in these strategies provides, an allocation to a particular hedge fund strategy is considered the most likely strategy to potentially smooth out any volatility, which could impact negatively on the relevant fund’s portfolio returns, and ultimately its total portfolio worth.

One Middle East-based family office said that it allocated to hedge funds because they were able to “provide the best of both worlds” by offering the level of **diversification** that it required as well as having a lower correlation to the rest of its portfolio. Above all, hedge funds’ appeal to the

investors we spoke to owed much to their ability to utilise a greater variety of tools and strategies, and, by consequence, a broader set of opportunities.

One large US private pension fund summed up this thinking when it spoke of the **in-built “advantages”** for hedge fund managers compared to their long-only counterparts. “Hedge funds benefit from more flexible mandates and less constrained use of financial instruments to execute their strategies (e.g., managers have the ability to short, use leverage, trade derivatives, and build more concentrated positions),” it said. “Strategies have greater breadth and, therefore, are less dependent on market directionality (which improves risk-adjusted returns).

“Performance for absolute return strategies is driven more by **active risk** (as opposed to passive beta replication) whereas long-only managers’ portfolios and risk profiles are often heavily constrained by the need to closely track an index. Performance fees incentivize managers to focus their attention on absolute returns. And meaningful **co-investment**, GP ownership stakes and high water marks encourage disciplined downside **risk management**.”

This pension fund manager added: “These factors provide hedge fund managers with the **flexibility** to potentially deliver attractive risk-adjusted returns by capturing various market risk premia opportunistically; tailoring risk postures to market conditions; executing relative value trades; and providing liquidity to the market through complex trades or when risk capital is scarce.”

## Section 2

# The Investment Process

**Operational due diligence has become a critical part of investors' decisions to allocate to hedge funds.**

**Investors welcome the increased emphasis placed by hedge funds on transparency, but do not want to be swamped with unnecessary information.**

**The increased regulation of the hedge fund industry is generally regarded positively, although there are concerns over potential restrictions in investing in managers in certain jurisdictions.**

One of the most significant industry trends of recent years, driven by increased institutional investment in hedge funds, has been the process of **institutionalisation** of the industry. In the case of pension funds, these organisations tend to have a very structured investment process that requires extensive control and approval. As such, any investment mandate would need to be met with the majority approval of the pension fund board of directors/trustees (or similar entity responsible for the operation and oversight of the investment process of the pension fund).

Investors spend a great deal of time researching the universe of hedge fund investments to identify the appropriate investment for them. Upon finding this investment, more time will be spent on the **due diligence** process to ascertain whether it can be accepted into their portfolio.

“Hedge funds need to compete for capital versus all other return-seeking investments in the portfolio,” remarked a UK pension fund. “In order to make an allocation to a hedge fund, it must be deemed to be more attractive than, and uncorrelated to, other components of the portfolio such as equities, bonds and other, less liquid alternatives.”

Given that a **knowledge gap** around alternative investments (of which hedge funds are considered

a part) still exists among some pension fund board members as well as equivalent personnel at other investors, the challenge remains for their portfolio managers/investment staff to advocate the merits of hedge funds as an appropriate investment.

“We wanted to get invested as fast as we could because we had too much [exposure to] equities,” said one US pension plan, which invests around 5% of its assets in hedge funds. “The plan was to gain the trust of the trustees, who were new to hedge funds, with a funds-of-funds programme, and then go direct. Today, we have invested about two-thirds of the amount originally approved by the board.” The investor added: “There is still a lot of work to do, but we feel good about it so far.”

### Specialist advice

Dependent on the experience and size of the institutional investor, they will very often hire specialist advice (i.e. fund of hedge fund manager and/or investment consultant) who will help them implement an investment program to leverage off their knowledge of the hedge fund universe and provide access to managers that otherwise they may not be able to invest in.

“We chose to implement the programme via a **fund of funds** to overcome a number of issues and challenges,” said one large Asian investor, which allocates about 10% of the assets of its medium-term and long-term portfolios to hedge funds. “Those challenges include picking strategies, sourcing and identifying managers, due diligence (investment and operational), monitoring, risk aggregation, ability to negotiate fees and capacity, building a diversified hedge fund portfolio and rebalancing.”

Investors often hire their own staff to help them invest more directly. That does not rule out the role of the **consultant** entirely though; we are witnessing an emerging trend of investors calling on consultants to help them invest into more niche markets or assess the value of investing in hedge fund strategies which the investment principals are unable to spend the required time on. Indeed some of our larger investor respondents have called on the services of hedge fund consultants to allow them to build a hedge fund program to

invest in some of the smaller (as a measure of AUM) hedge funds too, which have demonstrated proven diversification and risk adjusted returns for their portfolio.

Sometimes, outside help is brought in just to deal with specific steps in the process. One large US endowment that conducts the investment research and due diligence itself but outsources operational due diligence to consultants, told us it wanted to maintain control over the allocation decisions. “We feel that consultants tend to direct larger institutional investors like ourselves towards bigger funds, and we usually like to invest with medium to large managers,” said this investor.

The hedge fund industry has evolved considerably since 2008 in response to more operational and organisational demands by investors. Most hedge fund firms have upgraded their **operational infrastructure**, while investors’ due diligence is taking longer and going into ever-greater depth.

“Our due diligence process for new investments typically takes 6-24 months,” said a large university endowment fund. “Being able to complete a ‘deep dive’ on a manager is time-intensive and requires an experienced and dedicated team.”

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Investors are usually prescriptive about what they may invest in. A European pension fund said that it had “very strict due diligence criteria, which limits the universe of alternative funds we can look at to about 100 managers”. It said it excluded funds with “any restriction to assurance of being able to redeem in 12 months or less, difficult-to-value underlying instruments or illiquid underlying (for example, in the case of direct lending), lack of world-class risk management. In theory, any strategies that can pass these tests are admissible.”

But more often, investors will exclude certain opportunities. “We prefer a high emphasis on

operational due diligence to ensure a sufficiently robust operational and compliance framework,” said a UK pension fund that tends to invest with established managers with good track records. “Without this, we will not invest even if the investment strategy is excellent.”

This investor said it also required independent legal sign-off on the terms of the investment before it entered a fund. “Occasionally we have had to drop plans for investment due to unreasonable terms within fund documents, such as an inability to deal appropriately with conflicts or the ability to amend investment strategy without notification to investors.

“Newer fund documents are getting better, but old investor terms (pre-2005) may simply allow the manager too much flexibility. Typically we require external administration, independent pricing and segregated custodianship of assets for managers,” it added.

Hedge fund **fees** are often a constraint. “We do not have a formal constraint to investing in alternatives. However, in practice, the constraint is fees, which is why we are limiting the allocation to 15%,” said a European investor. “To obviate the above constraint, we have selected a number of alternative managers who are running traditional strategies with the same risk management as their alternative funds. Costs tend to be much lower.”

**Size**, both of the investor’s allocation and the hedge fund itself, could be another limiting factor. “We have to be wary of our size. We have been looking at tickets of \$100 million-\$300 million and don’t want to be more than 10% of anyone’s firm,” said a large US public pension fund, which also said that it focuses on “liquidity terms, length of lock-ups, fees and ‘key man’ issues”.

Sometimes, however, investors are flexible about their demands. “There are few hard constraints, if any, for our portfolio,” said a US endowment fund that allocates about 20% of its assets to hedge funds. “We require that the manager be of institutional quality, which encompasses a whole range of objective and subjective measures, but we try very hard not to draw lines in the sand and remain as open-minded as possible.”

## Risk management

Assessing risk is a critical part of the overall investment process. As such, the primary aim of the portfolio risk management process is to maximise the return-to-risk profile of the portfolio, subject to it reaching the actuarial objective.

As has been highlighted above, central to the investment process being followed is the oversight and governance put in place by the fund's trustees/members.

In the case of our respondents, the relevant investment teams (CIO etc) work to a mandate set by the fund's trustees/board of directors to manage the investment process within the fund. To that end, the fund's investment teams have full authority to manage the portfolio construction and implementation, subject to the investment guidelines set.

An insight into an institutional investor's risk-management process was provided by a pension fund respondent to our survey, which detailed the following 10-step process:

- 1) **Risk reports provided by managers:** Manager and strategy-specific; systematically collect and analyze; important feedback loop for return attribution and confirmation of investment process; negotiate transparency upfront prior to investing; gross/net exposure;
- 2) **Returns-based analysis:** Ex-post prior to investment; betas (average and rolling) to market risk factors and correlations to existing managers in portfolio as well as potential; consistency with risk reports and investment process; excess returns; IRRs; VaR;
- 3) **Liquidity of underlying investment:** Includes an assessment of the appropriateness relative to investment terms;
- 4) **Evaluating hedge fund's investor base:** Concentration; type of investor; disparity in investment terms across investors (generally don't want to underwrite liquidity for other investors as a new investor or being subject to longer lockups);
- 5) **Scenarios analysis;**
- 6) **Factor analysis;**
- 7) **Portfolio construction:** Contribution to risk by strategy and manager; correlations across managers; portfolio liquidity (cheapest (no redemption penalties) vs. fastest);
- 8) **Leverage and financing terms; margin;**
- 9) **Periodic review of underlying portfolio, as appropriate;**
- 10) **Background and reference checks.**

Investors often **outsource** elements of risk-management. In the area of due diligence, many respondents confirmed that they hire third party consultants/investment advisers to assist them in carrying out due diligence of any prospective fund investments and current allocations.

Notably, the area of operational due diligence has become critical, forming the core of any decision by the CIO/investment staff to proceed with making an investment allocation or not. Global custodians and administrators are hired to ensure investment guidelines on the underlying funds are being followed and performance is being monitored and reported on to the various parties.

"In addition to the operational queries that we undertake, each fund is also evaluated from an operational due diligence perspective by an independent third party. This forms the core of a decision to proceed further or not and is more important than the investment component," one large UK investor explained.

"External legal sign-off is also a prerequisite before we invest in a fund, as is an analysis of **money laundering risk** and the fund's know-your-client procedures. Once a fund has been through our internal recommendation process, we monitor **investment risk** as well as operational risk on an ongoing basis. Funds with high leverage are generally avoided. Investment risk is monitored on an ongoing monthly basis via quantitative and qualitative due diligence process. We review investment risk reporting on a monthly basis for each fund as well as for the overall portfolio," it added.

**Portfolio risk analysis** (pre- and post-allocation) is

also an integral component to the risk management process. Investors work with hedge fund managers to ensure that they understand all risks of their investment and that the appropriate limits (i.e. stop/loss) are put in place to safeguard them against over-exposure.

Investors also work with the underlying hedge fund managers to ensure that all counterparty risks are appropriately measured. In the context of this discussion, counterparties are to be understood as entities against which the fund is at a risk of loss (or delay in the restitution of its assets), should such an entity default.

A US endowment said its primary risk-management tool was “position-sizing with the manager”. “Additionally, we conduct frequent due diligence meetings, covering the individual manager’s exposures and risk factors,” it said.

Investors also study the **risk of failure** by the hedge fund management firm itself. “For us, risk management is managing existential risks, which we define as risks that can cause a dramatic implosion in the value of our investment,” said a US pension fund. “With the exception of leverage, such risks are usually not investment related. I worry most about cash management, custody of securities, accounting, etc. We tend to shy away from highly leveraged strategies. Our philosophy is rooted in the notion that good returns are generated over time by limiting losses. If we can limit dramatic losses by limiting or eliminating existential risks, we are highly confident that we will meet our return objectives.”

A Middle Eastern investor cited diversification and “robust” **asset allocation** as its primary risk-management focus. “Assessing risk is a critical part of the overall process,” this investor said. “The goal is to know the types of risks we might face, make choices about those we are willing to take, and understand how to build and balance the portfolio. We believe a robust asset-allocation process goes a long way to managing systematic risk because different categories of investments respond to changing economic and political conditions in different ways. Diversification allows us to manage non-systematic risk by tapping into the potential strength of different sub-classes.”

There has been considerable debate over how much **transparency** is enough, and among the investors we spoke to, opinion was mixed, suggesting the debate is on-going.

“We don’t get position-level transparency – we don’t know what we would do with it. We have an internal risk manager who looks at the entire portfolio,” said one US pension fund.

A UK investor said it supported the standardisation of reporting under the Open Protocol initiative.

Further, one of the endowments we surveyed said it was less concerned about statistical reporting packages and reports than knowing what risks its managers are taking and understanding how those could be affected in a variety of investment environments. “In our view, risk management comes down to sizing and correlation, so we spend a great deal of time on both,” it added.

An Asian institutional investor said that it preferred monthly reports from the hedge fund manager. “Whilst managers are assessed over an investment cycle, we do monitor their short-term performance to ensure all the aberrations detected are raised with them,” it said. “We do receive detailed transparency reports from funds of funds managers. At an investment level, strategic asset-allocation reviews are carried out annually to ensure the risk and return profile of the portfolio and we still continue to adopt such an approach in the future.”

**“If we can limit dramatic losses by limiting or eliminating existential risks, we are highly confident that we will meet our return objectives.”**

## Impact of regulation

There were different opinions as to whether greater regulation was a source of comfort or a cause for concern.

Many investors welcomed the introduction since the crisis of new or additional reporting requirements for managers. “Increased regulation will have little to no impact on our decision to allocate to hedge funds,” said one large US endowment.

“Broadly, we feel that required registration with and additional reporting to regulators are both positive trends in the industry and will improve oversight and transparency long term.”

“Increasing regulation has no impact on our investment decision to allocate to hedge funds,” said an Asian pension fund. A US institutional investor agreed: “We do not anticipate material changes in our approach to investing as a result of regulation.”

Other investors admitted that they were either already concerned or were closely monitoring developments.

A Middle Eastern investor said that it hoped that regulatory changes “would not impair the ability of the manager to exploit market inefficiencies using their skills to achieve higher risk-adjusted returns”. Were this to happen, “there would certainly be a very big question as to whether we would be paying high fees for beta returns,” said this investor.

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**“It’s a cost of doing business that managers have to bear. We don’t want to invest in managers that are not SEC-registered.”**

A UK pension fund manager said that, while increased regulation had not deterred it from investing in a particular hedge fund or strategy, it would continue “to monitor regulatory developments in this area”.

“Regulation is not generally a constraint for us as a pension fund investor,” said another UK institutional investor. “Nevertheless, we are concerned that the EU’s forthcoming **Alternative Investment Fund Managers Directive** – effective July 2013 – may effectively reduce our choice of managers offering products in Europe. Where managers feel that they will withdraw their offering due to regulatory or reporting reasons, this may be an impediment to our members being able to obtain the best risk-adjusted returns or strategies.”

But while the additional reporting requirements would result in even greater operational demands

(around compliance, due diligence etc.), most of the investors we spoke to said that on balance it was a net positive.

“Some of the regulation may be too onerous, but other changes are necessary,” said a US public pension fund. “When I was a small manager, we registered. It was expensive, but you had to do it. It’s a cost of doing business that managers have to bear. We don’t want to invest in managers that are not SEC-registered.”

Indeed one endowment made a point of saying that increased regulation was actually providing new investment opportunities. “We believe that this additional regulation is resulting in markets becoming more inefficient, for example in terms of the decline of proprietary trading desks leaving a liquidity gap. Consequently, we are more active in allocating to relative-value hedge fund strategies,” it said.

## Section 3

### Looking ahead

**Most investors intend to increase their allocations to hedge funds in the future.**

**Asked what steps the hedge fund industry could take to attract new or increased investments, the investors cited lower fees, further transparency, additional changes to governance and further improvements to operational infrastructure.**

**Larger hedge fund managers are generally attracting most of the institutional investment, but investors are keen to explore ways of allocating to smaller, emerging managers.**

In our survey, we asked the institutional investors about how they perceive hedge funds' role in their future investment portfolio decisions. Most of the respondents said they planned to increase allocations to hedge funds and become more risk-tolerant as market conditions improve.

The following response of one US pension fund was representative: "We expect to increase our allocation to hedge funds over time."

An endowment agreed, adding: "After significant market declines, the portfolio is likely to be reinvested in higher-risk strategies across the portfolio, and as the market moves up, it will be used to mitigate downside risk in the portfolio. At the end of the day, we are trying to use this part of the book to enable us to buy low and sell high."

"The idea would be to go back to the board once our limit is reached, and assuming everything is good, recommend that the board increase the allocation to hedge funds," said another US investor. "Last year generated 8% net return with 4-4.5% volatility and 0.14 beta and 0.35 correlation to the S&P, so, so far, so good. Hopefully, we can continue on this path."

A Middle Eastern investor said it expected that hedge funds would play a very important role in

meeting its investment objectives in future. "We believe they will continue to be an integral part of our future investment decisions," it added.

This was echoed by a university endowment, which said it continued to view its hedge fund portfolio as a "core allocation" in the overall endowment portfolio. "We have no near-term plans to decrease it in size," said the investor. "We believe that hedge funds can continue to generate equity-like returns with one-third to one-half the risk of equities. We think that the hedge fund allocation balances our private equity portfolio, which targets returns higher than public market equities, but with the same risk as equities."

An Asian pension fund said that, as it traditionally used hedge funds to dampen volatility of its portfolio, it would "continue to adopt such an approach in the future".

One of the UK institutional investors we surveyed said that it was currently exploring a method of accessing smaller, emerging hedge fund managers, as well the bigger managers that it was more used to allocating to. It said smaller managers charged "more reasonable" fees and were better able to generate higher returns with fewer assets. "This is not a preference for all strategies," the UK investor went on, "but it is possible where managers are open to considering different fee structures, including those where management fees decrease as aggregate funds managed increase. We are also considering access to some hedge fund strategies (i.e., convertible arbitrage) via liquid, passive replicators so as to reduce overall fees and enable dynamic allocation with no high-water mark issues."

### Evolution of the industry

Finally, we invited the investors to suggest steps that the hedge fund industry could take in order to encourage further institutional investment.

Perhaps unsurprisingly, many of the respondents said they would welcome lower fees. "Management fees should only cover reasonable costs to run the business, and should be reduced as assets grow – i.e., they should not be a source of profits," said a pension fund.

Many investors called for further improvements to be made to back office and operational procedures.

For example, an endowment called for improved transparency in terms of exposures, attributions and portfolio positions.

It also said it would like to see “reasonable liquidity terms that reflect liquidity of the underlying investments – 0-1 year weighted average life for equity long/short managers, 1-2 year weighted average life for credit managers”.

A US investor recommended modifying the current 25% limit on ERISA plan assets before a hedge fund becomes a plan fiduciary.

A number of other investors said they would welcome improvements to fund governance, with one UK pension fund calling for more independent directors on hedge fund boards.

The nature of the manager-investor relationship was also touched on. One US pension fund said it would like to see hedge funds “willing to take fewer large clients and build strong strategic partnerships with them”, while an Asian investor said it wanted “more alignment of interest with investors”.

The need for continued investor education was also cited.

**“A number of investors said they would welcome improvements to fund governance, with one UK pension fund calling for more independent directors on hedge fund boards.”**

“I would emphasize that educating the investors about the strategies and the role it can play to achieve overall objective is very important,” said a Middle Eastern investor. “I am not sure how educated are investors globally but in Middle East you would not find many sophisticated investors; although their portfolio runs in millions of dollars.”

Ultimately, the investors said, the industry would – and should – continue to mature and evolve. “I think the industry should continue to advance in transparency, liquidity, fee reduction and best practices – just like any business should,” said a US endowment. A large pension fund agreed. “In general, they have gotten better,” it said, “they

just need to continue down the path. We need them, and they need us.”

## Appendix

### AIMA Investor Steering Committee Questionnaire

The respondents to the ISC survey were asked the following questions:

#### A. Your investment portfolio

1. Briefly describe what the overall risk and return objectives are for your investment portfolio?
2. Does your investment portfolio allocate to hedge funds?
3. If your response was NO to question 2, why not?
4. If your response was YES to question 2 above, what percentage of your portfolio is allocated to hedge funds today? How does this compare to any allocation that you made in hedge funds prior to the recent financial crisis?
5. Briefly outline the role of the hedge fund program in your investment portfolio? When doing so, you could mention:
  - (a) Alpha
  - (b) Volatility
  - (c) Risk-adjusted returns
  - (d) Preservation of capital
  - (e) Uncorrelated return
  - (f) Access to variety of investment strategies

#### B. Your Investment Process

6. What are the issues and challenges that you face when deciding on making an allocation to hedge funds?
7. Do you have any constraints to investing in hedge funds?
8. How does increasing regulation impact on your investment decision to allocate to hedge funds?
9. What hedge fund investment strategies do you allocate to within your investment portfolio?
10. How do you structure the hedge fund allocations that you make to your investment portfolio?
11. Explain briefly the risk management practice that you follow when managing your investment portfolio?

#### C. Your view on what role hedge funds should play in the future

12. How do you perceive the role of hedge funds in any future investment portfolio decisions that you make?
13. What would you like to see being done by the hedge fund industry to encourage more institutional investors to allocate to the industry?

# AIMA'S ROADMAP TO HEDGE FUNDS

2ND EDITION

AIMA first published the *Roadmap to Hedge Funds*, its educational guide for institutional investors in hedge funds, back in 2008. Although it was released at the height of the financial crisis, it quickly became the most-downloaded publication in AIMA's history.

Commissioned by AIMA's Investor Steering Committee, it sought to de-mystify the hedge fund industry at a time when misconceptions around issues such as short-selling, fees, transparency and risk were widespread. It had a global readership and in 2010 was even translated into Chinese.

In the new 2012 edition the author, Alexander Ineichen, one of the leading authorities on hedge funds, has identified new trends and developments and strongly makes the case that hedge funds still provide a value proposition for investors.



Download the Roadmap to Hedge Funds at [www.aima.org](http://www.aima.org)

## About AIMA

As the global hedge fund association, the Alternative Investment Management Association (AIMA) has over 1,300 corporate members (with over 6,000 individual contacts) worldwide, based 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. They all 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](http://www.aima.org).

## About the AIMA Investor Steering Committee

AIMA is the founder of the AIMA Investor Steering Committee – a group of institutional investors whose activities cover pension plans (public and private), endowments, foundations and family offices. It undertakes educational initiatives and provides practical guidance within AIMA, the global hedge fund industry association.

Members of this committee include representatives from Acadia Investment Management, Ascent Private Capital Management, British Airways Pension Investment Management Ltd, California Public Employee Retirement System, GM Asset Management, Hermes BPK Partners, Hong Kong Jockey Club, Kaust Investment Management Company, Kedge Capital Fund Management, Pacific Alternative Asset Management Company, Universities Superannuation Scheme and University of Texas Investment Management Company.

For further information on the ISC or to find out how to get involved, please contact Tom Kehoe, AIMA's Head of Research, at [tkehoe@aima.org](mailto:tkehoe@aima.org).

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