



Funds-of-Funds Redemption Re-Investment

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The Shadow Sows article titled "Redemption Mania" makes an accurate assessment that many funds-of-funds do not provide much value to investors. On February 10, 2006 we disseminated a research piece, "Standard Deviations: Hedge Fund Investing – The Movie," (located on our HFN page and at www.ferrellcapital.com) that agrees with many of the Shadow's criticisms. However, his negative conclusion regarding the entire business of structuring and managing portfolios of hedge funds is overreaching. The value of qualified funds-of-funds managers has never been higher. For most investors, well managed funds-of-funds provide access to professionally vetted hedge funds, many of which may be closed to new investment, and control of risk variances as they affect returns. The correct response to the Shadow's comments is not that the fund-of-funds function is not valuable, it simply isn't always performed properly. This article describes what a fund-of-funds manager should provide to manage hedge fund investments and how they can assist investors seeking to improve overall portfolio performance.

The evolution of the funds-of-funds business has been short, but reminiscent of the growth of the mutual fund business. There will always be money managers more adept at marketing than investment management. Many were "packagers" or "asset gatherers" all along, equipped with neither the trading management expertise nor the risk allocation tools necessary to perform their investment management role. Understanding the nature of strategies and market behavior requires a unique set of tools and skills.

Funds-of-funds are collections of proprietary trading accounts. Proprietary trading management and managing funds-of-funds are linked by a common discipline – capital allocation. The industry's "best practices" are usually found within the management of proprietary trading groups at top-tier investment banks. Capital is continuously allocated to the best diversified sources of risk-adjusted returns, recognizing that risks and correlations change, often dramatically, over time. Thus, a static picture of risk allocation violates common sense. Blue-chip funds-of-funds managers adapt to market changes dynamically and never lose focus on investment performance. They constantly re-evaluate sources of risk and return to avoid unnecessary exposures and to take advantage of profit opportunities. Smart investors will find managers who know how to use and further develop sophisticated risk allocation tools to stay abreast of the markets.

The benefits of professional hedge fund portfolio construction and management are compelling. Investors seeking attractive absolute returns should invest with experienced traders/risk managers who add value due to their:

- Risk allocation process to investments in diversified strategy buckets
- Qualifications to evaluate hedge fund strategies and the pedigree of traders
- Large pipeline of hedge fund managers

- Risk management tools to evaluate and monitor each hedge fund within each strategy bucket
- Extensive trading experience and the ability to recognize issues and opportunities facing individual managers and strategy buckets
- Confidence and judgment to act in response to changing market environments
- Passion to produce attractive risk-adjusted returns for investors

Many funds-of-funds lack these vital capabilities. In the universe of some 8,000 hedge funds, more than a few single strategy managers are likewise lacking. Capitalism does not generally reward poor performance. The current avalanche of redemptions highlights the cost of poor or non-existent management of risk capital.

Very few investors, regardless of size, have the resources necessary to properly manage hedge fund portfolios. The vast majority need qualified managers to deal with hedge fund complexities and actively manage their risk allocations. Moreover, top funds-of-funds managers use analytic tools that can be applied broadly to large portfolios not limited to hedge funds. Investors should encourage these managers to examine their portfolios through the eyes of risk. Often the analysis will show unequal risk distributions prompting the investor to adjust their existing portfolio. For example, they may wish to swap out of some holdings either over-weighted with risk or underperforming against the measure of marginal contribution to risk-adjusted returns. In any case, the analysis should give each investor the ability to determine the "relevance" of an investment with the manager to their existing portfolio. Periodic review of the portfolio "fit" can expose investors to a new and totally useful perspective on their portfolio performance.

In conclusion, the ability to generate alpha to make overall investment portfolio returns more dependable is extremely valuable. Funds-of-funds managers capable of providing reliable alpha will remain a vital resource to astute investors. Today's redemption cash flows will soon find their way to the skilled funds-of-funds managers who regard investment performance as their top priority.

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Ferrell Capital Management, founded in 1988 as a financial market risk management consulting firm, has advised many of the largest banks, pensions, endowments and hedge funds on risk allocation. The firm currently manages a fund of 70 hedge funds representing nine strategy buckets.