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Set Guidelines for Hedge Fund Investments

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Hedge fund managers look and act like investment cowboys, leaving it up to you to enforce the Code of the West.

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Adding hedge funds to your asset allocation requires a different set of rules than traditional stocks and bonds. Hedge fund managers are largely unregulated, ignore established style boxes, lack long-term historical returns, defy conventional benchmarking, and disregard the usual customer service protocols. In short, the standard rules and guidelines just don't apply.

The maverick nature of hedge funds makes writing an [Investment Policy Statement](#) (IPS) difficult. The parameters you set must be broad—hedge fund managers require a lot of latitude—but specific enough to meet your [fiduciary responsibilities](#) and protect your clients' interests.

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To establish policy guidelines for hedge funds, consider what

you want these investments to accomplish. You'll then be able to set the allocation and clearly articulate your expectations about returns, risk, and client service.

Planning your hedge fund allocation

The first step in establishing a policy is to determine the role you want these funds to play in your client's portfolio.

"Consultants have been slow to embrace hedge funds because they can't fit them into their asset allocation structure," says [Jim Owen](#), a consultant to advisors and founder of the Prudent Investment Network (805-565-5855). Advisors often make the mistake of lumping all hedge funds into one asset class labeled alternative investments. But hedge funds in total do not constitute a distinct asset class. "Hedge funds are merely an investment structure driven by strategy. You can't generalize their risk and return profiles," says Owen.

However, you can divide hedge funds into one of two investment objectives: return enhancement or risk reduction. Pick the objective that best fits your needs and then treat that subset of funds as a standalone asset class.

Yale University, for example, allocates 22% of its \$8 billion endowment to an asset class it calls absolute return strategies. The objective is to get a target rate of return regardless of which way the market moves.

"Once you understand that hedge funds should be categorized by strategy—not style—it's easy to fit them into your allocation," says Owen.

Determining the allocation

The next big question concerns portfolio weightings. Conventional prudence specifies a 5-15% allocation, although Roger Stinnett, a principal at myCFO Inc., in Century City, Calif., recalls one prospect with 50% of his portfolio in municipal bonds and 50% allocated to 12-13 well-respected hedge funds. "His lifestyle was totally immunized by his fixed-income investments, so he took the position that the rest of the money could grow as aggressively as possible," says Stinnett.

Allocating half of your portfolio to hedge funds is unusual. However, other advisors suggest that you could build a traditionally diversified allocation entirely around alternatives.

"Your core could consist of an 80% allocation to a non-

directional fund of funds with a low beta," says Ken Phillips, [IMCA](#) spokesman and managing partner of Money Management Partners, a consulting firm specializing in hedge funds and alternative investments in Boulder, Colo. "You could then start slicing off directional allocations from the other 20% to get exposure to funds with a higher beta. The volatility isn't that bad and you are generating alpha by exposing smaller allocations."

Of course, setting the allocation depends on your client's investment profile. There is also the question of where to place the funds within the allocation structure. "The majority of clients go into hedge funds to hit a home run," says Stinnett. "However, hitting that home run may entail considerable risk and generate tax implications. Where are you going to take that risk? In the client's personal assets? Assets earmarked for charity? In the next generation? Will the taxes thrown off from interest, dividends, and short-term capital gains violate a foundation's or trust's restrictions?"

Establishing guidelines

Once you've developed your asset allocation, you can begin setting guidelines that will articulate the client's expectations and guide your investment strategy. While you will use many of the same investor inputs that make up your more-traditional allocation, your controls and service issues will change with the introduction of [absolute return objectives](#) and active management.

Returns

Clients, consultants, and committees choose absolute return strategies for two reasons: predictable returns and a low correlation to traditional markets. "Absolute return strategies typically target a 10-15% return," says Owen. "For example, my objective is a rate of return that is 10-15% net of fees over a three-year period irrespective of the market's direction."

Avoiding market volatility is key. "The attraction to hedge funds is not the high returns, but the low correlation with traditional stocks and bonds, and capital preservation in bad markets," says Owen. "Yale doesn't care if the market goes up 80%, they just want a predictable 10-15% return that is independent of the market."

Because hedge fund managers aim for steady returns in any kind of market, you can't compare them to the S&P 500. However, you can establish a mutually agreed-upon benchmark. "Ask them how they grade themselves—what

benchmark they use to measure their performance," says Phillips. "Then affirm the authenticity of that benchmark."

Risk

While you can't use the S&P 500 to evaluate returns, you can use it to establish your risk parameters. Owen tells his managers that he wants a 10-15% return with half the volatility of the S&P as measured by standard deviation. Jeff Diercks, a managing director of InTrust Advisors, a multi-family office in Tampa, Fla., with his own fund of funds, looks for managers with positive alpha in relation to their peers, and a favorable Sharpe ratio.

Another way to set risk controls is to determine at the outset the degree of diversity you want as measured by R-squared. "A high R2 gives investors an increased level of security," says Phillips. "You can dial up or down the amount of risk you want to take. If you only bet on four to five managers, you're taking the same risks you would with a highly concentrated portfolio—with a lot more standard deviation. Increase the number of managers to 15-30 and you'll conceptually lower risk and R2."

Phillips also suggests monitoring the tracking error, even if it's good. "Huge upside surprises equal huge downside surprises. And you want managers to maintain tight return streams. Look at the five-year track record and the five-year standard deviation record. A 6-30% dispersion of returns is significant. Of course, if you're looking for 20% alpha, you can tolerate a much larger dispersion," says Phillips.

Absolute return objectives can also introduce absolute risk controls. Owen stipulates that a manager should earn the target rate of return with *no down calendar years*. "If anybody has a double-digit loss, they're gone," says Owen. "I won't can the guy who is down 9.5% after two years of 25% performance. However, I would fire the manager who was down 13%."

Client Services

Hedge funds aren't your father's mutual fund. They don't have huge operating staffs, and regulations don't require them to offer the services, reports, and transparency you're used to with mutual funds or separate accounts. "There will be no client service meetings, no hand holding, and they won't come out and talk to a committee," says Owen. "They are paid to deliver performance, and the more days they are out of the office, the more the numbers will suffer. You also won't

get long reports—just brief ones telling you what they did and why."

However, you can insist on a few client services. "It's extremely important you get monthly performance reports," says Owen. "If the numbers are too good, that raises a red flag. Hedge funds should be consistent. "

And you want the numbers as of yesterday. Don't settle for a monthly report showing their allocation. "Everyone understands that these are flash numbers," says Owen. You may only be able to get a roll forward of the balance, but check it monthly to see if the manager is maintaining his alpha.

Stinnett also recommends that you request immediate notification in writing of changes in ownership, organizational structure, or personnel. But he warns that managers won't release much information. "One reason why that investor with the munis/hedge fund portfolio met with us was because he wanted more information on his funds," says Stinnett. "He was invested with 12 to 13 of the big, elite hedge fund managers, but the information was sporadic. He really just wanted us to dig into his funds."

There are other services you can ask for, but will be lucky to get. You can ask for a quarterly conference call. And they may give you a peek at their top 10 holdings, but don't expect much. "You're not dealing with salespeople here," says Phillips. "You're dealing with a principal who is very protective of his portfolio and his quality of life. If you hold them to some high level of transparency, you're going to eliminate a number of talented professionals who could give you good performance."

Hiring and firing managers

One of the primary ways to control risk is to conduct an exhaustive due diligence search. Because hedge funds are formed as limited partnerships, you and your client are actually investing—and going into partnership with—a small business. "You're trading market risk for other types of risk," says Diercks. "They could fail because they're overwhelmed with the back office, or the manager could abscond with the money."

Diercks insists on meeting every manager he's considering face-to-face. "I want to see how they react when I ask about their business," he says. "If they squirm, I don't like it at all." He'll also interview the fund auditor, the fund administrator,

the prime broker, and other members of the team. He even employs a private investigator to check on managers' background and business interests.

On the firing side, Diercks works fast to bounce managers who don't meet his standards. Like Owen, he is ready to quickly walk away from inconsistent performance. And he also looks for less tangible clues. "Firing requires finesse," says Diercks. "Managers should know who I am when I call them and what my investment is. I want to see that their back office is on top of the situation. If I feel their accounting or their staff is weak, I'll pull the plug first and ask questions later. With hedge funds, you've got to take the subtle hints."

Code of the West

Hedge funds may reside in the [new Wild West](#) of the investment frontier, but forward-looking pioneers have poured more than \$8 billion into these nontraditional vehicles over the last six months, reports [Hedgeworld USA](#). And these managers may rope in more assets as market volatility increases.

As with any gunslinger, you should give managers plenty of room. "You don't want to put too many constraints on them," says Stinnett. "Find out what they do best, do your due diligence, and assess their adherence to style. However, you have to realize that they are totally performance-oriented, and they need the latitude to do whatever it is they do to generate returns."

At the same time, protect your clients' interests by developing a disciplined and rigorous investment management process. Setting controls and developing investment policy guidelines is a step in building the emerging Code of the West—and goes a long way in preventing shootouts at far-flung corrals.

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