Funds of Hedge Funds: A Balanced View

February 23, 2009
By Kevin P. Quirk, Partner

A number of prominent investment industry professionals have recently grabbed headlines by casting funds of hedge funds as the primary accessories in Bernard Madoff's alleged fraud. Labeled "a cancer" by one and casting the industry as broadly responsible for investors' misfortune by others, funds of hedge funds have taken much of the brunt in the aftermath of the scandal. Funds of hedge funds, after a year of brutal markets, now face a formidable reputational assault.

As advisors to a broad group of institutional investors, funds of hedge funds, and single-manager hedge funds for the past several decades, we'd like to offer another perspective on the situation. Clearly there is an understandable temptation during a scandal of this magnitude to throw the baby out with the bathwater. But we believe the critiques to be both simplistic and, largely, wrong.

Let's start with a few simple facts about funds of hedge funds and the Madoff scandal:

- **Fact 1: very few funds of hedge funds, and no institutional leaders, actually invested with Madoff.** Although the capital invested by several funds of hedge funds was enormous and represented a substantial percentage of the overall assets, only two of the top 20 funds of hedge funds (which represent approximately 50% of the total assets in funds of hedge funds) are known to have invested in Madoff. Importantly, neither of the two firms is regarded as an institutional market leader. In fact, in a review of the top 50 funds of hedge funds, none of the firms regarded as institutional leaders, are known to have invested in Madoff.

- **Fact 2: many funds investing in Madoff actually were single-manager "feeder funds," not funds of hedge funds.** Many of the vehicles committing assets to Madoff simply served as marketing conduits for the underlying manager. Few, if any, prominent institutional investors use these structures. Sophisticated institutions employ funds of hedge funds to access a diversified portfolio of quality managers. Although these firms' broader businesses included funds of hedge funds, it is important not to confuse them with single-manager feeder vehicles.

- **Fact 3: Madoff's fund wasn't even considered by the vast majority of funds of hedge funds, and was rejected by the few that did take a look.** A number of prominent, institutionally-oriented funds of hedge funds told us their Madoff experience fell into one of two primary camps: either "never met them/not on our radar screen" or "met them and they'd never pass our due diligence requirements." In these cases, the due diligence processes of the funds of hedge funds actually kept their clients from investing in Madoff.

Madoff would have failed the due diligence test on at least three components of most fund-of-hedge fund processes. First, **investment process transparency**: lack of access to senior investment professionals, and historical patterns that were inconsistent with the stated process and "edge," would have raised a major red flag among most funds of hedge funds. Second, **operations & vendor transparency**: any examination and verification of the managers' operating environment, including the role and caliber of third parties (such as the auditor, administrator, custodian, pricing, leverage provider, and prime broker) would have yielded little transparency and unveiled unacceptable practices. And finally, operations **due-diligence veto power**: regardless of the fund-of-hedge-fund portfolio manager's wishes, virtually all institutional quality funds of hedge funds maintain a policy that allows operations due diligence the power to veto any investment that does not meet their criteria. Had the Madoff investment reached this point in the process, most operations due diligence officers would have exercised their veto.

Many of the firms and their respective fund vehicles that poured money into Madoff lacked the primary characteristics sophisticated investors seek in investing with funds of hedge funds:

- First, investors are seeking **diversification**: they want investments that do not correlate with others in their portfolio. Funds of hedge funds provide a different return/risk profile to investors. Although their recent performance (a loss of between 15% and 20% for the year 2008) reflects the broader returns offered by the hedge fund industry, long-only portfolios fared significantly worse, and investors are largely pleased that they had increased their allocations to hedge funds at the expense of traditional equities.

- Secondly, investors are seeking **access to skilled investment managers.** Some of the most talented investment managers have migrated to the hedge fund industry. Assuming investors want active investment management, this is a pool of managers that simply cannot be ignored. Many smaller investors cannot access leading hedge fund managers directly, usually because they cannot meet account minimums or the funds are only open to a select set of investors. Leading funds of hedge funds provide diversified access, thanks to their size and investment sophistication.

- Thirdly, and maybe most importantly, investors are seeking **professional sourcing, due diligence, and monitoring.** Funds of hedge funds have substantial and experienced professionals continuously scouring the hedge funds universe, well-structured due diligence processes and protocols, and ongoing monitoring functions. Few institutional investors have the resources and experience to replicate this kind of system.

For most institutional investors, the foray into hedge funds via funds of hedge funds has been a largely positive experience. Funds of hedge funds have provided needed and desired skills and products to investors strapped for time and resources. Additionally, the industry has increasingly improved itself by increasing transparency, offering products and services for lower fees, and working with clients in a truly consultative manner. More than 80% of institutionally-focused investment consultants we recently surveyed indicate they feel their clients will prefer funds of hedge funds to direct investing.

Will there be more examples in the future of fraud and underperformance in the hedge fund industry? Almost certainly. However, using the Madoff scandal as supporting evidence to castigate the entire fund-of-hedge-fund industry is faulty logic. A simple review of the facts suggests that funds of hedge funds have served, and will continue to serve, a critical role for investors. Even if further victims of the Madoff fraud come forth, we would be very surprised to find the leading institutional funds of hedge funds among them. The real headline for funds of hedge funds in this scandal is "Madoff: virtually no funds of hedge funds invested."

Kevin P. Quirk is a Partner in the Darien, CT-based management consulting firm, Casey Quirk & Associates. Casey Quirk focuses exclusively on advising the senior management teams of investment management firms and pursuing its mission of "Building great investment management organizations." Casey Quirk's clients include some of the largest and most successful investment management firms around the world.