

# Why hedge fund of funds are fatally flawed

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The tide may be turning for funds of funds, until now the most popular way for individual investors to invest in hedge funds. According to Hedge Fund Research, there was an outflow of \$1.02bn from funds of funds for the third quarter, after almost 10 years of solid inflows.

Why might sentiment be turning? This piece was submitted for publication by a respected hedge fund manager, who has opted to remain anonymous. A lot of assets are tied up in hedge funds of funds, and the views expressed would not be popular in the industry.

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Fishing lures are not designed to catch fish. They are designed to catch fishermen. (Fish don't have any money.)

The concept of fund of funds is reasonable and seductive. Because few people know how to select an investment manager, having an "expert" pick several managers seems a good idea that justifies the extra fees. However, it is designed to catch investors, not produce superior investments.

This simple concept has been taken to the extreme common to big new ideas in the investment community. An amazing array of individuals and companies have proclaimed themselves "experts" - accountants, lawyers, bankers, stock and bond brokers, and so forth. But hardly of those groups have previously distinguished themselves for investment acumen. They number in the thousands now, with several hundred billion dollars under management. So how do they raise money?

In the early days, some enterprising fund of funds promoters promised their clients access to the best performing hedge funds that supposedly were closed to new investors. More common today is the promise of broad diversification in an array of hedge funds with varying styles selected by a host of brilliant MBAs as part of an elaborate strategy that would produce moderate returns with almost no risk, high returns with modest risk, and so on.

Central to the fund of funds rationale are the selection and the monitoring of the underlying hedge funds and the assumption that the fund of funds managers are capable of both functions.

Instead it would seem many of them do neither well. Most such funds operate in a manner designed to appeal to potential investors rather than enhance returns. To most investors, including many institutions, statements from fund of funds that they review thousands of hedge funds from which they select the anointed few sound pretty good. The sophisticated investor knows that beyond a certain point the more managers you follow, the fewer you know.

Another seemingly sensible policy is to prohibit the sin of "style drift". Having allocated money among their selected investment styles, fund of funds managers do not want hedge fund managers to change what they have been doing. Picture the ensuing dilemma for a small-cap growth manager who is smart enough to know the economy is changing and that his stocks will fare poorly over the next year or two. He can raise a lot of cash or shift his portfolio into larger stocks, seeking better performance, and have millions of dollars withdrawn by his fund of funds investors when his crime is discovered; or he can avoid withdrawals by staying fully invested in his current style and just trying to lose less than the other managers in his category.

Guess which one he chooses.

The massive amount of monetary liquidity sloshing around the world looking for a few extra basis points of return has created inefficiencies and distortions. At this point the process of investing has become more important than the function of investing. A few thousand dollars can be invested with ease. A few billion dollars is a big problem. Large amounts of money demand large funds. Therefore, the large fund of funds are mostly forced into a relatively small number of giant hedge funds, which in most cases can no longer do what made them successful when they were smaller.

Probably the greatest flaw in the fund of funds concept is that it really does not matter how good a hedge fund manager is if he is in the wrong place at the wrong time. It is well understood that asset allocation accounts for more than 90 per cent of portfolio performance. Even experienced high-tech stock investment managers were down over 75 per cent during the recent bear market. Yet fund of funds managers, many of whom have no direct investment management experience, determine asset allocation. The reams of statistics they produce to justify their selections mean nothing if they get the market wrong.

There are of course many well-managed fund of funds, which invest clients' money carefully and intelligently. But, in general, it looks like fund of funds managers will have to start using judgment instead of statistical strictures when placing money with hedge fund managers, and they will have to allow those managers to use their judgment instead of following orders from above.