

# Funds of Funds — Risk Management Assessment

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*This article looks at the ways in which the fund of funds industry is meeting investors' demands for increased transparency, at the different types of risk that can be identified and how these risks are being addressed.*

There is a strong logic to hedge fund of funds, the operations of which are a formalised version of the activity undertaken by most hedge fund investors. Investors do not, by and large, invest in a single manager. They spread their investments over managers and styles, using a 'folk' or even formal version of portfolio theory to achieve diversification.

The fund of funds 'systematises' that process, and wraps it into a product which charges a second set of fees. This second level of fees is compensation for access to top managers and closed funds, and by a superior and smoothed-out set of returns compared with those attainable on an amateur, standalone basis. A diversified fund of funds, for example, will often see its remit as capital preservation, low volatility and attractive returns, with participation in the upside and downside protection.

Assuming a risk-free rate of 5%, for example, the average fund of funds has an annualised standard deviation of 5.5%. The figure is pulled up by sector-specific offerings, and many funds of funds have a standard deviation of more like 2.5%. Even with sector-specific funds of funds, not many are over 11%. As a result, funds of funds have been a particular focus for institutional investors, particularly in Europe, where they have accepted that they lack the tools necessary to assess the risks of individual funds or to build a diversified portfolio.

A fund of funds is not a risk-free investment, however. The risks inherent in a fund of hedge funds portfolio have become particularly evident over the past three years, as average returns — albeit within a wide dispersion — slumped to what we hope will turn out to be a low of 1.56% in 2002.

The risk profiles of funds chosen by institutions have also changed from low-volatility funds with the same risk profile as fixed income to the equity-replacement profile of a balanced fund typically investing in 40% arbitrage-type strategies and 40% equity long/short, with diversification varying between short-selling, CTAs and global macro strategies. That trend was deepened during the stock market slump, when low-volatility funds demonstrated they didn't have the offset to boost their performance.

Coupled with an institutionalisation of the industry in general, the low returns of the average fund of funds have prompted a renewed focus on the way they identify and manage the risks inherent in their operations. Funds of funds have tended to be good at picking managers (caveat: though the fund of funds business has traditionally had low barriers to entry) and undertaking due diligence on them. Those skills are increasingly seen as necessary, but not sufficient to develop a fund of funds business.

The fund of funds business model is changing. We are beginning to see them acting like mainstream investment houses, with a focus on top-down allocation, an emphasis on scale and building an infrastructure that will address investor concerns about risk management. The skill set needed by the fund of funds that wants to take up this challenge is often more akin to investment banking (derivatives expertise in overlays, risk-adjusted version of funds, etc) than it is to picking funds.

## Alternative IQ

Not all funds of funds will adopt this business model. Niche players, perhaps focusing on early stage managers or on a specific geographic area, will be aiming for a different set of risk-weighted returns. While these niche players may well remain independent, the mid-sized fund of funds will largely be eaten up by banks and large investment management houses, both of which will deepen the tendencies towards risk control increasingly requested by investors.

A fund of funds combines all the risks inherent in its underlying investments with another layer on top. Risks can be characterised as investment management risks, due diligence risks or operational risks. These days, fund of fund managers are tending to unbundle asset allocation from manager search. Asset allocation has migrated from the long-only environment, and in the context of hedge funds means allocation by style and sub-style. Funds of funds vary in their approach to style diversification, but increasingly focus on mathematical approaches to the problem, as the inherent returns of particular styles become better understood. A fund of funds might, for example, ensure a geographical spread across the US, Europe, Japan and emerging markets, and allocate over global macro, debt trading, long/short and even long-only equity. All these styles invest in broad, deep markets and have different sources of returns.

There are as many approaches to the particular style mix and the way weightings are altered as there are managers. A manager might take a contrarian view, and buy or sell styles when the rest of the market seems to be doing the opposite. He might not buy or sell styles in the traditional manner at all, but, by having control over the underlying assets through a managed account, might instruct a manager to liquidate a proportion of its assets in accordance with his top-down view while leaving his manager allocation unchanged. Equally, as the vehicles through which it is possible to invest in hedge fund style indices liberalise, we will see them used as style overlays that do not disturb an underlying manager mix.

Other allocation risks are the invisible risks to sources of return. Can we really be sure, for example, that a basket of arbitrage styles is a diversified basket at all? Arbitrage styles pick up a risk transfer premium and occasionally take a hit in dislocations. They can only truly be said to be uncorrelated to the extent that those outlying events are uncorrelated. Much work is being done on such issues at the moment, and on others, such as the applicability of

the Sharpe Ratio — the traditional risk/return measure for a hedge fund — to various hedge fund styles.

The correlations within styles are also increasingly an important consideration. In European equity long/short, for example, average correlation between funds is high, at 0.8, and higher still among short sellers. The chance of picking an outstanding manager in these styles is very low.

Another source of risk is the number of managers. Harry Kat, a professor at London's City University, for example, recently wrote a paper concluding that once a fund of funds has reached a certain number of managers — 15, according to his research — adding more flattens the return curve and diversifies away alpha. Adding more managers also increases the likelihood of the blow-up of a single fund and of achieving equity market correlation. This theory only translates in practice, however, if a fund of funds can consistently pick winning underlying funds. As a 'by the way' on underlying managers, research suggests that the failure rate for hedge funds rose to 17% last year.

Underlying funds have to be monitored not only for performance, but for fraud and misrepresentation and to ensure that they stick to their prescribed investment style.

Then come the qualitative risks in the infrastructure and culture of the fund of funds management environment itself: the factors are too numerous to list, but include organisational structure, control procedures, personnel issues, operational issues, infrastructure, systems, investment process, manager due diligence and monitoring, risk management policy and procedures, valuation procedures, legal and compliance and conflicts of interests. Documents will show up issues such as, for example, whether unwanted risks are transferred to the investor. Terms and conditions of capital guaranteed structures, and the conditions under which hedging is implemented, should be examined in detail. However, none of this will demonstrate the soft factors that indicate whether or not an organisation is an open one, or a 'happy ship' with all its hands steering in the same direction.

Without its relationships with underlying managers, there is no fund of funds business. Just as the underlying manager will have done due diligence on the fund of funds as an investor, so the fund of funds must vet its

investors to ensure they do not plan on churning their investments and making the fund of funds look like an unreliable source of assets under management.

While operational and organisational risks can be monitored with ongoing periodic monitoring of the fund of funds operation, the investment risks in the asset mix and in the individual funds can only be assessed by access to better reporting. Whether an investor demands more frequent NAVs, or position level reporting himself, or trusts his manager to monitor them, the net result is more frequent, more timely, risk-based reporting.

Fund of funds managers want more frequent reporting. They want to see money flows to the underlying managers, and they want to see manager performance based on inflows and sector reports. They want their final month-end valuations as soon as possible after the end of the month, and more and more of them want to see daily numbers.

Some fund of funds managers will use these numbers for overlay purposes and some banks will use them to hedge protection they have written on the fund of funds. One manager is even reported to be using position-level data to develop a product that tracks a hedge fund-style index.

A surprisingly high 60–70% of underlying funds will provide fund of funds managers with position-level data. The rest fear their advantage will be weakened by others trading against their position, and either give out selected positions or none at all. Funds of funds often quote this problem of obtaining data from underlying managers as one of the biggest they face.

Since underlying investors, even institutions, mostly do not know what to do with position-level data, it is questionable whether such transparency does anything other than provide investors with a false sense of security.

As a result of these two factors, we are witnessing the development of a risk-report industry, which takes data feeds from the fund via the fund administrator and provides aggregated risk information to a client.

In addition to earlier final numbers and more frequent estimates (weekly, usually), fund managers are looking for more detailed reports that include money flows to underlying funds; the underlying funds' performance based on the amount of funds invested; charts detailing

the percentage invested in particular strategies and underlying funds; reports that compare underlying fund performance to an index; as well as reports by strategy, and cash flow forecasts.

A report might detail portfolio concentration, sector, country, or instrument-type exposure, and it will often profile the risks of the fund using one of the statistical risk measures, such as value-at-risk (VaR).

With such measures available, the investor is beginning to have at his disposal the tools necessary to enable him to properly assess the risks inherent in the burgeoning funds of funds industry.

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