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Alternative and traditional multimanagement

A meeting of two Worlds

The multimanagement of the 1980s is a world apart from the multimanagement of today. Eric Bissonnier, EIM Partner and CIO Europe & Asia, describes the new challenges faced by fund pickers.

Legend: Eric Bissonnier, CIO Europe & Asian - EIM

EIM was originally based on a multimanagement-style business model. Is there any advantage in you not being managers yourselves?
The underlying principle of multimanagement is being able to delegate to the best in each class. This is a profession in its own right and requires different skills. Trying to do the two things at once would evidently give rise to conflicts of interest, due to the possible risk of replication of certain management methods or transactions. This is especially true since hedge fund managers are still very secretive about hedge funds, often with good reason.
When you started out, there weren't that many hedge funds around. It must have been easy to choose between them. How has this changed?
Clearly when our majority shareholder [Arki Busson – editor's note] began in 1986, we had 35 managers on our list and there were around 1,000 or so that were worthy of note: it wasn't a question of "selection" as such. Things were very different to how they are now! Also, the majority of our clients were private, which meant that they could tolerate managers who were more volatile and less structured than they are today. This was made up for by the fact that yields were much higher than they are currently. Things have changed, not just in terms of clients and structure, but also in terms of management.

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Hence the change in due diligence procedures…
There were things we could do then that we can't do today, such as accepting very light infrastructures, putting up with shortcuts, either in terms of fund structure or in terms of the relationship between the administrator and the fund, and a whole host of other things that, shall we say, were acceptable at the time, since everything was based on trust. Today, with the institutionalisation of our clients, this will no longer do: managers need to be highly structured and we need to exercise much more control over operating structures, which is quite painstaking work.

Do you think that the obligation for hedge funds to register with the SEC will act as a sort of filter and help you choose between them?
Not at all. We still have to do our job: the regulator acts purely at an administrative level, and this has no bearing on the quality of the manager. Other examples of regulatory mechanisms, such as those applied to listed companies, which frequently undergo a variety of external audits, show that this does not prevent companies from committing fraud. Similarly, if you take the traditional funds market in the US, which is undoubtedly one of the most highly regulated, there has been widespread fraud there in recent years [*relating to late trading and market timing favours granted by a large number of US funds to certain preferred investors at the expense of other investors – editor's note*]. Let's just say that it reduces the chances of any impropriety – for registered funds – but does not change anything in terms of the underlying work, which is to identify hedge fund managers, who really ought to be regarded as small businesses, with the specific requirements that this entails. Regulation is undoubtedly one aspect of this, but it is not the be-all and end-all.

So, if they are actually small businesses, doesn't the regulation process risk adding to the administrative workload of managers?
Of course, but the industry is set up to handle this. If you take the example of London, where managers have always been regulated, this does not stop them from functioning, even with light infrastructures, because a system of *compliance* has been introduced which minimises the impact on managers. However, it is clear that this increases the infrastructure costs and still represents a constraint. In addition, the regulator is not really equipped to monitor future events, either in terms of expertise or simply in terms of the number of agents. Where this definitely will have an impact on us is in terms of liquidity, since managers who don't want to register will introduce a two-year lock-up [*to avoid registration – editor's note*]. There will be a load of interest if so, and the task of educating and training clients will be enormous.

How many of the managers in which you invest are registered?
We are waiting until 1 February to find out, since some managers will decide at the last minute. For the time being, it seems that around one third of US managers who were not previously regulated have decided not to register.

You talked about regulation in the UK: is this more restrictive and does it therefore allow managers to be filtered more efficiently, even if only in terms of operating risks?
Again, this is no guarantee of quality. It might reassure investors, but it is more a question of the industry's image than of actual efficiency. And it all depends on what you mean by "operating risks". If you're talking about fraud, OK, but fraud represents a very small percentage of the problems that can crop up with hedge funds. If a manager is linked with fraudulent activity in any way, even remotely, it is relatively easy to find out by implementing basic due diligence – even if this only means consulting the databases that have existed for a long time in the US. Contrary to what you might think, the alternative sector, despite its growth, is rather small, and news travels fast. For other operating risks, such as those arising from strategically inadequate infrastructures, from an excess of assets, from an inadequate management company shareholding structure or from a poor *incentives* system, regulation makes no difference.

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There are an increasing number of fund pickers like yourselves and, if conventional descriptions of due diligence processes – i.e. visits, interviews, telephone calls, etc. – are to be believed, one cannot help wondering whether this will not ultimately distract managers from their work…
We have lots of managers who have around 30 clients and who want to hold onto them. That's manageable. Secondly, they choose their own clients: if you are an institutional investor, such as a pension fund or central bank, and have been around for a while, clearly you will have access to the manager. But if you are a private client and have $500,000 to invest, you have to be realistic: you will only have access to the manager in exceptional circumstances.

Or not to the same managers…
Either that, or you will have access to the person responsible for dealing with investors, but not to the manager. Even so, we have a fair number of managers who ask for a minimum investment of $25 million: this means that – to use an extreme example – we can invest 25 times one million rather than one times 25, due to the fact that we have been around for a long time. And we're certainly not the only ones. But clearly this is one-sided. It's only fair though, since otherwise, as you say, they would end up spending all their time managing clients. These aren't investment funds, they're hedge funds. We would rather they spent their time managing than speaking to clients.

What do you think of the phenomenon of leading hedge fund managers launching long only funds?
That all depends on the context in which it is done. But on the whole we think it is a good thing. Clearly, if you are talking about a small caps portfolio which replicates the long part of a long/short portfolio, that's going to be problematic, but if you take the much more common cases of long portfolios which replicate a mid/large caps portfolio where conflicts of interest are well managed, then that's good. Because with funds which are, by definition, free from *tracking errors* and *benchmarks* – which is really quite a sound principle if we are looking to obtain absolute returns from traditional investments – this phenomenon creates interesting prospects for investors and allows hedge fund companies to stabilise. In any event, it is something we are looking at very closely.

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In what way does it allow hedge funds to stabilise?
It allows them to acquire an asset base which is more stable and easier to manage, since long positions are really much more liquid and less dangerous than short positions. The client base is also more varied.

That might well be the case for a store, but long/short funds…
Yes, but we are not investing in just one portfolio, we are investing first and foremost in a business which is able to manage this portfolio. So if economic longevity is guaranteed by a well-balanced business, we welcome it.

Do you invest in these long only funds?
For our traditional multimanagement activity, yes. At least, this is one of the directions we take. We are different though in that we also make a lot of niche investments, which allows us to exploit our strategic diversification capacities – everything we have learnt in fact from the alternative market. We have been doing traditional multimanagement for 10 years, which has allowed us to gain expertise. So, building multimanager portfolios with these managers is almost second nature to us. And clearly this forms part of our growth strategy.

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When you say it is "almost second nature", is it because you think that the cream of managers are found in hedge funds, or simply because these are people you have known for a long time and whom you trust?
We have 60 traditional managers in our portfolios who are not hedge fund managers. However, if we take the products that we want to set up and which represent the future of long only – i.e. without any *tracking error* or *benchmark constraints*, but with *absolute return* – nobody is more capable of doing this than a hedge fund manager. Provided he is good of course, which is a different story…

I'd like to pick up on the conflicts of interest you mentioned. To what types of conflict of interest were you referring?
The usual things that crop up when you're managing several portfolios, such as front dealing, trades allocation, etc. When you make a transaction and it doesn't pay off, you put it in one account; if it does pay off, you put it in another account, i.e. the one that earns the highest interest. Regulation dramatically reduces these risks.

In which case, it's better to be in the hedge sector…
That depends on the fees and client base. That said, unlike mutual funds, I can't see a hedge fund – even if hedge funds are synonymous with conflicts of interest – that launches a long only fund risking allocating dubious trades to this fund, since it risks losing investor confidence across its entire business. And hedge funds are clearly involved in trades, where there can be conflicts of interest, so if we can't trust the manager, we get out: there are plenty of other managers!

When a hedge fund manager launches a long only fund, what is the typical fee structure?
Typically, the management fee is between 1 and 1.5%, plus – in the vast majority of cases – a performance fee calculated according to a risk-free rate or the net asset value, which is always based on a *high water mark*. But what matters at the end of the day is overall performance.

And in a business like yours, what is the effect of having two teams working alongside each other, one dedicated to traditional management, the other to alternative management, your core business? Isn't the team dedicated to traditional management a bit like the poor relative? And doesn't the long only sector seem dull to you in comparison with hedge funds?
That all depends on how passionate you are about it. Clearly, for me, these past years have been devoted to alternative investments, and I am passionate about this sphere, while being fascinated by current developments in traditional management, or even the possibility of opening up and diversifying our investments once traditional constraints – *benchmarks* and *tracking errors* – have been overcome. And, to be specific, in our traditional team, there are people who are passionate and who have the same desire to succeed as there are in the alternative sector. Having said that, obviously 90 to 95% of our assets are under alternative management, although I think we are witnessing a dynamic which is much more coherent and much more empowering – for us as well as for investors – in the long only sector. Institutional investors, particularly pension funds or institutions who need to obtain absolute returns, were left in no doubt that it was not with indexes that they were going to achieve these returns. So we needed to look for a broader approach, and for us, this could only be via alternative management. Depending on the markets and the characteristics of the clients, alternative and traditional management have to be used together. *Long only* and alternative management will be combined: what matters is how the two are combined and the most attractive investment method chosen in view of the different environments and cycles. For me, there is no competition between the two, no more than it being a question of a poor relative. It is a combination of these two investments that will, in future, make us stand out from those who confine themselves to one or the other.

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But why are you looking at hedge funds – with performances of 4 or 5% – when US bonds yield 4.5% per annum?
The answer lies in the question. Clearly, if all alternative management can offer over the next few years is cash and 30 base points, then we have no future. But if you take the last 12 months, from September to September, performance was around 8 to 10%, and for the calendar year, this will be in the region of 5 to 6% which, yes, is not very exciting. And if, in the next two or three years, while the traditional sector, especially equities, does well, the alternative sector continues to deliver yields of 5% per annum, then naturally this will cause us problems. But I don't think that this is a likely scenario: in the long term, we should revert back to the LIBOR + 300 to 600 base points, or 7 to 10%, particularly in view of economic and market growth, the accumulating risks and the numerous developments that make alternative management an interesting option…

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Provided it is implemented properly. You said recently that what was missing was the money to invest, rather than good managers, whereas someone like Jim Rogers (the co-founder of Quantum with George Soros) says that there can't be as many brilliant minds in the world as there are hedge fund managers.
Sure. Let's just say that of 8,000 managers, we invest in 160 and monitor around 300. Worldwide, if you had 30 professionals looking for managers every day, then of course you will find quality – and you won't have to go through 8,000 managers before you find it. In any case, it is good that there are so many: lots of them are mediocre, some are average and a few of them good. Those that are good have even more chance of making money. The others create opportunities. For example, managers who are trailing behind and who rely on information from brokers can generate *momentum* for stocks and allow more gifted managers, who are ahead of them, to take advantage of outstanding performance. Conversely, in some strategies, such as those that focus on differentials (*spreads*) – such as bond arbitrage or merger arbitrage, or basic statistical arbitrage – this is not the case: it is harder to come across inefficiency, and therefore harder to make money using the alpha. More betas must be used now – including alternative betas such as credit spreads and volatility spreads – rather than relying on the alpha alone, unless the levers used are completely disproportionate.

What about the publicity surrounding bad managers? If investors follow indexes…
This is a necessary evil. The same thing happens in the traditional sector. Even in large Swiss caps, there are businesses which are poorly managed: does that discredit the entire market?

The difference is that it is harder to get close to hedge funds.
I'm not convinced. As proof, the problems suffered by equities recently – whether in terms of fraud or mismanagement – have not cropped up in this sector. If dozens of well-trained analysts who claim to be independent have not identified these problems, either in Switzerland or elsewhere, it is because the information is one-sided. I find it easier to understand hedge funds, because they are small businesses, than, for instance Vivendi, Worldcom, Swissair or major banks. Trying to understand what happens in a large bank is hard: it's a leveraged hedge fund, very well managed, but no investor can understand exactly how it works. In these cases, we are all along for the ride. Whereas with a hedge fund, if you work at it, you can meet the person, see how he operates, examine his portfolio and his performance, deal with the directors: you can actually grasp what it is he does.

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To tell you the truth, the most damaging thing for the industry are the cases of pure fraud, of the Bayou type, or incidents such as Kensington [*the halo fund of Citadel Investment Group, which ran Kensington Global Strategies – editor's note*], which recently banned investors from withdrawing more than 3% of their assets: this does more harm than managers with mediocre performance in bull markets. That said, for an institutional investor who understands why there are alternative products in its portfolio and why, in certain circumstances, it is difficult to make money and that in the long-term it is unwise to have 100% of the portfolio invested in Swiss equities (particularly to cover pension commitments), for which 2005 was most definitely not a good year, alternative management still has a role. Conversely, as alternative management professionals, we need to be transparent and very clear on the reasons why there are alternative products in a portfolio: if we try to sell it as a means of generating aggressive outperformance no matter what, then clients will always be disappointed, because this is not what alternative management is about.

Interview by Indira Tasan