Customised accounts **Navigating the hedge fund maze: An institutional investor's guide to hedge fund investing**

The tailored route: how to unleash the full potential of a hedge fund allocation

William Glass, partner and head of business development at EIM, talks about how to invest in a professionally designed portfolio of hedge funds that is customised to suit the needs of individual investors

Understandably, in the past, the first foray into the world of hedge funds by many institutional investors was through commingled fund of hedge funds products. The lively debate about whether or not hedge funds represented a new asset class, or just a series of new investment strategies applied to existing asset classes, reflected the fact that investors were having trouble understanding the structural underpinnings of hedge fund returns.

Hedge funds, as a whole, clearly seemed to deliver on their stated ability to generate positive performance, or at least provide significant downside protection, even in unfavourable markets, but their low correlations to equities and bonds led to uncomfortably high theoretically optimum weightings when they were included in traditional mean-variance asset allocation models.

In this context, funds of hedge funds provided convenient, pre-packaged, diversified vehicles through which investors could test the waters and gradually build familiarity with hedge fund investment strategies.

The minimum required investment was relatively low, and buying into a product with an existing track record and many other investors brought an additional measure of reassurance.

Over time, however, as investors have gained in comfort and sophistication, many have come to realise that investment into hedge funds through existing commingled vehicles only unlocks part of their potential. This has led to a significant trend among institutional investors who are turning to customised investment solutions for their hedge fund allocations.

Why is this? The principal benefit of going the tailored route is flexibility, which allows a much more precise matching of the hedge fund allocation to the role it is expected to play in the client’s broader asset mix. In particular, a tailor-made solution can evolve in response to changes in the investor’s specific needs.

The life cycle of a tailored hedge fund investment often progresses along the following path. In a first phase, the investor views hedge funds on a stand-alone basis. The objective is to get exposure to the particular absolute return, volatility and de-correlation benefits that hedge funds as a whole seem to bring.

The investor’s primary focus is on the predictability of returns, and the portfolio-level benefits he sees are what might be called ‘first-order diversification’ benefits. Because of their risk and return characteristics, hedge funds will move the efficient frontier of the investor’s global portfolio disproportionately in relation to their weight.

An all-weather, diversified multi-strategy hedge fund portfolio is a straightforward way to advance towards that initial objective. In such programmes, tailoring focuses on ensuring that the portfolio’s structure has a high probability of meeting the targeted investment returns and risk tolerance established in discussion with the investor.

The second phase starts when investors realise that the payoff profile of a hedge fund portfolio can be significantly modulated by altering the mix of strategies within it, and that hedge fund portfolios can therefore be tailored to provide solutions to more specific portfolio problems.

The risk and return drivers to which individual hedge fund strategies are sensitive vary widely, and individual managers within a given strategy can differ significantly in the exposures they take, and in their trading style. This provides a rich palette with which to compose a mix of managers to achieve specific investment objectives.

Take, for example, an investor with a significant exposure to equities who is beginning to feel nervous because of conflicting signals from continuing growth, weak housing markets, turmoil in credit, and an uncertain interest rate outlook. Hedge funds offer several possible solutions.

One might be to structure the hedge fund allocation as an equity substitute that would behave generally like equities, but with significantly skewed returns. Its mission: capture a good bit of any further rise in equity markets, but cut off a large portion of the downside if markets go down. Well-structured portfolios of long/short equity managers, for example, have amply demonstrated their ability over time to meet such an objective.

In the context of a tailored mandate, both upside participation and downside protection can be enhanced by actively adjusting the portfolio mix as market trends evolve and as the investor and portfolio manager prepare for plausible future market scenarios, while keeping the allocation's sails trimmed for the prevailing winds.

But the allocation can also be structured to provide more of an 'insurance-like' payout: in benign markets, it should at least earn its keep, producing, say, a bit better than Libor. In scenarios where equity markets reverse into a decline, however, the portfolio would be expected to produce high returns to offset losses the investor would likely suffer elsewhere in his asset mix.

Structurally, this might typically be achieved through a hedge fund allocation where directional strategies are present to profit from the trends that are typically born of market reversals, and long-volatility, long-event type managers are included to generate returns from the increased volatility that generally accompanies such reversals.

Once again, the tailored approach involves ongoing scenario-based discussions between the investor and investment manager so that the portfolio remains fit for its task as circumstances change.

Similar substitute and diversifier solutions can be constructed for fixed income, with the aim of enhancing bond returns, while explicitly controlling for the asymmetric risks now faced by bond investors in a low rate-and-spread environment.

The third and most complete phase in tailoring begins when the hedge fund allocation is fully integrated into the investor's broader asset mix. The portfolio of hedge funds is structured not only with regard to the sensitivities of the various hedge fund strategies within the portfolio to various possible market scenarios, but also with regards to the sensitivities of the investor's other assets, and also liabilities where appropriate.

As an example, take a portfolio that follows a liability driven investment approach. The plan has funded one portfolio to hold bonds and swaps that match the projected cash flows required to meet future obligations to pensioners. The mandate was to manage the plan's remaining assets, representing roughly 40% of its capital.

Extensive actuarial work was available on the structure of the pension's liabilities and the characteristics of the liability matching portfolio, and the pension fund's management had framed very precise investment objectives and acceptable risk parameters for the return portfolio. These included a minimum absolute rate of return required to meet plan costs, given current market circumstances; an adjustment factor to this minimum return for changes in Libor (which directly affects the cost of swaps in the liability matching portfolio); and another adjustment factor reflecting the pension fund's non-obligatory objective to offer some compensation for cost-of-living increases, if possible.

The return portfolio's risk budget was expressed as an absolute maximum allowable drawdown amount. Finally, the manager had to take into account certain exposure limits set by the pension fund's regulator that notably constrained the maximum possible allocation to hedge funds.

During the set-up phase of the mandate, very active discussions between the customised solutions provider, the client, and the client's consultant, based on complex global modelling of the plan, led to a solution that included hedge funds, absolute-return, long/only equity mutual funds, a limited amount of traditional indexed equity, and some non-indexed thematic equity exposures.

In this extremely specific context, portfolio construction was guided by a series of non-conventional metrics devised to reflect the particular challenges of the project. One of them, for instance, is the probability of not reaching the technical return required to meet obligations over a given time horizon.

A related second metric is the expected shortfall in cases where the target is not reached: it is clearly better to stumble just short of the mountain top than to fall off a cliff and land half way down to the valley. To a pension fund, these are the true long-term preoccupations, as opposed to the probability of losing money. Careful tailoring of the hedge fund and absolute-return long-only allocations were critical to achieving the desired result.

As the above examples illustrate, tailored solutions can address very specific needs and can continually evolve as market circumstances and changing investor requirements dictate.

The portfolio belongs to the investor, and the investor retains control over the investment policy. The investor can therefore change the portfolio's focus at any time without having to redeem from one product and re-tender for another.

But along with flexibility, tailoring brings another significant benefit: transparency. The central focus of any supplier providing tailor-made solutions is meeting the specific set of investment objectives and constraints on each mandate.

This has major organisational implications. Firstly, the hedge fund selection and monitoring process itself must be structured to ensure that, on an ongoing basis, the return and risk drivers of each fund, as well as available investment capacity with each, are understood and made available to portfolio managers in a timely manner and practical format.

The second implication is that the risk budgeting and control tools made available to portfolio managers must be capable of rapidly drawing robust conclusions, not only about the hedge fund portfolio itself, but also about the likely behaviour of any other client assets included in the modelling exercise.

And thirdly, the portfolio manager himself must have only a limited number of mandates to manage so each can receive the required attention at all times. This leads to a portfolio management framework that efficiently supports as much ongoing dialogue with the investor as the investor wishes.

The portfolio manager can at all times discuss with the investor all aspects of the mandate, including information about individual managers, the reasons for individual trades in the client's portfolio, changes in current market outlook, and the portfolio's positioning in relation to other plausible market scenarios.

Perhaps most importantly of all, when the client calls, the person on the other end of the phone knows whose portfolio he is managing.