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Foundation Investments

Hedge Fund Basics: Risk, Return, and Reality

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Family foundations are major players in the investment world, with nearly 30,000 organizations accounting for $182 billion in assets.[1] Like other institutional investors, they have gravitated to hedge funds in a big way in recent years, motivated by anemic returns elsewhere and a chance for diversification or gaining access to an exposure not otherwise available. As with any financial instrument, hedge fund investing can provide a wealth of opportunities, including a chance to invest in funds with a specific strategy, some of which are listed in Exhibit 1. Within each type, a family foundation can select from a wide array of individual funds.

Some hedge funds invest mainly in equity securities. Others focus on debt or currency exposures. Some hedge funds use derivative instruments, and yet others combine various asset classes. Then there are funds of funds, which essentially pool individual hedge funds into a jumbo portfolio. With so many choices, the difficult part is identifying which funds are most appropriate, taking factors such as liquidity, suitability, return, and risk into account.

Balancing Risks and Returns

Evaluating return without considering risk is folly for any investor, but especially so for family foundations. Their holdings are frequently concentrated in stock issued by the closely held family business. Social or environmental preferences, not to mention legacy restrictions, can dramatically limit the kinds of investments that can be made without violating the foundation investment policy statement. The upshot is that the family foundation faces the need to diversify and manage risk without being free to construct an optimal portfolio based on risk and return considerations alone.

Exhibit 1: Hedge Fund Categories

- ❒ Equity Long/Short
- ❒ Event Driven
- ❒ Global Macro
- ❒ Long Only
- ❒ Market Neutral
- ❒ Sector Driven
- ❒ Convertible Arbitrage
- ❒ Distressed Debt
- ❒ Managed Futures

Moreover, investors cannot ignore the risks that are more pronounced or unique to hedge funds. For example, a hedge fund that takes aggressive short positions in a security is much more vulnerable to losses than a fund that employs a buy and hold approach. A hedge fund that employs leverage—through either the use of derivative instruments or with borrowing on margin—is more sensitive to changes in market conditions and can fluctuate wildly. A hedge fund that takes a position in companies likely to be acquired is directly affected by hostile actions or changes in any regulation that caps ownership of would-be suitors.

Hedge fund investments tend to be much less liquid than other alternatives. This is a big factor for any family foundation with a predefined and rigid distribution schedule associated with a capital project such as financing a hospital or school.

Valuing assets held by a hedge fund manager is another issue altogether. Complex security models are expensive to run and a small or mid-size family foundation may not even have the in-house expertise to validate numbers that come from the hedge fund, if they are provided in a meaningful format at all. (One criticism of hedge funds is their lack of transparency, and reluctance on the part of hedge fund managers to offer too much information in the event that trading strategies get leaked to competitors.)

The Role of Correlation. Part of assessing the risk associated with a hedge fund involves looking at the correlation coefficient. A number that has to fall between

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+1.00 and -1.00, the correlation coefficient measures the way hedge fund returns move with the returns for some other investment such as a growth-stock index. The goal is to combine assets that are perfectly negatively correlated (with a correlation coefficient of -1.00), thereby maximizing the diversification benefit. Since perfect negative correlation is more a theoretical construct than reality, the family foundation investor will look for investments with high negative correlations, such as -0.80. Empirically, hedge fund correlation coefficients with major stock and bond indices tend to be negative, though it is hard to generalize, given the diversity of available funds.[2]

The good news is that, properly selected, hedge funds can produce robust results when other investments in a portfolio are losing value. Including hedge funds reduces the overall variability in returns during different market phases. The bad news is that nothing is fail-proof and hedge funds are no exception. Despite their negative correlations with many security types, hedge funds tend to lose ground more rapidly when things get bad. During bear markets (and especially during crisis periods) poor liquidity, difficulty in executing trades, margin calls, potential loss of funding from new investors, withdrawals from existing clients, and a dramatic widening of spreads can impact many hedge funds in a uniformly deleterious manner.

Furthermore, the correlations that form a basis for investing in hedge funds in the first place can change over time, sometimes very quickly, due to factors outside the control of any one investment manager. International securities are a case in point. For a long time, foreign market returns moved inversely with those of U.S. equity and fixed income markets. While still true for some countries, a lot of the diversification benefits have been eroded as improved computing power and capital market deregulation make rapid information dissemination a reality. What happens in one part of the world is no longer contained within local borders. Decisions based on stale, historical information will not only affect how much gets allocated to hedge funds, but how often, and to what extent, rebalancing occurs.

Bottom line: On a stand-alone basis, hedge funds can offer high absolute returns, regardless of whether a market is trending up or down. In contrast, most family foundation investments only perform well in up markets. Additionally, due to the nature of the investment strategies and kinds of financial instruments employed, hedge funds may offer a level and pattern of returns that are simply not attainable from other vehicles.

Hedge fund investments tend to be much less liquid than other alternatives. This is a big factor for any family foundation with a pre-defined and rigid distribution schedule associated with a capital project such as financing a hospital or school.

Tradeoff of Control and Transparency for Returns. In order to create the attractive return properties described above, hedge fund managers insist on having a high degree of discretion over the investment process and specific trades. This lack of flexibility on the part of family office investors can lead to significant losses due to the aforementioned strategies—the use of leverage (i.e., borrowed funds), taking short positions, use of derivatives products, and investment in complex securities with embedded options. Since hedge fund managers are typically not bound to managing to a market benchmark (such as the S&P 500), their return streams are often much less predictable. Adding to this uncertainty is the fact that many hedge funds have track records of less than five years. Managers who have not been tested during market crises may be unable to survive tough times, similar to the turmoil of 1987, 1994, and 1998.

A potential investor will likely have little empirical data to assess how a hedge fund manager might perform under adverse circumstances. Even when a request is made, a hedge fund manager may protest, citing the need for secrecy in order to move, unnoticed, in and out of the markets with ease. Most managers are willing to discuss general investment themes or provide monthly attribution reports at an asset class level. Few are willing to provide complete transparency to the investor. As such, investors are left in the dark as to the precise degree of risk being assumed by the manager.

Less Regulatory Protection. Another factor that differentiates hedge funds from other investment such as mutual funds is the degree of regulatory oversight. Most hedge funds are not registered with the U.S. Securities and Exchange Commission ("SEC"), but are instead treated like private placements, and therefore exempt from the 1940 Investment Company Act.[3] As such, the level of disclosure, transparency and availability of information is far less than in the mutual fund industry. It is left to the investor to ferret out this information from other sources such as background checks or a review of audited financial statements and the offering memorandum. As with all market participants, hedge funds are governed by SEC rules and guidelines on market manipulation, hot issues, and up-tick rules on short-selling. Basically, hedge funds are sophisticated products that require professional management and oversight on the part of the investor, a veritable "buyer beware" situation.

Hedge-Fund Operational and Financial Issues to Keep in Mind

In addition to the fact that most hedge funds are relatively young, having been in business for no more than three to five years, most are very small enterprises compared to brokerage firms, banks, and mutual funds. The majority of hedge funds employ between 10 and 25 professionals. A growing concern is the dearth of skilled financial and technology professionals who can work in this specialized environment with ease. Inexperienced staff or an insufficient number of employees paves the way for operational risk. This is the name given to problems that arise because of computational flaws or human error.

Compounding things, some hedge funds may not have sufficient working capital or free cash flow to develop the appropriate systems infrastructure, hire a solid operations staff, develop risk management software, and regularly review their policies and procedures. The net effect for some funds is a recurring problem in clearing or settling trades, preparing good accounting numbers, assessing asset class limits, not to mention periodically reviewing who has authority to trade. It is very important for a family foundation to understand the capabilities and limitations of any hedge fund being considered for investment. Fortunately, in the modern web-enabled financial world, many of

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these functions can be outsourced to third-party vendors. Of course, outsourcing still requires attention and oversight from the hedge fund manager and a family office will want to inquire about use of third-party vendors.

Managing a Foundation's Hedge Fund Investment

A family foundation can approach hedge fund investing either by hiring internal staff to select and monitor hedge funds or by hiring a fund of funds manager. As detailed above, hedge fund investing requires the investor to:

- Perform due diligence of potential hedge fund investments;
- Select the appropriate investments; and
- Carefully monitor those investments once funds have been committed.

Hedge funds are not "buy and forget" investments. The investment management process is ongoing and requires a significant commitment of staff due in part to a fast-expanding universe of hedge funds and the complexity of this asset class. Few small or mid-size family foundations can afford to hire their own resource to manage hedge fund investments. According to a 2002 survey done by the Family Office Exchange ("Alternative Investing Practices by Family Enterprises"), the use of an external consultant by family foundations varied by how much they had allocated to hedge funds and by the specific function itself. Family foundation investors that had allocated less than 25% to hedge funds relied more extensively on an external consultant or chief investment officer to carry out due diligence, investment recommendation, and investment selection work.

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Most family foundations therefore have chosen to invest in hedge funds by employing a fund of funds manager to select an appropriate investment portfolio of hedge funds. For providing this service, fund of funds managers charge an asset management fee as well as a performance-based fee. It is important to remember that the fund of funds manager's fee is in addition to the fees charged by the individual hedge fund managers. The fund of funds manager will assist the family foundation in performing due diligence on hedge fund managers, constructing a portfolio based on the foundation's stated risk-return parameters, as well as monitoring the hedge fund managers on an ongoing basis.

Looking Ahead

Hedge fund investing can offer benefits not matched by other opportunities. However, a family foundation that does not incorporate the complexities of this asset class in its decision-making is doing itself a disservice. Some risks are unique to the hedge fund world and can materially impact returns and the way they are expected to change over time. Hedge funds already grab headlines as more and more philanthropists allocate monies to this alternative investment. With market volatility on the rise, and added regulations making it more expensive for hedge funds to garner huge fees for their clients, due diligence is needed more than ever before.

Endnotes

1. "Summary Statistics for Family Foundations: 1998 and 2002," *Key Facts on Family Foundations*, The Foundation Center, June 2004.

2. See the correlation tables in "An Excursion Into the Statistical Properties of Hedge Fund Returns" by Harry M. Kat and Sa Lu, Cass Business School, City University Working Paper, July 19, 2002. The full paper is available online at http://www.business.city.ac.uk/airc/pdf/WP0016.pdf.

3. On October 26, 2004, the U.S. Securities and Exchange Commission voted in favor of hedge funds having to register by 2006. Many people expect this new rule to increase the cost of operating a hedge fund due to additional recordkeeping and filing requirements. ■