



HEDGE FUND INVESTING:
DO IT YOURSELF OR HIRE A CONTRACTOR

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NOW THAT I'VE DECIDED TO INVEST IN HEDGE FUNDS....

WHAT DO I DO?

- Decide how to build a program
 - By yourself
 - With a consultant
 - With a fund of funds
- Costs involved
- Consultants and fund of funds...what's the difference?
- How to choose an allocator



DO IT YOURSELF....

MONEY MATTERS!

- Do you really need to pay someone to do this for you?
 - Are you already using a consultant?
 - Is the hedge fund world easy to understand?
 - What is the cost of getting it wrong?



THE CASE OF UNIVERSITY OF NEW DUNDEE

AN INVESTMENT POOL OF \$500 MILLION

- The trustees have settled on a 5% allocation to hedge funds (\$25 million)
- 15 managers will be selected
- Consultant or fund of funds a possibility
- The CIO believes UND can do it themselves...



THE CASE OF UNIVERSITY OF NEW DUNDEE

DO IT YOURSELF...WHAT'S INVOLVED

- Buy 2 databases
 - Each covers 2500 managers (8000 in existence)
- Data analysis package geared to hedge funds
- Contact prime brokers for suggestions
- Develop a list of 100 possible managers
- Send out RFPs- create a new RFP for hedge funds (10 hours)

The Tab...	
Outright Costs	
Databases	\$14,000
Time Invested	
New Rfps hrs	10



THE CASE OF UNIVERSITY OF NEW DUNDEE

DO IT YOURSELF...WHAT'S INVOLVED

- Initial vetting of RFPs
 - Incomplete, not appropriate, etc.
- More thorough evaluation on 75 RFPs
- Leaves 30 candidates for first hand evaluation

The Tab...	
Outright Costs	
Databases	\$14,000
Time Invested	
New Rfps hrs Initial vetting	10
Thorough eval hrs	60 hrs 150



30 MANAGERS TO MEET.....

The CIO and a senior staff members travel to the following cities...



The Tab...	
Outright Costs	
Databases	\$14,000
Travel	\$14,500
Time Invested	
New Rfps	10
hrs Initial vetting	60 hrs
Thorough eval	150
hrs Travel	120 hrs
120 hrs Process Info	120 hrs

The information gathered must be processed...



THE CASE OF UNIVERSITY OF NEW DUNDEE

NOW, UND IS READY TO INVEST

- Review memorandums and complete sub docs
- Wire the funds and...

Finished!...
but what about monitoring?

The Tab...	
Outright Costs	
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120 hrs Process Info	120 hrs
120 hrs Document review	15 hrs



ADVANTAGES TO DO IT YOURSELF

- Low dollar outlay
 - \$28,500 out of pocket
- Managers self-selected
 - Portfolio tailored to UND specifications
- DIY confers the most knowledge

But...

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DISADVANTAGES TO DO IT YOURSELF

- Limited selection universe
- Most Important- TIME DEMANDS
 - 475 hours for initial work
- If UND's CIO makes \$300,000/year
 - Cost of \$47,500 (\$100/hour)

**This is just the beginning...
investments must be monitored and
changes made!**

**Bottom Line: Necessary to replicate much of the
"initial" work 2-3 times a year...**

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**TOTAL
COST:\$76,000**



THE ALTERNATIVE TO DIY...

USE AN ALLOCATOR (CONSULTANT OR FUND OF FUNDS)

- KNOWLEDGEABLE consultants rare in Canada
- Initial work is similar
 - RFPs
 - On-site visits
- Initial outlays are similar...



WHAT DOES AN ALLOCATOR BRING TO THE TABLE?

- Professional Management
- Active Management
- Ongoing Monitoring
- Experience
- Contacts
- Access
- Customized portfolios

But at what price?



THE COSTS....

Typical Fund of Funds

- 1% management fee, 10% incentive fee over 5% hurdle
- \$250,000 Management Fee
- If the fund makes 12% (before incentive fee)
 - \$175,000 Incentive Fee
- Total Cost: \$425,000

Typical Consultant

- 50bp (1/2 of 1%) fee
- Total cost: \$125,000
- How are fees paid?

Remember: Everything's Negotiable



THE COSTS....

	<u>Fund Of Funds</u>	<u>Consultant</u>	<u>DIY</u>
Management Fee	\$250,000	\$125,000	\$76,000
Incentive fee (12% gross)	<i>\$175,000</i>	<u>\$0</u>	<u>\$0</u>
Total Cost	<i>\$425,000</i>	\$125,000	\$76,000

- Fund of Funds get paid when they perform!
- Staff and consultants get paid regardless
- Consider the costs of ongoing work...



THE COSTS....

	<u>Fund Of Funds</u>	<u>Consultant</u>	<u>DIY</u>
"Management" Fee	\$250,000	\$125,000	\$0
Additional Professional		\$100,000	\$200,000
Annual database fee			\$7,500
Travel	\$5,000	\$15,000	\$20,000
CIO Time	\$15,000	\$20,000	\$30,000
Admin support	\$2,500	\$15,000	\$15,000
Legal counsel	<u>\$5,000</u>	<u>\$20,000</u>	<u>\$30,000</u>
Total Cost	<i>\$277,500</i>	<i>\$295,000</i>	<i>\$302,500</i>



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LESS EXPLICIT COSTS....

- Time spent evaluating/monitoring hedge funds
 - What is being delayed or dropped?
 - Where is the CIO's value added?
- Disaster cost
 - What happens when a manager underperforms...
 - 12 months ended June 2002....

■ Top quartile large cap growth manager:	-26%	600bp difference
■ Bottom quartile	-32%	
■ Top quartile distressed manager:	+15%	1600bp difference
■ Bottom quartile:	-1%	
 - Difference between you selecting a disaster and FOF selecting one



HOW TO CHOOSE YOUR ALLOCATOR

	<u>Fund Of Funds</u>	<u>Consultant</u>	<u>DIY</u>
Fees	Yes	Yes	No
Customized	Possible	Yes	Yes
Manager Transparency	Possible	Yes	Yes
Client control	Some	Yes	Yes
Ease of investment	1 investment	Many	Many
Track record	Yes	Possible	No
Time Spent by Institution	Some	More	Lots
Additional Knowledge Needed	Some	More	Lots



HOW TO CHOOSE YOUR ALLOCATOR...TRACK RECORD ISSUES

- FoFs have clear definable records
- Consultants have composites
 - Construction process
 - All accounts included?
 - Performance of clients who fired consultant?
 - What performance can you expect?



HOW TO CHOOSE YOUR ALLOCATOR...TRACK RECORD ISSUES

- How important is a track record?
 - Better to have one than not
 - What funds drove performance
 - Are these funds available to you?
 - Luck plays a role



HOW TO CHOOSE YOUR ALLOCATOR...TRACK RECORD ISSUES: LUCK

- Manager A annualizing at 18% for 13 years
- In 2000, Manager A made 62%
 - Could you have predicted this?
- Impact on FoF with a 5% weighting: 310 bps!

- 135 Fund of Funds have track records from July 1996- June 2002
 - Median Return 11.84%
 - Top quartile return 15.26%
 - Difference: 342 bps
- SUPERIOR PERFORMANCE CAN BE GENERATED FROM A FEW LUCKY CHOICES
- Are repeated “home runs” evidence of skill?



HOW TO CHOOSE YOUR ALLOCATOR...PERSONNEL ISSUES

- Personnel Turnover
- Experience
- What are the senior people doing?
- What is their motivation?
- Side-by-side investment



HOW TO CHOOSE YOUR ALLOCATOR

	<u>Large Groups</u>	<u>Small Groups</u>
Resources	Deep	Stretched
Access	Good	May be limited
Manager Flow	Good	May be limited
Small Managers	Can't access	Can access
Closed Managers	Hard to access	May be able to access
Senior People	More removed from process	Deeply involved
Committees	Probably	Probably not
Client Service	Dedicated teams	Done by the professionals
Client Access	Limited to "best" clients	May be better
Drive	May be lessened	Probably greater
Survivability	High	Challenge
Talent Pool	Deep but can have high turnover	May be more cohesive



HOW TO CHOOSE YOUR ALLOCATOR...DOES SIZE MATTER?

- Why don't allocators have capacity issues?
- Increase the number of managers
- Start "clones" or Version 2.0 products
- Allocation of manager capacity



HOW TO CHOOSE YOUR ALLOCATOR...INVESTMENT PROCESS

- Source Managers
- Evaluation
 - Quantitative
 - Qualitative
- Number of Managers
- Top down or bottom up
- Specialists or generalists
- Transparency
- Firing of Managers
 - High turnover = shoddy due diligence or performance chasing
 - Low turnover = falling in love
- EVERYTHING SHOULD BE CONSISTENT AND LOGICAL



HOW TO CHOOSE YOUR ALLOCATOR...OTHER ISSUES

- Honesty
- Original Thinking
- Forward looking
- Always ask why



CONCLUSION

- No easy answers
- Control
- Input
- Cost should not be the driving factor
 - How many of us drive Yugos?
 - Is paying for performance bad?
- Understand the strengths and weaknesses
 - Of Allocators
 - Of Yourself

