



The Cost of Funds of Funds

A new fee structure makes this asset class more attractive to investors.

Many investors looking for substantial returns that are uncorrelated with the ups and downs of the market are turning to hedge funds. Despite the growing interest in this asset class, there are some practical considerations associated with it.

Difficulties with hedge funds

Minimum wealth levels and sophisticated investor requirements constrain many small investors. Legal limits on the number of U.S. investors allowed in hedge funds imply that these funds have high minimum investment requirements. In fact, many otherwise attractive hedge funds are closed to new investment. For those open to new investment, the minimum unit size is usually quite substantial. Even for smaller institutions and endowments it can be expensive, and in many cases impractical, to invest in hedge funds with a prudent degree of diversification.

Unlike registered investment companies, hedge funds are not required—indeed by most legal interpretations not allowed—to publicly disclose performance and holdings information that might be construed as solicitation materials. This has the unfortunate effect of making it more difficult for potential investors to evaluate managers on a comparative basis.

In addition, little public information exists about fund operations and their holdings, and investment strategies are typically undisclosed for strategic reasons. As a result, it is difficult for fiduciaries to conduct the due diligence required under most prudent investor rules and statutes.

Funds of funds are financial intermediaries established to address several of these issues. They are hedge funds, themselves, which hold shares in other investment companies and charge a fee for doing so. They allow investors to invest in smaller unit sizes, to participate in hedge fund investments that are otherwise closed, and to diversify across hedge fund investments.

Funds of funds reduce the standard deviation of monthly hedge fund returns by one-third, while also

significantly reducing the value at risk of hedge fund investments. In addition, they provide professional management services and access to information that would be difficult or expensive for an investor to obtain on a fund-by-fund basis. For these reasons, a fiduciary who is primarily concerned with downside risk and due diligence issues associated with hedge fund investment should consider a fund-of-funds alternative.

Fees on fees

One often-cited disadvantage of this arrangement is the cost to the investor. In addition to the fees charged by the fund of funds, these vehicles effectively pass on all fees charged by the constituent funds to the investor, since, in most cases, they report their net returns after all of the underlying manager fees are paid.

The relatively disappointing after-fee performance of many funds of funds can be attributed to this fee structure. In addition, a common concern among practitioners is that this double-fee arrangement might induce fund of funds managers to invest in unduly risky hedge funds to ensure that the returns gross of fees are sufficiently large to absorb the overall level of fees charged.

New fee structure

Fortunately, a new type of fee structure has recently emerged. The fund of funds manager absorbs the individual fund incentive fees in return for a higher fund of funds management fee and/or incentive fee structure. If appropriately hedged at the fund-of-funds level, this alternative arrangement is revenue neutral to the fund of funds provider, and it reduces the overall fee burden on the investor. In addition, it mitigates the risk taking incentives of the current fee-on-fee arrangements. Widespread adoption of this alternative fee arrangement will substantially increase the attractiveness of this new asset class. ■