SENIOR VICE-PRESIDENT AND MANAGING DIRECTOR, ALTERNATIVE INVESTMENTS, AMERICAN EXPRESS ASSET MANAGEMENT — Ken Stemme

Investing in Hedge Funds

Should you do it yourself or hire a contractor?

When a plan sponsor makes the decision to invest in hedge funds, it needs to consider whether it can make the allocations on its own, or if a consultant or a fund of funds is necessary. Money and in-house resources often determine which approach a sponsor will adopt.

It costs about $28,500 and approximately 475 hours of work for the databases, requests for proposals and first-hand evaluations needed to build a hedge fund portfolio. The total cost is about $47,500. In addition, the portfolio needs to be monitored and possibly revised several times a year. This approach is beneficial to the plan sponsor because it provides the most information.

The alternative is to use an allocator such as a consultant or a fund of funds. Allocators offer such benefits as active management, ongoing monitoring, experience and access to the market. However, these advantages come with a price. Below is an example of the estimated costs:

	FUND OF FUNDS	CONSULTANT	DIY
"Management" fee	$250,000	$125,000	$0
Additional professional	$0	$100,000	$200,000
Annual database fee	$0	$0	$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	$5,000	$20,000	$30,000
Total Cost	**$277,500**	**$295,000**	**$302,500**
Incentive fee (12% gross)	$175,000	$0	$0
Total Cost	$452,500	$295,000	$302,500

Before incentive fees, all three approaches have roughly similar costs. The incentive fee makes a fund of funds the most expensive choice. However, this fee is only paid when performance is generated. As well, plan sponsors should realize that most costs are negotiable. Other less obvious costs must also be taken into account such as the time an institution spends evaluating funds, which may mean that another project is delayed.

If a sponsor decides to hire an allocator, it must start by examining the party's track record. This requires the sponsor to understand what funds drove performance and whether they are still available. Also, superior performance for a fund of funds can be generated by just a few managers outperforming their competitors.

In addition, there are a number of factors to consider when comparing the relative strengths and weaknesses of small and large allocators: resources; access; manager flow and size and how it impacts their work; closed managers; senior staff; committees; client services and access; their drive; the firm's ability to survive; as well as its talent pool.

For example, a large allocator will have deep pockets, dedicated teams, a strong pool of talent and future sustainability. However, its size will mean that access may be limited to its best clients and its drive may be less than that of a smaller firm. On the other hand, a small firm has senior officials who are deeply involved in the work as well as good client service, but its resources may be stretched and long-term survival will be a challenge.

The allocator's capacity is another issue to think about. The sponsor needs to consider how much money the allocator can put to work effectively and if it is getting the allocator's 'second choices.' Of course, the investment and risk management process is another important issue.

Most importantly, however, an allocator should be compatible with the sponsor's philosophy. Sponsors should always ask questions and be sure to understand the strengths and weaknesses of allocators as well as their own organization. ∎