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GRAPPLING WITH CAPACITY

Liquidity and diversification are at the heart of hedge fund analytics.

As assets flow into hedge funds, individual managers are constantly looking at their ability to increase capacity without negatively impacting performance. To increase capacity, a manager may look at increasing the liquidity of the positions being traded or increasing the number of positions being taken (in effect diversifying the portfolio), both of which are not without problems, as we see in the comparison below.

• Liquidity - as managers seek new investment opportunities they are often forced into more liquid markets, which are typically more efficient, hence less likely to support return expectations.

• Diversification - a manager only has a limited resource to research investment ideas; if more positions are sought, the level of knowledge or comfort may be compromised. While many industries will just increase headcount, the specialist nature of highly skilled hedge fund managers means that hiring new analysts is no guarantee of added value. In fact, in some cases, the additional requirement to manage teams of analysts can erode productivity.

Both of these developments make the role of ongoing due diligence all the more essential. While the better hedge funds have no difficulty in raising assets and reduce their liquidity terms in a bid to create a more stable asset base, there is a potential erosion of marginal returns for those less discerning about asset accumulation. Another risk is that leverage is used to bolster returns, thus increasing inherent risks within a portfolio.

Fund-of-Funds Framework

From a fund-of-hedge-funds perspective, the issues of liquidity and diversification are broadly similar. In the case of liquidity, the industry is grappling with the same liquidity mismatch that exists between many funds of hedge funds and the positions they hold. As quality managers reduce their liquidity terms, funds of hedge funds have to follow the same course of action or take on the business risk if investors begin to redeem their holdings. The growth of more retail money—which is typically less sticky—is serving to increase this liquidity dilemma for funds of hedge funds; as is the case with individual hedge funds, the best managers are also seeking investors whose interests are aligned with their own.

Dangers of Overdiversification

On the issue of diversification, the fund of hedge funds manager essentially looks to mitigate event risk by gaining an understanding of the relationships between funds and by diversifying portfolios across managers and strategies. As the best funds close, there is a danger that the fund of hedge funds manager may overdiversify their core positions and lose the ability to define the sources of risk at the same time as diluting returns.

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To conclude, due diligence is a consideration of growing importance in sourcing new managers, defining the available alpha pools and in securing capacity. Reducing hedge fund liquidity is important to the long-term prospects of the industry, a fact that both investors and funds of hedge funds need to understand. Finally, while 2004 turned out to be a less-than-stellar year for many alternative investment strategies, this is not necessarily a function of capacity but rather a result of a lack of trading opportunities brought about by macro factors. ■