

# Implementation and impact

## Positioning hedge fund management for the future.

FIELD NOTES

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Canadian pension and endowment funds that for decades relied on traditional stock, bond, and cash investments have slowly begun embracing hedge funds as an alternate source of returns. While much has been said about the diversification benefits and value-adding absolute return strategies of hedge funds, there needs to be a focus on implementation and impact issues: how should institutions begin to invest in hedge funds, how should hedge fund managers respond to this flood of new money, and what will be the impact on managers' ability to generate excess returns or alpha?

The early adopters of hedge funds were high net worth individuals and endowment funds, who were attracted to the potentially large absolute returns available and were generally not concerned with the low levels of transparency, disclosure and liquidity. Hedge fund managers were often small groups of skilled investment professionals who managed limited partnerships for a small number of investors, including the manager's personal stake, set minimum investments of \$1 million or more, and earned a performance fee.

Since the mid-1990s, institutional investors (primarily in the U.S.) began to recognize the absolute returns offered by hedge funds. In October 2000, the California Public Employees' Retirement System board agreed to establish a US\$1-billion hedge fund program. However, by February 2003 only US\$550 million was invested with 13 fund managers. At the end of 2002, the Ontario Teachers' Pension Plan had \$2.5 billion invested in alternative investments and relative value strategies, representing 4% of all investments. And the Ontario Municipal Employees Retirement System made its first \$200-million investment in hedge funds in the second quarter of 2003. As hedge funds move into the investing mainstream, the scale and pace of investments could be dramatically different: an immediate allocation of as little as 2% by

Canadian pension funds would more than double the entire hedge fund assets under management by individual Canadian hedge fund and fund-of-funds managers.

Canadian institutional investors will need to come to grips with a number of implementation issues, some of which are analogous to issues faced with traditional investments, others of which are new. One issue is the wide variety of available hedge fund strategies: in the traditional equity and bond investing arena, institutional investors chose strategies to position their investments along active and passive lines. Many pension funds access market beta through core investments in index (and closet index) funds, and supplement returns with more alpha, but place smaller-sized bets in less-liquid markets such as small-cap stocks, or high-yield bonds. Institutions may well take a similar route in their hedge fund portfolios, seeking large amounts of smaller alpha through fund-of-funds or diversified portfolios, and smaller amounts of larger alpha through niche managers.

However, institutional investors will also face some unique implementation issues. Even the relatively simple task of evaluating and choosing external hedge fund managers can be a new challenge. For example, when an institutional investor is considering an active Canadian equity manager, the process is relatively straightforward: consultants can create a short-list of managers for an apples-to-apples comparison of performance history, risk and investment style. Yet the hedge fund world is often one of apples-to-oranges: convertible arbitrage is very different from long/short or statistical arbitrage strategies. Factors such as use of leverage and derivatives and non-standard presentation of performance can also make comparisons difficult.

There are other issues. Institutional investors typically expect their traditional managers to provide transparency,

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well-defined risk controls and uniform reporting of return performance and risk measurement. As well, institutions generally control their traditional investments through managed accounts, settling at a single custodian. Many hedge funds, however, are set up as lower-liquidity pools, and the assets are most often held at prime brokers owned by large investment banks. While the best hedge fund managers devote substantial resources to risk management tools, risk reporting has not yet been standardized. The difficulty in evaluating and monitoring hedge fund investments has given rise to fund-of-funds managers, who can provide process and structure in return for fee-based compensation.

Probably the greatest challenge will be meeting institutional investors' return expectations. It is generally accepted that, in the traditional world, fund size and alpha have a tendency to be inversely correlated, and most hedge fund strategies are less easily scalable than in the traditional investment world. Not all hedge fund managers will be able to handle the return and reporting demands of institutional investors. The greatest amount of assets may gravitate toward those funds that are able to meet the capacity demands, such as fund-of-funds managers and substantial multi-strategy managers. Investors may be forced to accept reduced alpha in order to invest in larger accounts.

What will hedge fund managers need to do to respond? One path they might follow is to become big, offering a multi-strategy fund with substantial diversification across hedge fund styles, but potentially less alpha. Another path for managers is to focus on a niche, thus “right-sizing” their funds, and attempting to offer more alpha (but with less capacity) than the multi-strategy path. The model for niche managers will evolve similar to current traditional niche managers: limiting the number of clients and capital to be “right-sized” for their niche markets.

In either case, fund managers must be prepared to respond to the demands of institutional investors. Growing from small investment firms into institutional-grade service providers could be difficult, which is why fund-of-funds have already begun to fill the gap.

Increasing size and complexity requires infrastructure, non-investment personnel, investment in processes, and business management skills. Few of the 6,000 hedge fund firms worldwide are in a position to offer a platform that can deal with the demands of institutional investors.

Current traditional investment management firms that cater to large institutional clients may also want to enter the hedge fund space, and will probably be most attracted to hedge fund firms that play to their strengths. These traditional managers will be faced with typical build or buy decisions, not dissimilar to the Canadian banks entering the investment dealer space in the late-1980s. Those banks who chose to build found the task extremely difficult, while those that bought were faced with substantial integration issues, some of which are still being addressed.

Increasingly, pension and endowment funds have received approval to invest in hedge funds, so an accelerated level of investment should follow shortly. Astute institutional investors will need to be careful not to overwhelm fund managers with their sheer size, and must choose managers that have (or are prepared to have) sufficient infrastructure in place. They will need to deal with hedge fund firms that understand the concept of “right-sizing” in order to continue to access alpha. Investors will also need to have a clear mandate, be well-educated, be capable of making informed decisions, and have reasonable alpha expectations given their size.

Astute hedge fund managers will have infrastructure devoted to client service, strong communication skills, ensure their strategies are scalable, and be able to run a rapidly growing business, while continuing to generate absolute returns. They will also need to assess their skill sets and capacity in the markets in which they participate, understand the skills required to take on large institutional mandates, and recognize how that changes their investment risk-reward profile.

More than any other asset class, the hedge fund universe will require a well thought-out, informed partnership between managers and institutional investors. Growth without a plan will mean pain for both sides. ■