



Are Hedge Fund Managers Worth the Money?

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Outline

- Why use hedge funds? - generating alpha
- Benefits and risks
- Funds of hedge funds vs. single managers multi-strategy
- What to watch out for
- Conclusions



Traditional long-only managers

- Capture market moves
- Add value relative to benchmarks
 - Constrained by tracking error and standard deviation
- Rely on equity returns and add bonds to 'reduce risk'
- Downside protection limited
- Are long-only active managers worth the money?
- Can hedge funds improve performance despite high fees?



Using hedge funds

- Hedge funds are not really one asset class
 - Style of management across many assets
- Absolute return emphasis
- Access more sources of market inefficiency - capture different risk premia
- Truly active management – not benchmark constrained
 - Talented managers attracted to greater flexibility
- Reducing risk is not just about volatility
 - Want lowest reduction of expected return



Benefits of hedge funds

- Wider range of asset classes and investment instruments
- Diversification can improve portfolio efficiency
 - Lower correlations enhance returns and reduce risk
- Wider opportunities for alpha and beta
- Alignment of interests if managers also investing
- Can use in different ways
 - Long/short in core-satellite equity portfolio in preference to long-only with wider tracking error?
 - Market neutral to help risk control as non-correlated



Risks of hedge funds

- Complexity, lack of transparency, due diligence costly
- Specific fund and manager risk, big performance variation
 - Bad outcomes very bad!
- Illiquidity, capacity and pricing concerns
 - High investment minima
- Understanding different strategies
 - Not all hedge funds alike
- Use of leverage adds extra potential risks
- Higher fees than traditional managers



Fund of funds can help at beginning

Lack of transparency

Monitoring & Reporting – better disclosure

Risk of failure

Due Diligence – experts know what to look for

Complex due diligence

Sophisticated Investment & Research processes

Choosing the right strategies or asset classes

Construct diversified optimal portfolios

Must find best managers

Early identification and monitoring of top talent



Compiling a hedge fund portfolio

- Must understand what strategies you need
- Emphasis on uncorrelated absolute returns
- Diversification across various strategies?
- Diversification across different managers?
- Education - identify which hedge funds suit you best
- Use a specialist consultant? Fund of funds?
 - Will add to costs



Fund of funds for initial investors

- Lower investment minima, better liquidity?
- Diversification
- Capture different risk premia from inefficient markets
 - Aim to compile optimal portfolio
- Should provide ongoing due diligence and monitoring
- Correlations and strategies change over time
- Are they worth higher fees?



Disadvantages of fund of funds

- Double layer of fees
- No control over strategy or manager selection
- Dilution of best returns
- Choose experienced fund of funds manager
- Beware strategy or style drift?
- Leverage?



Single manager multi-strategy

- Cheaper option than fund of funds
- Leave portfolio construction and security selection to one manager – specific risks
- Must have confidence in expertise – asset allocation?
- Ensure leverage is understood and controlled
- Shorting is a separate skill
- Jack of all trades?



Single manager single strategy

- Can focus on the kind of hedge funds you want
 - Control over strategy selection
- Can select specialist manager for the chosen strategy
- Access specific type of alpha or beta
- Complement existing portfolio at lower fee rate
- No dilution of returns if select best manager and strategy



What to watch out for

- Experience - specifically in hedge funds, not long-only
 - Robust portfolio construction models and risk control
- Shorting skills – risks of short side very high
 - Managing shorts is different skill set from long-only
- Historic volatility – how they performed in times of stress
- Fee rates – ensure you understand hurdles and lock-ins
- Personnel, administration, growth rate, managers invest own money
- Leverage



Conclusion

- Hedge funds can improve portfolio efficiency
- More complex than long only - not one asset class
- Choose the right strategies to complement your portfolio
- Use consultants or advisers relevant experience
- Select best managers with sound process and record
- Definitely worth the money if you get the right one!



Thank you for listening...

ANY QUESTIONS?

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