To use a fund of funds, or go direct? That is the question for institutions

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A decade ago, investors were asking whether they should invest in hedge funds at all. Today, while there remain a few holdouts, the majority of institutional investors have made the leap to hedge funds as an improved model for seeking active returns.

Hedge funds have recently reached a record high $2.245 trillion in assets, according to HedgeFund Intelligence. We estimate that the adoption rate of hedge funds by sophisticated institutional investors has reached almost 70%, and allocations are likely to grow rapidly, in part due to the low yields offered today in the fixed-income asset classes. Hedge fund strategies remain complex, with at least 50 unique sub-strategy classes, each with its own unique alpha, beta and risk characteristics to understand, monitor and incorporate into active portfolio construction. With the benefits of hedge funds now recognised by institutional investors, the question has changed from 'if' to 'how' they are accessed. Most commonly, investors are asking: "Should we use a fund of hedge fund (FoHF) manager or make direct hedge fund investments?"

There have been loud dissenting voices from many circles about the double layer of fees charged by FoHFs, but there has been little real analysis of the all-in costs of the different approaches. Similarly, there has been little documented consideration of the different benefits offered by the different paths to hedge fund exposure. Being unaware of any comprehensive cost-benefit analysis addressing this topic, my colleagues and I have recently undertaken such analysis that suggests that from a pure direct cost perspective, FoHFs are actually a less expensive path to executing a hedge fund programme in many instances because the additional costs of consulting services, custody, administration, legal work and additional staffing that are often not explicitly considered. And that says nothing about the benefits of scale in manager fee and term negotiations that most institutional quality FoHFs bring to the table.

The cost-benefit analysis, where value equals benefits minus costs, is a pretty simple equation. Unfortunately, because benefit is so hard to assign value to (and dependent on investor preference), consumers are often encouraged to focus their evaluation on costs alone. Further, in performing cost-benefit analyses, consumers often overlook indirect costs.


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We will attempt to address all of the direct costs and explore many of the indirect costs and benefits of the different paths of accessing hedge funds as we look at four approaches to making hedge fund allocations:

1) Investment in a seasoned FoHF commingled fund product.
2) Investment in a single investor fund (fund-of-one) managed by a FoHF.
3) Direct investment in hedge funds with the help of a generalist consultant.
4) Direct investment in hedge funds with the help of a specialist hedge fund consultant.

The direct costs

For the direct hedge fund path, the key cost model inputs are:

- The amount invested in the programme and the number of managers — since these will have an impact on the marginal costs for direct consulting fees, legal, custody and administration expenses, as well as search and monitoring costs.
- The level of service provided by the consultant and its associated fees.
- Marginal staff needed internally by an investor to effectively execute the programme and monitor managers.

For FoHFs, the key cost model inputs are:

- The amount invested in the programme that impacts management fees and certain other costs.
- The type of structure (commingled or fund-of-one).
- In the case of commingled investments, the size of the commingled fund (which helps defray other expenses across a larger investor and asset base).
- The scale the FoHF manager has in negotiating better fees with underlying managers.

This last point is one of the most important and least considered areas when comparing these various paths. FoHFs with scale can negotiate meaningful cost reductions in the form of better terms with underlying managers, which often include lower management fees and incentive fees, as well as use of incentive fee hurdle rates.

In many cases, these cost reductions are not available to direct investors, because of limited size. In our model, we create an underlying hedge fund 'fee/cost offset' that is based on the difference in expected hedge fund management fees paid by FoHFs vs direct investors of smaller scale.

On the next page are our cost model outputs for two scenarios, a $100 million hedge fund programme, and a $500 million hedge fund programme, each assuming weighted average manager returns of 8.5% (before fees paid to FoHF or consultant).

The other key assumptions used for the $100 million scenario are:

- Two internal staff hires required at plan (one administrative, one professional).
- Effective fees to underlying managers when going direct are 1.80% management fee and 20% performance fee vs FoHF fees paid to underlying managers of 1.5% and 17%.

Based on our direct cost estimates in the $100 milion scenario, a commingled FoHF compares very favourably to the direct investment options and may actually be the cheapest option, depending on the fees paid to advisors in the direct model.

The other key assumptions used for the $500 million scenario are:

- Four internal staff hires required at plan (two administrative, two professional).
- Effective fees to underlying managers when going direct are 1.75% management fee and 19% incentive fee vs FoHF fees paid to underlying managers of 1.5% and 17%.

In the $500 million scenario, FoHFs are now a slightly more expensive option. A key factor here is that the $500 million programme investor is able to negotiate underlying manager

Cost model output for $100m hedge fund programme

Cost category	FoHF fund-of-one (20 managers)	FoHF Commingled (45 managers)	Specialist consultant (10 managers)	Generalist consultant (10 managers)
FoHF manager or consultant fees	0.95%	0.95%	0.40%	0.18%
Custody and administration	0.05%	0.04%	0.05%	0.05%
Legal and compliance	0.05%	0.00%	0.07%	0.07%
External oversight	0.03%	0.02%	0.00%	0.00%
Internal staff management costs	0.00%	0.00%	0.27%	0.27%
Hedge fund fee/cost offsets	-0.45%	-0.45%	0.00%	0.00%
TOTAL	**0.62%**	**0.56%**	**0.78%**	**0.56%**

Source: Mesirow Advanced Strategies

fees to a greater extent. However, what may be surprising to some is how narrow the cost differences remain between the FoHF and direct models. In this case, the FoHF options are only approximately 20 basis points more in direct costs than the direct models. This is a much lower cost differential than commonly considered.

Indirect costs to consider

Indirect costs of the various models are important and also very difficult to estimate and quantify. And in fact, what one investor considers a cost another may consider a benefit. Below we list and describe some of the key indirect costs that should be considered.

- **Complexity and implementation risk:** Complexity of the programme creates additional support burden and communication costs beyond directly measurable costs — including requiring additional cash flows across custody accounts, data management, data sharing and reporting to other service providers and plan trustees.
- **Time to programme implementation:** how long will it take to implement and what are the opportunity costs incurred over the implementation timeframe? Presumably, implementation time is longer for the direct models that require multiple investments vs turnkey FoHF solutions.
- **Switching costs:** How easy or difficult is it to unwind the programme? What are the internal and external operational and approval hurdles? How quickly can service providers be changed?
- **Measurement and accountability:** Who owns, or is responsible for, any and all decisions? What are the return targets or appropriate benchmarks? Who is accountable for strategy allocation, manager selection or overall exposure decisions?

Answers to these questions should be specified in advance to properly track and evaluate decision making. For FoHFs, absolute returns, along with beta-adjusted peer and pre-specified benchmark returns, are all potential evaluation measures. For direct programmes, assigning clear accountability for decision making is critical, as is developing and using metrics for success in manager selection and allocation.

- **Fiduciary risk:** With each additional manager hired comes additional fiduciary risk to all parties involved in selection, implementation and monitoring. At the same time, use of consultants mitigates this risk — given their knowledge of the broad marketplace and execution of best practices.
- **Headline and peer risk:** With multiple managers headline risk increases for plan sponsors if they have direct and publicly disclosed associations with underlying hedge fund managers. With a FoHF approach, the headline risk exposure is with the FoHF manager typically and not the underlying hedge funds.
- **Service provider and internal staff turnover:** How long will it take to recruit and train internal staff? Who will train them? How important is the loss of a key person or senior staff turnover, and what effect might it have on the programme success? Thinking in advance about the recruiting, training and succession issues related to key staff is an important consideration.
- **Systems and infrastructure:** FoHFs and consultants have varying competencies and investment in systems and infrastructure to improve efficiencies in hedge fund manager sourcing, monitoring, portfolio construction and risk management. If an investor has plans to insource these functions, appropriate costs should be taken into account.

In general, many of these costs are higher in a direct allocation model, but all may be effectively managed. That said, managing them effectively may create other direct costs, like additional legal, compliance, oversight, technology and staffing cost. We have not explicitly assigned dollar costs for these indirect variables, but all of them should be considered and formulated into an investor's analysis when making decisions about which path of hedge fund investing to follow.

Direct benefits

The key direct benefit that is explicitly most important to institutional investors that I speak with is the future return that will be experienced. Thus, the key question investors at the $500 million level should ask is: do I believe the FoHF manager is likely to generate 20 basis points of return more than the direct model?

The problem with answering this question clearly is that future performance is unknowable in advance. That is true not only of the absolute level of the return, but also its volatility and correlation profile relative to other asset classes in which the institution invests. If we look at historic returns, we see that it is easily possible that a FoHF manager could generate well in excess of 20 basis points of additional return over the direct model. But without clairvoyance, an institutional investor cannot count on past performance being indicative of future results. What is knowable, and what we focus on below, are more 'indirect benefits'.

Cost model output for $500m hedge fund programme

Cost category	FoHF fund-of-one (20 managers)	FoHF Commingled (45 managers)	Specialist consultant (20 managers)	Generalist consultant (20 managers)
FoHF manager or consultant fees	0.75%	0.75%	0.08%	0.13%
Custody and administration	0.05%	0.04%	0.04%	0.04%
Legal and compliance	0.01%	0.00%	0.02%	0.02%
External oversight	0.01%	0.02%	0.00%	0.00%
Internal staff management costs	0.00%	0.00%	0.11%	0.11%
Hedge fund fee/cost offsets	-0.34%	-0.34%	0.00%	0.00%
TOTAL	**0.47%**	**0.47%**	**0.25%**	**0.29%**

Source: Mesirow Advanced Strategies

Indirect benefits to consider

Some of what we call indirect benefits may in fact influence the direct benefit of achieved future return. Because future investment performance of a FoHF manager or a direct programme cannot be predicted with certainty, an investor must rely on philosophy, process and conviction, among other things, to justify decisions. That is often a complicated effort driven by many unique personalities, decision processes and oversight dynamics. The question for institutional plan sponsors is: "What are the most important criteria that will or should drive our investment decision making — and give us confidence in future performance?" Potential benefit criteria important to consider are described below. Here again, it is worth mentioning that one person's benefit may be another person's cost.

- **Alignment of interests:** Incentive issues are of extreme importance in hedge fund investing. In our experience, capital co-investment is the most powerful incentive alignment technique and one that most consultants and FoHFs tend to require from managers with whom they invest. This is also common with FoHF commingled investments where principals of the FoHF firm invest alongside clients. In our experience, this is one of the most important and powerful benefits to consider. Because consultants and internal employees typically cannot invest alongside the plan, this type of alignment is harder, if not impossible, to achieve in a direct investing model. Another benefit of the FoHF model is the ability to negotiate a management fee plus incentive fee (typically over a hurdle) so that investors will pay less when performance hurdles are not achieved.
- **Research depth and quality:** While ex-post performance ultimately determines research quality, given the greater degree of specialisation and resources, FoHFs generally score highest on these metrics. For example, a typical mid-to large FoHF manager might employ one research analyst for every three to six managers covered, and could have an additional operational due diligence analyst assigned to only 10 to 12 managers per operations analyst. This depth of coverage is hard for other types of organisations to match and may be closer to 40:1 for organisations with fewer dedicated hedge fund resources. In addition to research analysts, FoHFs tend to have larger teams focused on data management, portfolio construction, and risk management.
- **Observable track records:** A live historical track record often instils confidence in decision makers. It is relatively easy for FoHFs to show live track records attributable to their team and process. This is a more difficult proposition for a nascent direct programme. One can construct a hypothetical performance stream based on a set of proposed managers and allocations, but that process is fraught with biases. We would argue that live track records are more critical in the hedge fund space than in traditional investments given the nuanced liquidity and rebalancing constraints involved with managing hedge fund portfolios.
- **Experience:** Experience in differentiating skill from luck in nuanced investment approaches, risk management experience, and operational due diligence experience are critical components of successful hedge fund investing. Experienced analysts and risk managers are aware of industry best practices. Experienced analysts can often negotiate the best liquidity, transparency, fee and governance terms with managers which can dramatically improve incentive alignment and mitigate the risk of poor outcomes.
- **Diversification:** Under most of our assumed scenarios, a FoHF will provide more immediate and appropriate diversification across managers, betas and alpha types. For a typical multistrategy FoHF this can be anywhere from 20 to 100 managers. The flip side of this argument is that many perceive FoHFs as potentially overdiversified. This excessive diversification is believed to eliminate a great deal of the available alpha. Our studies on the topic demonstrate that the issue of over-diversification is highly dependent on the portfolio construction, the availability of quality managers with capacity in the desired strategy segments, and the nature of alpha produced by managers in different strategy segments. Simple models of stock diversification greatly oversimplify this issue, and our work suggests that portfolios of 20 to 50 managers may in fact be optimal, depending on the objectives. As such, we perceive 'day-one diversification' as a key benefit of the FoHF approach.
- **Access:** Access to closed or unique managers and new ideas: FoHFs often have long-term capital that has been invested with high-quality managers, often for many years. Many FoHFs also negotiate capacity with managers given their history with managers and scale in fund allocations. In addition, FoHFs' well-developed sourcing networks are valuable in seeking out new, small or unique managers. Often these smaller or more unique managers are more willing to provide advantageous terms to large established day-one investors that help provide business stability and access to insights and best practices.
- **Liquidity:** Liquidity is similar for most options with the exception of commingled FoHFs. The benefit is that if one investor comes into a fund while another investor goes out, those moves can be offset with no disruption to the investment programme. Further, commingled FoHFs have 'seasoning', meaning some capital invested under lock-up arrangements with managers will likely have matured past lock-up dates. In addition, most FoHFs offer quarterly liquidity in commingled funds that is a benefit in normal periods. The problem is that quarterly liquidity can be a problem in crisis periods, since departing investors can have adverse effects on remaining investors in a fund. That is true because most FoHFs intermediate liquidity. Underlying investments are not 100% quarterly even though the fund provides quarterly liquidity. The best way to manage this risk is for investors in commingled FoHFs to monitor their size relative to the overall fund and other investors within the fund.
- **Customisation and service evolution:** Which potential partner or programme has the broadest and deepest knowledge, willingness and ability to customise the programme to your needs as they evolve? Does the provider bring economic, investment, liability and other expertise and a full set of potential solutions? On this front, generalist consultants tend to have the broadest knowledge and skill set, while FoHFs have the deepest skill set in hedge funds specifically. Specialist consultants probably lie somewhere in between.
- **Systems, reporting and infrastructure:** Different consultant and FoHF firms have differing levels of access to transparency from underlying funds. In some cases, FoHFs and consultants utilise internal or external risk aggregation services to provide better transparency into underlying holdings and risk exposures. These in turn enhance reporting and risk management capabilities. In addition firms employ teams of operational experts and accountants — providing economies of scale in accounting for and reporting on underlying hedge fund investments. These can often be leveraged by investors and are key benefits and should be analysed and compared across potential advisory partners.

Conclusion

All-in cost differences between the models are not as great as many commonly believe. While much investor attention is paid to the 'double layer of fees' in the FoHF model, the corresponding incremental direct staffing and other expenses incurred in employing the direct model is often ignored. In addition, because FoHFs have greater asset scale, they are usually in a position to negotiate more favourable terms with underlying managers, offsetting a significant portion of the underlying manager fees relative to the other models.

From a pure cost perspective, a $100 million hedge fund programme may in fact cost more to implement via a direct programme model than through a FoHF. At the $500 million level, we estimate the FoHF model is only roughly 20 basis points more expensive than a direct model. The question of which is a greater value, however, relies on the net return achieved in the future (which is an unknown) and each investor's own assessment of the value of the indirect costs and benefits.

The benefits brought to bear by things like incentive alignment, experience, research coverage and quality, observable track records, diversification, liquidity, systems, risk management expertise, reporting and infrastructure should be explicitly analysed. In the end, it's simple: V=b-c. Or, sort of simple… maybe.