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The Upside of Transparency and Control

by **Misha Graboi, Director** | 1st Quarter 2015

This paper examines how institutional investors can most effectively take advantage of hedge fund transparency and investor control structures. It is written in three parts. The first part of the paper traces the evolution of improved hedge fund transparency and control structures, particularly in the wake of 2008, initially as a defensive mechanism and, later, as a potential toolkit to generate upside. The second part addresses practical issues: now that the toolkit of transparency and control structures is in place, what are some of the “levers” that can actually be pulled to generate benefits for a hedge fund portfolio? The third part looks at how institutional investors make partnerships with hedge funds work.

I. The Evolution from Defense to Offense

Investor Control and Fund Transparency: Initially Playing Defense

While many hedge fund investors had advocated for better fund transparency and more investor-friendly fund control structures long before the global financial crisis, in the wake of 2008, these issues took center stage. The vast majority of funds operated in the way that was expected by investors and weathered the storm as best they could given the circumstances. However, some hedge funds surprised their investors in a number of ways.

Investors in the latter group discovered during 2008 that investing in some funds was a little bit like being thrown in the trunk of a car - they were unsure of what was happening and helpless to do anything about it. They had low transparency and little control. Some investors discovered that the risk profiles of some funds they invested in were radically different than returns-based analyses predicted. Some discovered that funds promising monthly or quarterly liquidity were packed with positions that could only be unwound over the course of years. Others found funds gated - even in the presence of a liquid market for the underlying securities. An unfortunate few found that their money was simply not there at all. Though many investors still saw the utility of hedge funds from an investment perspective, they needed mechanisms to deal with these problems, and the solutions focused primarily in two areas:

The financial crisis of 2008 brought hedge fund control and transparency issues front-and-center for many investors

- **Control Structures:** These included more favorable terms in subscription agreements; a focus on independent boards and better fund governance; or more sophisticated approaches, including separate accounts and/or funds of one with direct investor control. Whatever the methodology used, the initial investor focus was on asset security and liquidity management intended to protect the downside.

- **Transparency:** Similarly, there were a wide array of solutions undertaken to improve transparency, from better exposure reporting by fund managers (either detailed or aggregate) and standardized aggregate reporting templates (e.g., Open Protocol), to third-party verified position-level or aggregated transparency through risk aggregators or separate account platforms. Again, the initial focus was on risk mitigation - ensuring that there were no “ticking time bombs” in the portfolio, and that aggregate exposures remained within tolerable, advertised bounds.

Leveraging Sunk Costs: Moving to Offense

There are many possible combinations of solutions available to investors, but regardless of the one implemented, they all typically have one thing in common: they generally require resources and thus represent increased cost. Protecting against certain downside risks is important, and

Some defensive structures designed to protect assets can also be used to try to improve portfolio returns

from an investment management perspective, the potential of hedge fund strategies to produce low-correlation returns to other assets classes means that broad divestment is not the best option. However, purchasing such an "insurance policy" often means increased legal expenses, internal staffing needs and third-party service costs.

On the other hand, organizations who invest in better control and transparency get something besides just risk management mechanisms—the same tools can often also be used to try to improve returns. With the proper mindset and an appropriate partnership framework with the underlying fund managers, utilizing these tools in portfolio construction, tactical and strategic exposure management and fund customization can make it possible to generate upside, rather than just manage downside.

Transparency and control can provide a toolset for better portfolio construction and for modifying funds to better suit investor needs

Indeed, investment in more advanced risk mitigation techniques has opened up a panoply of new options with regards to investment in low correlation portfolios by also solving two other issues: first, separate accounts that can be customized have the potential to overcome limitations inherent in many commingled hedge funds. CIOs of hedge funds often play dual roles, managing both fund investments and the management business itself. Without the luxury of numerous funds and a massive distribution network as seen in large fund complexes, it often means that the business is heavily dependent on the commingled flagship fund. As such, commingled funds' risk-return profiles, position limitations, draw-down rules and other guidelines are often geared to appeal to what the manager perceives is the widest array of investors needs - "the lowest common denominator." Indeed, when pressed, some fund managers admit that the way they run their commingled funds is different than the way they would run an unconstrained mandate from a long-term investor. While the risk-return profile of the fund may be the most broadly appealing, that does not mean it fits well into every investor's portfolio. Freed from the constraints of commingled funds, investors with the appropriate separate account infrastructure (and a solid partnership with their fund managers) are free to adjust a fund's risk-return profile to better suit a multi-fund portfolio. This can be done by relaxing or tightening risk limits, adjusting leverage, carving out part of the portfolio, or other customization in consultation with the fund manager.

Second, with transparency, managing the entire portfolio as a holistic entity becomes much easier. In long-only investments, unless the fund in question is showing a massive tracking error, its benchmark serves as a pretty good proxy for its risk-return characteristics (and of course, position transparency is also often readily available). However, hedge funds, because of their investment flexibility, may have no meaningful benchmark, may be levered long or may be short common market factors, or may be neutral to those and loaded on entirely different factor risks. In addition, these exposures may change over time, sometimes quite quickly. If hedge funds are a black box, it is difficult to integrate them into broader portfolio decision-making without making a number of potentially very erroneous assumptions. As hedge funds become larger parts of institutional portfolios, investors armed with transparency into their hedge fund investments have the potential to make more effective portfolio construction decisions for their hedge fund allocations and overall portfolios, possibly increasing return, reducing risk, or both.

Conclusion: Sometimes You Can Have It All

Increasingly, we are seeing some sophisticated investors who have invested in better control and transparency structures now paying more attention to methods of utilizing these structures, not only in downside mitigation "insurance policies," but, increasingly, in generating upside through fund customization and more integrated portfolio construction. Both toolsets are generally needed: transparency and control - the instrument panel and the steering wheel. Even with this toolset, there is no guarantee the road ahead will be easy, but for those investors exploring the structural benefits that this new partnership paradigm may provide, it is an exciting time.

II. The Tools of the Trade

Now that the toolkit of fund transparency and control structures is in place, what are some of the levers that can actually be pulled to generate benefits for a hedge fund portfolio? In our view, the key to understanding how to utilize these tools lies in understanding the twofold rationale for an external active manager program to begin with:

- **Global Market Opportunities:** Most institutional investors have fewer internal resources than needed to take advantage of the global market opportunities potentially available across all asset classes. A North American investor may have a strong in-house domestic equity management team, but may lack internal resources to effectively evaluate themes in Asia or South America, or determine which collateralized debt obligations to hold. As opportunities vary, it is difficult to maintain in-house staff with the necessary expertise to take advantage of all of them.

The key rationales for external manager programs are enhanced with better transparency and control

- **Seeking "The Best of the Best":** No one - no institutional allocator, no multi-strategy hedge fund, no large scale fund complex - has the most skilled people sitting on every trading desk. Even within high performing organizations, skill varies across geographies and asset classes. An external manager program allows an allocator to pick and choose what they view as the best provider from a variety of external sources to manage capital.

Closely paralleling these dual rationales, we believe there are two fundamental ways of thinking about how better control structures (particularly separate accounts or funds of one) and transparency (particularly position-level transparency) can improve returns:

- **Market-Driven Opportunities:** Take advantage of a macro/structural issue, mispricing, or temporary dislocation across one or more securities. The bulk of returns are expected to come not from individual manager skill (though at the margin, they can add value) but rather from an expected move in the asset(s). Thematic ideas can come from a manager, third party research, or originate at the allocator. However, understanding that an opportunity exists (e.g., a housing bubble), and being able to implement it effectively (e.g., figuring out which mortgage backed securities on which to purchase CDS), are two very different things. Getting pure exposure to this type of opportunity lends itself to customization, with a high quality, but not necessarily perfect, manager. Investors need someone who can execute on the trade and understand potential fundamental and market microstructure pitfalls. Other considerations, such as fees, implementation speed and a willingness to work within an investor's parameters are also paramount.

An active customization program at the allocator level can attempt to take advantage of market opportunities and get the most out of underlying managers

- **Manager-Driven Opportunities:** Find the convergence of portfolio needs and a manager's skill set - where a manager's consistent skills (rather than a thematic market opportunity) drive returns. Even without large-scale dislocations, some managers remain quite adept at generating returns through individual security selection in many different market environments. The customization options here center on getting the most appropriate people to manage exposures that fit well within a broader portfolio.

The tables on the next page outline some of the levers available to implement particular opportunities and illustrate the need for both transparency and appropriate control structures.

Market-Driven Opportunities:

Customization	Example	Rationale/Considerations
Single Position Upsize	Upsizing a distressed debt position beyond what is held in a commingled fund	• Increase exposure to high conviction idiosyncratic position that runs into position limitations in a commingled fund • Must ensure it is an attractive trade, is idiosyncratic and has an appropriate liquidity profile
Tactical Trading	Relaxing a fund's gross exposure limits such as when merger arbitrage spreads widen significantly	• Take advantage of short-term market distortions (usually has to be implemented with a manager already in the portfolio) • Must make sure there is a strong rationale for the distortion to normalize and that the trade is timely and can survive temporary adverse movement
Dedicated Funds to Capture Market Opportunities	Dedicated short CDO fund	• Pure-play exposure to a significant longer-term structural market distortion • Must make sure it justifies its own fund and that it is not better/cheaper/more efficient to gain exposure through a commingled fund, even if it is diluted

Manager-Driven Opportunities:

Customization	Example	Rationale/Considerations
Custom Leverage	Custom-Levered Pari-Passu (e.g., 2x leverage of the commingled fund)	• Attractive exposures, but fund risk-return doesn't fit the overall portfolio • Capital and fee efficiency
Sub-Strategy Carve-Outs or Exclusions	Taking only the credit book of a multi-strategy fund	• Pure play exposure to key traders that fit portfolio needs—the "best of the best"—wherever they reside
Custom Risk Limits/Biases	Asking a manager with strong short skills to double the size of their short book to reduce beta of the overall hedge fund allocation	• Extract key skills from an individual trader that fits portfolio needs • Change shape of the portfolio moderately while retaining key skill sets • Overcome excessively diversified portfolios run by good managers, where most returns are concentrated in top positions
"Ground up" Mandate Construction	Taking a high yield manager with strong credit selection and applying that skill to investment grade bonds	• Transplant fungible skills to areas with better opportunities, higher liquidity, or which fit better with the portfolio • Must make sure skills are truly fungible—generally better to move to increasing liquidity and decreasing complexity/risk

As illustrated, there are a variety of ways one can utilize advanced control structures to customize accounts, coupled with deep transparency to understand portfolio fit. These can give more pure-play exposure to market opportunities and more efficiently extract key manager skills.

While not all of these ideas make sense for every allocator, they are examples of some of the ways that transparency and control structures, while initially designed to mitigate risk, can also improve returns.

Hedge fund – investor partnerships are not mechanistic, they are relationships between people and organizations

III. Making It Work

So how do institutional investors actually make these partnerships with hedge funds work? While much of what we have outlined, in theory, makes sense (e.g., extracting pure exposures to fit the needs of a broad portfolio), as Einstein said "in theory, theory and practice are the same, in practice they are not." In practice, hedge fund and investor relationships are just that—ties of people and institutions to one another for common benefit. These relationships can be subject to the same complex interpersonal and structural issues that all relationships face. Much ink has been spilled by the sell side and media on the new emerging paradigm of investor-hedge fund partnerships. While the benefits to hedge funds (e.g., stickier capital, deeper relationships, a chance to run less constrained mandates, etc.) and institutional investors (e.g., customization ability, better transparency, extended macro-thematic and portfolio construction intelligence, etc.) are significant, issues can also arise, and working through them can be key to pulling off a successful partnership.

Bright Lines and Grey Areas

It does not take a hedge fund expert to see that many of the customizations described in part two of this paper represent a significant shift in control between the hedge fund manager and the allocator. Historically, hedge fund managers virtually had complete control over the entire investment and portfolio construction process, and the allocator was limited to deciding (roughly) the timing and amount of allocation. In the "new world," these roles can change, sometimes significantly. In delineating who has control over what, we believe that a key question is a variant on the question that investors have asked hedge fund managers since they began investing: what is the "edge" of the respective parties? In our view, the key edge of the external manager must be security and market-specific knowledge - they must select and execute trades on individual securities. Quite frankly, if an institutional investor feels they are a better security selector than an external manager, that external manager probably should not be considered for an allocation. This fact gets to the core of both key rationales (see part II) of an external manager program. However, as mentioned, an allocator has a key edge - with the right transparency, they know the composition of their overall portfolio and what exposures it needs - an information hurdle that managers can't really overcome (without investors revealing a LOT about their portfolios). Decisions on where to allocate capital externally are informed by this edge. Therefore, we believe that managers should clearly be in charge of individual security selection, and that allocators should be in charge of the overall shape of their portfolio, including its risk and return profile. This delineation of responsibilities leaves a number of decisions in a "grey" area where neither side has a clear information advantage - for example, fund-level position sizing, portfolio construction and risk tolerances, thematic trades and implementation of macro views. Many of these decisions historically fell to the hedge fund manager, and indeed, the "edge" still often tilts somewhat in that direction. But the portfolio-level knowledge of the allocator, and potentially their own investment acumen, means that in a world where large-scale fund customization is possible, lines of control are more mixed, and both parties must get comfortable with a shift away from historical norms.

In determining who controls what part of the investment process, both fund managers and allocators should stick to their respective "edges"

Make Sure It IS a Partnership

So, how do both parties get comfortable sharing these roles, particularly when the success of the program and the remuneration of the manager are affected? The short answer is that the relationship between a hedge fund and investor must be a true partnership. On the investment

Both sides need buy in to run significant customization programs

decision making side, this means true buy-in from both parties on the merits of and rationale for the customization. Pushing managers to take on exposures they are uncomfortable with, in our view, is a road to potential disaster. Such unwanted investments can significantly influence a skilled manager's investment decision making process, may end up damaging returns (and the relationship), and could create results that are opposite of the goal. The manager must be comfortable with all exposure decisions - achieved through a process of delineating the potential benefits to the portfolio itself. Furthermore, the rationale must be supportable not only on a portfolio basis, but the partnership must also make sense from a net performance perspective on the allocator side and from a business perspective on the manager side, as running customized separate accounts represents substantial operational complexity and costs. This requires a careful discussion and the rationale will be dependent on the willingness of the managers and relative bargaining powers of the managers versus the allocators. Fees in particular may be problematic, as some changes (increasing leverage above the commingled fund, for example), can interfere with traditional AUM-based fee structures. This is generally not problematic on the performance fee side (as performance fees scale with performance, which in turn hopefully scales with deployed capital rather than AUM). On the management fee side, while we have not seen major shifts from the traditional AUM-based fee structures, it is possible we might see negotiated "flat fees" unlinked to AUM, but instead linked to the complexity of the portfolio, management costs, and/or capital deployed. Once the partnership decision is made, choices should be made and documented concerning issues such as the nature and frequency of the interactions; the mechanisms for actively sharing views, information and portfolio decisions; how various custom guidelines are calculated and enforced; what the "baseline" reference is (usually the commingled fund); and who, in the event of disagreement, ultimately has control and veto rights (as discussed above, we view the ability of either party to veto a significant proposed shift in the portfolio to be the right call).

It Isn't Just the Managers Who Will Change

The major focus of this section has been how the relationships between hedge funds and allocators may be changing - in particular the shift in control of certain aspects of the investment process away from the sole discretion of the hedge fund manager and towards a partnership. But utilizing these tools for customization will require significant cultural shifts for allocators as well. Portfolio and risk managers will have to get comfortable analyzing and interpreting the transparency given, and will have to have a deep understanding of the managers. Similarly, many allocators may need to become more comfortable with a shift in role from pure "talent scout" to a more active role in key areas of investment decision making, even down to which thematic trades to undertake or how to implement a top-down macro view in the external hedge fund portfolio. While these adjustments are challenging, it is our view that opening up a broader array of tools which allow both allocators and hedge funds to better do their respective jobs has the potential to significantly improve returns for those who embrace these changes.

Misha Graboi, JD, CFA, FRM is a Director working in Portfolio and Account Management. In September 2009, Misha moved to PAAMCO's Singapore office to strengthen PAAMCO's Asian manager research team. Prior to PAAMCO, he was a Director of Rigel Associates, a middle-market financial advisory firm. Before joining Rigel, Misha was an Executive Director at Goldman Sachs International in their Equity Research division. He began his finance career at CIBC Oppenheimer, first as an investment banking analyst and then as an equity research associate. Misha holds an MBA from Harvard Business School, where he was a Baker scholar, and a Juris Doctorate (magna cum laude) from Harvard Law School. He holds a BS degree in Finance and International Business (magna cum laude) from Georgetown University.

UNITED STATES
19540 Jamboree Road, Suite 400
Irvine, CA 92612
United States
Tel. + 1 949 261 4900
Fax. + 1 949 261 4901

UNITED KINGDOM
25 Victoria Street
London SW1H 0EX
United Kingdom
Tel. +44 20 7593 5360
Fax. +44 20 7593 5361

SINGAPORE
50 Raffles Place
#13-06 Singapore Land Tower
Singapore 048623
Tel. +65 6594 2400
Fax. +65 6594 2401