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Funds of Funds Part II: More funds of funds exploring co-investment opportunities

By Lois Peltz

There is much discussion around co-investing but not many funds of funds have developed a real expertise in the area.

Co-investing is a difficult thing to do. A large staff is needed and it tends to focus on illiquid investments. One source says those who have scale i.e. $5 billion or more, are doing it. A fund of funds needs at least $500-700 million to have a focused fund. Potential conflicts of interest are another stumbling block.

Another reason for the slow pace of hedge fund co-investment is that hedge funds only started to get into co-investments following the 2008 financial crisis.

"Large and medium-sized funds of funds have a great opportunity to offer co-investing if they have the resources. Those who tout co-investing and are successful in executing it are better able to rationalize their fees with clients and prospects. Those investing only in commingled funds and not offering co-investing as an additive solution will continue to be pressured on fees and lose mandates," says James McKee, senior vice president and director at Callan Associates.

Co-investing is a type of customization with additional complexity and the complexity premium can be a source of return for the investor. Co-investing is one notch deeper than typical manager due diligence and therefore requires a specific skill set and ad-hoc structuring capabilities, says Lionel Erdely, head and chief investment officer of hedge funds at Investcorp.

PAAMCO says that its portfolio customizations through themes and concentrated investments is a significant part of its value add. "The term "co-investment" is an industry buzzword that is often used to denote a concentrated investment. In our co-investments, hedge funds come to us with specific trade ideas, and because of the strength of our client base, we can help emerging managers punch above their weight class by bringing to bear a meaningful amount of capital," says Putri Pascualy, managing director at PAAMCO.

Other types of customizations involve a collaborative process between the funds of funds and the manager. "If we see areas and themes where we expect attractive risk/return profile, for example investing in non-agency mortgages post crisis or consolidation in the media industry, we can actively seek the team who can help us increase our exposure to these themes," adds Pascualy.

Another recent example of a co-investing opportunity is a Lehman claim where a fund of funds acquires such a position in a separate account that it directly owns or controls. An underlying manager may be filled up on Lehman claims in its commingled fund and doesn't want to add more. But the fund of funds can add it separately with the manager's blessing at a much lowered fee, like 10% of the upside and no management fee, says McKee.

Erdely says Investcorp has been involved with co-investments such as securities from corporate restructuring, commercial mortgage-backed securities and non-performing loans.
Another fund of funds points out that they've invested in illiquid secondary investments since 2006. "We bring in investors along side in one-off deals. The plan is to build multi-deal funds, mixed investments - things that fall between the hedge fund space and the private equity space. That product will have some beta in it."

"Our structuring capabilities enable us to act on our convictions through customized mandates with underlying hedge fund managers. The vast majority of our capital is managed in vehicles where our clients are the only investors. Because the investment vehicles are already up and running, should an opportunity arise and we need to move quickly, we can implement quickly because we don't have to start from scratch," adds Pascualy.

Consultants say they have a number of clients reviewing direct co-investing that are still on the edge. Funds of funds need to convince investors that they're doing things that the investor can't do on its own.

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Layout and Additional Research by Jina Cha

Lionel Erdely

Investcorp

Lionel Erdely joined Lyxor Asset Management in 2002 as a fund of hedge funds manager, responsible for the "top-down" allocation process for Lyxor's investment committee. Erdely was appointed as the head of Lyxor's alternative investments business in 2004 and is a member of the Lyxor management committee and the executive committee. He moved to New York in April 2009 to take additional responsibilities as CEO of Lyxor Asset Management Inc., Lyxor's US based asset management subsidiary.

Prior to joining Lyxor AM, Erdely was a vice president in the equity corporate finance department of Société Générale, where he worked on several IPOs, capital increases and convertible bond issues, mainly on the German market.

Infovest21: Tell me briefly about Investcorp's businesses and the role hedge funds/funds of funds play.

Lionel Erdely: Investcorp is a leader in the alternative investments industry with a 32-year track record and distinctive co-investment philosophy. The firm has three lines of business: Corporate Investment, Real Estate and Hedge Funds.

In Corporate Investment, Investcorp operates primarily in the middle market segment, assuming the underwriting risk on every deal and placing the investment with its institutional and high-net worth investors and clients. Investcorp has Corporate Investment teams in North America, Europe and the Middle East who are focused on making investments in their respective regions.

Real Estate investments are primarily made in North America. Investcorp invests both in commercial and residential real estate properties.

The Hedge Funds business has three distinct product lines: Customized fund of hedge funds, single managers (seeding) and special opportunity portfolios which offer unique investment opportunities.

The Hedge Funds business has strategic value to Investcorp due to the complementary nature of its products and the synergies it creates across its other product lines. Investors have access to a diverse array of investment choices in the alternative space, and can identify a tailored investment solution based on their risk return preferences.

> Investcorp uses its balance sheet capital to seed managers whereas other seeders solely rely on investor capital. Investcorp is therefore much more aligned with its clients as our own capital is at risk.

Infovest21: It seems as if many fund of funds seeders have left the space. You have a thriving seeding business. What differentiates you in seeding? How do you see the seeding landscape changing over the next few years?

Lionel Erdely: Investcorp has always been a believer in investing with early stage managers, having invested in approximately 80 early stage managers since launching its hedge funds business in 1996. Based on this interest and experience, we decided to launch our seeding business (Single Managers) in 2004. The primary differentiator for us is that we are able to align the interests of all the parties involved including investors and the manager, because we provide capital from our own balance sheet to seed managers.

We believe Investcorp has a very unique and differentiated seeding model.

- Investcorp uses its balance sheet capital to seed managers whereas other seeders solely rely on investor capital. Investcorp is therefore much more aligned with its clients as our own capital is at risk.

- Many seeding firms are under pressure to deploy capital due to the nature of their seed fund terms, whereas Investcorp can afford to be very selective in its choice of managers due to the proprietary nature of its seed investments. Investcorp targets two to three seed investments per year.

- Investcorp solely participates in a share of the managers' fees whereas other seeders' models tend to require a buy-back option. The buy-back option forces managers to create cash reserves, limiting their ability to invest necessary resources into the business. Investcorp's model supports the manager, allowing them to plan and invest in their infrastructure and hire talent as the firm grows.

- Investcorp is a strategic partner to its seed managers. The firm provides seed capital but also takes on the responsibility for distribution. Many other seeding firms provide the capital and then step away.

The seeding landscape has changed for managers and seeders. Managers need to be prepared to invest in the business for multiple years by providing an institutional quality platform while having the patience required to raise capital. The landscape for seeders has changed due to an increase in one-off entrants. Seeding requires a dedicated approach due to the need for a robust infrastructure that includes: sourcing, evaluating managers' business acumen, investment and operational due diligence and post investment monitoring.

Due to the enhanced returns provided by seeding activity, many institutional investors including endowments, family offices etc are increasingly interested in the seeding space. The return enhancement potential is attractive, especially in a low return environment.

> Many pension plans are re-evaluating their investment strategy for hedge funds, and we think many of them will gradually transition to risk factor based investing.

Infovest21: What are the challenges with co-investing? Many say it is difficult to do.

Lionel Erdely: Challenges of co-investing include sourcing of investment ideas, skill set required to assess investment opportunities, structuring of the transaction, and placement among the appropriate investor base.

Investcorp has had a very positive experience in this space and has successfully developed and placed several co-investments. Some examples include securities from corporate restructuring, commercial mortgage-backed securities and non-performing loans.

We have deep relationships with a broad set of hedge fund managers that have been developed over 18 years in the business. These relationships help Investcorp source unique and differentiated investment ideas.

We also have an investment team with a broad skill set across multiple disciplines: Corporate investments, real estate and hedge funds who are able to evaluate individual investment opportunities. Lastly, our dedicated team has tremendous experience in structuring complex and innovative deals. All of these attributes, along with our distribution capabilities place Investcorp in an enviable position in the co-investment space.

Infovest21: Are you planning a new products/offerings that you can talk about?

Lionel Erdely: Investcorp will continue to focus its efforts on providing innovative investment solutions to clients. We will source and seed new hedge fund managers that are differentiated, and provide the investment community access to these managers. We will also offer new tranches of co-investment solutions. Since 2011, we have launched four tranches and we are currently working on our fifth co-investment opportunity tranche.

Consistent with our investment philosophy and investor appetite, Investcorp intends to offer a product solution based on alternative risk factors. We believe there is a fundamental and deep transformation happening in the investment industry towards risk factor-based investing. Institutional investors are adopting the approach more frequently. It is very difficult for large investors to scale their hedge fund investments and execute them in an economically efficient manner.

Investcorp has significant experience and has conducted extensive research on risk factors. We construct our investment portfolios based on rigorous due diligence and analysis of underlying risk exposures and continue to enhance our capabilities in this area. Our solution is intended to help investors allocate capital across risk factors, identifying the environment when certain risk factors are likely to perform well and when they are not. This product solution will be complementary to our other products: Customized Fund of Funds, Single Managers and Special Opportunity Portfolios. We are currently at the product development stage and we hope to be in the market with our product offering in due course.

Infovest21: What impact do you think the CalPERS move will have on hedge funds? Fund of funds?

Lionel Erdely: We do not comment on specific investor decisions.

Many pension plans are re-evaluating their investment strategy for hedge funds, and we think many of them will gradually transition to risk factor based investing.

A challenge faced today by a typical large investor investing in hedge funds is the concentration in the industry, i.e., a significant portion of hedge funds AuM is managed by a small number of players. This means it is difficult for a large investor to be selective about the hedge funds to invest in.

Risk factor investing is efficient and scalable for an investor to deploy a large amount of capital. It also allows an investor to have more control on allocations and exposures to specific risk factors. Risk factor based investing, therefore, directly addresses the challenges that a typical large pension plan faces.

Investcorp

Lionel Erdely

Title: Head of hedge funds, Chief investment officer

Total assets: $11.4 billion
Hedge funds assets: $5.0 billion
Funds of funds assets: $2.5 billion
(Customized and funds of funds)

Office locations: New York, London, Bahrain, Riyadh, Abu Dhabi

Putri Pascualy

PAAMCO

Putri Pascualy is a managing director and the senior credit strategist at PAAMCO. She is responsible for managing investment portfolios on behalf of leading institutional investors. She specializes in evaluating global opportunities in corporate credit and distressed debt. She has led the research and structuring of large institutional mandates, where she utilized hedge funds and complex alternative investment strategies as part of innovative portfolio solutions for global investors. Pascualy is the author of "Investing in Credit Hedge Funds" (McGraw-Hill), a practical guide on various aspects of alternative investing in corporate credit.

Infovest21: How do you assess funds of funds today?

Putri Pascualy: We think the old model of fund of funds, one which serves as the intermediary between hedge funds and investors, is past.

The new breed of funds of funds can add significant value. Many opportunities exist in the market place to serve even the largest institutional investors. 99% of our investor assets are from institutions. Funds of funds that can add value though structuring, due diligence and investment alpha will exist even alongside large direct programs due to structural or resource limitations of those programs.

Infovest21: How do you perceive funds of funds' relationship with consultants?

Putri Pascualy: You raise an interesting issue about consultants becoming asset managers and whether we see them as competitors. We have worked alongside many consulting firms and expect to continue to do so. We see consultants' role as an impartial advisor and a voice of reason to help pension plans on asset allocation, governance and structure.

There is a significant split in the consultant community about the move by some consultants into asset management. It seems in the US there is more client resistance about having the same entity be their consultant and provide asset management services.

Infovest21: Is the line between hedge fund manager and funds of funds blurring?

Putri Pascualy: To your question on whether the line between hedge funds and fund of funds are blurring, we are starting to see some overlap in the industry between what hedge funds and fund of funds do. However, for investment firms that offer both fund of funds and hedge funds, I do think it is important to keep a "Chinese wall" between the two. Due to potential conflicts of interest, we don't trade directly. We execute investment ideas through underlying third party investment teams.

> 99% of our assets comes from institutional investors, many of whom also have significant direct programs. Our goal is to add value through dynamic asset allocation, unique structuring advantage, and ability to customize mandates at both the client and hedge fund levels.

Infovest21: Tell me about PAAMCO's customization and co-investments.

Putri Pascualy: We believe that our portfolio customizations through themes and concentrated investments is a significant part of our value add. The term "co-investment" is an industry buzzword that is often used to denote a concentrated investment.

In our co-investments, hedge funds come to us with specific trade ideas, and because of the strength of our client base, we can help emerging managers punch above their weight class by bringing to bear a meaningful amount of capital. Other types of customizations involve a collaborative process between us and the manager. If we see areas and themes where we expect attractive risk return profile, for example investing in non-agency mortgages post crisis or consolidation in the media industry, we can actively seek the team who can help us increase our exposure to these themes.

Infovest21: How can an investor determine how experienced a fund of funds is in co-investing?

Putri Pascualy: Questions an investor should ask about co-investing are: How are the co-investment ideas sourced? How are the ideas executed? How soon can you implement them and put them in your portfolio? How long have you done this? How do you measure your success in co-investments?

Having strong investment talents gives us the ability to have conviction in our investment ideas. Our structuring capabilities enable us to act on our convictions through customized mandates with underlying hedge fund managers. The vast majority of our capital is managed in vehicles where PAAMCO clients are the only investors. Because the investment vehicles are already up and running, should an opportunity arise and we need to move quickly, we can implement quickly because we don't have to start from scratch.

Infovest21: Are institutions increasingly starting their own internal funds of funds?

Putri Pascualy: The reason behind institutional investors starting their internal fund of funds is to save on fees, i.e., to do more with less. However, one needs to ensure that there are enough resources dedicated to do the necessary due diligence.

The beauty of the hedge fund structure is its flexibility, and the ability to add bells and whistles to the investment mandate. However, this means that there are additional layers of complexity involved in hedge funds. The investment strategies are more complex. They invest in asset classes that are off the beaten path and are not easily understood. The fund structure and its terms are more complex. Part of the alpha hedge funds generate comes from harvesting a complexity premium.

As a result, deep due diligence is needed not just before the decision to invest is made, but also during the investment period to monitor whether the investment strategy is still the same one as the one used by the fund at the moment of entry. Similarly, investors also need to keep an eye on the proper time to exit.

All that work needs to be done. Whether it's at the institutional or at an external fund-of-fund level, good due diligence requires resources. Resources can be systems and tools, but most importantly human resources. People with the right level of expertise and given the right amount of time and access to monitor hedge fund investment is the most important resource. Furthermore, the people running a hedge fund program need to come with the right negotiation and structuring skills to optimize the institutional investor's buying power.

From our experience, a direct hedge fund program is effectively an internal fund-of-funds. 99% of our assets comes from institutional investors, many of whom also have significant direct programs. Our goal is to add value through dynamic asset allocation, unique structuring advantage, and ability to customize mandates at both the client and hedge fund levels. Our clients appreciate our ability to access parts of the hedge fund market that they may not be willing or able to do through their direct programs.

Infovest21: Does PAAMCO use managed account platforms and funds of one?

Putri Pascualy: When many say "managed account", they are referring to both true managed accounts and funds of one. Structural differences exist between the two. However, we have used utilized both fund-of-ones and true managed accounts in our investments. We believe that they enable us to better safeguard our clients' assets and act on our investment convictions.

Infovest21: PAAMCO is known for its focus on emerging managers.

Putri Pascualy: There has been a great focus on emerging managers. It's important to focus on experience in the emerging manager space and the true ability to source talent. There has been a lot of interest on emerging managers and when seeking to put together an emerging manager mandate, it's important to focus on experience and the ability to source talent.

Do not hesitate to ask how they define emerging managers, how many of their current managers are emerging managers, what amount of money do they manage out of a particular fund and/or the fund of funds' total assets? When did they start investing in emerging managers? What are their sources? How did they know them?

Infovest21: What is the optimal size for a funds of funds?

Putri Pascualy: Institutional clients want "belts and suspenders". We need to be robust enough to safeguard assets as well as stable enough to hire and retain good people. Our goal is to be near the optimal point where we are able to do the former and maintain our edge to be nimble and opportunistic.

There has been a lot of interest in emerging managers and when seeking to put together an emerging manager mandate. It's important to focus on experience and the ability to source talent.

Infovest21: What are PAAMCO's plans regarding liquid alts?

Putri Pascualy: This has been a popular new development in the market. We don't have any plan to offer liquid alternative products for a few reasons. The main reason is that our franchise is focused on institutional investors rather than the retail market targeted by liquid alternatives.

Infovest21: Do you think there will be more consolidation in the funds of funds space?

Putri Pascualy: There will continue to be consolidation because if you look at the trend, most dollars go to big established names. The majority of assets in the fund of funds space is already dominated by the top 20 names. In the next few years, some of the names may change, but the need to have sufficient asset size to have a robust and stable business is here to stay.

Infovest21: What are the major challenges for funds of funds today?

Putri Pascualy: Going forward, we need to continue to evolve with the market. In the world of low interest rates and no cheap asset classes, the challenge for our industry is to generate attractive risk-adjusted returns for our investors. Nonetheless, based on what we are seeing, we are excited about the opportunities available to our portfolio. We think this type of market environment is particularly suitable for our roster of smaller, more nimble managers who can capture pockets of opportunities others may overlook.

Infovest21: Do you see the funds of funds label changing?

Putri Pascualy: The fund of funds label might change. One thing that I know is that rather than focusing on a moniker ("fund of funds"), we are focused on how we can add value as an active investor.

PAAMCO

Putri Pascualy

Title: Managing Director

Total fund of funds assets: $9.5 billion

Max Gottschalk Andre Keijsers

Gottex Fund Management

Max Gottschalk is a co-founder, senior managing director, head of Asian business, head of global marketing, and director of Gottex Fund Management Holdings Ltd. He also serves as the chief executive officer at Gottex Fund Management (HK) Ltd & Penjing Asset Management (HK) Ltd.

He joined Gottex in August 1998 and had played an integral part in the design of Gottex's suite of products and had grown the business to become one of the main alternative investment groups globally. He is a board member and co-founded the asset management arm of the Gottex Group.

Andre Keijsers has been managing director, head of corporate strategy and human resources of Gottex Fund Management Holdings Limited since January 17, 2008.

Infovest21: What are Gottex's main business lines?

Andre Keijsers: Gottex is global asset manager with three business activities.Gottex's core business activity, since the firm was founded in 1992, is offering hedge fund investment solutions to institutional clients around the world in the form multi-manager programs, single manager products and customized advisory solutions.

Leveraging of its hedge fund and alternative investment expertise, Gottex developed its the multi-asset business in 2007. Applying a US endowment style of investing with a major part allocated to alternative investments, Gottex has developed and manages a broad range of multi-asset programs.

Lastly, Gottex has developed its Asia business and has been managing Asia dedicated programs since 2005. Gottex offers a broad range of Asia investment solutions, mostly through multi-manager programs, but also China onshore dedicated funds through its Shanghai-based partner Vstone. Gottex is one the first alternative managers to receive RQFII quota and is working closely with the Chinese government on the development of its QDI programs

Infovest21: Are you looking to do more acquisitions and joint ventures?

Max Gottschalk: The alternative asset management industry has seen some significant consolidation over the past years and Gottex has played an active role in it. We will continue to evaluate opportunities as they present themselves and contemplate strategic acquisitions and distribution partnerships. Nevertheless, we do see demand for hedge fund solutions on the rise and expect a big part of our growth to come organically over the coming years, especially out of Asia.

We do see demand for hedge fund solutions on the rise and expect a big part of our growth to come organically over the coming years, especially out of Asia.

Infovest21: Do you expect other funds of funds will do the same?

Andre Keijsers: We do expect that consolidation will continue in the multi-manager industry as smaller players struggle to retain assets and remain competitive. Increased fee pressure, client demands and regulatory requirements mean that small firms can no longer survive.

Infovest21: Is there an optimal asset size for funds of funds? Do you look for acquisition candidates of a certain size?

Max Gottschalk: Scale matters and today multi-manager firms with less than $5 billion will struggle to raise assets and win new business.

Infovest21: What is the breakdown of your client base?

Andre Keijsers: 80% of our clients are institutional investors, such as pension funds, endowments and sovereign wealth funds. 60% of our clients are based in Europe.

Infovest21: How strong is institutional demand in Europe?

Andre Keijsers: Demand for hedge funds in Europe remains strong. Most of the interest is in liquid alternatives. Multi-manager interest is increasing as investors are starting to look for bond or equity substitute programs. It is a broad mix of institutions looking at alternatives.

Infovest21: Do you see any impact from CalPERS' decision?

Max Gottschalk: The flows into hedge funds remain positive and we don't expect CalPERS' decision to impact overall demand. CalPERS decision to get out of hedge funds was due to reasons specific to CalPERS and not a reflection of the merit of investing in the asset class.

Infovest21: Is there a blurring of lines between funds of funds and consultants in Europe?

Max Gottschalk: Consultants and multi-managers are undoubtedly competitors today. Time will tell who is better at selecting, and probably more importantly, investing in hedge funds. I believe that investors could be in for a surprise. We have started to see a number of clients coming back to us for help with their hedge fund portfolios as they realize the limitations of consultants' solutions.

Infovest21: You are one of the few public companies in the hedge fund space. What are the implications of that?

Andre Keijsers: As a public company, we are used to transparency and reporting more than a traditional hedge fund used to be. With the new AIFM directive in Europe and more frequent reporting required by the SEC, that is slowly changing. Now, the whole hedge fund community is catching up. The new regulations over the last few years are forcing everyone to report more and be more transparent.

Infovest21: Do you think more hedge funds/funds of funds will go public?

Andre Keijsers: I certainly believe that more firms will seek to go public in the coming years. Firms with a diversified business and scale may have an opportunity to go public in the coming years. Many are looking to replicate the success of large alternative platforms.

Infovest21: How do you see funds of funds evolving in general?

Max Gottschalk: The multi-manager industry is moving from commingled fund offerings to bespoke/advisory investment programs where multi-managers work hand in hand with their clients in meeting their investment objectives. Alternative investments are a growing part of investor's portfolios and multi-managers provide investors, with a unique access to certain strategies and geographies. Investors' needs are changing rapidly and therefore multi-managers that will succeed are those that can adapt and offer tailored solutions.

Demand for hedge funds in Europe remains strong. Most of the interest is in liquid alternatives. Multi-manager interest is increasing as investors are starting to look for bond or equity substitute programs. It is a broad mix of institutions looking at alternatives.

Infovest21: Are funds of funds becoming more like hedge funds i.e. setting up trader platforms?

Max Gottschalk: Some multi-managers are developing their own multi-strategy platform. At Gottex, we are developing liquid alternative programs that resemble multi-strategy funds without hedge fund fees. We believe that demand for these actively managed liquid multi-strategy programs will grow as investors seek better liquidity, transparency and lower fees.

Infovest21: Where do you see market opportunities? Do you have new products planned?

Andre Keijsers: Liquid alternatives is an area that we see lots of growth potential over the coming years. Multi-asset and Asia dedicated programs should also see some strong growth.

Infovest21: What trends do you see in seeding? Is seeding a growing business?

Max Gottschalk: For firms who can make large investments ($100 million+) and commit capital for a period of time, there is a great opportunity for seeding. The problem with many seeding programs is that they are too small and have a liquidity mismatch.

Our seeding platform, HS Group, is very well positioned to take advantage of Asia-based seeding opportunities as we believe the market timing for such vehicle is good.

Infovest21: Looking out five years, how do you see the fund of funds industry evolving?

Max Gottschalk: A lot fewer players with 80% of the assets gathered in the top 10 groups.

Gottex Fund Management

Max Gottschalk

Title: Co-Founder, Senior Managing Director

Andre Keijsers

Title: Managing Director

Total client assets: $8.5 billion
Assets related to hedge funds: $7.0 billion

Recent Funds of Funds News

London Borough of Brent Pension Fund drops Fauchier fund of funds

(Infovest21 News Provider, October 1, 2014)

London Borough of Brent Pension Fund, which has a funding of level of 55.6%, has dropped a Fauchier fund of funds from its portfolio.

The local government pension invested £40.5 million ($65.7 million) with Fauchier Partners in March 2013 but cut it to £27.3 million ($43.9 million) in March 2013. Those assets have now been diverted to Baillie Gifford's diversified growth fund, reports Local Government Chronicle.

In its just-released annual report for 2013-14, the pension said it dropped hedge funds and "re-assigned the assets to lower cost and less complex alternatives."

Oklahoma Firefighters issue RFP for funds of funds

(Infovest21 News Provider, September 26, 2014)

The $2.1 billion Oklahoma Firefighters Pension and Retirement System is looking for a fund of funds to manage $50 million in assets.

The deadline is October 31 at 5 pm EST. The finalists are expected to be selected on or about November 21 with a final selection made by December 19.

The system, which uses only external managers, says it is looking for a fund of funds that has an existing track record and which is a registered investment adviser with the SEC. It is desirable but not required that the entity have at least a six-year performance history in the proposed product or similar hedge fund strategy. It is also desirable but not required that the entity have at least $100 million in assets under management in the proposed product or similar hedge fund strategy. It is also desirable that the entity have at least one tax exempt institutional client invested in the proposed product or similar hedge fund strategy.

The fund of funds allocation falls under the "other" category which has an 8% target.

Among the specified duties are at a minimum, providing quarterly reports with gross and net performance, and attending at least two regularly scheduled meetings of the board.

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Jon Lukomnik: Some thoughts on CalPERS' hedge fund decision

Jon Lukomnik is the managing partner of Sinclair Capital, a boutique alternative asset consultancy. He has advised on more than $1.5 billion in hedge fund investments for various institutional investors. Lukomnik was formerly deputy comptroller for the City of New York, serving as investment advisor for defined benefit plans with some $80 billion in assets, as well as the City's treasury. He then served as managing director, head of strategic planning and business development for CDC Investment Management Corporation.

Lukomnik currently serves on the board of the Van Eck mutual funds and insurance trusts and chairs the investment committees of the Forward Association.

Here are some of Lukomnik's views on CalPERS' recent decision to end its hedge fund program:

"In the public pension fund world, the question keeps getting asked if investors are getting what they paid for with hedge funds. There seems to be an awful lot of beta. A number of hedge fund programs haven't lived up to their billing. That isn't an indictment on hedge funds. Investors are re-thinking where hedge funds fit in terms of risk exposure and return profile in different market situations.

"And, hedge funds are expensive. If, for example, a long/short equity hedge fund has a beta of 0.8, why pay hedge fund fees for it? That's not to say that 0.8 or 0.6 beta long/short equity hedge funds don't have a role to play. But it may not have a role to play at 1 ½- 2/20 [fee structure] when you can get the equivalent by artificially constructing it yourself through long exposures and non-correlated assets or through liquid alternatives at a much lower fee basis or you may decide it doesn't fit.

"On the other hand, there are strategies that only fit in hedge fund areas but if you're CalPERS, you can get those on a bespoke separate account basis. Some of them may work because you are getting liquidity premiums or trading exotics and you want to be in control of the capital base so you're not subject to other investors pulling money and having to liquidate at exactly the wrong time in the market place. It is fairly easy for a major institution like CalPERS to have a negotiation with a top flight manager to create a separate account for, say, a distressed debt allocation.

A legal structure not an asset allocation

"What's happening is a rethinking about hedge funds. Hedge funds were never an asset allocation. They are a legal structure. There is now maturation in the market place where investors are thinking about the legal structure and whether it is the appropriate structure for the risk exposures they want and the investment products they want.

"We're going to wind up with asset allocations that are based on risk exposures rather than asset allocations based on legal structures.

"For example, there are good reasons for activist funds to have hedge fund performance fee structures whether or not they are in a separate account. If you're a good activist, you're devoting a lot of time and energy. It's sort of a private equity skill set and private equity economics. But at some point, an investor may think he can get that in some direct account at better economics.

"I find it fascinating that the CalPERS decision is being viewed as an asset allocation switch instead of a legal structure switch, particularly since it has not announced where it will reallocate the money.

"$4 billion is a lot in absolute terms but it is 1.3% of CalPERS' allocation. They're going to reallocate it but they haven't said what they are going to reallocate it to.

Multiple ways of getting risk exposures

"It's a crystallizing event for an end of an era where you call something a "hedge fund" and it is blindly accepted as complex and wonderful. It's an intelligent move on CalPERS' part to say hedge funds haven't delivered what it thought it would deliver. At 1.3% of the assets, it was a disproportionate amount of the fees. If it did not provide a disproportionate amount of return or risk reduction, why do it?

"There is an increasing lack of being enthralled by the word "hedge fund" and trying to get behind what it means. There are institutions which looked at hedge funds as an asset class and therefore attributed risk/return characteristics to a legal structure.

"CalPERS' decision will accelerate the trend towards saying there are multiple ways of getting these risk exposures, whether through hedge funds, liquid alternatives, replication or separate accounts. Hopefully, institutions will choose the format that is most appropriate for them.

"Hedge funds have been the default format to gain those sorts of risk exposures. That is changing to hedge funds being one of the formats in which an investor can get these risk exposures which is most appropriate for that investor."

Appeared in Infovest21 News Provider, September 18, 2014

Changing Relationship Between Funds of Funds and Hedge Fund Managers

Some funds of funds say one of the biggest trends they are seeing is funds of funds competing against hedge fund managers. They see it all levels including specialized product, e.g., macro or credit.

"For us, the overlap with specialized products is a more recent phenomenon, say in the past three years. The consequences of it aren't fully clear, but it should have implications in terms of both acting as a strategic partner and going further up the value chain, potentially even including direct hedging and overlays," says Arvin Soh of GAM.

If some funds of funds think there is a specific opportunity, some may put on a direct trade. More of that type of discussion will occur in the industry. It can change the product offering: It is a big picture issue, adds Soh.

Citi Private Bank's Eric Siegel observes that some funds of funds are bringing managers on platforms.

Funds of funds can hedge risks. "Three to five years down the road, with Chinese walls, some are thinking about building a trading infrastructure. This model generates alpha," says one $3 billion fund of funds.

Increasingly those funds of funds taking this route point out that most of the people on their investment team came out of a hedge fund business and therefore they have a hedge fund "culture" and "outlook."

Callan's James McKee points out that some funds of funds are competing with hedge funds in order to command an extra premium over fund-of-fund peers. How they express it is based on their core competencies. Room exists, though, for symbiotic relationships with hedge funds as well. One example is Lighthouse Partners. With its size and managed account infrastructure, it is able to get fee reductions from underlying managers and amplify its stock-specific bets.

Many point to Blackstone's Senfina Advisors. Blackstone, the world's largest fund of funds with $58 billion in assets under management, until now has focused on investing in third party funds. It is now signing on trader teams that will manage money exclusively for Blackstone but not be employees. They plan to have as many as 30 teams, each strategy will be given about $100 million to start. In essence, they are forming a multi-strategy hedge fund. It is expected that others will copy the model or morph into it.

Putri Pascuali, a managing director at PAAMCO, points out that not all funds of funds agree with this approach. Some see potential conflict. "For investment firms that offer both fund of funds and hedge funds, I do think it is important to keep a "Chinese wall" between the two. Due to potential conflicts of interest, we don't trade directly. We execute investment ideas through underlying third party investment teams."

The situation works in the reverse as well. Some hedge fund managers have created funds of funds. For example, David Einhorn's Greenlight Masters currently allocates to 17 managers. While it allocates 62% of its capital to Greenlight, it also allocates to Third Point, Firefly Value Partners, JMP, Lonestar, Lakewood Capital, East Bridge Capital, Mangrove Partners, EcoR1 Capital, Darsana Capital, SQN Investors, Sheffield Partners and others.

Recent Funds of Funds News

(Continued from page 7)

Alameda County commits $100M to Lighthouse fund of one

(Infovest21 News Provider, October 6, 2014)

Alameda County Employees' Retirement Association investment committee approved a $100 million commitment to Lighthouse Investment Partners for a low beta/high alpha product at its September 10 meeting. According to minutes of the meeting, the proposed fund of one is designed to generate returns in volatile markets in an attempt to improve the quality of ACERA Fund returns.

The fund of one will hold a concentrated portfolio of diversified high alpha potential sub-managers/strategies and have a low correlation to traditional investments.

Strategic Investment Solutions helped make the selection. ACERA, which has $6.6 billion in assets, allocates 15% to private equity and alternatives.

Pennsylvania Turnpike Commission issues RFP for funds of funds

(Infovest21 News Provider, July 14, 2014)

The Pennsylvania Turnpike Commission has set up a retiree medical trust to fund port-retirement medical benefits. The trustees have issued a notice about the RFP on its website to identify, evaluate and retain a firm to manage about $13 million in a diversified hedge fund of funds mandate. The intent is that a single contract will be awarded.

Minimum requirements include having $5 billion in assets firm wide in hedged strategies, a commingled fund structure with minimum assets in the proposed product of $750 million, and a minimum 10-year verifiable track record for the proposed commingled fund.

The proposed product performance must exceed the HFRI Funds of Funds Composite index for three, five, seven and ten years on an annualized basis. Fees and liquidity terms must be reasonable. There must be an independent audit of the proposed commingled fund performance at least annually; use of a reputable independent third party custodian/administrator for all assets; have independent pricing of assets at least monthly; demonstrate current industry best practices in operational and investment due diligence, ongoing monitoring and risk management; provide transparency and disclosure of all underlying hedge fund managers and strategies; carry a minimum of $10 million in errors and omissions insurance; be domiciled in the US and registered as an investment advisor with the SEC; and have no material regulatory issues during the past ten years.

The RFP is only available from David Russell at Investment Performance Services. The deadline was August 18 at 4pm EST.

Investment Performance Services recently completed an asset allocation review in which the hedge fund of funds target increased from 5% to 10%.

The commission is also issuing RFPs for global tactical asset allocation and real estate managers.

Sentiment Indicator: Marketers see softening in current asset raising environment, 50% describe it as "good"

Infovest21's just-released Marketer Sentiment Indicator reveals that 50% of marketers feel the current asset raising environment is "good" while another 12.5% say it is "very good." This reflects some softening from last quarter when 23.1% said the environment was "very good."

Investor category

The majority of marketers felt interest was "the same" in seven investor categories - consultants (66.7%), charities (66.7%), pensions (56.3%), family offices (55.6%), foundations (44.4%), sovereign wealth funds (44.4%), and endowments (44.4%).

In one category - insurance companies - the majority of marketers (44.4%) felt the interest was "up slightly" while for funds of funds, the majority of marketers (37.5%) felt the interest was "down slightly."

	Up significantly	Up slightly	The same	Down slightly	Down significantly
Family office	11.1	33.3	55.6	0.0	0.0
Fund of funds	12.5	25.0	24.0	37.5	0.0
Consultants	11.1	22.2	66.7	0.0	0.0
Charities	0.0	11.1	66.7	22.2	0.0
Endowments	11.1	33.3	44.4	11.1	0.0
Foundations	11.1	33.3	44.4	11.1	0.0
Insurance companies	11.1	44.4	33.3	11.1	0.0
Pension plans	11.1	22.2	56.3	22.2	11.1
Sovereign Wealth Funds	11.1	22.2	44.4	22.2	0.0

Strong geographic interest

In four out of 10 regions, the majority of marketers felt investor interest was "up slightly" from last quarter. These were Europe (66.7%), Asia (66.7%), Latin/South America (44.4%) and Japan (44.4%).

In five regions, the majority of marketers felt investor interest was "the same" as last quarter. In rank order, these were Australia (62.5%), Africa (62.5%), United Kingdom (55.6%), US (55.6%) and Canada (55.6%).

Middle East was the only area where the majority of marketers felt interest was "down slightly" from last quarter.

	Up significantly	Up slightly	The same	Down slightly	Down significantly
US	0.0	33.3	55.6	11.1	0.0
Canada	0.0	33.3	55.6	11.1	0.0
Latin/South America	0.0	44.4	33.3	22.2	0.0
United Kingdom	0.0	44.4	55.6	0.0	0.0
Europe	0.0	66.7	22.2	11.1	0.0
Middle East	0.0	22.2	33.3	44.4	16.7
Japan	0.0	44.4	33.3	22.2	0.0
Asia	0.0	66.7	33.3	0.0	0.0
Australia	0.0	25.0	62.5	12.5	0.0
Africa	0.0	12.50	62.5	12.5	0.0

Concerns

Marketers highlighted general investor concerns such as protection of principal, access to liquidity if needed, finding reasonable return and fees.

Specific investor groups' main concerns included:

Endowments - missing opportunities because they are not properly staffed to source and evaluate ideas, heavy exposure to fixed income, inflated expectations of return
Family offices - tax issues, wealth transfer
Sovereign wealth funds - declining oil prices
Funds of funds - too much pressure on fees
Consultants - conflicts of interest, fee pressure
Pensions - herd mentality

Ranking: Top Performing Fund of Funds in August 2014
(Funds with assets over $30M)

Company	Fund	Estimated July Returns (%)	Estimated YTD Returns (%)	Estimated July Assets ($M)
James River Capital Corp	Turbo Multi-Strategy Fund LLC Class A6	2.55	12.12	220.00
William Blair & Company LLC	Blue Terrain LP	2.40	2.20	100.00
Permal Asset Management	Permal Natural Resources Fund	2.20	4.50	93.00
Optima Fund Management	Optima Partners Focus Fund Ltd	1.82	1.14	326.69
6800 Capital LLC	Princeton Diversified Strategy Fund LP	1.68	1.62	33.00
Merritt Capital Investment Advisors	Merritt Capital Partners LP	1.40	1.30	126.00
Private Advisors LLC	Private Advisors Hedged Equity Fund (QP)	1.34	2.27	540.80
Fundamental Capital Management	Fundamental LP	1.27	1.66	75.00
Arden Asset Management LLC	Arden Alternative Advisers SPC USD	1.21	2.19	737.00
Aurora Investment Management	Aurora Global Opportunities Offshore Fund	1.13	2.13	127.00

Based on top performing fund per firm and reported numbers to Infovest21's database as of September 26, 2014.

Who's Who: Sampling of Non-US Chief Investment Officers at Funds of Funds (Sorted Alphabetically by Company)

Name	Company	Position	City, Country
Anne Richards	Aberdeen Asset Management	Chief Investment Officer	London, United Kingdom
Bernice Yu	Cube Capital	Chief Executive Officer/ Chief Investment Officer	Hong Kong
Olivier Kintgen	ERAAM	Chief Investment Officer	Paris, France
Sarah Allen	Ermitage Group	Chief Executive Officer/ Chief Investment Officer	London, United Kingdom
Andrea Nasce	Ersel Asset Management	Chief Investment Officer	Torino, Italy
David Smith	Global Asset Alternatives	Chief Investment Officer	London, United Kingdom
Olivier Louvet-Martin	Groupama Alternative Asset Management	Chief Investment Officer	Paris, France
Georg Wessling	Harcourt Investment Consulting AG	Chief Investment Officer	Zurich, Switzerland
Bill Maldonado	HSBC Holdings plc	Chief Investment Officer	London, United Kingdom
Roberto Paganoni	LGT Capital Partners AG Ltd	Chief Executive Officer	Pfaeffikon, Switzerland
Jeff Holland	Liongate Capital Management	Chief Executive Officer/ Chief Investment Officer	London, United Kingdom
Michel Alofs	Lombard Odier Investment Managers	Chief Executive Officer/ Chief Investment Officer	Almere Stad, Netherlands
Ronnie Wu	Penjing Asset Management	Chief Investment Officer	Hong Kong
Nicolas Campiche	Pictet and Cie	Chief Executive Officer/ Chief Investment Officer	Geneva, Switzerland
Alberto La Rocca	Pioneer Alternative Investment Management	Chief Executive Officer/ Chief Investment Officer	Dublin, Ireland
Jacopo Redi	Redi and Partners Ltd	Chief Executive Officer/ Chief Investment Officer	London, United Kingdom
Edward Rogers	Rogers Investment Advisors	Chief Executive Officer/ Chief Investment Officer	Tokyo, Japan
Clive Jory	Saad Investments Geneva	Equities Investment Manager	Geneva, Switzerland
Dominique Montier	Stenham Asset Management	Chief Executive Officer/ Partner	London, United Kingdom
Jean-Francois Hirschel	Unigestion SA	Managing Director	Geneva, Switzerland

Source: Individual Company Websites