

Funds of Hedge Funds

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One of the fastest growing investment areas is hedge funds, which have soared to over 8,000 funds with over \$1 trillion in assets over the last decade. And within that space, approximately 45 percent of hedge fund assets are held by funds of hedge funds (FOFs), and approximately 60 percent of net sales are attributed to FOFs, according to Morgan Stanley. Why are FOFs so popular, and how are they regulated? What additional disclosures, if any, are needed by FOFs?

This article first discusses the advantages and disadvantages of FOFs relative to hedge funds, then reviews the current regulatory regime for FOFs in light of this discussion, and finally suggests improving the market for FOFs by standardizing their performance reporting.

Advantages of FOFs

Investors buy FOFs rather than hedge funds for three main reasons—diversification of risk, access to certain hedge funds, and expertise in selecting and monitoring funds.

Diversification. Hedge funds are generally designed to deliver returns that are not correlated to the overall stock market, though in reality there are many different types of hedge funds, and some retain considerable market risk (or beta).¹ In choosing FOFs, investors are seeking the benefits of diversification by holding a number of hedge funds across a number of different strategies.

It is unclear how many hedge funds are held by the average FOF. On the one hand, a survey of the TASS database concluded: “Fund of funds contain a mean of fewer than five funds, and a median of four.”² Others have stated that most FOFs hold between fifteen and forty underlying funds.³ An intermediate view was obtained by a telephone survey of the MAR database on hedge funds—the mean number of hedge funds held by

¹ See Morgan Stanley, “Structural Alphas and Betas,” *Global Pension Quarterly* (Fall 2004).

² Park and Staum, “Diversification: How Much is Enough?” *J. of Alternative Investments* (Winter 1998).

³ Lhabitant and Learned, “Hedge Fund Diversification: How Much is Enough?” *J. of Alternative Investments* (Winter 2002).

FOFs was between 9 and 11.⁴ However, there is substantial evidence that FOFs are realizing some diversification benefits—they have lower volatility on average than individual hedge funds.⁵

Access to Hedge Funds. Investors with smaller portfolios can utilize FOFs in order to meet the minimum subscription requirements of hedge funds. Most hedge funds require that investors meet the conditions of the exemption in the Investment Advisers Act allowing them to charge performance fees—either \$750,000 invested in the hedge fund or a net worth of \$1.5 million. By contrast, the median FOF had a minimum investment requirement of \$250,000, with 37 percent of FOFs requiring \$100,000 or less; only 3.5 percent of FOFs had a minimum requirement of more than \$1 million.⁶

FOFs also may have access to certain hedge funds that are not readily available even to investors with \$5–\$10 million to invest. While this is undoubtedly true in many circumstances, the very best hedge funds are sometimes closed to FOFs, and may accept monies only from long-standing partners.

Expertise. Investors rely on FOF managers for expertise in selecting the best hedge funds. A recent article on hedge fund performance by Malkiel and Saha⁷ shows that there is roughly a 50 percent chance that past performance of a hedge fund will be repeated over time. Therefore, the expertise of an FOF manager is needed to evaluate factors such as the quality of personnel and investment process at hedge funds.

FOF managers also provide expertise in monitoring hedge funds and presumably in withdrawing when signs of trouble emerge. While FOF managers do redeem from poor-performing hedge funds, there is no systematic data available to test how well FOF managers perform this function.

⁴ Farrell and Gregoriou, “Fund of Funds: When more definitely means less,” *Canadian Business Economics* (Feb. 2000).

⁵ Brown, Goetzmann, and Liang, “Fees on Fees in Funds of Funds,” Yale ICF Working Paper No. 02-33 (June 14, 2004).

⁶ Inceichen, “Fund of hedge funds: industry overview,” *Journal of Wealth Management* (Spring 2002).

⁷ Malkiel and Saha, “Hedge Funds: Risk and Returns,” *Financial Analysts Journal* (Dec. 2005).

Disadvantages of FOFs

The main disadvantage of FOFs is the extra layer of fees relative to hedge funds. There are also fiduciary risks and liquidity constraints.

Extra Layer of Fees. An FOF charges its own management fees in addition to those charged by the underlying hedge funds. The most common structure for FOFs is a base fee of 1 percent of assets plus an incentive fee of 10 percent of gains (above a specified minimum); the second most common structure is a 1.5 percent base fee and no incentive fee.⁸ Thus, since hedge funds generally charge a base fee of 1 percent to 2 percent plus an incentive fee of 15 percent to 25 percent of gains, the total fees of an FOF are very high; a total base fee ranging from 2 percent to 3.5 percent, with incentive fees ranging from 10 percent to 35 percent of gains.

Have FOFs delivered incremental returns that justify this additional layer of fees relative to hedge funds? The answer appears to be no. According to a thorough paper by Brown, Goetzmann, and Liang for the period 1994 to 2003, FOFs showed lower Sharpe ratios (returns above the risk-free rate divided by volatility) as well as lower average returns than hedge funds in most years.⁹ In other words, direct investments in hedge funds on average resulted in better returns relative to risk than indirect investments in hedge funds through FOFs.

One explanation for the relatively inferior performance of FOFs is that investors can pay incentive fees to some of the underlying hedge funds even if the overall performance of the FOF is subpar. Indeed, the more diversified a FOF is, “the greater chance that at least one of the funds generates an incentive fee to an underlying manager.”¹⁰

⁸ J. Nichols, *Hedge Fund of Funds Investing: An Investor's Guide* (Bloomberg Press 2004).

⁹ Brown et al, *supra* note 5.

¹⁰ *Ibid.* at page 16.

Fiduciary Risk. Every investor who entrusts his or her money to an investment manager takes the risk that the manager will exploit its position—for example, by mispricing its portfolio or by miscalculating its incentive fees. In addition, an investment manager may take advantage of potential conflicts of interest by making contracts at favorable prices with affiliated entities.

Of course, all these fiduciary risks are relevant to investors in hedge funds as well as in FOFs. Although investors in FOFs have to deal with two layers of fiduciary risk, the manager of FOF can add value by monitoring the behavior of the managers of its underlying hedge funds to the extent that they allow access to relevant information.

Liquidity Constraints. As compared with investments in publicly traded stocks or bonds, investments in FOFs have the disadvantage of a liquidity constraint. A survey found that 77 percent of FOFs allow withdrawals at either monthly or quarterly intervals, and 88 percent accept contributions at the same intervals.¹¹ Furthermore, FOFs usually require advance notice of redemptions, limit the amount that can be redeemed at one time, and reserve the right to impose tighter redemption constraints in special circumstances.

However, the liquidity constraints on investments in FOFs are often lighter than those on direct investments in hedge funds. Many hedge funds do not allow monthly withdrawals; some permit withdrawals only on a yearly basis. Moreover, a number of hedge funds have imposed lock-up periods of over two years in order to take advantage of an exemption from the SEC's recently adopted rule on registering managers of hedge funds under the Investment Advisers Act.

Current Regulatory Regime

Most managers of FOFs are registered with the SEC under the Investment Advisers Act, and a small number of FOFs are registered as closed-end funds under the Investment

¹¹ Incichen, *supra* note 6.

Company Act of 1940. Starting in 2006, most managers of hedge funds will also be registered under the Advisers Act (unless invalidated under pending litigation).

Advisers Act. Registration of FOF managers under the Advisers Act imposes no substantive constraints on the strategies that FOFs may pursue or the leverage that they may take on. While a registered investment adviser must deliver to its clients a disclosure document, that document contains a fairly general description of the types of hedge funds the FOF may invest in. The document does not specify the degree of diversification the FOF will achieve by number or type of hedge fund.

Registration under the Advisers Act does require symmetrical performance fees (same decrease on downside as increase on upside relative to a recognized stock index), absent an exemption. The most popular exemption for FOFs is to limit investors to one of two categories: investing \$750,000 or more in the FOF, or having a net worth of over \$1.5 million. If all investors in an FOF qualify for the exemption, then the FOF manager may charge an asymmetrical performance fee—a percentage of FOF gains, but not a percentage of FOF losses.

The most important implication of registration under the Advisers Act is that FOF managers become subject to SEC record-keeping rules and periodic SEC inspections. SEC inspections cover subjects such as the pricing of FOF holdings, the calculation of performance fees and disclosure of conflicts of interest.

Closed-End Funds. Most FOFs offer their securities in private offerings under various exemptions to the Securities Act of 1933 and the Investment Act of 1940. One set of exemptions limits the number of purchases of an FOF to less than 100 “sophisticated” investors (having a net worth of at least \$1 million).¹² Another set of exemptions allows an FOF to offer its securities to up to 499 investors with net worth of over \$5 million (excluding their homes).¹³

¹² Section 3(c)(1) of the Investment Company Act.

¹³ Section 3(c)(7) of the Investment Company Act.

As of November 2005, however, 94 FOFs had chosen to register as closed-end funds under the Investment Company Act of 1940. Some of these FOFs are designed to offer small units (\$25,000 or \$50,000) to relatively unsophisticated investors in public offerings; such FOFs do not charge performance fees at the FOF level. Other FOFs register under the Investment Company Act primarily to take advantage of favorable treatment of such registered funds under ERISA;¹⁴ they are offered to pension funds and other high net worth investors that meet the criteria for qualified investors (described above) in the exemption for asymmetrical performance fees.

Although mutual funds must stand ready to redeem their shares on a daily basis, closed-end funds do not redeem their own shares. Instead, closed-end funds typically declare that they intend (but are not obliged) to make an issuer tender offer to buy back a specified portion of the fund's securities every three or six months. In other words, registration as a closed-end fund does not resolve the liquidity constraints of FOFs unless their shares are publicly traded.

Nor does registration as a closed-end fund resolve the diversification issues related to FOFs. A closed-end fund may register as an "undiversified" investment company, and then be permitted to concentrate its investments in a handful of hedge funds. FOFs registered as closed-end funds must disclose to their investors the types of hedge funds it will seek to purchase. But these disclosures do not specify the number of hedge funds or the exact mix of hedge fund strategies that will be held by an FOF.

Performance Reporting

Most importantly, the performance reporting by FOFs is weak. It is voluntary and non-standardized, and often contains time gaps.

¹⁴ Once ERISA assets are invested in a registered investment company, they are no longer "plan assets" for purposes of ERISA.

Registered Entities. Since most FOF managers are registered under the Advisers Act, they must deliver a disclosure statement to their clients. But that statement does not contain statistics on the performance of the FOF manager.

As mentioned above, most FOFs do not register under the Investment Company Act of 1940. If these do register under that Act as closed-end funds, their initial prospectus typically contains no performance data because these FOFs are newly formed entities. In a few instances, FOFs registered as closed-end funds include as an appendix to their prospectus a summary of the investment performance of a similar non-registered entity or the performance of a composite of such entities. Such an appendix typically cautions the reader not to rely on these performance statistics because of material differences between the existing non-registered fund and the registered fund being offered.

After investors purchase investments in a registered FOF, they are sent annual reports including a list of hedge funds held by the FOF along with the FOF's annual returns. However, as explained below, the performance statistics on the underlying hedge funds are difficult to compare. Moreover, the reporting practices of non-registered FOFs are quite uneven.

Non-Registered Entities. Since the SEC does not require regular public reporting of their performance by hedge funds or non-registered FOFs, a number of private vendors have been compiling and disseminating data based on their performance. These vendors include, for example, Tremont and Standard & Poor's. Despite their good faith efforts, all of these vendor data bases on FOFs and hedge funds are plagued by serious methodological problems. Malkiel and Saha discuss three such problems, which systematically result in overstated annual returns of as much as 4 percent by the hedge fund industry.¹⁵

¹⁵ Malkiel and Saha, *supra* note 7.

1. All reporting on performance is voluntary. Naturally, entities with better performance tend to report to these vendors more than entities with weak performance.
2. When entities begin to submit performance data to these vendors, they can choose the starting date that maximizes their returns. For instance, a hedge fund beginning in 1995 can report its performance in 2005 starting in 1997.
3. The databases of some private vendors contain survivor bias by removing the statistics on hedge funds that go out of business after 3 or 4 years because of poor performance.

In addition, private vendors are not able to insist on a standardized methodology for reporting returns by FOFs or hedge funds. The SEC and the mutual fund industry took several years to reach agreement on such a standardized methodology. More recently, the SEC has required mutual funds to report their returns before and after taxes.

Hedge funds and FOFs present difficult accounting issues that are not typically confronted by mutual funds in reporting performance. For example, the incentive fees of many hedge funds may not be actually collected on gains until past losses are made up or a minimum return is achieved. Should such incentive fees be accrued in reporting the net performance of hedge funds and FOFs?

As hedge funds expand their investment universe in an effort to boost returns, some have begun putting large sums into private equity investments like shares of private companies and interests in real estate. These non-liquid investments are often held in “side pockets” that are segregated from the general assets of the hedge fund and are subject to longer restrictions on withdrawal. How should these “side pockets” be taken into account in reporting the annual performance of hedge funds and FOFs?

Conclusions

FOFs offer investors a number of benefits: diversification of risk, ease of entry, and expertise in selecting and monitoring hedge funds. However, these benefits appear to be outweighed by the extra layer of fees charged by FOFs on average. The question is: does the regulatory regime provide investors with sufficient information to select above-average FOF managers?

Unfortunately, the answer seems to be no. Most FOF managers have been registered under the Investment Advisers Act, and soon most hedge fund managers will also be registered under that Act. But such registration does not require standardized reporting of performance by FOFs or hedge funds. Nor is such reporting included in the initial offering prospectuses of the small number of FOFs registered as closed-end funds under the Investment Company Act of 1940 (because they do not usually have historical records).

Private vendors do collect and disseminate performance statistics on many hedge funds and some FOFs. However, submission of these statistics is voluntary and submitters are allowed to choose the starting year for reporting purposes. Some databases also suffer from survivor bias, as a significant number of hedge funds go out of existence after 3 to 4 years of operation because of poor performance. Most importantly, there is no standardized methodology for reporting performance by hedge funds or FOFs, especially in light of complex issues like the treatment of incentive fees.

The SEC and the Federal Reserve could substantially improve the market for hedge funds and FOFs by convening a task force to set ground rules for performance reporting. If an agreement could be reached on such ground rules, they would quickly be adopted by the private vendors. Furthermore, the task force should establish two guidelines for private vendors—they should accept submissions of performance data from hedge funds and FOFs starting only from the first full year of operations; and they should correct the overall performance record of hedge funds and FOFs to eliminate survivor bias.

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