



Diaries of
Hedge Fund Investing

Edward Patchett, CFA
Independent Fiduciary Services

Thomas K. Wotring, Esq.
Sheppard Mullin, Richter &
Hampton LLP



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- Key considerations and things to look for
- “Real world” examples
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Chapter 1 – “Hedge Fund” Defined

- ✦ Term normally used to describe the “structure” of an investment vehicle rather than the “type” investment strategy
 - Limited partnership
 - Broad manager investment discretion
 - “Absolute return” investment objective (not “relative return”)
 - Manager has incentive fee
 - Manager invests own money in strategy along with investors
- ✦ Common structures include: single manager/strategy, single manager multi-strategy and “fund-of-funds”

Lesson: Term is often used generically, so understand the structure of vehicle you’re discussing or evaluating.

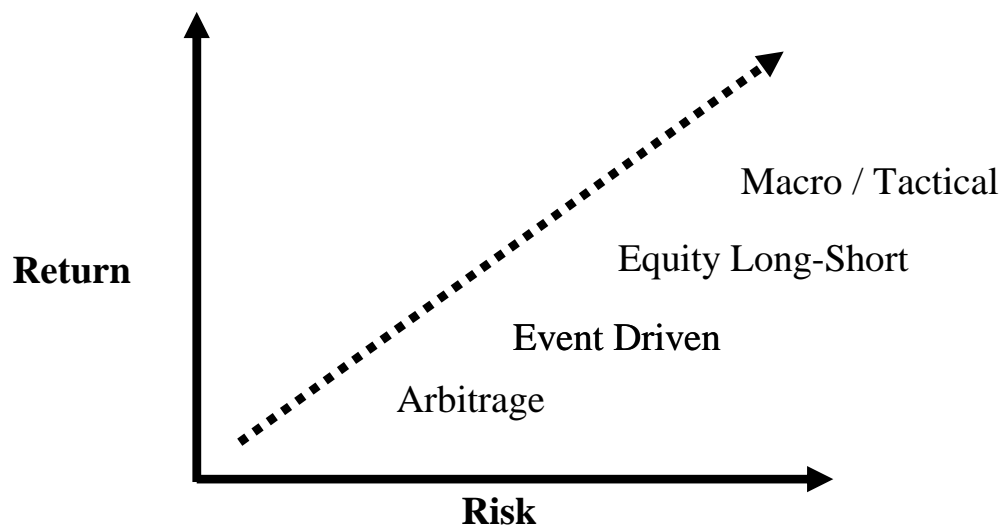
Chapter 2 – *Single Manager Fund or “Fund of Funds”?*

- ✦ Specialized nature of these strategies argues in favor of broad diversification among many strategies
- ✦ “Single manager, multi-strategy” funds may provide strategy diversification, but style/strategy drift and concentration can occur
- ✦ “Fund-of-funds” can provide more manager and strategy diversification (with one plan investment) than most plans could achieve by investing in single manager funds
 - Also provides an additional layer of on-going management, expertise and oversight (but for an additional fee)

Lesson: Consider establishing a “core” hedge fund allocation through a “fund-of-funds” and, depending on the size of your plan’s allocation, complementing that allocation over time with single manager funds.

Chapter 3 – *Hedge Fund Strategies*

- ✦ Many strategies exist, with a wide range of target return and risk
 - Hedge Fund Research Inc. (“HFR”) maintains 37 different hedge fund indices
- ✦ Major strategy classifications include



Chapter 3 – *Hedge Fund Strategies*

- ✦ **Arbitrage** -- attempts to take advantage of relative pricing discrepancies. Exploit securities that may be mispriced relative to the underlying assets, related securities, groups of securities, or the overall market.
- ✦ **Event Driven** -- investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks.
- ✦ **Long-Short Equity** – investing in equity securities believed to be undervalued (“long”) while at the same time hedging those positions with short sales of stocks believed to be overvalued and/or stock index options.
- ✦ **Macro / Tactical** -- managers using a "top-down" global approach, based on anticipated price movements of stock markets, interest rates, foreign exchange and physical commodities

Lesson: Understand the types of strategies the hedge fund manager (or fund-of-funds) employs.

Chapter 4 – *Leverage and Transparency*

- ✦ Most hedge fund managers use “leverage” within their investment process
 - Leverage can enhance returns in “up” markets and magnify losses in “down” markets
 - The degree of leverage used varies by fund manager and investment strategy
 - Excessive leverage by some hedge funds has resulted in spectacular hedge fund “blow-ups”
- ✦ Hedge fund managers often limit the amount of portfolio “transparency” provided to investors
 - Rationale: manager wants to protect proprietary information from others who could compromise the portfolio (particularly short positions)
 - Most managers provide various forms of risk reporting (leverage, position concentration, sector exposures, etc.)

Lesson: Evaluate the process and procedures used by the manager to manage portfolio risk and consider the amount and type of information needed to perform on-going due-diligence.

Chapter 5 – *Illiquidity*

- ✦ Hedge funds (and fund-of-funds) are structured as private limited partnerships
 - No public market
- ✦ Partnership may require initial lockup with periodic liquidity thereafter (e.g., one-year lockup with quarterly liquidity thereafter on 60 days notice)
- ✦ To varying degrees, underlying investments by hedge funds may be illiquid

Lesson: Carefully consider the unique financial condition of your plan (particularly its on-going cash-flow needs) when evaluating the prospect of investing in hedge funds and the size of their investment.

Chapter 6 – Fees

- ✦ Investment management fees for hedge fund management varies by fund, but are considerably higher than for traditional asset management
 - Traditional management: Large cap equities 0.4%-0.6%, small cap 0.7%-1.0%
 - Single manager hedge fund: 1-2% annual management fee plus 20% incentive
 - Hedge fund-of-funds: underlying hedge fund fees plus 0.8% - 1.25% annual management fee (in some cases, and incentive fee up to 10%)
- ✦ Despite growth in hedge fund (and fund-of-funds) assets, there has been little, if any, reduction in fees

Lesson: Historical performance analysis and the evaluation of prospective returns should always be on a net-of-fees basis; little room for negotiation.

Chapter 7 – *Fiduciary Status of Manager*

- ✦ Not all hedge fund managers are “Registered Investment Advisors” with the SEC
- ✦ Certain hedge funds are specifically structured so as to avoid being deemed “plan assets” under ERISA
 - Thus, the manager may not be an ERISA fiduciary
 - Trustees’ fiduciary responsibilities regarding portfolio may not be properly delegated to investment managers

Lesson: Plan counsel should carefully review hedge fund documents and determine stated fiduciary status of hedge fund manager.

Chapter 8 – *Side Letters*

- ✦ Hedge fund is “governed” by the terms of its offering documents / private placement memorandum
 - Since document is written by the manager, terms tend to favor the manager
- ✦ On occasion, investors require additional clarification or seek comfort of regarding certain terms, or may need to address items not reflected in the document
- ✦ Certain managers will accommodate these investor requests via a “side letter” to the offering document/PPM written by plan counsel

Lesson: Plan counsel should engage the hedge fund manager in an active discussion regarding key terms and (if necessary) seek to clarify terms via a side letter.

Chapter 9 – *Involvement of Fund Professionals*

- ✦ Given the complexities of hedge fund strategies, plan trustees should involve all plan professionals in the vetting process
- ✦ Investment consultant should be qualified to evaluate alternatives and their impact on total plan return and risk, perform due-diligence make specific recommendations and perform on-going monitoring
- ✦ Plan accountant should evaluate any implications the investment may have on its work related to annual audit
- ✦ As noted previously, plan counsel should carefully review hedge fund documents

Lesson: Plan trustees should be able to demonstrate a thorough and rigorous due-diligence evaluation and process in selecting hedge fund investments and on-going monitoring.

Chapter 10 – *Trustee Education*

- ✦ Hedge funds, and other “alternative investments” must require additional Trustee education
 - Investment strategies are very different than traditional stock or bond managers
 - Requires thinking “outside the box”
 - Hedge funds may increase plan diversification and enhance long-term returns, but require more time and effort to understand

Lesson: Educate yourself by attending sessions, asking questions and putting your plan professionals to work.

Q & A Session