WHAT ALLOCATION SHOULD BE GIVEN TO HEDGE FUNDS BY TRUSTEES AND PRIVATE CLIENTS?

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Hedge Funds have a useful role to play, and with prudent allocation and manager selection, can enhance the risk and return profile of many portfolios

In a climate of poor investment returns, it is no surprise that many investors are looking for better solutions for their current investment portfolio. Every person wishes their manager could have had the clairvoyance to have sold technology shares near their peak, moved to bonds or cash and then timed the move back to equities.

Hedge Funds seem to offer the best of both worlds with the goal of absolute returns in any economic climate and, in theory, will not be fully correlated to that of Bonds and Equities.

However, every journal, newspaper and television commentator seems to have grasped the concept of hedge funds as the solution to all our problems, even going so far as to say investment managers will have to change to survive because we are in a new paradigm which all sounds very familiar to another story three years ago!

Why Hedge Funds?

Hedge Funds typically focus on Absolute Returns rather than returns relative to the market. They can take long and short positions and can use leverage to further amplify the effect of the investment.

A variety of strategies exist including: Long-Short, where a manager has the ability to sell shares he does not own and thus go short of the market: Global Macro, which is synonymous with the large bets taken by George Soros against the pound in 1992: Market Neutral, which is where the manager seeks to avoid positive or negative exposure to the market but instead takes a bet on the stocks themselves - an example of this would be a fund buying McDonalds and shorting Burger King. Arbitrage is best described as where the manager identifies a small differential in price and capitalises on this, often using gearing. Each approach has a different return and risk profile.

Trustees and Private Clients usually gain their first exposure to Hedge Funds through a Fund of Funds. By diversifying across more than one fund, the risk of default or a major loss is reduced.

Multi Manager, Multi Style Hedge Funds go one step further by diversifying across many styles that are often not highly correlated, resulting in a smoother return and risk profile.

The Risk Issues

The potential risks may not be as well known as the benefits. Liquidity represented by the frequency of dealing are often monthly or quarterly and sometimes longer for redemptions. The funds sometimes use large amounts of gearing which can alter their risk profile. Investor protection may not exist in many of the jurisdictions where the funds are registered, and managers may not have to adhere to the same level of standards applied onshore. Charges which take into account performance fees are higher than traditional mutual funds. Finally, many of the issues outlined above can be exacerbated by a lack of clarity about the fund and how it is managed.

How much should be allocated?

The Trustee Act 2000 highlights the importance of good client profiling. It also emphasises that Trustees must play a more active role in determining the optimal asset mix and, in so doing, give clear instructions to managers.

Computer investment modelling usually recommends 100% towards hedge funds when comparing Bonds and Equities on a risk (volatility) and return basis! This would completely fail to take into account the qualitative risk factors mentioned above.

Ask most Discretionary Investment Managers and they will probably recommend between 0% - 15%, whereas a Family Office, whose clients usually have minimum asset value of £50m tend to have higher allocations.

However, Hedge Funds are complex and when determining the optimal allocation between each asset class, most firms will want to seek external advice and delegate to professionals.

Hedge Fund Asset Allocation Solutions

Depending on the assets involved and the account profile, there are probably three routes available to manage the decision taking process once a rigorous investment and risk profile analysis of the account has been performed.

- **Discretionary Investment Managers** can determine the allocation based on the account profile and this delegates to them the decision taking and manager selection process. It will generally lead to an asset allocation in line with market practice.

However, most traditional investment managers will still specialise on bond and equity selection and therefore care needs to be taken to ensure the Investment Manager has the desired skills to identify the appropriate hedge funds and has the resources to monitor and replace their hedge managers.

- **Specialist Absolute Return Managers** start with the premise that their clients are just as concerned with capital preservation as they are with making portfolio gains. Asset Allocation is usually between bonds, equities and multiple styles of hedge funds, often with a higher weighting towards hedge funds than most Discretionary Managers.

There are an ever growing number of companies offering this type of management and the challenge is to ensure they have the resources to manage the additional risks involved with this type of approach. A proven track record is also important when differentiating companies.

- **The Investment Consultant** route ensures that the profiling is performed rigorously with a healthy debate about asset allocation, and places the onus on the consultant to identify the most suitable firm in each of the categories above.

Thorough research on consultants is just as important as each will have a different attitude to risk, asset allocation, research or even the types of managers to be proposed. It is also important to understand their level of 'independence' as some are tied either through ownership or through retrocessionary payments by certain managers and there is also a growing trend for consultants to manage money which can create conflicts.

Conclusion

Hedge Funds have a useful role to play and with prudent allocation and manager selection can enhance the risk and return profile of many portfolios. The absolute return philosophy sits comfortably with most Trustees' needs but is partially offset by the lack of history and transparency.

Allocation to Hedge Funds will increase over the years as investor's understanding grows and as regulators, investors and advisors bring about positive changes in investment and marketing practices. In the meantime, allocation and selection of hedge funds will be reserved for the professionals and delegated by Trustees and Private Clients alike. ■