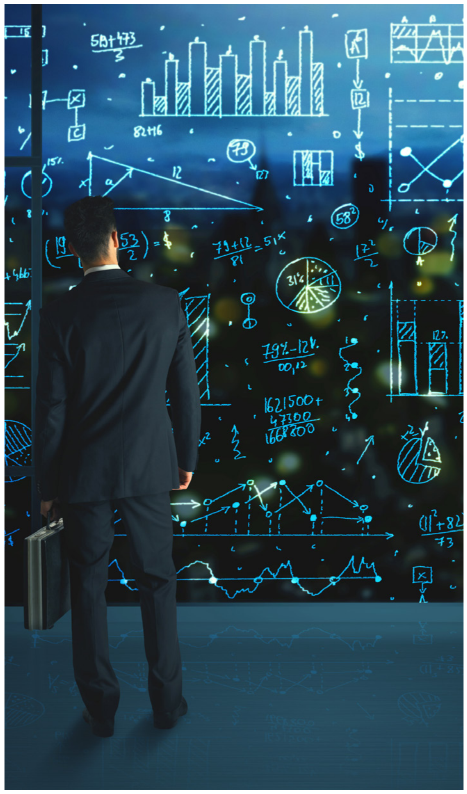
QMC INTERVIEWS A FAMILY OFFICE PRINCIPAL ON SELECTING HEDGE FUNDS

Quality Manager Consultants' Gary Reneau, CFA, recently sat down with the retired senior partner of a major global consulting firm and the current principal of a family office. The discussion topic was the state of the hedge fund industry today, and the challenges facing family offices when investing in hedge funds. The gentleman is an active member of an external advisory committee for a $20 billion Hedge Fund of Funds. Earlier in his career he was a senior member of the consulting firm's investment committee, which directed the company's retirement plan's assets. That committee was one of the first corporate entities to allocate their plan assets to hedge funds back in the mid-1970s, when few investors knew what hedge funds were. Our investor had many interesting things to say about the hedge fund industry and investing directly in hedge fund managers. We found the interview valuable, and we hope you do too.

Gary: *First, thank you for joining us today. Could you tell us a little bit about yourself and your investment experiences?*

Family Office Principal: Sure. I am a retired director and senior partner of one of the largest management consulting organizations in the world, advising businesses, governments and institutions. In addition, I was a member of the in-house investment team overseeing the firm's [defined benefit] retirement plan. At the time – this was back in the 1970s – we, like the great majority of non-financial institutions at the time, were using bank trust departments to manage our investment portfolio. Dissatisfied with their performance, we decided to look at alternatives, pardon the pun, and began investing in hedge funds and other alternative strategies very early on. Michael Steinhardt, one of the most successful hedge fund managers ever, was one of our first manager allocations.



> ***"Hedge funds perform an important function in any portfolio. Properly constructed and managed, they offer the investor diversification, downside protection, and access to niche strategies that aren't offered by more traditional managers."***

Gary: *What was that like, overseeing a large company's employee pension plan?*

Family Office Principal: It was an excellent opportunity to learn at a deep level how markets operate, analyze a wide variety of investment strategies, and interact with accomplished investment professionals. I also learned how to analyze managers, and identify the attributes of a successful hedge fund manager.

Gary: *Analyzing hedge fund managers is one of the most important and most difficult tasks facing family offices. What do you look for in a superior manager?*

Family Office Principal: Primarily, I look at three things:

1. *The individual* (I'll use the male gender for purposes of exposition): How bright and motivated is the manager? Has he "floated" into a career of managing money or has there been a conscious purpose to his career choices? Next, I look at the person's ethics and morals, for obvious reasons. Finally, I'll try and make a judgment as to the manager's personality and family environment. Is the individual balanced in temperament? Does he have a happy and settled family life? Will he be able to emotionally withstand the inevitable ups and downs that come with managing money? These are obviously all quite subjective, and difficult to know for sure. But, after direct talks with a manager, I generally come away with a very good sense of where things stand.

2. *Performance* - As a famous investor once said, "Rule No. 1 is never lose money. Rule No. 2 is never forget rule No. 1." The math of money management is straightforward: lose 50% of your capital and you have to earn 100% just to get back to even. Because of that, I pay particular attention to a manager's ability to preserve capital in down markets. This implies the manager needs to have under his belt a certain amount of time managing money, so an assessment of his capabilities over an entire market cycle can be made. In addition, the manager must have a reasonable amount of assets under management. Unlike larger managers, two or three good investment ideas for a small manager can make a big difference in returns. However, as assets increase, the manager won't have the luxury of relying on such a limited number of outperformers. Therefore, I generally want to see a diversified portfolio within a fairly focused strategy.

   Furthermore, I'll want to fully understand how the manager selects stocks. What are the drivers to performance in his opinion? And what is the portfolio construction process on both the long and short side? Next, I want to know about the manager's risk management process. How much has he lost in down markets? How risk adverse is he? How does he hedge against drawdowns? Does he have an intelligent plan for reducing risk, should markets start to decline? And are the investment positions sufficiently liquid to allow the manager to exit them, without excessive price slippage?

3. *The strength of the manager's organization:* It is rare that a superior money manager is also a great administrator and manager of people. However, they do exist. Probably the best example is Julian Robertson of Tiger. Mr. Robertson was not only a truly fine hedge fund manager, he has proven himself to be an able administrator, a very shrewd judge of talent, and a wise mentor. In like manner, I want to see some of these same characteristics in the hedge fund managers I interview. How does the manager go about the hiring process? How strong is the firm's investment and operational support staff, and what is the state of employee morale? What is the caliber and educational background of the people the manager has surrounded himself with? All of these are important subjects to explore in detail with the manager.

Gary: *Thank you, that's an excellent overview of the proper steps to take when evaluating a hedge fund manager. All that being said, still, even quality fund managers struggled during the financial crisis of 2007-8, and many continue to struggle. Why do you think that was?*

Family Office Principal: As you say, many hedge funds weren't effective dealing with the severe financial and economic challenges of 2007-8. They exercised poor risk management, had too much leverage, and relied too much on illiquid instruments. And there was a misunderstanding of how markets behave during times of severe stress. All of these factors conspired to produce a negative outcome. This poor performance has certainly brought greater scrutiny of the industry's fee structure, and rightfully so.

I think there is an even greater challenge for the industry today. And, that is the "institutionalization" of hedge funds. What I mean by this is that as big money has flowed into hedge funds over the past decade, it has affected how managers invest. In the past, high quality hedge fund managers earned the greater part of their compensation from performance fees. Consequently, they were extraordinarily focused on delivering the highest risk-adjusted returns to their investors. Now, however, those same funds derive a far higher percentage of their compensation from management fees. As a result, they are less inclined to reach for high returns, and risk the loss of the investor by falling short. A decent performance and the avoidance of significant losses, even if temporary, will do just fine. This new conservative ethos also stems from their heightened focus on fitting performance to their institutional investors' desired risk profile - high single-digit or low double-digit returns, with reduced volatility.

It is no small irony that today the largest hedge funds may be more concerned about not losing money, and beating a particular benchmark, rather than alpha generation. This change has, I think, worked to the detriment of investors, and understandably, called into question the value the industry is delivering as a whole.

Gary: *Well, it's certainly true that hedge funds in particular are the subject of some rather scathing criticism in that regard. Do you think it's justified?*

"It is no small irony that today the largest hedge funds may be more concerned about not losing money, and beating a particular benchmark, rather than alpha generation."

Family Office Principal: In many cases it is. Because the barriers to entry are relatively low, there are thousands of fund managers competing for alpha. Like any industry where supply exceeds demand, there is a natural winnowing down of profits, in this case, investment returns. That makes life difficult for everyone. It is difficult for the manager who finds it harder to outperform the market, and difficult for the investor trying to identify the truly superior manager.

Gary: *Your analysis makes the current situation quite understandable. How then are you operating in this environment? Do you still believe active* *management has a place in investors' portfolios?*

Family Office Principal: I do. Hedge funds perform an important function in any portfolio. Properly constructed and managed, they offer the investor diversification, downside protection, and access to niche strategies that aren't offered by more traditional managers. And, in the zero interest rate policy environment we find ourselves in today, certain hedge funds can act as an alternative to fixed income funds. Speaking of today's markets, I don't think many investors realize how unusual the market's behavior has been over the past 2-3 years, in terms of volatility. It's been well over 1,000 days since the S&P 500 has experienced a 10% correction, double the average since 1949. The apparently reduced risk investing in equities has emboldened investors, and caused them to question the need for hedged portfolios. This is evident in the exodus from long-short funds to long-only index funds. While there are good reasons for an investor to have a core position in index funds, it is worrisome that this shift in preferences is occurring after such a positive and extended run in the stock market.

Gary: *You've worked with Quality Manager Consultants and Marc Rosenberg for many years. What first attracted you to Marc and QMC?*

Family Office Principal: I first met Marc at a hedge fund conference many years ago, and our relationship has expanded over time. He and QMC have been extremely helpful to me in sourcing good managers. Given there are thousands of managers currently operating, it is very difficult for an individual, or family office, to identify the few truly capable ones. My experience investing in the managers QMC has represented has been salutary, as nearly all have preserved capital (Rule No.1) and several have turned out to have been quite profitable investments. Equally important has been the approach QMC has taken: consultative and informative without pushing a particular point of view. Their counsel has been valuable and their manager selection superior.

Gary: *For a taxable investor like yourself, investing in hedge funds has the drawback of being tax inefficient. How do you think about that?*

Family Office Principal: Unquestionably, the fact that a high percentage of most hedge funds' profits are taxed as ordinary income detracts from their attractiveness. This is one major reason why separately managed accounts have become more popular, as it allows the investor to have a say-so in how and when profits will be taken..

Gary: *What is your opinion of fund of funds?*

Family Office Principal: Over the past few years there has been an evolution in the role that fund of funds play for the individual and family office. In the early days, funds of funds were quite useful. When properly managed, they offered investors an efficient way to diversify their investments and enjoy reasonable to good performance. More recently, however, performance has suffered due to a) funds of funds' failure to consistently select top performing managers; and b) a lack of urgency in quickly weeding out underperformers. When one is being charged both a management fee and a performance fee for relatively mediocre performance the underlying rationale for this asset management structure evaporates, which is why we're seeing more and more allocators go direct. Having said this, there remains a role for fund of funds to play. For the novice investor in alternatives, funds of funds can provide professional management and guidance in manager selection and portfolio construction. And, as previously mentioned, the structure offers diversification benefits which can be particularly useful when investing in certain investment strategies, such as private equity and credit.

Gary: *What are the investment challenges you see for individuals and family offices looking into the future?*

Family Office Principal: Individual and family office investors often have tremendous demands on their time. They frequently don't have the breadth of experience and resources required to cope with the difficult and important task of managing theirs and others' assets. One of the services a valuable advisor can provide is to identify unique investment approaches, and uniquely qualified managers these investors might not be aware of. I expect these advisors to have done a meaningful amount of due diligence before they present managers for consideration, because I don't have the same resources the institutional investor can draw upon. In addition, since persistence in investment performance is rare, manager selection is critical, and being able to count on the professional guidance of experts like QMC makes my job far easier. ■

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