Fund of hedge funds – re-aligning the model

HEDGE FUND FAILURES HAVE OFTEN BEEN ATTRIBUTED TO OPERATIONAL ISSUES. VINCENT VANDENBROUCKE OF HERMES BPK PARTNERS OUTLINES THE IMPORTANCE OF DUE DILIGENCE IN IMPROVING STANDARDS AND GOVERNANCE WITHIN HEDGE FUNDS.

Vincent Vandenbroucke
Partner & Head of Operational Due Diligence
Hermes BPK Partners LLP

In the past twelve months we have witnessed significant changes in the fund of hedge funds landscape with many businesses closing or consolidating operations. At the same time more robust and sustainable businesses have risen to the challenges, adapting their business models, increasing their market share and securing their future for potentially years to come. There has been a clear recognition that long-term institutional investors will make up a growing proportion of the fund of hedge funds' investor base and this is set to raise the demands made of the industry. Recent research has identified that for institutional investors, issues such as transparency, risk management, firm reputation and the quality of personnel are now much more significant factors than they have been in the past.

While others have spent 2009 dealing with the effects of the financial crisis, Hermes BPK Partners has been in the privileged position of establishing itself as a new business with some $1.4 billion of anchor capital from the BT Pension Scheme (BTPS), the UK's largest private pension scheme. Unencumbered by many of the issues still surrounding the industry, we have been able to reposition the business model to ensure that BTPS and other institutional clients receive products and services that are adapted to a radically altered marketplace.

Most importantly, we have recognised that a clear alignment of interests has to underpin the model and that new governance standards have to apply at all levels of the industry. Between the client and the fund of hedge fund for example, we believe that product liquidity terms should be aligned to the terms of underlying managers thus significantly avoiding a mismatch; we believe that the transparency gained from underlying managers should be shared with investors; and we recognise that longer-term performance fee structures have to be deployed to avoid investors paying solely for the upside with no mechanisms for clawback if performance falls.

Perhaps the most important shift in the industry has been in the role and significance of operational due diligence activity. With many hedge fund failures being attributed to operational issues (lack of segregation of duties and independent controls, fraud, counterparty risk, poor valuation and pricing policies etc), the need for best-in-class due diligence work at the fund of hedge fund level has to be a primary focus going forward, and we believe this should be one of the first areas that investors focus on when considering an allocation to a fund of hedge funds.

However, assessing the quality and depth of operational due diligence activity can be very challenging. While many fund of hedge funds can demonstrate alignment with recognised industry best practices, this is a function where experience counts and which should therefore never be a box-ticking exercise performed by more junior employees. The necessary expertise is however expensive and only available for those with scale. With many fund of hedge funds under cost pressure from falling assets, investors should check that there have been no cut-backs or compromises in the numbers or seniority of staff covering this function.

Independence is also critical, as the function often has to oppose the advocacy of qualitative and quantitative research analysts who will typically have a strong positive skew towards any manager they have spent time reviewing. Independent reporting lines and the power of veto have to be held by the operational due diligence team. We also favour the function being conducted within the fund of hedge funds rather than being delegated by the fund of hedge funds to an outside provider. The process of outsourcing simply shifts the focus of investor due diligence on to that service provider adding another dimension to the investment. It is our belief that from an investor's point of view, accountability has to be explicit – particularly when an immediate response may be required to any potential operational monitoring issue that may emerge.

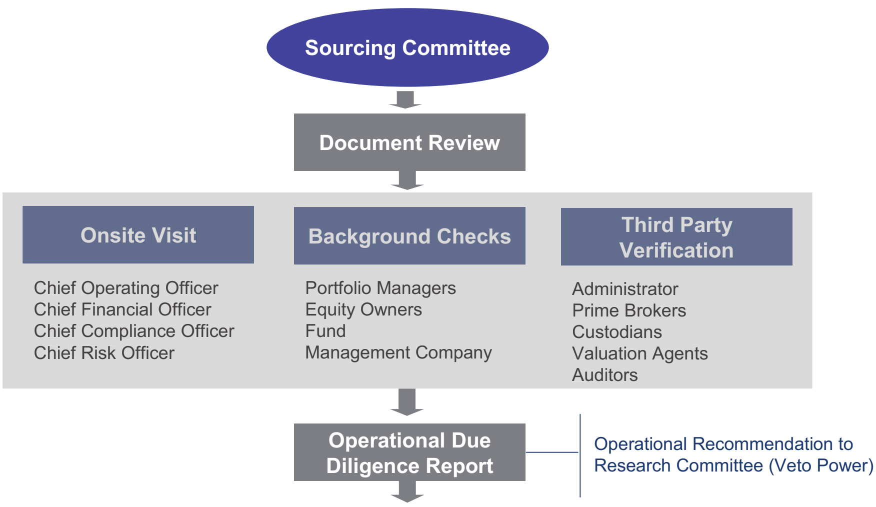
"the need for best-in-class due diligence work at the fund of hedge fund level has to be a primary focus going forward"

For any pension fund looking to make an investment into a fund of hedge funds, one should expect the due diligence process to cover a number of minimum steps as highlighted by our process below.

For example, when we look at new investments, we start with a detailed document review of all financial, legal, regulatory, business process and marketing documentation. We then go onsite to meet all the 'Chief' officers of the company to understand the business setup, the trading flows, the NAV calculation process, the Compliance and Risk Management framework and the business' relationship with service providers. Our goal is to assess whether a business can make money in a culture of compliance, in a robust risk framework and with appropriate operational infrastructure to support a fund's strategy.

We also use outside agencies to perform background checks on the portfolio managers, the equity owners and the legal entities. This is an expensive activity but one of the most significant in providing reassurance in the people that we are investing in. Again, investors should check that this activity is performed and if so, that there have been no cut-backs in the scope or frequency of the work. We have a policy of never investing where questionable background checks emerge and there can be no mitigating factors where a corporate culture of integrity is absent. To provide additional reassurance with an industry in constant evolution, these checks are repeated on an annual basis.

Finally we verify all the controls and services provided by third parties e.g. we check the existence of the assets directly with the custodian, we confirm all material agreements linking the fund to its service providers including the administrator, the custodian, the prime brokers and the auditors as well as reviewing the minutes of the Board of Directors. Based on all the above factors the Operational Due Diligence Team write up an operational due diligence report and present their views and recommendations alongside – but independent from – their qualitative and quantitative research colleagues. Unanimity across the three groups will then place a manager on a 'buy list' for potential investment. The work however does not stop there as full ongoing monitoring and due diligence of all existing investments is undertaken on a continual basis.



In our new alignment model, we believe that the operational due diligence function can and should go one further step in attempting to improve standards and the governance within hedge funds. In our approach we attempt to do this through a proactive engagement with hedge funds alerting the hedge fund upfront that they will receive feedback following our due diligence activity regardless of whether or not we make an investment. With our team possessing experience as both hedge fund auditors and financial controllers within hedge funds, the hedge fund typically sees this as free consultancy and as such the initiative leads to increased openness and transparency. When we provide feedback, we highlight both strengths and weaknesses, making recommendations to improve both the operational and business infrastructure. We believe this activity makes the hedge fund a more robust proposition not just for ourselves but for the business itself and for the benefit of all investors (including other fund of hedge funds). We classify this value-added activity as 'operational alpha' as we believe that raising the standards in the industry through a collaborative and mutually beneficial approach goes above and beyond what has traditionally been performed.

With fund of hedge funds projected to grow substantially over the next five years, we firmly believe that a carefully thought-through alignment and engagement model will underpin the successful players. Long-term institutional capital is desired by the fund of hedge funds (and the underlying hedge funds) and that has to be matched by good governance and improved standards, transparency and alignment, ultimately leading to a higher quality investment proposition with improved safeguarding of investor capital.