

The Swiss Funds of Hedge Funds: Unique or Identical?

An Industry Survey

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Executive Summary

Switzerland is a world centre for funds of hedge funds. This survey covers about 40-50% (in terms of AUM) of the Swiss fund of funds industry and aims at bringing an extensive overview of its current situation and the dynamics of its business model. Our findings suggest that funds of funds in Switzerland are relatively homogenous in terms of finding their clients (mainly Europe), setting up fee structures and investment processes, and deciding which services they provide. Most of their operations are conducted in-house. The companies we surveyed offer, apart from funds of funds, a wide variety of services related to hedge fund investments such as tailor made portfolios or advisory mandates. These similarities are of concern for clients in particular since it begs the questions on how they shall structure their own selection process when most funds of funds claim to offer the same expertise. We find it particularly noteworthy that 85% of the funds of funds in this survey cover the full spectra of hedge fund strategies. Given the diverse complexity of hedge fund strategies this is indeed a contestable proposition, especially for small firms with limited resources.

We found that an overwhelming majority of the companies claimed to be alpha providers. Given the sluggish results of 2008 and the large rebound in 2009 this may seem to be a bold claim. Interestingly, this survey does also find the most pressing challenges for the industry to be to meet client expectations.

Other prominent concerns in the industry are regulation, liquidity, and transparency. This is also likely to explain that most companies found the UCIT fund structure to be an opportunity for their business going forward.

One of the most central services funds of funds provide their clients with is due diligence of hedge funds in an inherently opaque investment environment. We therefore found it surprising and somewhat worrying that the majority of funds of funds have over the past five years experienced a hedge fund failure (fraud or blow up).

This survey is based on three parts. The first gives a brief overview of the fund of fund industry in Switzerland, the second part explores the investment process, and the third part presents views and expectations on the future of the industry.

Introduction

The Swiss Fund of Hedge Funds Industry

Despite being severely affected by the recent financial crisis, the fund of hedge funds (hereafter fund of funds) industry remains important in Switzerland and in particular for its Wealth Management business. Switzerland has long been established as a centre for fund of funds management, with many private banks offering multi-manager solutions to their clients on a large scale since the 1990s.

The aim of this survey is to give a better picture of the current situation and the outlook of the Swiss fund of funds industry. A strong emphasis is put on the organisation and process behind fund of funds companies' portfolio construction process that are the fundamental drivers of their return performance. Most research and evaluation of funds of funds in Switzerland and worldwide is rightly focused on return performance analysis and their decomposition. This has, however, at times come at the expense of little attention to the industry itself and its main characteristics. We believe this survey fills this gap.

Hedge Fund Research (HFR) estimated that assets managed globally by funds of funds were \$530 billion by the end of Q2 2009. About one third, or \$160 billion, of global funds of funds assets are being managed out of Switzerland, according to Centre Alternative Investments & Risk Management (CAIRM) at Zurich University of Applied Sciences. This makes Switzerland the country with the second highest share of asset under management in the fund of funds industry, just after the USA. According to CAIRMs database over the Swiss fund of funds industry there were 313 funds of funds in Switzerland at the end of 2008. Necessary to highlight is that most companies manage several funds of funds that in turn significantly reduce the number of companies in this industry.

Data

This survey is based on a questionnaire which was sent out to 43 fund of funds companies in Switzerland. The sample was collected from three sources: Hedge Fund Research database, Swiss Financial Market Supervisory Authority (FINMA), and the authors' own network in the funds of funds industry. The companies which were asked to participate in the survey had to have their head office and the major share of their employees in Switzerland. Within these companies, we have sent this questionnaire to the executives with a direct role in the investment decision making process (i.e. CEO, CIO, senior portfolio manager, or senior risk manager). Of the 43 fund of funds companies in the sample 44% (19 companies) answered. All answers were collected in the last quarter of 2009 and

questionnaires were filled out anonymously. However, we have confirmed that many of the largest fund of funds companies in Switzerland participated in this survey. All in all, a conservative estimate of our sample representativeness is between 40 to 50% of the Swiss industry’s AUM. The following analysis is based on a subsample of the posed questions in our questionnaire.

Overview

Exhibit 1 summarizes the sample in terms of AUM size, head count, and fees of funds of funds. In general most firms (68%) in this survey have operated for more than 10 years. The median staff size in this sample is between 11 and 30 people. 42% of the companies manage less than \$1 billion of asset, 26% manage between \$1 and \$5 billion. A conservative estimate of the aggregate asset under management (AUM) of the funds of funds in this survey is approximately \$70-80 billion.

Throughout this survey, clients are categorised as either private or institutional. Overall in Switzerland there does not seem to be a particular trend towards either private or institutional clients. Within each company, however, we do find a slight bias towards the clientele type that is either more private or more institutional.

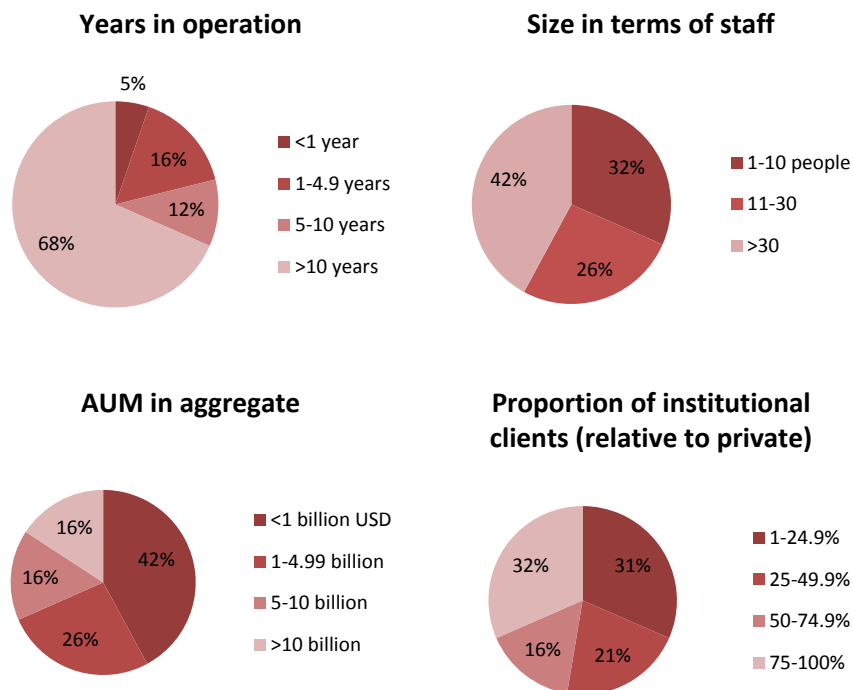


Exhibit 1

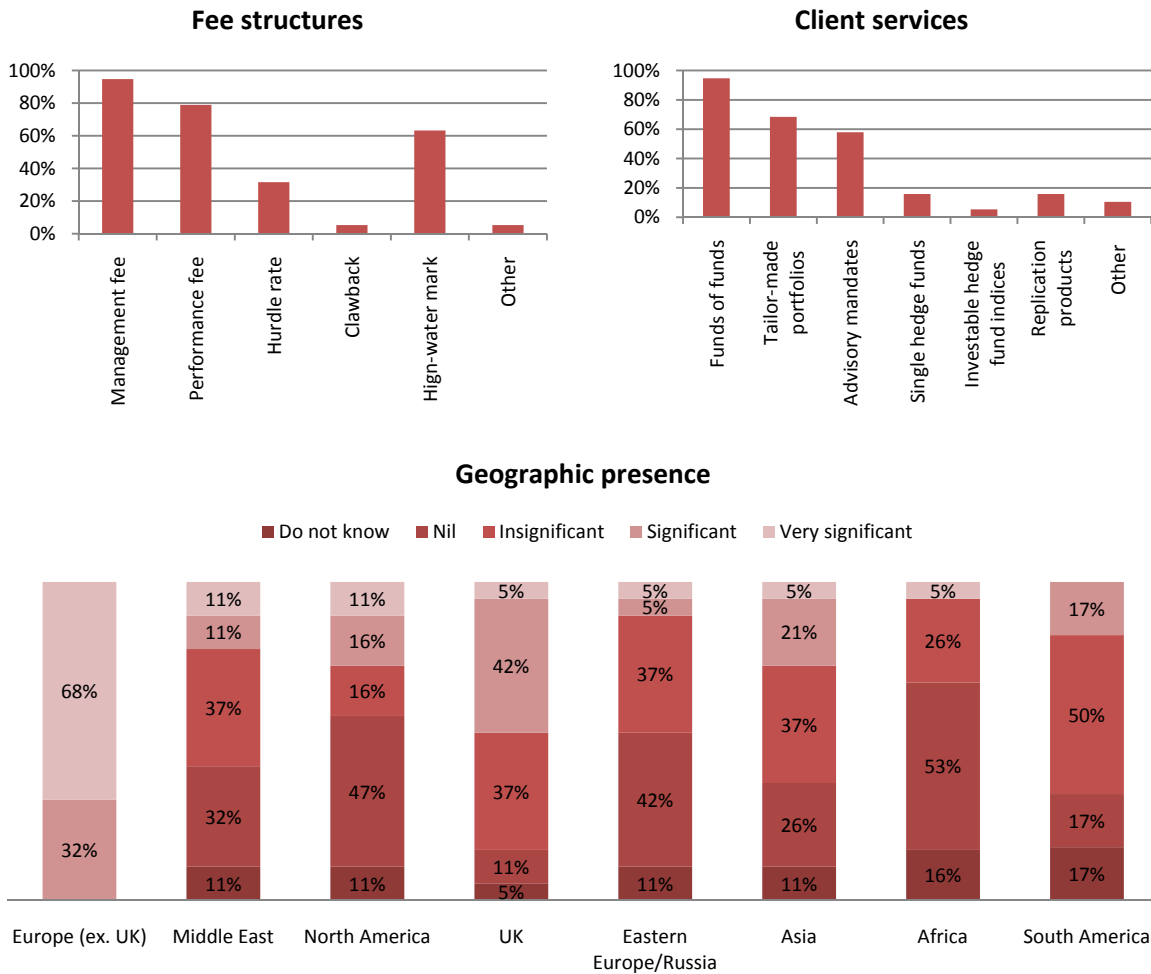


Exhibit 2

The various fees structures used by companies are presented in exhibit 2, top left panel, which indicate a relatively homogenous sample. The most common fee structures used by funds of funds are management fee (95%), performance fee (68%), and high water mark (63%). 32% offer hurdle rates but only 5% have clawback clauses.¹

The top right panel in exhibit 2 presents the services offered by funds of funds in this survey. In this respect fund of funds companies in Switzerland offers a wide range of different services—from funds of funds to single hedge funds and from tailor-made hedge fund portfolios to hedge fund replication

¹ A cross-sectional analysis did not result in any significant relationships between the fund of funds companies AUM and any of the following characteristics: fee structures, years in operation, or proportion of institutional clients. However, given the small sample size this analysis should be given a cautious interpretation.

products. Funds of funds are offered by most, but not all, companies. Interestingly, more than 50% of the funds of funds offer tailor-made portfolios (68%) and advisory mandates (58%). There are obvious economics of scale to asset management operations due to the high proportion of fixed expenses relative to variable costs. Hence, diversifying into new services, other than providing funds of funds, and increasing AUM may be rational as long as it does not negatively alter margins. However, offering a wide variety of products and services may also be demand driven. It is quite likely that the most profitable fees are charged on fund of funds. But large customers and institutions can be “fee sensitive” and keen to tailor-made solutions. Finally, proposing different services, as advisory mandates, can also be strategically motivated since more profitable long term client relationships (discretionary mandates) can be formed with clients who may first be attracted by a lower cost solution.

The bottom panel in exhibit 2 shows that Swiss fund of funds overwhelmingly find their clients in mainland Europe. The UK, however, is still an important market. Presence in other regions is relatively small. At least 70% of the funds of funds in this survey estimate their presence outside of Western Europe to be insignificant or nil. Hence, companies in this survey clearly favour closeness to clients rather than closeness to hedge fund managers.

The Portfolio Construction Process

We now turn to one of the central pillars of the fund of funds business model: the process which is put in place to construct and manage their funds. This survey has put a particular emphasis of the portfolio construction process which is the driving force behind fund of funds performance.

Fund of funds managers have almost since the emergence of the industry had to justify their intermediation role between investors and hedge fund managers. Many times it has been argued that funds of funds do not add value to clients (e.g. Ennis and Sebastian, 2003). Not surprisingly, all fund of funds in this survey state that industry expertise is the main added value they bring to clients (see exhibit 3). It is also the prevalent view among most funds of funds (88%) to claim that their added value to clients is to deliver alpha performance.

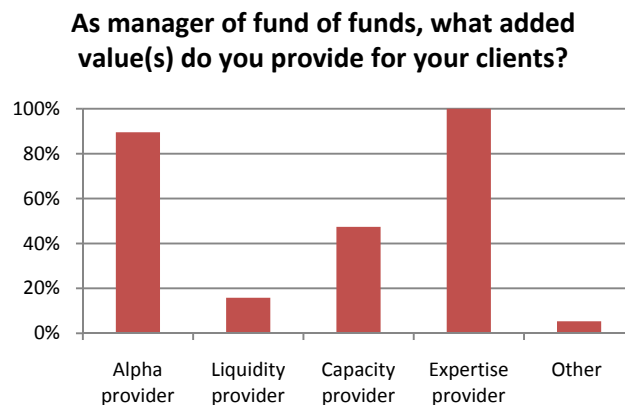


Exhibit 3

The academic debate is somewhat divided on both the issues of offering expertise as well as alpha performance, which of course is closely related. At the center of the debate is how to define alpha performance. Ang, Rhodes-Kropf, and Zhao (2008) claim for example that it is incorrect to compare fund of funds performance against hedge fund indices. A more coherent approach is to compare performance against the set of available hedge fund investments clients' face. They also conclude that funds of funds deliver performance to clients which are commensurate with their fees. There are, however, many articles which conclude that funds of funds do not deserve their fees. For example, Ennis and Sebastian (2003) claim that funds of funds are to a large degree exposed to common market factors; hence they only deliver easily accessible beta exposure and not alpha returns. Fung *et al.* (2008) study fund of funds performance over the period 1998 to 2004 and find that while there exists a subset

of funds which deliver alphas they find strong evidence that the good performance attract large inflows of new capital which in turn hurt future performance.

Alpha performance in itself exhibits risk; that is the level of alpha of a fund varies on a month to month basis. Hence in order to rest assure of earning alpha returns funds of funds ought to be long-term investors so that month of low levels of alpha returns can be leveled out with month of high levels of alpha returns. Exhibit 4, left panel, shows that most funds of funds (85%) have an average holding period in their portfolios of 2-5 years. As can be seen in the right panel of exhibit 4, most funds of funds in this survey also advice their clients to be invested over a period of 3-5 years.

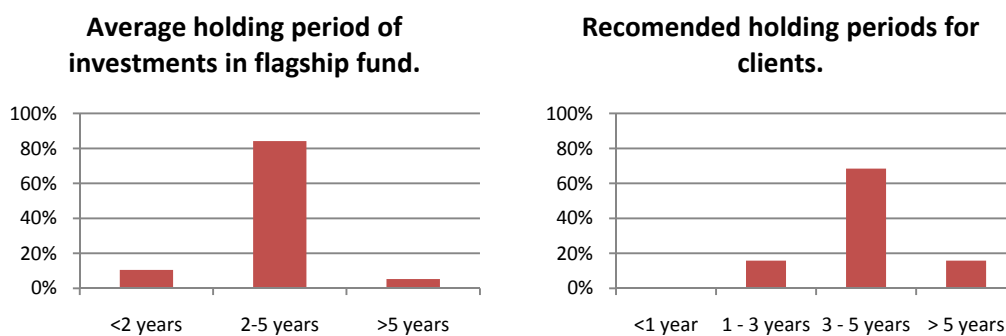


Exhibit 4

However, the rationale for the 3-5 (2-5) year holding period of funds of funds (hedge funds) is in fact seldom questioned. Assuming normality of the alpha part of returns and using standard *t*-statistics, we can easily estimate for how many years one need to be invested in order to be assured that promised returns have been delivered. More precisely the *t*-statistics is

$$t = \frac{\alpha \cdot \sqrt{n}}{\sigma}$$

Assume that alpha (α) is 2% on an annual basis with a respectable volatility (σ) of 4%. Solving for *n* so that *t* is greater 2 yields 16 years ($n=16$). That is investors should wait 16 years to make sure the average 2% delivered is truly and significantly different from zero and not obtained by “pure luck”. Let us now use data on the HFRI fund of funds composite index and make the (questionable) assumption that its full returns have been alpha returns.² With this data we do obtain a respectable 12

² Over the period 2000 to 2008, the HFR FoF index had an average return of about 3.4% and a standard deviation of about 5.9%

years, a much longer period than the average holding period in funds of funds of many investors and certainly more than the 3 to 5 years usually advice to clients.

Note that the rationale for a shorter time period can also be attributed to some form of cyclical variations in returns. There are some academic researches supporting this. Fung *et al.* (2008) show for example that well performing hedge funds also gather large in-flows which seem to dampen future performance. Agarwal and Jorion (2010) find evidence that newly started hedge funds seems to have outperformance during the first 2-3 years of existence. During the consecutive years, however, performance seems to drop. These findings support the idea to have a relatively short investment period in hedge funds, if the fund of funds manager believes he or she can exploit various cyclical patterns. However, it does not support the recommendation to clients to be invested for 3-5 years.

Funds of funds offer, almost without exception, at least monthly liquidity. At the same time their underlying assets have in most cases considerably worse liquidity conditions. In this respect, long notice periods and lockup periods can be very costly for hedge fund investors. Ang and Bollen (2010) find under reasonable assumptions that lockup and notice period restrictions can cost about 4% of the initial invested capital. Interestingly enough, exhibit 4 shows that while the majority of about 90% of the funds of funds in this survey experienced side pockets during the financial crises, only 42% passed on their constrained liquidity conditions to the end clients by also implementing side pockets. However, our data sample is biased since the sample excludes funds of funds which decided to close down and liquidate their funds. In addition, only 18% of the funds of funds in this survey claim to be liquidity providers (see exhibit 5). Funds of funds thus appear reluctant to be perceived as liquidity provider likely due to important liquidity mismatch between the portfolios they manage and the underlying hedge funds in which they invest

	Response %	
	Yes	No
Experienced sidepockets over the past 5 years?	90	10
Implemented sidepockets over the past 5 years?	42	58

Exhibit 5

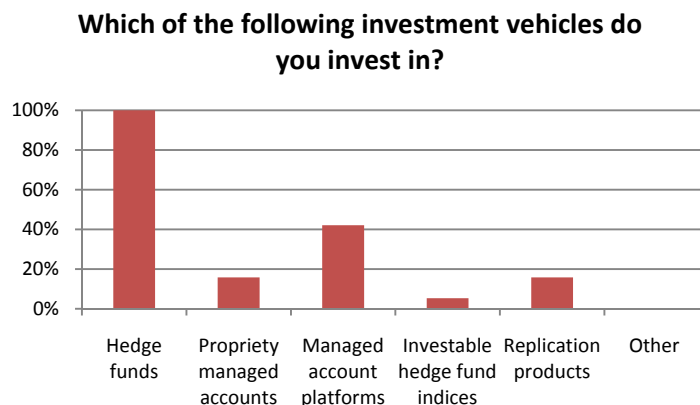


Exhibit 6

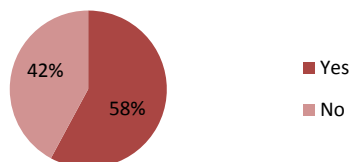
There are obviously different ways to access hedge fund performance in addition to acquiring hedge funds shares. Exhibit 6 lists the investments vehicles used by funds of funds in this survey. All funds of funds naturally make direct investments into hedge funds. Managed account platforms has recently gained momentum and emerged as an investment vehicle that gives better asset control and better insight into the holding of hedge funds. We see in exhibit 6 a considerable popularity for this form of investments with 40% of funds of funds which use it.

Replication products aim to be low cost and liquid alternatives to hedge fund investments. They showed promising performance during 2008 and 2009 according to Wallerstein, Tuchschnid and Zaker (2010). As can be seen in exhibit 6, only 16% of funds of funds currently use replication products. However, about 1/3 consider investing in replications product going forward (see exhibit 14).

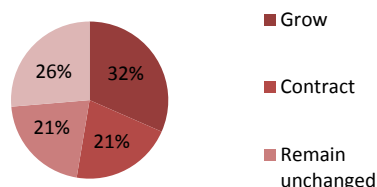
Secondary markets of hedge fund shares have been organized over recent years in order to mitigate liquidity constraints of exiting hedge fund investments. The majority of funds of funds in this survey has also taken advantage of this as can be seen in exhibit 7, top left panel. However, as the top right panel in exhibit 7 shows, only about 1/3 believes the hedge fund secondary market segment will grow in the future.

Exhibit 7, bottom left panel, presents the investment approach funds of funds use. For this survey we have chosen to label the process as bottom-up, top-down, or a mix of the two. Most funds of funds (63%) us a mix of the two while 26% use a pure bottom-up approach and few (11%) us a top-down approach.

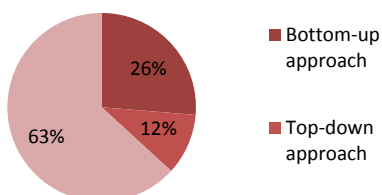
Have you over the past 5 years used secondary markets of hedge fund shares?



How do you believe the secondary market for shares in hedge funds will evolve?



Categorization of investment process.



Avg. Number of funds in flagship fund of funds.

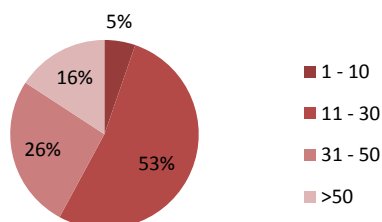


Exhibit 7

We found that 74% have a separate risk management team. Furthermore, we also found that almost all funds of funds in this survey involve analyst-, portfolio manager- and risk manager-teams in their due diligence process. In terms of due diligence process, most participants, or 79%, spend about 3 to 6 months to complete their due diligence process and as many as 89% revise it at least annually. All these findings suggest that the trend among funds of funds is to be increasingly institutionalized with minor differences across companies when it comes to investment and due diligence processes.

In their portfolio construction process, funds of funds managers appear to be focused mainly on diversifying the manager specific risk through manager selection. Even if a majority of funds of funds (almost 65%) has recently experienced a hedge fund failure (fraud or blow up), exhibit 7, bottom right panel, shows that most maintain a concentrated portfolio of 11 to 30 hedge funds (53%) and do not expect to reduce the specific risk on managers (84%).

Return attribution of the portfolio performance is done on a regular basis by as many as 95% of funds of funds. As can be seen in exhibit 8, most funds of funds (94%) claim that fund of funds indices are the most suited benchmarks, followed by Libor plus (absolute return objective) and surprisingly by equity indices.

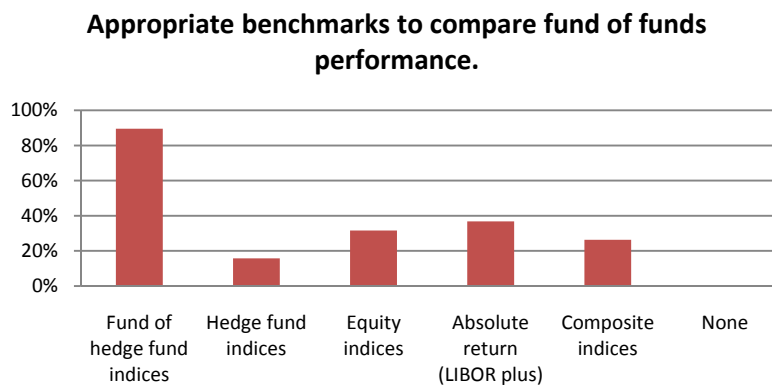


Exhibit 8

In exhibit 8 it is interesting to note that risk diversifier vehicles with supposed low correlation to equity markets are sponsoring directional benchmarks (i.e. equity indices). Comparing a mix of different markets with specific alternative risks factors to single equity indices is in fact incomplete and might be misleading. However, the use of traditional equity indices might be due to a clientele effect. Indeed, as more institutional investors, e.g. pension funds, insurance companies, banks, endowments, allocate capital to funds of funds, the use of widely accepted benchmarks might be required.

To summarize, even though the traditional allocation model to hedge funds still pertains there are indications that managed account platforms and the secondary hedge fund market will play an increasing role in the industry. Furthermore, funds of funds also present a lot of similarities when it comes to their selection or due diligence process. In parallel, most funds of funds state that they recommend clients to have a 3 to 5 year investment horizon which we argue is difficult to justify on a sound theoretical foundation. Interestingly, little consensus seems to exist on how funds of funds benchmark their products, a result that naturally stems from the heterogeneity of hedge fund strategies that in turn renders difficult the choice of a well-defined and unique point of comparison.

The Outlook for the Industry

This section will turn to the views on the future of the Swiss fund of funds industry. Exhibit 9 presents responses on which challenges going forward are perceived to be the most important for the industry. As can be seen here, the most significant issue is to meet client expectations. Allocations to hedge funds require indeed clients to understand well the investment opportunities to then set sensible return expectations. We conducted a cross sectional analysis where answers on concerns of meeting client expectations was compared to the client base of the company (see exhibit 1). A higher or lower degree of concern in meeting client expectations could not be pertained to any group of companies in terms of their client type. There is thus in general a demand to educate as well as to communicate reasonable expectations to the full spectra of clients. This result can also be analysed in light with what happened during the financial crisis and the disappointing downs and ups performance of funds of funds that caught many clients by surprise. In this context, delivering positive, stable, and uncorrelated returns seem now to be perceived by funds of funds as especially demanding.

The often discussed liquidity mismatch in fund of funds portfolios and regulation onslaught did also emerge as either significant or very significant challenges for the fund of funds industry in Switzerland.

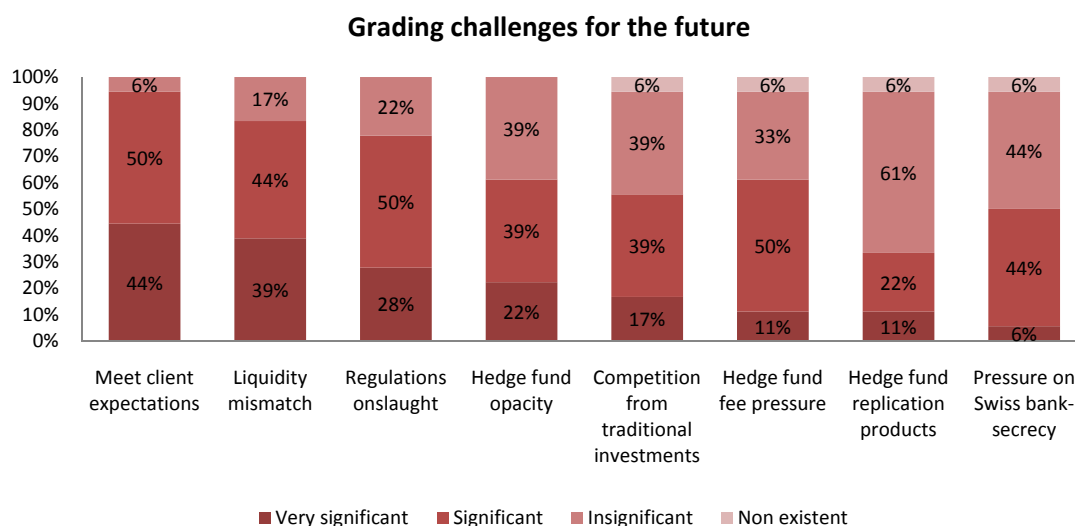


Exhibit 9

Exhibit 2, bottom panel, highlighted the Eurocentric presence of current clients. Exhibit 10 presents the results from a similar question on the growth opportunities for the coming 12 month in terms of region. As can be seen from this panel, growth opportunities for Europe (ex. UK) still remains, with

44% respondents believing this region has large growth opportunities. This is followed by Asia (33%) and it stands in contrast to the current presence of clients, with only 5% of funds of funds admitting to have a very significant presence of clients in this part of the world. Hence, it is reasonable to assume that Swiss funds of funds plan to increase their presence in this region which is likely to pose a challenge for them.

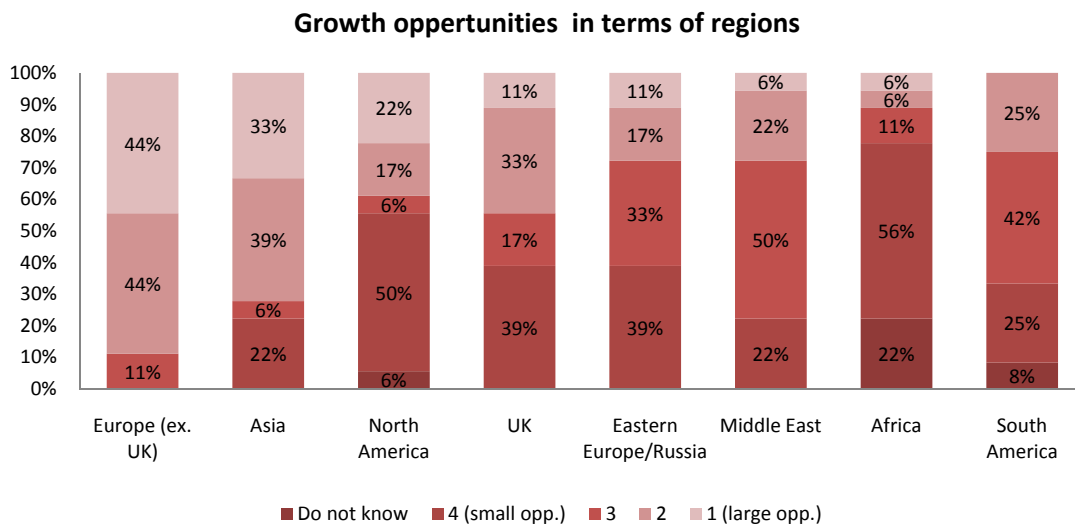


Exhibit 10

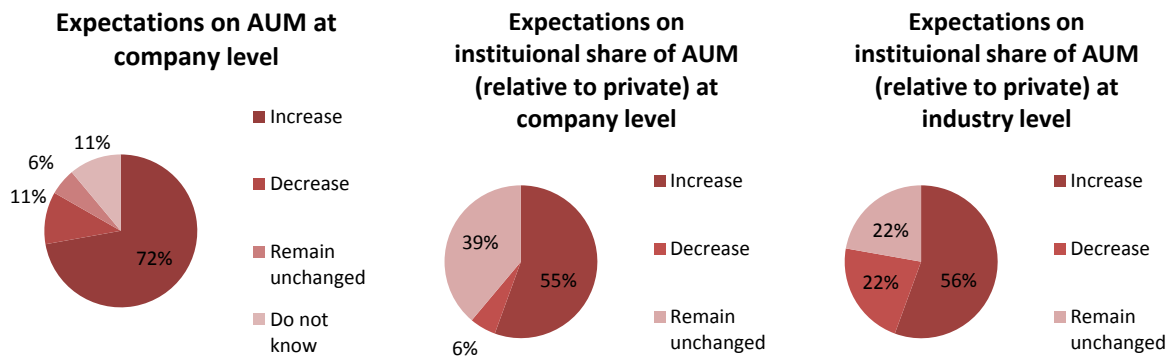


Exhibit 11

Exhibit 11 presents the results from three questions on expectations of AUM flows. From the left panel in exhibit 11 we see that most companies are optimistic. 72% expect to see their AUM increase over the coming 12 month. The mid and right panel of exhibit 5 present the outlook of which clients, either private or institutional, will increase or decrease their investments in hedge funds. 55% of the participants in this survey expect institutional clients to constitute a larger share of their own AUM

going forward. The views for the future are similar when looking at an industry level. However, about 22% believes institutional clients will play a smaller role on overall industry level as compared to 6% on a company level.

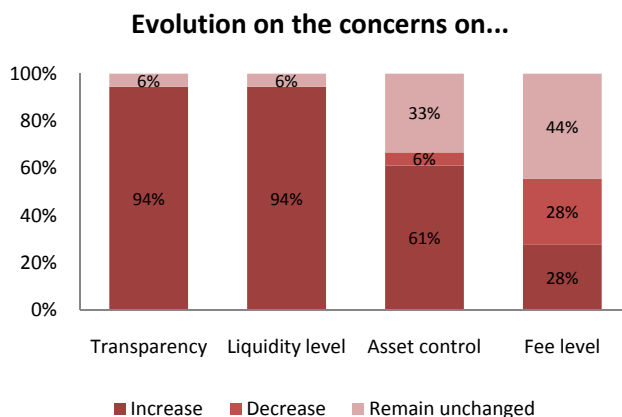


Exhibit 13

Some frequently mentioned concerns on hedge fund investments are fee levels, transparency, liquidity, and asset control. Exhibit 13 presents the responses on the evolution of these issues in the hedge fund industry over the coming 1-2 years. Transparency and liquidity was overwhelmingly viewed as to be an increasing concern. Asset control seems also to be of increasing importance. Somehow more surprising, 72% believes fee-levels will not be an increasing concern going forward.

Exhibit 14 presents a more detailed view for the future with regards to fee-levels. When interpreting these figures one should bear in mind the frequent criticism of fee-levels in the industry after the poor performance of 2008. In this respect, 44 % of the participants in the survey expect to renegotiate fees with hedge funds and 39% with their clients. With this in mind it is somewhat contradictory that 72% believes fee-levels will not be an increasing concern.

	Response %	
	Yes	No
Expect to renegotiate fees with clients:	39	61
Expect to renegotiate fees with hedge funds:	44	56
Invest or consider investing in replication products:	33	67

Exhibit 14

Hedge fund replication has caught much attention over recent years. They were heralded to compete with hedge fund fees and bring better liquidity to hedge fund portfolios. Exhibit 6 presented results on the interest in replication products. A considerable share of funds of funds (33%) in this survey has invested or considers investing in replication products. Exhibit 11, left panel, presents results from

some further questions asked to this subgroup. Not surprisingly, the most prominent reason, stated by 83%, is to use hedge fund replication as a liquidity enhancer.

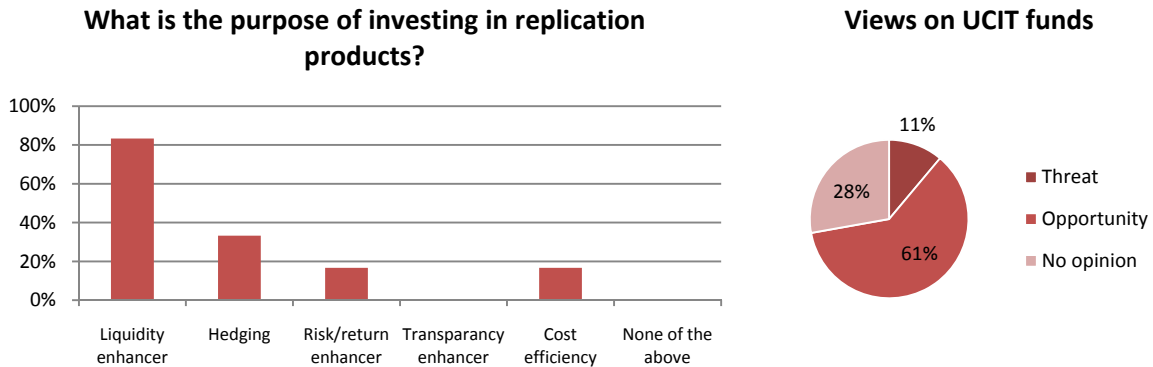


Exhibit 15

The UCIT fund structure is promoted to bring better regulation around hedge fund investments and specifically be required to keep a high level of liquidity. The right panel in Exhibit 15 shows that funds of funds indeed view UCIT funds as an opportunity for the business.

There has been an ongoing pressure on regulatory issues from the EU and the US on Switzerland. We found in our survey that 47% believe that going forward; Switzerland is advantageous to operate in compared to other countries in terms of domestic politics and regulation. 41% did not believe this and 12% were uncertain. Yet, Switzerland seems still to be the preferred choice of location for operational headquarter. Only 11% of companies in this in this survey consider moving their operations outside of Switzerland.

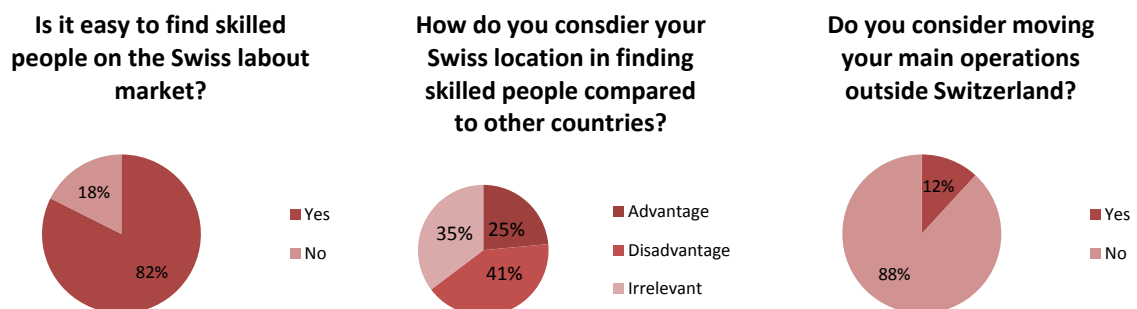


Exhibit 16

In the ambition to keep Switzerland as one of the foremost centres for funds of funds it is important that the region is able to provide these companies with skilled people. 82% in this survey (see exhibit

10, left panel) found the Swiss labour market to be sufficient in meeting their demands on finding skilled workers.

Exhibit 17 present some results on how resources on a company level will be going forward and how people believe the number of funds in the Swiss fund of funds industry will evolve. Most companies believe the growth of resources will be zero or increase at company level. At the same time most companies believe that the overall fund of funds industry will contract over the coming 12 month.

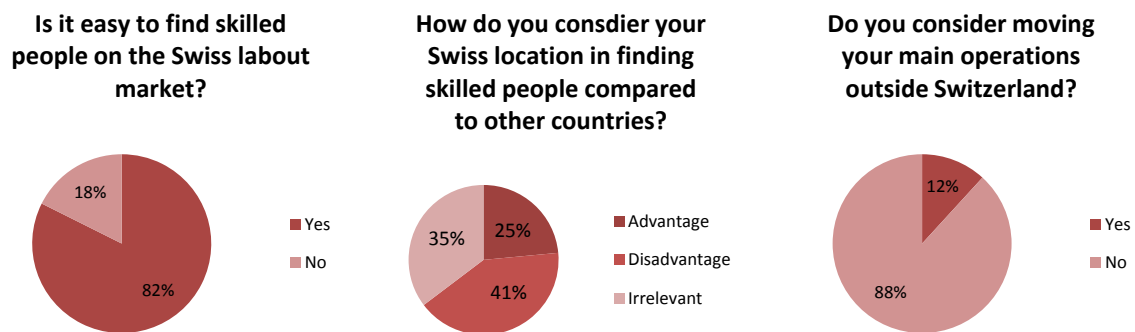


Exhibit 17

To summarize, the challenges for funds of funds in Switzerland are of diverse nature. Meeting client expectations is perceived as the most challenging issue. Some could advocate this result shows an industry that is client centric. Others may argue that it is the result of oversold promises during the prosperous years preceding the crisis and with managers who now are facing pressure to deliver. In parallel, close to a majority of funds of funds in this survey believe fee-levels needs to be renegotiated. Yet, few seem to believe fee levels to be a concern for their business going forward. Finally, we understand the positive attitude towards the UCIT fund structure as indicative of an increasing pressure on funds of funds with regards to liquidity and regulation of hedge fund investments.

Conclusion

Given the sluggish results of 2008 and the rebound of 2009, the claim that most of the funds of funds are alpha providers seems to be a bold one. In this respect, we find it particularly interesting that the most pressing challenge for the industry is to meet client expectations.

Our survey suggests that funds of funds, regardless of size, do not deliver bulletproof due diligence process of hedge funds—one of the key services offered to clients. We base this on the fact that the majority of funds of funds have over the past five years experienced a hedge fund failure (fraud or blow up).

This survey found an increasing interest in launching products under the well-regulated UCIT structure. This is symptomatic of the increasing regulatory pressure as well as to increasing demand for transparency and liquidity.

Swiss funds of funds in general offer several different investment services, as tailor-made portfolios or advisory mandates. This business model, however, entails concerning conflicts of interest. Funds of funds have limited access to most of their hedge funds. This stems from the hedge fund industry's inherent limitations of capacity where large capital inflows dilute performance. Hence clients of funds of funds should question which customers are severed first in terms of most promising investment opportunities. The clients shall require more information about the processes fund of funds companies have put in place to deal with capacity constraints of hedge funds.

The bird's view of the Swiss fund of funds industry which this survey offers suggests that within this industry we face relatively homogenous set of companies. Their client base is in Europe. They apply similar fee structures. The majority argues to be alpha providers. None are specialised on certain hedge fund strategies despite their limited human resources. From a client perspective this is worrying, since there are not many differences between funds of funds to base a selection process on ... unless to believe that one "pick" fits all.

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