Fund of hedge funds: origins, role and future

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The emergence of the fund of hedge funds (FoHF) was the natural evolutionary outcome of the appearance of the hedge fund itself and its consequential rapid rise to success as a result of offering absolute returns to a market where the generality of world savings was invested in relative returns. However, the lack of transparency, large minimum required investment and some early highly publicised accidents restricted access to this investment class mainly to high net worth individuals. To overcome this, the concept of packaging hedge funds into funds of hedge funds was born, though at first with mainly institutional investors using these funds as providers of ill-defined alpha rather than introducing them into their portfolios as a particular style.

From this simple beginning, the role of the fund of hedge funds has evolved into today's fully-fledged multi-manager. This progression occurred naturally as the growing concern to identify more rigorously the type of risk from which hedge funds generated their returns and the need for managers to prove their added value meant that, increasingly, funds of hedge funds had to clarify their role in terms of risk management, asset allocation and reporting as they do today. A lack of experience, together with the complexity of risks to which hedge funds were exposed, highlighted both the importance of making a risk assessment prior to an investment, and the importance of risk management during the investment's lifetime.

Despite a better understanding of risk exposures and alpha sources, building a well-diversified multi-manager portfolio remains a difficult task. However, due to their in-depth knowledge of alternative styles and their use of an investment process combining top-down asset allocation and bottom-up manager selection, funds of hedge funds have been able to build robust portfolios, generating absolute returns over the long term. Furthermore, capitalising on their ability to consolidate and interpret information from various hedge fund managers has allowed funds of hedge funds to produce meaningful reports for their investors.

Over the last few years, it has been thought that the huge inflow of money into this universe would exhaust the source of alpha. However, this capacity constraint concern has since faded (to be replaced to a certain degree by manager constraints) and funds of hedge funds have been able to strengthen their role by providing secured access to a diversified source of alpha as a result of their ability to identify, monitor and time risk factors.

The knowledge acquired in understanding and evaluating the role of skills in producing absolute returns has also proved to be of value when applied to the traditional space, and has contributed to broadening the added value of the managers' institutional proposition. As funds of hedge funds have become fully-fledged multi-managers in their own right, they are also now able to compete in the institutional sector with the traditional multi-manager.

1| ORIGIN OF FUNDS OF HEDGE FUNDS

The emergence of the fund of hedge funds was the natural evolutionary consequence of the appearance of the hedge fund itself and its rapid rise to success. During the 1980s, hedge fund capital grew by several hundreds of billions of dollars, offering absolute returns to a market where the generality of world savings was invested in relative return funds linked to traditional benchmarks. Fuelled by their superior performance, absolute returns generated by hedge funds went from 15% per annum (versus a balanced world index of 10%) in the 1980s to 19% (versus a balanced world index of 9%) in the 1990s. (see Chart 1)

On a risk-adjusted basis, absolute returns have performed four times better than relative returns –contrary to general belief. Even when the abnormality of absolute returns is included in the risk quantification, investors who were used to evaluating their investment on a relative risk basis (i.e. on the risk of underperforming the traditional benchmark) recognised that relative risk had to be reconsidered in the evaluation of the probability of benefiting from positive performance. This new attitude dramatically increased the attraction of absolute risk adjusted returns and of hedge funds. Mitigating this success, however, was the lack of transparency offered by the new breed of hedge fund managers, jealous to guard the secrets of their successes.

Inevitably all hedge fund managers were not born equal. Since 1993, several accidents (Granite CTA (1993), LCTM (1998), Manhattan (2000) and more recently Bayou Capital (2005) and Amaranth (2006)), have made headlines that have sulphur-tainted the success story. Greed and fear played their roles in the selection of hedge funds and in the positioning of these investment vehicles in an optimum manner. Moreover, hedge funds broadly were reserved for high net worth clients able to make the minimum required investment of upwards of USD 500,000. These forces came together to spawn the creation a diversified portfolio of hedge funds accessible to lower level uptake.

Chart 1
Performance comparison – absolute vs relative return
(Monthly data, January 1990 – December 2006)

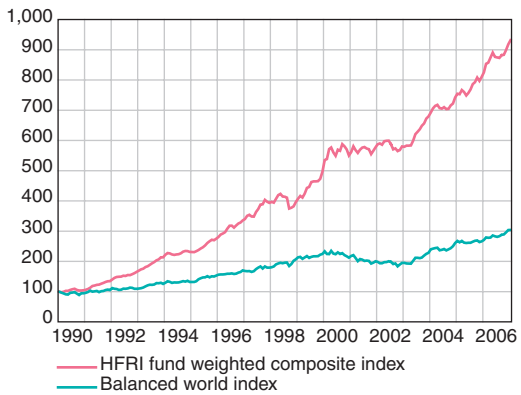
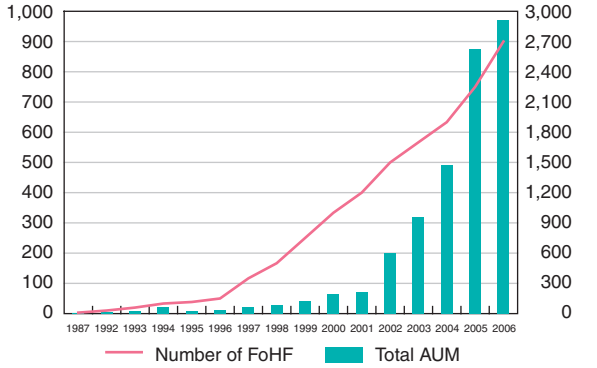


Chart 2
Funds of hedge funds (FoHF) growth
1987-2006
(USD billions) *(number)*



Sources: Hennessee Group, Barclay Group

Hedge funds packaged into funds of funds were an evolutionary success story that led assets under management (AUM) to USD 42 billion by the end of 1999, soaring to USD 972 billion by the end of 2006 and to one trillion dollars today – 111% cumulative per annum growth over the period. (see Chart 2)

Packaging indeed it was, with added value from the manager consisting mainly in offering a simple diversification and some mutualisation of the specific risk with an average number of investments amounting to between 10 – 25 different hedge funds. Such a simple construction led the managers to concentrate on investing in the larger and most successful hedge funds for which due diligence and evaluation of performance was easier to achieve than for younger, more specialised funds that did not offer a long track record. In other words, fund of fund managers were relying in most cases on the successful hedge funds to make their own offering attractive with little added value other than that of providing access to quality capacity. This had the immediate consequence of

fund of fund returns converging quickly to the mean return of hedge funds (less the fund of fund fees), with very little dispersion around the mean. Another consequence, less noticeable in the beginning but nonetheless consequential for the industry, was that institutional demand for these products resulted in lower fees as fund of funds were substantially similar and managers were not yet competing on added value. This situation led institutions, encouraged by consultants, to look at fund of funds as an asset class (as differences were not obviously identified) and to introduce them into their otherwise traditional portfolios as providers of ill-defined alpha rather than introducing them as a style with the accompanying benefits in terms of asset allocation.

In other words, investing in alternative products consisted mainly in monitoring the tracking error of the traditional allocation model resulting from the introduction of absolute return.

This situation lasted until the early years of the present decade, when increasing concern over the need for the more rigorous identification of the type of risk from which hedge funds generated their returns, as well as the growing need to stand out from the crowd and embrace the challenge of adding value in order to survive, began to take effect. To convert the fund of hedge funds business from a popular (albeit not well understood) fad into a solidly based industry, their role evolved from the original simple model to today's fully-fledged multi manager, allocating capital by strategy rather than by asset class or geography. Indeed, some time ago, as globalisation took effect, geography as a means of diversification disappeared. At the same time, bonds and equities in the deflationary boom cycle (such as the one we have been in since 1980) have been seriously correlated thus reducing significantly the quality of a traditional balanced mandate. So, allocating capital to different hedge funds meant, de facto, allocating capital to different styles and strategies. With this, the role of a fund of hedge funds became clear –to select the best managers for the relevant style, ensuring quality of performance and capacity, as well as structuring the appropriate liquidity to allow for an optimum dynamic allocation process.

2| HEDGE FUND RISK

Hedge funds make the headlines with unfortunate regularity. High profile collapses, generally accompanied by huge losses for investors and (less well-publicised) lengthy and costly legal engagements, are a well-travelled track.

Amaranth and Bayou Capital are two recent, notorious cases –though the causes of each collapse were very different. Amaranth, a respected multi-strategy American hedge fund, lost almost USD 10 billion from a single massive spread bet on energy futures that went against them. The loss was never recovered and the company ceased activity not long after. In the case of Bayou Capital, the company defrauded investors of half a billion dollars by manipulating illiquid security prices with the help of it own associated brokerage company.

These two examples illustrate the variety of risks to which a hedge fund investor is exposed. Fraud and market risk are not the only dangers. Because many hedge funds use significant leverage in an effort to generate outsize returns, even a small investment management blunder can cause a massive implosion. A hedge fund is not a risk-free investment.

Risks are commonly divided into three categories: market risk, investment management risk and operational risk. The Financial Services Authority (FSA) estimates that around twenty hedge funds collapse every year. The majority of these appear to be the result of operational risk (fraud and/or inadequate resource and structure) and only around 40% to be the result of investment risk (e.g. market and/or investment management).

Since hedge funds operate in a lightly regulated environment, little prevents a fund manager from misleading his investors. The investor (or the multi manager) has to fully understand and accept these risks and carefully monitor them. Risk management has therefore to be present at every stage of the investment process, a process that generally starts

with in depth due diligence (the initial risk assessment exercise applied to any candidate hedge fund). To this risk assessment is added a market risk analysis of the fund and its strategy.

The decision to invest in a hedge fund has to be accompanied by an effective monitoring process. This monitoring is only possible if a sufficient level of transparency can be obtained from the hedge fund manager.

Provided that these conditions are met, the investor is in a good position to manage his allocation passively or dynamically according to his own mode of management.

3| DUE DILIGENCE

Due diligence is the voluntary investigation of the business, legal and operational aspects of managers targeted for investment. The depth of the due diligence exercise is entirely up to the hedge fund investor. As it is now commonly accepted that the process significantly reduces the manager specific risk, proper due diligence is now considered as industry-standard by the great majority of fund of hedge fund managers.

Due diligence typically covers two main areas: the operational and legal set-up of the fund and of the management company, and the investment strategy and related risk management policy (if any). The first of these will typically include a brief history of the firm, the principal biographies, the various service providers and how they interact as well as the level of responsibility and accountability of the various parties. The second is aimed at describing how a hedge fund produces its returns, the type of instrument traded, how they are traded, how the portfolio is constructed and what are the risk management policies.

A more thorough review can be made. The inclusion in the due diligence of the fund service provider (administrator and prime broker, auditors) can, for example, be beneficial. This might enhance the independence of the pricing system (for illiquid securities) and other key factors in evaluating operational risk (e.g. ownership, staffing, execution procedures etc.).

Some companies would also include in their due diligence a principal background check and references (i.e. Securities and Exchange Commission filings, legal past or pending legal litigations).

A thorough due diligence should be an integral part of the process of investing in hedge funds and should never be overlooked or considered as a bureaucratic constraint. In the case of Bayou, proper due diligence would very likely have raised issues relating to the potential conflict of interest brought about by the ownership link between the management company and its brokerage arm. However, due diligence would not have protected against the collapse of Amaranth.

Due diligence can also be used in the asset allocation process by limiting the exposure to hedge funds that appear weak operationally but still show great potential (i.e. start-up funds).

In depth due diligence may require the extensive use of resources and where a hedge fund, perhaps by design, has a short opening and closing period to raise capital, the individual investor has a limited time to make an informed decision. As experts, funds of hedge funds can help in this process by providing skills and infrastructures that contribute to the reduction of manager specific risk.

4| TRANSPARENCY

The hedge fund industry has a culture of (occasionally justified) secrecy that poses problems for due diligence and risk monitoring.

Hedge funds are under no obligation to disclose information to investors. However, growing pressure from institutional investors is gradually imposing new standards of transparency such as weekly pricing, exposure reports, sector allocation etc. There are still improvements to be made, in particular in areas such as offering memorandums that define what a fund manager is allowed to do (as evident in recent discussions on PIPEs - private investments in public equity, side pockets and/or other complex fee or redemption term structures). Nonetheless, we have seen over the last few years significant changes. In general, hedge fund managers are now willing to cooperate with a due diligence exercise.

Full transparency, however, though conceptually appealing, poses its own questions. For instance, it is in everyone's interest to keep the hedge fund manager's competitive advantage quiet –if anyone wants it to remain so. Full transparency can erode a hedge fund's competitive edge and precipitate the collapse of the vulnerable. Transparency risks generating a false sense of security in investor and regulator alike. Full and timely transparency did not lead to the raising of a red flag about Amaranth's. Self evidently, hedge fund managers are remunerated for their ability to produce return and manage their specific risk and not for the data they provide to their investors. Amaranth's dutiful registering with the SEC of their long exposure did not prevent its collapse. But to argue that increased investor transparency requirements have reduced hedge fund performance is probably to exaggerate.

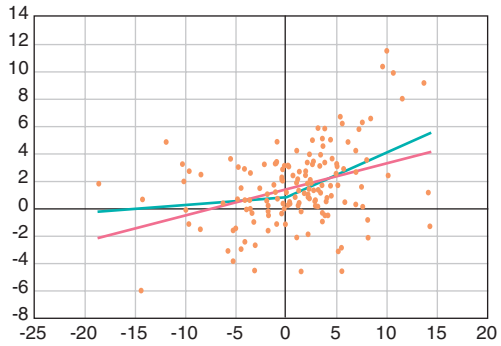
Nonetheless, an investor reasonably needs to monitor the risk to which he is exposed and appropriate transparency can be achieved without compromising the proprietary nature of a hedge fund's investment strategies. Disclosure can be limited to aggregated performance, exposures (long and short) and specific risk indicators (such as greeks, value-at-risk, margin to equity etc.). Some well-known quantitative third party risk management software providers now offer products and infrastructure that allow the fund manager and investors to share information without compromising confidentiality. A minimum level of transparency should include performance/risk attribution and contribution, broken down into meaningful categories (depending on the strategy), top exposures and strategy-specific risk measures.

Yet an investor can be rapidly overcome by the amount of information that needs regularly to be processed. This again is where fund of hedge funds can add value by providing skills and infrastructure to monitor investments and allocate capital accordingly.

5| RISK ASSESSMENT

A basic step in any alternative risk management process is to partition the universe of hedge funds into categories. In the alternative world, this partitioning exercise is generally driven by the manager's skills that determine the investment style or strategy, rather than by the more traditional asset class or geography sector that is commonplace in the long-only space. This is well illustrated by alternative index vendors who publish monthly returns of risk arbitrage, long-short equity, convertible bond arbitrage etc.

Chart 3
Regression analysis
(%; DJ EuroStoxx 50 monthly returns X-axis; Hedge fund monthly returns – Y-axis)



A hedge fund investor must then be able to identify the drivers or risk and return of each strategy and sub-strategy. Various quantitative methods can be used to analyse and monitor the systematic exposure of each strategy –the most straightforward one being simple or multiple regression analysis.

In addition to traditional market exposure, hedge funds are also exposed to 'alternative' factors, *e.g.* factors that result from the systematic approach of an investment style. Moreover, because of the active nature of most styles, it is important to recognise the non-linearity of the risk/return profile and its implications for the methods used in the quantification and monitoring of the relevant relationships. This is illustrated in the chart below that shows the relationship between the monthly returns of a well-known European long/short manager and the EuroStoxx 50 index.

In Chart 3, the red line measures the sensitivity of the return to the factor using a linear model; the green line uses a piecewise linear model (with slopes varying according to the direction of the market – positive versus negative). This analysis illustrates the typical non-linearity (the green is not a straight line) in the relationship between the hedge funds return and the reference index. This option-like pattern is typical of an absolute return manager – e.g. this analysis suggests that on average, in the long run, this manager loses less money than he gains.

This regression analysis also allows the identification of the alpha that is made up of 'pure alpha', or the manager's skills in selecting securities, as well as alternative betas, i.e. normal returns generated from an exposure to systematic risks, other than market risk. The change in the return profile of hedge funds is more likely to be due to a change in the value added through dynamic betas, which depends on the ability of managers to time factors successfully, whereas the level of pure alpha is linked to the number of opportunities available on the market.

For example, a very common strategy in the long/short equity was to have a long exposure to small cap equities and a short exposure to large cap equity. The sensitivity to this 'spread' cannot be well captured simply by analysing a small and large cap relationship separately. This is because there is a time dependent correlation between these two factors that is exactly what the fund manager is trying to exploit. For technical type strategies, a hedge fund investor can construct his own synthetic risk factor – for example to describe the return of a long volatility style, a simple benchmark can be constructed by combining a market index with a basket of options with the appropriate pay off structure. For trading, a simple benchmark can be constructed by applying a classical technical algorithm on a reference market index. This type of approach is obviously not suitable for all types of investment strategies.

Armed with these tools, a risk manager is in a much better position to understand the nature of the systematic risk to which he is exposed and to detect any potential drifts that are not easily identifiable through a basic analysis based purely on market factors.

The critical step in this approach is the ability to understand the fundamental nature of the strategy of the manager. This is where qualitative expertise comes into play.

This approach of systematic beta exposure analysis is universal but is irrelevant for some strategies that are more driven by market events. However, it remains one of the many risk indicators that should be analysed, despite its having the limitations common to any historical data analysis.

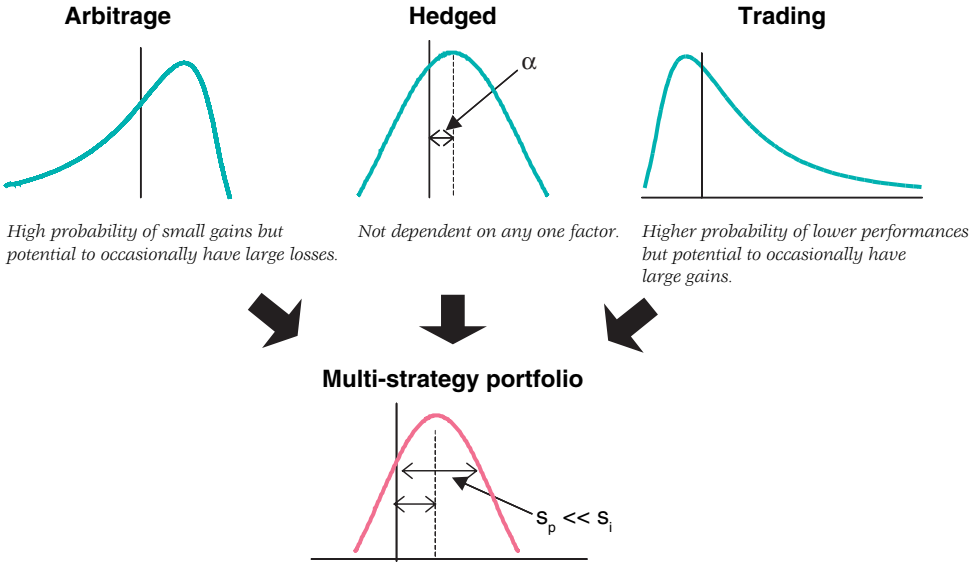
6| ASSET ALLOCATION

Despite all the risks associated with hedge funds and the difficulties of monitoring them, many believe such funds can play a constructive role in a well-diversified portfolio and it is here that risk management and portfolio management skills come into play. Traditional risk management techniques such as mean-variance analysis, beta and value-at-risk do not fully capture many of the risk exposures of hedge fund investments.

The very first question –how many hedge funds need to be invested in to diversify risk?– requires some careful thought given the nature of the risk involved. It cannot be answered by simply considering the correlation of historical returns because the variance and the covariance do not tell the whole story. To account for manager specific risk, another risk indicator (or maybe more than one other) that is more sensitive to the downside risk needs to be considered. The downside standard deviation, the conditional value-at-risk with or without Cornish Fisher expansions or the expected shortfall are good candidates. In most cases, there will probably not be a simple analytical solution and the answer to this simple question will almost certainly require some complex simulation analysis with the inevitable loss of generality that goes with it. Most simple studies suggest a minimum number of hedge funds to be in the range of ten to twenty. However, when introducing operational risk into the model, this number increases to dozens, resulting in a possible over-diversification of the alternative and traditional risks and their associated trading costs.

What percentage of a hedge fund portfolio should be allocated to a given manager in order to maximise the risk/adjusted return and/or satisfy a risk-return objective? There is no definite answer to this. Traditional asset allocation methodologies (mean-variance, capital asset pricing models, Black-Litterman methods) suffer from the same limitations as when used for traditional asset classes (historical bias, instability, complexity etc.). Moreover, for a hedge fund portfolio, the additional difficulty in measuring the risk of a portfolio of hedge funds and the non-normality of return makes these various

Chart 4
Gaussian and non gaussian distribution
(%)



approaches at best limited and, in most instances, inadequate. The answer to this question is still a matter of debate between academics and practitioners.

The generation of absolute returns requires an in-depth knowledge of alternative styles. Despite being referred to often as one single class, hedge fund strategies cover an extended range of styles, which have little in common with each other. Correlations between the various alternative styles are not stable and an active asset allocation allows the preservation of the risk and return characteristics of a portfolio over time. Similar to the long-only universe, this active process requires the combination of both a top-down and a bottom-up approach.

The top-down asset allocation starts with the identification of the macro-economic and common hedge fund factors, which have an impact on the risk and return of individual styles. The factors provide a statistical basis for the forecast of each strategy/style performance under various economic and market scenarios. Once the factors have been identified, the weights to each style, based on the mandate of the portfolio, can be allocated.

A key for the protection of an investor's capital and enhancing return is the active management of the asset allocation through a portfolio construction process based on those various alternative styles, geography and asset classes. As shown in chart 4, the distribution of returns is very different from one style to another. The management of a multi-strategy portfolio requires the blend of various strategies to provide a more stable return distribution with a higher positive alpha.

Once the weights have been defined at the portfolio level to optimise its risk and return profile, it is necessary to review and adjust the weights of the managers within each style. This can only be successfully achieved if hedge funds are properly classified between the various styles, which supposes an in-depth review and full understanding of the manager's investment process. The weights by managers are adjusted taking into account their risk contribution within the style and within the portfolio, their expected returns, based on their sensitivity to the style forecasted return and a qualitative review of the manager skills.

The bottom-up manager selection starts with the screening of the entire hedge fund universe to identify attractive new managers, which have then to be classified according to the identified styles. Based on the initial assessment and categorisation, a full due diligence process is set up in order to review in detail the qualitative, quantitative, legal and operational robustness of the manager.

A challenging step following the top-down asset allocation and the bottom-up manager selection is the reconciliation of the two processes in order to build a robust portfolio. The main challenge is to assess to what extent the risk, return and correlation forecasted for the style indices during the top-down asset allocation can be applied to the individual managers identified by the bottom-up selection. The more precise the definition of the styles and the more detailed the categorisation of the manager, the more accurate and robust will be the extrapolation of the forecasts from the indices to the managers. This is critical as it allows one to assume limited divergence between the managers and the relevant indices and to model the relationship using a linear equation under a single index model.

The robustness of any asset allocation model can obviously only be guaranteed by a regular review of both the top-down and the bottom-up processes. As correlations between styles are not stable, it is important to review the macro-economic and hedge fund factors regularly in order to adjust the style's weight and to preserve in the long term the portfolio performance. Similarly, managers within the portfolio have to be reviewed closely and on a regular basis to ensure that hedge funds do not drift from their original style and that their risk and return characteristics are in line with what is expected, i.e. that the manager does not significantly underperform his peers.

A useful tool for the manager review is to monitor abnormality or red flags. It is up to the investor to define these red flags and to put in place a monitoring process. These could be, for example, abnormal returns, a sudden increase in the fund's volatility, too large price discrepancies between estimates and final prices (for funds which provide estimated performance), or a large change in the hedge fund assets under management. Interestingly, most if not all hedge fund failures have happened to hedge funds, which have previously posted some outstanding risk-adjusted performance. Understanding how performers have achieved their best results is probably as important, if not more important, than worrying about their worst ones. When something looks too good, it is a good time to wonder if this is not indeed too good to be true, especially if a due diligence has raised issues about the pricing methodology used in valuing the fund assets. There is also the qualitative monitoring: change in service providers (such as the administrator or the prime broker) or change of fund terms (liquidity, fees etc.).

The limitation of the red flag approach is that when an abnormality is identified, it can sometimes be too late to be acted upon. This is why a hedge fund investor must have not just one but as many risk indicators as possible to enable him to make a wise and informed judgment.

7| REPORTING

Investing in hedge funds is not a free lunch. Committing money to this asset class is no guarantee of absolute returns. A successful alternative investment is more likely to be made in several hedge funds, allowing for a sufficient level of diversification by managers and across alternative strategies.

For many years, funds of hedge funds have been criticised for the poor quality of their reporting, which focused on comparing returns to a benchmark (often a market index), using indicators designed for the long-only universe, such as the Sharpe ratio. Thanks to the institutionalisation of the industry, the transparency of hedge funds has improved and managers are keener to disclose specific information, such as their various risk exposures, etc.

Despite this increased transparency, it would be a delusion to believe that producing a report on a portfolio of hedge funds is an easy task. The complexity and non-linearity of risks to which hedge funds are exposed cannot be assessed through traditional tools, because using those tools can lead to a significant underestimation of the risks associated to alternative strategies. Therefore these strategies require the use of more advanced indicators, such as style VaR, the Omega ratio, conditional beta analysis, etc.

Moreover, even within the same strategy, not all hedge funds communicate the same indicators to their investors, nor in the same manner. For instance, it would not be possible to compare correlation analyses if they were not calculated versus the same market index, over the same period and using the same frequency of data (daily, weekly, monthly, etc.). The production of a usable report requires infrastructure, as it requires the collection,

combination and interpretation of information received from the various managers.

Over the past few years, investors have been made aware of the importance of transparency when investing in the alternative universe, increasing their requirement for more detailed reporting on their investments. The main challenge facing fund of hedge fund managers is to produce reports that provide clear evidence of the value added and that meet the needs of their clients. For instance, there are no official definitions of the various hedge fund styles, and the categorisation of managers between the various styles can therefore be affected. Through their reporting, fund of hedge funds can help the investor to refine their definition of the various styles and improve their understanding of the alternative universe. They can also develop customised reporting, according to the specific needs of their investors (e.g. identification of specific risk exposures depending on the characteristics of the overall portfolio, i.e. both alternative and traditional allocation).

8| CAPACITY CONSTRAINTS

Hedge funds have been recognised since the 1980s for their ability to generate returns in excess of other asset classes. According to traditional performance attribution models, the part of the return that does not come from the rewards of market risk is considered to be alpha, or the manager skills that generate return in excess of the market. Due to the lack of transparency in hedge funds, it was difficult to identify the various risk exposures that they took, and most of their returns were considered as alpha. As academic research and transparency have progressed, hedge fund returns have been broken down into other sources of return and the portion of unexplained return, or alpha, has sharply decreased. However, alpha generation remains a corner stone in the hedge fund industry.

The capacity constraint issue first emerged with the need to identify managers able to generate alpha over a long period. Performance comparisons between hedge funds with a short track record and usually with small assets under management, and older funds with larger assets, highlight the overperformance of the former group of managers. Similarly, a manager will tend to generate higher return in the earlier years of his performance. However, those results should be put into context, as market conditions can significantly differ between the launch of a fund and its later maturity. Moreover, this does not imply that a manager with a long track record or large AUM is unable to continue to generate alpha.

Hedge funds managers usually define a maximum amount of AUM above which they consider they cannot fully implement their investment process and therefore generate alpha. As soon as this amount is reached, the fund is closed to new investment. Depending on the strategy, this amount can be limited to two hundred million dollars (e.g. ABL specialised hedge funds) or several billion dollars (e.g. global macro managers). From the investor's point of view, a closed hedge fund means not only a manager able to generate alpha on a consistent basis, but also a fund to which it is obviously almost impossible to gain access. Funds of hedge funds, due to the large range and long-term profile of their investments, are able to identify managers in their early years, while the alpha generation is at its maximum, and secure capacity when the fund reaches a more mature stage and is closed to new investment. Therefore, through their portfolios, funds of hedge funds are able to offer exposure to a long-term alpha-generating pool of managers.

Over recent years and with the declining returns of hedge funds, a new concern has emerged – that the capacity constraint shown at manager level has been extended to the overall hedge fund industry, with only a fixed amount of alpha available in the alternative universe. The large inflow of assets and the increased number of hedge funds would therefore reduce the alpha generated by each manager.

As described earlier, the pure alpha (i.e. stock selection) component accounts only for a limited part of a hedge fund return, while the active alternative beta timing constitutes the largest part of what is commonly called alpha. The overall amount of opportunities available in the market cannot be increased indefinitely and this could limit the production of pure alpha by hedge fund managers. However, regarding alternative betas, there is currently no clear evidence that new and existing managers are any less able than in the past. Even if the capacity of a manager to forecast trends and time factors can be affected by the market environment, it is not possible to conclude that this capacity has a tendency to decline with the increase

in the number of participants. The importance of beta timing as a way of generating excess return in the long term should be noted.

While the capacity constraint at the manager level is an issue for investors, the capacity constraint at the industry level is a myth. Funds of hedge funds can provide a solution to the capacity constraint at the manager level, by investing in new managers and securing investment capacity with closed funds. Nevertheless, the most important role of funds of hedge funds related to the capacity issue is the alternative beta identification and their ability to build portfolios diversified across the various risk exposures.

9| THE FUTURE

In the main, the future of funds of hedge funds depends on two factors: the continued growth of absolute returns in satisfying institutional requirements and the continued commitment from funds of hedge funds to adding value and constructing superior institutional portfolios.

The growth of institutional investment in hedge funds, directly or indirectly, seems set to continue at least at the same pace as in the past so long as the capacity for alternative and active investment styles continues to expand sufficiently and sustain growth in the AUM of multi managers operating in the alternative space. In other words, with close to 5% of the institutional pool of money invested today in alternative investments, the point of no return has been reached and the process of shifting from relative returns to absolute returns is irreversible. Such a trend is well illustrated by the increasing number of RFPs (requests for proposal) being despatched by institutions worldwide, and by the large influx of new types of clients, such as pension funds, entering the alternative space and contributing to its expansion.

As to the second, the commitment of funds of hedge funds in continuing to add value can be best reflected by the fact that, while they have so far been successful in generating absolute returns from decorrelated alpha, their ambition has, over the last five years, broadened to include market-related returns. Indeed hedge funds were the first to introduce market beta into their portfolio and capture market returns whenever appropriate. For example, several hedge fund managers have made it known that they will expand their long-only portfolio and reduce the proportion of their short positions. This evolution has not gone unnoticed by fund of hedge fund managers who, as a consequence, have had to integrate market directionality into their asset allocation model. In fact, the experience acquired in understanding and evaluating the role of skills in producing absolute returns, proved also of value when applied to the traditional space and contributed to broadening the added value of the multi managers' institutional proposition. Now that funds of hedge funds have become fully-fledged multi managers in their own right, they should be able to compete in the institutional sector and accept (as is their obligation) the responsibilities that go with that position.