The quintessential blend

Which hedge strategies and vehicles are plan sponsors choosing?

IT IS NOW accepted wisdom that hedge funds are increasingly making their way into institutional investors' alternative investment portfolios. In large part, it is the promise of above-market return that has made hedge funds so magnetic to corporate and public plans, a promise that is particularly alluring in an unhappy market. "The lower the equity markets [go], the stronger the appetite for hedge funds," observes Hal Lindquist, senior investment officer, Blackstone Alternative Asset Management. Adds Lori Runquist, senior hedge fund product manager for Northern Trust Asset Management: "In the past, interest in hedge funds was largely driven by a desire for risk reduction. Today, it's more a search for return."

Where specifically is all this money headed? As a first step into hedge funds, many plan sponsors have gravitated naturally to funds-of-funds. "It's not dissimilar to what happened between Commonfund and the endowment community," says Stephen McMenamin, a pension fund advisor and managing partner of Greenwich, Connecticut-based Indian Harbor LLC. "The pension funds want to invest in funds-of-funds for an initial exposure to hedge funds, but they also demand to see the names of the underlying managers. Having received an education, then they can directly approach well-performing managers over time."

Meeting this demand has been an explosion of multi-manager supply. "Some of this product is very good, and a great deal is very bad," says Jon Lukomnik, a managing partner of consulting firm Sinclair Capital LLC and a former pension fund manager for the **City of New York**, "but, the pension funds need this type of service because many are not staffed up adequately to select their own hedge fund managers in terms of quality and scale." Plan sponsors also are looking for some sort of institutional stamp of approval on their investments. "Plan sponsors want some degree of tracking, transparency, and fiduciary responsibility in their hedge fund investments," says McMenamin, "and the bigger institutions are increasingly providing this type of middle-man stamp of approval to pension fund clients. It's more defensible to put money with a Deutsche Bank than some small hedge fund on your own."

Indeed, Deutsche Bank's Absolute Return Strategies Group has been among the most aggressive in constructing institutionally oriented hedge fund products. In addition to traditional funds-of-funds, the firm offers single-strategy vehicles such as the Deutsche Convertible Arbitrage Fund. In this product, the bank will choose either inside or outside managers within the convertible bond universe and then take active responsibility for monitoring these managers, providing back-office functionality and analytical transparency to the ultimate client. Likewise, the Goldman Sachs Hedge Fund Strategies Group has raised more than $4 billion in hedge fund assets across four fund-of-funds programs—long/short equity, event-driven, tactical trading, and relative value market-neutral. "We are true believers in the diversification benefits of owning multiple hedge fund managers," says Kent Clark, CIO for the Hedge Fund Strategies Group. "As a result, we have not yet provided external single-manager funds with a Goldman Sachs endorsement."

Banks are not the only players in the space. "Some private equity firms are migrating into funds-of-funds management," says Joe Pescatore, a Lehman Brothers alternative investment advisor to institutional investors, "and many mutual funds are starting to roll out their own hedge fund products as well. Putnam, Old Mutual, and J.W. Seligman are all now active hedge fund managers. It remains to be seen, of course, whether any of these offerings will be particularly good or not. Many will likely still include substantive long bias."

While the flows of institutional monies into these vehicles is on the rise, only a small minority of pension funds see hedge funds as a stand-alone asset class, consultants say. However, there are other ways that plans can come to terms with hedge funds, including the growing popularity of so-called portable alpha. Portable alpha is best understood if one assumes

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a pension fund manager takes $100 million and buys an equivalent amount of S&P 500 futures, but, in lieu of leaving the required 10% margin money in support of this position invested in T-bills, the plan sponsor invests an equivalent amount in a fund-of-funds. **BP Amoco**'s pension fund was among the first institutions to embrace and popularize the concept of "portable alpha" and, for a variety of reasons, most pension fund managers feel far more comfortable with this concept as opposed to treating hedge funds as a stand-alone asset class. This may revolve around hedge fund capacity constraints or the belief by many pension fund managers in efficient market theory. However, for whatever reason, there is little expectation that hedge fund investing should in any way displace traditional investing in stocks and bonds. Instead, hedge fund investing is seen as a way to complement traditional investing—specifically to soften the return profile of traditional long-only programs, and to end up with added yield on top of benchmark returns. A whole new lexicon has even started developing around this process. Adding hedge funds on top of an index-oriented equity investment is now called "equitization," and doing so on top of a fixed-income program is called "bondization." According to Maarten Nederlof, a managing director at Deutsche Asset Management, some four out of every five pension fund managers consider hedge fund investing as an extension of their investment program, with labels such as enhanced indexing and equitized long/short programs. "Pension managers are usually evaluated relative to a benchmark," says Nederlof. "They prefer products that include benchmark returns versus those that do not."

Where there is demand for index-oriented products combining several sources of yield, there is, of course, supply, and Wall Street has been quick to start developing a wide range of new structured products around hedge funds. Shane Gadbaw, a managing director at Zurich Capital, sees a huge derivatives market developing around hedge funds. "Investment banks that were largely scared away from hedge funds in 1998 are now looking for new business areas of revenue growth, and this is one of them. There is hardly a firm out there that isn't developing products around total return swaps, call options on hedge funds, and principal guaranteed notes. The whole concept of collateralized debt obligations is starting to be applied to this industry in collateralized fund obligations. The swapping of synthetic exposures is already a huge business."

One bank structurer goes on to describe a $1 billion offshore fund launched earlier this year that was wrapped around a group of first-tier hedge managers previously closed to new investment. In this case, a bank promised each of these managers new money under attractive three-year lock-up provisions. The bank, meanwhile, offered institutional investors quarterly liquidity to invest in the fund and only a slight mark-up on underlying manager fees. "Everyone was happy," explains the structurer. "The investors got access to otherwise inaccessible first-tier managers, and the hedge fund managers attracted stable long-term capital. The slight premium in fees paid by the investors was worth it to them."

As well as considering different vehicles, plan sponsors are considering different styles. Even as consultants generally shun so-called "statistical arbitrage" managers that trade short-term market differentials between paired securities and sectors, the consistent success of stat arb-oriented managers such as D.E. Shaw and Millenium Partners has drawn a large institutional interest. "Stat arb and fixed-income arbitrage are most certainly part of our portfolio" says one large plan sponsor, "and, while we consider them as market-neutral most of the time, we are aware that, a bit like slipping on a banana peel, they can go awry in spades in certain environments. That is why we tend to build our entire portfolio assuming stressed market conditions, and keep these allocation sizes light."

Transparency also remains an issue, but maybe less of an insurmountable obstacle than it once was. Plan sponsors historically have been uncomfortable investing in hedge funds where market exposures cannot be monitored and where fee structures are far higher than traditional long-only fund-management norms. However, slowly behind the scenes, certain tradeoffs are being made. These tradeoffs typically involve added transparency in exchange for longer lock-up periods. Different classes of shares with different fee structures also can play a part in this process. One New York-based merger arbitrage manager attacks the transparency and fee issue with a tiering of share classes. "If a pension fund manager will agree to a three-year lock-up, I not only offer a class of shares that has a discounted management and incentive fee, but I will also provide that client with my top 10 holdings, as well as all my real-time risk and leverage statistics," explains this manager. On such a basis, and working through consultants who have approved his fund, this firm has succeeded in attracting approximately $700 million from endowment and pension fund clients—or almost half of its total assets.

There remain other problems for plan sponsors with hedge funds: the issue of leverage and the lack of benchmarks, in particular. "Institutional clients may migrate back toward simple active-equity management where fund managers worry less about building up cash from time to time or the consequences of creating benchmark 'tracking error,'" says Robert Jaeger, vice chairman and chief investment officer of Norwalk, Connecticut-based Evaluation Associates. "That type of manager became something of an endangered species as we moved to a benchmark obsession in recent years, but maybe demand for this type of traditional manager will come back. At the end of the day, there could be 48 different reasons why pension funds hesitate to fully embrace hedge funds."

The data, thus far, however, suggest a different story. Hedge fund managers raked in $86 billion in new assets during 2001, according to Hennessee Group, an inflow equal to the combined funds thrown at hedge funds over the prior three years, and the bulk of that inflow was institutional. The anecdotal evidence also is impressive. "I have never received such a steady flow of inquiry from pension funds looking into convertible arbitrage, merger arbitrage, long-short managers, as well as multi-strategy and multi-manager hedge funds. Private equity is still alive, but interest in hedge funds is truly hopping," says McMenamin. —*Barclay T Leib*