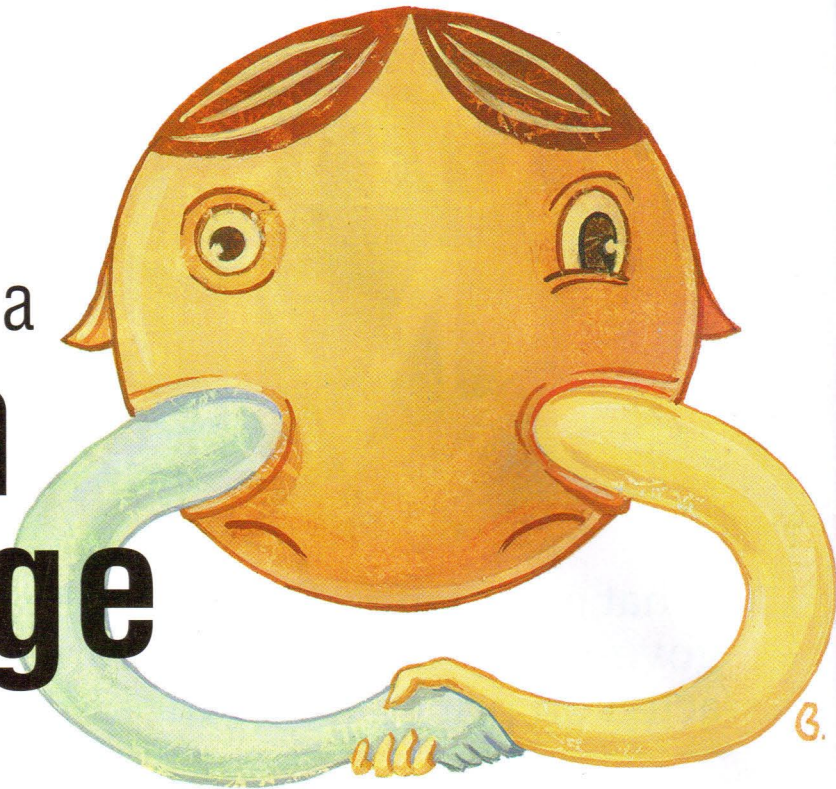


The beginning of a common language



When John Griswold, executive director of Commonfund Institute, looks back at the growth of endowment investing in hedge funds over the past decade and contemplates similar growth within the public and corporate arena, he sees a story led in both instances by the best and the brightest.

"If it was not for the early creative policies of the managers at Harvard, Princeton, and Yale to invest in alternative assets in a large way," says Griswold, "and the consistent outsized returns they achieved over the years, we would certainly not be where we are today." Where we are today, according to Commonfund analysis, is at an all-time high of 32% of endowment assets invested in alternatives, with a growing proportion of that total allocation going to hedge funds as opposed to private equity or real estate.

That said, there is clearly still a gap between the hype and the practice when hedge funds and institutional investors intersect. Nonetheless, *PLANSPONSOR* is sufficiently confident to make five predictions as to what the world of alternative investing may look like for plan sponsors in the year 2008, five years hence.

1. If plan sponsors on average currently have less than 3% of their investments in hedge funds today, this number will have swelled to 10% on average by 2008. Long-only benchmarking will lose its luster, and absolute return will be the order of the day.

Plan sponsors bemoan hedge funds' high fees, the lack of

transparency, and the tendency of hedge fund managers toward style drift. Going forward, while the fiduciary need for added transparency certainly remains, much of this past trepidation is being put aside.

A report by Putnam Lovell and New River estimates that "US and public pension plans alone will have about \$527 billion invested in hedge funds by 2010, up from \$87 billion at year-end 2001." According to the report, institutions are going to "reconsider the fundamental implications of modern portfolio theory" and conclude that diversifying across traditional benchmarks and asset classes simply is not sufficient.

"If there is one major change that I foresee in endowment and plan sponsor investment behavior over the next five years, it is that the days of relying only on long-only investing and style-based benchmarking are numbered," says Mark Yusko, president and CEO of UNC Management Company. "Just as endowments have learned over the past decade that hedge fund strategies are much more diverse than just wild macro traders, a realization should slowly dawn on plan sponsors that hedge funds are simply a form of active equity management that can actually reduce risk and enhance portfolio returns. We're all going to move to a better model than just judging ourselves against a long-only capitalization-weighted benchmark." Yusko is acting on this belief—he already has reduced the endowment he manages for the University of North Carolina to a long-only equity exposure of less than 7% of its total portfolio.

In terms of transparency, the plan sponsor community

already has begun asking for more transparency to meet “Prudent Investor” requirements and, while there is resistance from some hedge funds, many are beginning to provide detailed statistical exposure reports. “In the future, there will still be some small boutiques, but there will also be far more multistrategy hedge fund organizations catering to institutional needs and demands,” says Sandra Manzke, co-chief executive officer of Rye-based hedge fund consultant Tremont Advisers.

2. Investment banks will be accepting fees from hedge fund managers for institutional capital introductions.

Over the past two years, a substantial business has emerged in investment bank capital introductions of hedge fund managers to institutional clientele. Any prime broker worth its salt has a capital introduction group, and has changed the dynamics of distribution. “Word of mouth and prime broker introductions are, without a doubt, the primary way a hedge fund manager gets my attention,” says one Toronto-based hedge fund allocator for a major public pension plan. “Consultants are still important, of course, but less so than in the past.”

largest self-managed plan sponsors—will look to buy funds of funds managers. Accordingly, watch for M&A activity to heat up around funds of funds asset management companies. Hedge fund due diligence and portfolio construction expertise will be joined at the hip with investment capital—a natural combination.

4. Investment management companies will find ways to bring hedge funds into their product set.

The demarcation between traditional money managers and hedge funds has already started to blur, and will continue to do so. Some fund managers are even attracting institutional money into hedge funds without labeling it such. “I was recently visiting a fund manager on the West Coast, and this firm had all of these small pension plans invested into its new hedge fund offering,” says Joseph Pescatore, a managing director at UBS in charge of hedge fund capital introductions. Pescatore asked one of the firm’s principals how they had ever succeeded in attracting these investors. “He said that it was easy: His firm just doesn’t call the product a hedge fund, but labels it, instead, as one of their traditional products that has ‘added resiliency’ in adverse market environments.”

“There will be far more multistrategy hedge fund organizations”

To date, investment banks have stopped short of becoming straight third-party marketers, wary of any perceived conflicts of interest that fee-sharing with hedge fund clients might cause. Instead, the prime brokerage units of these firms have been content to use these capabilities to bind their hedge fund clients more tightly with them, but this is likely to change. “We’re not that far away from the day when an investment bank will make the leap to become directly paid by underlying managers,” says a consultant. “Properly disclosed, there’s really no reason that this shouldn’t happen. Banks will eventually just say to fund managers: ‘As long as you’re paying third-party marketers for high-net worth introductions, why not just pay us for more significant institutional access.’”

3. The rush to funds of funds

There is, it is generally recognized, a surplus of funds of funds managers. As one pension fund manager quips: “Just as they say there are more mutual funds in the US than there are underlying equities, it seems to me that there must be more funds of funds than underlying hedge fund managers.”

Some of these funds of funds will prosper, some will be bought, and many more will simply fade away when they show they can’t add value. However, there is a school of thought that a handful of investment managers—and perhaps even the

Mainstream investment managers are adding hedge funds or quasi-hedge funds with alacrity. Wellington Asset Management has already developed a stable of hedge fund offerings with an in-house fund of funds as well; PIMCO has attracted \$500 million to its fixed-income hedge fund. MacKay Shields, says chairman and chief executive Ravi Akhoury, started a high-yield hedge fund, quickly raised more than \$500 million and just as quickly closed it to new investors. But don’t expect all new offerings to be great performers. As Akhoury notes: “If you decide to launch hedge funds, you better have the right people. Every good long-only manager is by no means a good hedge fund manager.”

5. Increased SEC scrutiny and regulation of the hedge fund industry will occur, but it is unlikely to stop these instruments from becoming more central to plan sponsors.

There are no win-win situations in any asset class. “Many hedge fund investors think they can have it all—15% annual returns, low monthly volatility, low correlations, and high alpha,” says Jon Lukomnik, a consultant with Sinclair Capital and former CIO for the City of New York, “but, at the end of the day, you’ve always got to give up something. There are always tradeoffs.” —*Barclay T Leib*