Quality Control

How to Make Sure You Add the Right Hedge Fund to Your Soup

by FRED DOPFEL

Back in the early 2000s, the BlackRock Multi-Asset Client Solutions (BMACS) Group's Client Strategy team noticed a pattern of client inquiries surrounding hedge funds and, more specifically, how they might fit within institutional portfolios. My mantra became: "Waiter! What's this hedge fund doing in my soup?" (see sidebar on next page). The title is a play on a joke about a diner who asks the waiter to explain why a bug is in his soup. The waiter's explanation, "well, sir, it appears to be the backstroke," is literally correct, but doesn't really answer the client's question.

In the case of hedge funds and alternatives, the client's question needs to be answered clearly. Your portfolio is a soup. It is a blend of asset classes and managers. If indeed very spicy ingredients like alternatives strategies are in the recipe then you—*the chef de cuisine*—must determine that they are quality ingredients, and also blend them in proper proportions.

Quality Ingredients

In "Waiter! What's this hedge fund doing in my soup?," we looked at the performance of hedge fund styles in up- and down-markets. The hedge funds (by style and as a whole) showed low correlation with market indexes when client portfolios were performing well, but, shockingly, showed significant positive correlation with market indexes when client portfolios were doing poorly. That defeated the diversification benefit that clients had hoped for in stressed markets. A plague of bad bugs in your soup!

The finding about average hedge funds pointed to the need to select hedge fund strategies with a high level of care. We codified that by saying you should only select "institutional quality" hedge funds. But what is institutional quality?

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For a hedge fund to be institutional quality, two requirements must be met:

- Investor must clearly identify hedge fund's factor exposures, providing an unambiguous separation of alpha and beta from total returns;
- Investor must skillfully judge whether or not the hedge fund manager has the ability to produce a positive expected alpha.

These criteria apply both to the candidate hedge funds and to the selection process of the investor. The first requirement ensures that the investor can understand how an allocation to the hedge fund impacts his overall portfolio risk via the risk of the hedge fund itself and covariance with other allocations—a definitive separation of alpha and beta. The second requirement concerns skill. This skill requirement is not exclusive to hedge funds but applies to incorporating any active strategy in a portfolio. The point is worth repeating here because of the complexity and lack of transparency of some hedge fund strategies. It is the most critical question because the ultimate goal of investing in hedge funds is to find a positive expected pure alpha, and this is only possible with above-average skill.

Kitchen Checklist

If I were to rewrite the paper today, I would dedicate more time to operational and governance issues. In other words, how do you know if the manager's hedge fund kitchen could pass a restaurant inspection?

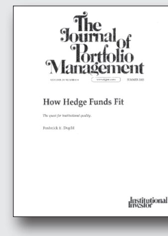
The "Connoisseur's Checklist" (see next page), developed by my colleagues Rick Arney and Pete Wilson from BlackRock's Alternatives Investment Strategy Group, points out that institutional investors need to carefully consider both investment and operational implications when selecting alternatives strategies, including the support of an organization that can provide good governance and risk management expertise.

Blending the Soup

Having quality ingredients is not enough; the chef must know how to blend them in the proper proportions. The BMACS Client Strategy team has helped individual clients assess the sizing and composition of the alternatives portfolio. The characteristics of the alternatives portfolio has been a hot topic these days for two reasons: 1) many plans are derisking by selling off equity allocations and increasing alternatives allocations; and 2) since the credit crisis, liquidity budgeting has become an important consideration for investment policy.

"Waiter! What's this hedge fund doing in my soup? How hedge funds fit into the institutional investor's portfolio," *Investment Insights*, March 2005.

"How hedge funds fit: The quest for institutional quality," *Journal of Portfolio Management*, Summer 2005.



Ask your account manager for a copy.

There is no general rule that applies to all plans for the sizing of the alternatives allocation, or its composition. Whenever we are asked to look at client portfolios, the solution must be considered in the context of the client's current portfolio, the funding sources and the cash demands. The manager structure framework we use for blending alternatives strategies is quite similar to blending active strategies in any other asset class, but here with additional cautions because of transparency issues, complexity, and the aforementioned institutional quality concerns.

More than ever, clients have been asking us to "stress test" their portfolios for various allocations to alternatives against extreme market events—both historical periods of market stress and future (hypothetical) ones. On the liquidity point, we have worked with clients to assess the supply and demand for liquidity and, more critically, to assess the frequency and impact of rare downside events on the plan's ability to pay its obligations.

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The Connoisseur's Checklist

Important criteria for alternative investors		What institutional investment partners should offer
Organizational issues	Fiduciary responsibility	Never trade against or ahead of clients
	Manager experience	A robust platform that allows them to attract, hire and retain top industry talent
	Alignment of interests	Significant principal, firm and employee investments alongside clients
Operational issues	Risk management and continuous oversight	Globally integrated analytical systems capable of 24-hour monitoring; a culture of risk management, an environment where risk is deliberate, diversified and appropriately scaled
	Independent risk monitoring	Clear separation of risk management and investment responsibilities
	Counterparty risk management	Experience negotiating, managing and diversifying counterparty risk
	Operational framework	Robust infrastructure and valuation procedures within a strong culture of compliance
Investment issues	Investment strategy	Diverse set of strategies with unique opportunities to generate alpha Ability to deliver *solutions* rather than *products*
	Performance/track record	Strong risk-adjusted returns and avoidance of negative compounding
	Liquidity, gates and sidepockets	Liquidity matched to investment strategies and adherence to withdrawal requests
	Leverage	Ability to properly mitigate risk with leverage (shorting) and proper leverage monitoring
	Transparency	Full position level transparency
	Fees	Profit for performance

Save the Recipe

Feeling confident about the process of designing the alternatives portfolio is also critically important. We emphasized how investors need to make a reasonable assessment of their own organization's skill in evaluating hedge funds that will produce real alpha. Further, every alternatives investor ought to refine the definition of institutional quality for the special circumstances of their own plan. With such high expectations put on alternatives, and with current uncertainty about market regimes, institutional quality ideas need to be embedded in all our investment thinking. ♦

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