Selecting funds of hedge funds: A survey of the 20 largest funds

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Abstract This study examines the performance of the 20 largest funds of hedge funds from 1995–2002. Various performance measures are presented, to provide pension funds with a simple description of this popular alternative asset class currently gaining momentum in times of poor performing markets. While the largest funds of hedge funds do not necessarily perform better than smaller ones, their emphasis on due diligence and regular monitoring of their managers have allowed them to survive much longer.

Keywords: *hedge funds, funds of hedge funds, performance, Sharpe ratio, maximum drawdown, size*

Introduction

Many pension funds have been adding more of their employees' hard-earned money into funds of hedge funds (a basket of hedge funds) for downside equity risk management. At July 2002, the 20 largest funds of hedge funds in the Zurich Capital Markets (ZCM) database managed approximately \$US 10.4bn. What makes these mammoth-sized funds of hedge funds so successful is not only a proven track record, but also regular monitoring of their managers and due diligence.

In the ZCM database we found nearly half a dozen defunct funds of hedge funds with assets greater than \$500m. These funds have not ceased operating, they have merely stopped reporting to database vendors, probably because their managers no longer wished to attract additional capital. Investors need to

consider not only the size of a fund of hedge funds (in terms of assets), but also how many managers comprise it. Most of the top 20 funds of hedge funds in this study include roughly 20–25 hedge funds (the lowest being eight), which seems to be the ideal number for diversification.¹ While adding more funds can offer some benefits (such as very low volatility) it mostly hampers the manoeuvrability of the fund of funds manager. It could be argued that this defeats the purpose of investing into a fund of hedge funds. While a large fund of hedge funds can absorb the administrative costs of monitoring an undue number of managers, it would need to present a convincing case to justify such a strategy.

When constructing a fund of hedge funds, any potential hedge fund manager must be completely transparent because

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hedge funds are not bound by Investment Company Act (1940) regulations on disclosure. If a fund of funds manager is not willing to provide performance numbers regularly and does not provide annual reports that describe the objectives and goals of the fund, or restricts any other information on the fund or on its personnel, it would be better avoided. It is only through active management of a fund of hedge funds that timely entry and exit of managers can be determined. Keeping the same hedge fund managers over many years in a passive strategy may result in its premature demise.²

All funds of funds in this study actively oversee the operations of their hedge fund managers on a regular basis, to monitor the fund and its activities, such as changes in personnel or investment style drift. Well-managed funds conduct standardised person-to-person interviews with each manager at least once a month, to discuss the manager's economic outlook and how it may impact the sectors within which the fund is operating. Some fund of hedge fund managers assign a points system to each fund, based on characteristics such as transparency, track record, and future performance objectives. Industry professionals have often pointed out that managing a fund of hedge funds is a 'people business' more than a 'money business'. Certainly Rothschild's Leveraged Capital Holdings (the oldest fund of hedge funds) would agree, as it has been interviewing its managers regularly since the fund was started in 1969.

Data

The data for this study consist of monthly returns net of all fees ranked in terms of assets under management at 31st July, 2002. The 91 monthly returns of

funds of hedge funds from January 1995 to July 2002 were obtained from the ZCM Hedge Fund database, which includes both offshore and onshore funds. The LaPorte Asset Allocation System Software is used to generate statistics. This time frame was selected because 1995 was the first of five years of high double-digits returns for both the S&P 500 and the MSCI World indices, whereas during the period 2000–2002 these markets performed poorly. It was therefore felt that this starting point would make the study more pragmatic.

The performance returns and various descriptive statistics of the top 20 funds of hedge funds are displayed in Table 1 for the period January 1995 to July 2002. The funds are listed highest to lowest in terms of assets under management. We include the fund's Sharpe ratio (assuming a risk-free rate of 4.25 per cent), compounded return, standard deviation, along with various indicators of drawdown. The alphas and betas of each fund of hedge funds against the MSCI World Index, the S&P 500 Index, and the Salomon Aggregate Bond Index, are displayed in Table 2.

Results

As indicated in Table 1, the majority of funds had good performance for the period under consideration. Six funds achieved compounded returns of over 200 per cent, but only two of them had Sharpe ratios greater than unity, meaning high returns are also accompanied by high volatility in most of these funds. The largest five funds of hedge funds were not the top performers in the group and did not have the highest Sharpe ratios. It is reassuring that these same funds do not need many periods to recover from their maximum drawdown (see Table 1).

Only a handful of funds had alphas

Table 1: Performance of the 20 largest funds of hedge funds January 1995 to July 2002

Funds of Hedge Funds	Millions ending 31st July 2002	Compounded return (%)	Annualised standard deviation	Annualised Sharpe ratio	Probability next year's return is above 7%	Maximum drawdown (peak to valley) (%)	Months to recover from maximum drawdown	Highest monthly return (%)	Lowest monthly return (%)
Hausmann Holdings	2,500	127.78	11.07	0.66	0.64	16.99	0	9.50	-9.00
Permal Investment Holdings	1,500	122.49	12.31	0.58	0.62	17.80	0	10.15	-13.59
GAM Diversity Fund	1,357	195.38	9.37	1.13	0.78	11.91	6	10.13	-7.92
Olympia Star Series	1,085	146.77	6.45	1.23	0.79	3.94	4	6.82	-2.73
Leveraged Capital Holdings	800	146.41	12.76	0.67	0.65	22.41	0	13.03	-11.45
GAM Trading Fund	455	229.51	5.65	2.08	0.94	1.91	2	7.24	-1.91
Asian Capital Holdings Fund	330	22.64	15.11	-1.00	0.39	37.32	12	14.02	-9.71
GAM Multi Europe Fund	304	205.95	13.06	0.87	0.72	19.39	13	15.98	-14.16
Prima Capital Fund	303	94.31	9.86	0.51	0.58	19.27	0	7.52	-12.02
GAM Multi-Europe Fund (EURO)	253	243.20	15.70	0.85	0.72	19.44	10	16.95	-13.88
La Fayette Holdings	221	226.20	13.70	0.90	0.74	19.92	12	18.10	-11.71
Greenway Investments (EURO)	212	70.50	4.67	0.62	0.53	12.69	14	4.18	-6.78
Global Hedge Fund (SWF)	162	65.22	4.08	0.61	0.49	9.98	8	3.83	-5.62
Sperry Complete Manager Fund	145	123.26	10.87	0.64	0.64	12.42	5	10.57	-9.25
GAM Emerging Markets	138	41.33	18.48	0.11	0.45	42.85	11	18.13	-14.05
CSAM G7 Equity Long Short Fund	137	278.36	8.26	1.67	0.90	8.02	5	9.71	-7.95
GAM Trading Fund	134	218.33	11.88	0.99	0.76	12.20	2	16.77	-12.20
GEMS Low Volatility Fund	123	107.27	3.13	1.74	0.82	3.44	3	3.97	-1.47
Permal Emerging Markets	119	56.92	14.69	0.19	0.48	39.62	0	10.54	-14.80
Wafra Starvest Funds	118	94.10	11.18	0.46	0.57	18.78	14	8.02	-11.51

Table 2: Alpha, Beta, and Correlation of 20 largest funds of hedge funds with MSCI World, S&P 500 and Salomon Bond Index, January 1995 to July 2002

Funds of Hedge Funds	Relation with MSCI World Index			Relation with S&P 500 Index			Relation with Salomon Aggregate Bond Index		
	Alpha	Beta	Correlation	Alpha	Beta	Correlation	Alpha	Beta	Correlation
Hausmann Holdings	0.69	0.49	0.65	0.53	0.43	0.63	0.95	0.02	0.01
Permal Investment Holdings	0.68	0.47	0.56	0.55	0.40	0.52	1.01	-0.09	-0.03
GAM Diversity Fund	1.07	0.29	0.46	1.01	0.23	0.39	1.35	-0.17	-0.08
Olympia Star Series	0.98	0.05	0.12	0.97	0.05	0.12	0.67	0.51	0.33
Leveraged Capital Holdings	0.70	0.65	0.74	0.48	0.58	0.74	1.15	-0.13	-0.04
GAM Trading Fund	1.34	-0.01	-0.03	1.35	-0.02	-0.06	1.15	0.27	0.20
Asian Capital Holdings Fund	0.04	0.49	0.48	-0.04	0.35	0.38	0.81	-0.73	-0.20
GAM Multi Europe Fund	1.03	0.49	0.56	0.91	0.39	0.49	1.61	-0.45	-0.15
Prima Capital Fund	0.49	0.51	0.76	0.31	0.46	0.76	0.86	0.13	-0.05
GAM Multi-Europe Fund (EURO)	1.17	0.53	0.50	1.03	0.43	0.45	2.13	-0.98	-0.27
La Fayette Holdings	1.19	0.35	0.38	1.13	0.25	0.29	1.37	0.02	0.01
Greenway Investments (EURO)	0.54	0.10	0.33	0.52	0.08	0.28	0.62	-0.03	-0.03
Global Hedge Fund (SWF)	0.51	0.09	0.31	0.49	0.07	0.28	0.68	-0.18	-0.19
Sperry Complete Manager Fund	0.71	0.41	0.55	0.60	0.33	0.49	1.13	-0.29	-0.11
GAM Emerging Markets	0.20	0.58	0.46	0.11	0.41	0.36	1.37	-1.26	-0.29
CSAM G7 Equity Long Short Fund	1.32	0.33	0.58	1.20	0.29	0.58	1.62	-0.18	-0.09
GAM Trading Fund	1.28	0.10	0.13	1.22	0.11	0.16	1.31	0.04	0.01
GEMS Low Volatility Fund	0.78	0.06	0.27	0.76	0.05	0.25	0.88	-0.11	-0.15
Permal Emerging Markets	0.29	0.53	0.53	0.13	0.45	0.50	1.05	-0.68	-0.20
Wafra Starvest Funds	0.50	0.51	0.68	0.35	0.43	0.63	0.98	-0.29	-0.11

(manager skill) greater than one with the MSCI World and the S&P 500 indices (see Table 2). However, most had alphas greater than one with the Salomon Aggregate Bond Index. As expected, most betas with the MSCI World and S&P 500 indices are positive, while most of them with the Salomon Aggregate Bond Index are negative. In other words, fund of fund managers with betas less than unity are less volatile than their respective market indices. As anticipated, when examining the Salomon Aggregate Bond Index a large majority of funds have negative betas as well as negative correlations with this index. Table 2 also indicates that almost one half of the funds have a high correlation (greater than 0.5) with both the MSCI World and S&P 500 indices. Haussman Holdings (the largest fund of hedge funds in this study) and the GAM Trading Fund were found to have the highest and lowest correlation with these indices respectively.

Conclusion

This study suggests that there are marked differences among the 20 largest funds of hedge funds, in terms of risk/return characteristics. Indeed, during the investigation period many funds of hedge funds have had high Sharpe ratios and

low correlation with market indices. Many of these large funds of hedge funds are also among the oldest in existence.

Although a recent study suggested the 50 per cent survival time of funds of hedge funds is 7.5 years,³ the funds of funds in this study have lasted for much longer. Regular monitoring and due diligence has allowed them to adapt to changing market and economic conditions by timely turnover of hedge fund managers. Consequently, they have survived much longer than usually reported in the literature. While some funds performed well, their longevity and ability to weather economic turmoil over the years cannot be denied. This suggests that pension funds can expect a trade-off between longevity and performance in large funds of hedge funds.

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