

# Future of fund of funds up in the air

February 12, 2009

By Frayser White and Joe Mantone

While hedge funds will likely have an uphill climb to win back investor confidence, their brethren funds of funds could be facing an even steeper challenge.

Many hedge funds have recently disappointed investors by failing to make good on promises of growing returns. Indeed, early estimates from research firm HedgeFund.net indicate that hedge fund assets fell an additional 5.8% in January to \$1.748 trillion, largely the result of investor redemptions and fund liquidations.

Meanwhile, funds of funds, which serve as a conduit for investing in multiple hedge funds, ensured investors that they would offer greater liquidity and perform due diligence, but some have been forced to suspend redemptions and disclose their exposure to alleged Ponzi-scheme mastermind Bernard Madoff.

"The whole industry of hedge funds and fund of funds is in immense turmoil," said George Feiger, CEO of Contango Capital Advisors, a wealth management division backed by Zions Bancorp. Feiger told SNL Financial that he believes the loss of investor confidence in the fund of funds structure will mean pain for hedge funds and funds of funds alike.

While Feiger acknowledged that funds of funds have been outperforming the market, he stressed that they have not sustained their previous growth levels. "The returns haven't been terrible relative to markets, but they have broken the promise that they don't go down."

One of the key advantages of funds of funds can be the security of diversification, as they will spread investments across a variety of hedge funds. Also, fund of funds investors can enjoy the returns of hedge funds with lower upfront cost, and the structure gives them access to investment pools that could otherwise only be tapped with high levels of capital. Investor satisfaction was evident in fund of funds fundraising, which grew to \$55.3 billion in 2007 from \$19.7 billion in 2003, according to a report from Preqin Ltd., a data provider for the alternative assets industry.

But as the credit crisis took hold, funds of funds became "one of the hardest hit sectors in the industry," and fundraising through the first 11 months of 2008 plummeted to \$24.8 billion, according to the Preqin report.

The market volatility has led to hedge funds enacting gate clauses in an effort to slow investor redemptions and prevent the disposal of assets at fire-sale prices. The trend has also made its way to the fund of funds arena, where managers have instructed investors to give more notice when seeking redemptions and have provided fewer opportunities to redeem.

In hindsight, funds of funds may have offered redemption terms that were too favorable. Favorable liquidity terms can be used as a marketing tool, but funds of funds failed to calculate the consequences of the terms during times of distressed financial environments.

"There's been this panic collapse of the fund of funds," Feiger said. "The fund of funds explicitly promised liquidity, and they can't deliver it."

Legg Mason Inc. CEO Mark Fetting said Jan. 28 during a conference call that he believed redemptions from his company's fund of funds management firm Permal Group had slowed, but the asset manager remains concerned about sales.

Along with the redemption fallout, many would-be investors are likely put off by the negative press that certain funds of funds have received due to their Madoff exposure. Even though Bernard L. Madoff Investment Securities LLC was not a hedge fund, some funds of funds sent investor money to Madoff's firm and were paid performance fees. BlackRock Inc. Chairman and CEO Laurence Fink said the Madoff scandal will impact the entire fund of funds industry.

"Unfortunately, there are many fund of funds platforms that were a big allocator of Madoff, and so it puts a black eye in the entire industry," Fink said during the company's Jan. 21 fourth-quarter earnings conference call. "Where were their risk management tools?"

At the same time, Fink appeared to turn the Madoff situation into a marketing tool for BlackRock, noting twice during the call that his firm had no exposure and adding that as "clients reconcile their liquidity issues," they will turn to firms that were not exposed.

As a result of the redemptions and alleged Madoff scandal, some hedge funds and funds of funds will not be able to continue operations, said Meredith Jones, managing director of PerTrac Financial Solutions, an investor software analytics company. However, Jones said the current market turmoil reinforces the need for fund of funds managers because of the due diligence they provide.

"Even though there is contraction in that space right now due to a number of factors — redemptions, poor performance, being caught in the Madoff scandal — this is a section of the industry that has legs," Jones told SNL.

Many have speculated that hedge funds and funds of funds will likely evolve and offer more separate account platforms that do not comingle investors, Jones also said. This type of structure provides greater transparency and liquidity but is more difficult to administer because it increases the number of funds managers have to run.

Attorney Thomas Ajamie agrees that funds of funds will not go away, but he believes their fee structure should change. Typically, funds of funds receive management fees of up to 2% and performance fees of up to 20%.

While many in the fund of funds industry believe such fees will come down, Ajamie argues the performance fees should be eliminated. Ajamie said it makes sense for hedge funds to receive performance fees because they are making investments, but not for funds of funds.

"The [hedge] fund is actually doing the work, making the investments," he told SNL. "The fund of funds simply guides you there."

Ajamie contends funds of funds should charge a flat fee for the investigation of hedge funds and charge a small fee for monitoring clients' accounts. *i*