

THINK TANK

Key considerations when launching a fund of hedge funds



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Our panel of experts explain the challenges involved in setting up a Fund of Hedge Funds (FoHF)

THE QUESTIONS

For fund houses setting up their first FoHF, how do the operational considerations differ from other long-only funds?

How scalable is a fund of hedge fund business? Is it straightforward to launch new funds once the right platform has been set up?

Pension fund investors are driving much of the demand for FoHF – how can fund houses meet their demands for transparency, risk management and detailed reporting?

Some FoHFs are highly liquid. How difficult is this to achieve?

Much of the administration of FoHF remains manual. Has progress been made towards better automation and what can fund houses do to manage this area of risk?

What are the key operational considerations any fund house should have when setting up or managing a FoHF range?

For fund houses setting up their first FoHF, how do the operational considerations differ from other long-only funds?

DB The main difference between running a fund of hedge funds (FoHFs) and other investment strategies is that other approaches require research of particular investments and markets, whereas the manager of FoHF has to identify suitable hedge fund investments and then carry out in-depth due diligence on them. This will cover the fund's strategy and the risks involved in its execution, the operation and the structure of the funds, as well as

investing process, risk management and monitoring, performance reporting and the currency of the fund.

Fund of hedge funds (FoHF) are normally domiciled offshore, while the investment manager of the FoHF will be based in the UK. The FoHFs are not regulated in the UK; therefore they can only be marketed to qualified investors. New jurisdictions, such as Malta and Cyprus, are competing with the more established offshore centres.

The fund has to appoint an independent board of directors who will be responsible for the management of the fund. The fund will in addition need to appoint an offshore administrator, custodian, lawyers and auditors and enter into an agreement with the investment manager of the FoHF.

An experienced operational team for middle and back office and settlements is essential. Team members should have experience of offshore funds including subscription and redemption of investments processing, reviewing monthly NAVs, authorizing and monitoring cash movements. The operational processes are completely different to those of long-only funds.

The investments to an underlying hedge funds are made through

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checking the background and financial strength of the funds' managers. The process is time and resource consuming.

TP Some of the considerations and differences compared to a traditional long only unit trust or mutual fund with daily liquidity are: domicility of the fund, choice of service partners, the operations team, the subscriptions and redemption process by investors, the fund's

private placement memorandums (i.e prospectus) and application forms. An application form is completed, which is then submitted to the individual administrator of the funds, and the funds transferred to the individual funds custodian or prime brokers. Long-only funds usually buy and sell financial instruments listed on stock exchanges, which can be undertaken by a broker. In terms of FoHFs, the redemption of the investments in underlying hedge funds is normally monthly, quarterly or semi-annually.

While a long-only investor is dealing with highly sophisticated tools and models in identifying and managing risks literally on an hourly basis, in a FoHF a risk-management system would play a monitoring role. It tracks and indicates gainers and losers in the current investment portfolio and monitors the strategies undertaken by the manager.

FoHF can take up to 20 days after the month end to report its performance. The determination of the FoHF performance can only be calculated once the performances of all its underlying hedge funds are published by the individual administrators of the underlying hedge funds.

The reporting currency of the underlying funds and hedging process may need to be established to reduce currency risk.

DM Operationally, FoHFs are very different from the long only/traditional business. Important considerations include the need to undertake due diligence on the various service providers – including administrators and custodians.

The flows of information around fund of funds are still largely paper-based, with information from investment manager to custodian to target funds typically less automated than a long only or single manager hedge fund.

In addition, it is also important to take into account the various restrictions of the funds including investor-based restrictions.

How scalable is a fund of hedge fund business? Is it straightforward to launch new funds once the right platform has been set up?

DB The scalability of a FoHFs business depends upon the availability and capacity of suitable hedge funds, which might be only \$200 or \$300m. Neither the hedge fund manager nor the FoHF manager would wish the FoHF to hold more than 10% of the target fund, so a FoHF with a portfolio of 20 funds would be limited to \$600m, if the average size of the target funds is \$300m. This means that a pension fund will probably invest no more than \$60m in the FoHF. Once a platform has been established, it is straightforward to

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launch a new FoHF providing the manager has the resources to carry out due diligence and there are sufficient suitable high quality hedge funds available.

TP Once the legal structure is in place and the management company is set up then launching new fund products should be relatively straightforward. An ideal structure would be to set up the fund's legal structure as an umbrella fund with sub funds. Individual sub funds can be launched at a later date. The scalability of a FoHF will depend upon the performance, the strategy, the opportunity of availability of investments, demand by investors and infrastructure of the investment management firm including its investment management team.

DM FoHFs is a scalable business in a number of ways. Once a fund of funds operation has been established, it can increase by investing more in the target funds or by diversifying into different target funds.

Increasing the volumes is straightforward. Diversifying the target funds is less scalable as it requires comprehensive due diligence to be performed on the investment managers.

Once the service providers – administrator, custodian, lawyer, accountant – are on board, and the funds and investment manager have been approved by the local regulator, subsequent business is much easier to scale up.

Pension fund investors are driving much of the demand for FoHF – how can fund houses meet their demands for transparency, risk management and detailed reporting?

DB One problem for pension or institutional investors is the percentage of the institution's assets that it may invest in hedge funds. A \$1 bn pension fund that may not invest more than 5% of its assets in hedge funds could invest \$50m into a FoHF, which also means the institution does not have to research thousands of hedge funds to identify suitable opportunities.

Institutional investors should carry out their own ongoing due diligence on the FoHF's managers. Most hedge fund managers are reluctant to provide transparency with regard to their portfolios for proprietary reasons, and therefore it is difficult for the FoHF's manager to provide meaningful portfolio transparency. It can be open about the operation of the fund, including risk management, procedures, etc.

DM We have also witnessed fund houses setting up managed accounts where they manage the selection of the underlying hedge funds. This is a way of gaining greater transparency, investing with six or seven managers and managing the asset allocation themselves.

This managed account structure, providing transparency by being able to drill down into the individual portfolios, is appealing to certain investor categories and is increasing in popularity.

**Some FoHFs are highly liquid. How difficult is this to achieve?**

DB Highly liquid FoHFs need to borrow money or restrict investment into highly liquid funds. The majority of hedge funds are still monthly, quarterly or even annually dealing, however an increasing number are daily dealing funds. If the manager of the FoHF builds a portfolio of daily dealing funds, it can offer daily liquidity.

Demand for daily dealing funds will increase in parallel with demand for managed accounts. A FoHF, or managed account platform structured as a fund, will only be able to compete with a portfolio of managed accounts if the FoHF can provide the same liquidity in its funds. We have done this successfully by converting a managed account platform into a daily dealing Maltese master feeder fund.

TP Very few FoHFs are highly liquid, as the underlying hedge funds do not typically provide daily liquidity. Usually the FoHFs provide monthly liquidity. There are structures such as investment trusts, which are closed-end funds that provide daily liquidity using the market price, but this price may be at a discount to the NAV.

DM FoHFs are able to issue more frequent dealing NAVs only to the extent that prices exist for the underlying target funds in which they are invested. Recent pressure for more frequent NAVs of hedge funds, in particular on the back of the volume of capital that institutional investors have allocated to this asset class, has partly facilitated FoHFs being able to support more frequent valuations. Ultimately, the degree to which hedge funds can become more frequently valued, will continue to drive the extent to which FoHFs can support greater liquidity.

UCITS III products are becoming more prominent in hedge funds or funds using shorting techniques. Although the requirements are, to a certain degree, restrictive, the advantage of using this vehicle for traditional managers moving into the

hedge fund space and for fund of funds, from a distribution point of view, are considerable.

Much of the administration of FoHF remains highly manual. Has progress been made towards better automation and what can fund houses do to manage this area of risk?

DB The primary manual component of managing and administering a FoHF is pricing, because the prices of the underlying funds are only

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available when the administrator of those funds publishes them. Both Bloomberg and Valuelink have launched programs for administrators to publish the NAV of their funds on these platforms and, although this may not speed up the process, the ability to draw down prices automatically from a central source is beneficial.

TP Many FoHFs remain highly manual due to their complexity. As they evolve, providers in the market will continue to develop systems to assist with administrative processes.

DM Although much of the administration of FoHFs is currently manual, the whole industry is moving towards a more automated solution. One current initiative is a collaboration between service providers in various hedge fund jurisdictions who are working towards an automated solution for FoHFs using the SWIFT messaging system.

The SWIFT initiative is expected to standardise, to a large extent, the FoHF industry. Unique identifiers for target funds are an essential part of the standardisation process. Once in place the SWIFT initiative will allow the straight through processing (STP) of fund of fund trading from investment manager to custodian to transfer

agent. The SWIFT messaging platform will also facilitate a more automated approach to pricing, valuation and settlement of fund of fund trades.

What are the key operational considerations any fund house should have when setting up or managing a FoHF range?

DB For a FoHF to be successful it must have the capacity to carry out meaningful and effective in-depth due diligence, on a continual basis.

AIMA has produced a series of due diligence questionnaires, including one for investors selecting hedge fund managers (covering FoHFs). These questionnaires should be used to eliminate rather than select candidates. Once a shortlist of suitable candidates has been chosen, then serious due diligence should take place, which includes visiting the managers, taking up references and checking backgrounds. The FoHF manager must also have the skills and capacity to carry out an equally in-depth due diligence process when selecting service providers, including the administrator, custodian and, if required, banks to cover bridging loans, borrowings and leverage.

TP A range of administrators and administrative systems are needed to manage the monitoring of investments, dealing with investment inflow, outflow, administration of the NAV and reporting of NAV.

DM The key operational consideration for a fund house setting up or managing a FoHF range is to have the right service providers in place. The set-up of the service providers should meet the operational requirements of the investment manager. Service providers should be in a position to offer a full range of services required by the client and should be well positioned to take advantage of automation including STP of trades through the SWIFT messaging platform or an alternative automated process required by the investment manager. **TfB**