



Finding, evaluating and selecting top hedge fund managers

Investigating investment managers is one of the most challenging—but critical—functions of a well-run family office.

By Gordon Stone

ON THE LIST OF ROLES and responsibilities of the family office, none is more important than the preservation and proper investment of the family's wealth. But what does this endeavor actually entail?

In general, the investing role within a family office encompasses the following:

- **Development of an investment policy.** A comprehensive, thoroughly researched document should be created. The policy should catalog the family's investment constraints, objectives, strategies and implementation tactics. An effective policy follows from a deep understanding of the family's risk tolerances and lifestyle requirements, as well as other structural factors.

- **Implementation of the investment strategy.** This involves (1) decision making related to the allocation of assets to various broad investment categories; and (2) selection and monitoring of individual investment managers and other vehicles (such as funds of funds, hedge funds, managed accounts and exchange-traded funds) to satisfy allocations within these categories.

- **Monitoring and reporting of investment performance.** Information from numerous investments with various levels of aggregation (e.g., family-wide or by entity) must be consolidated and presented. Proper reporting enables the family office to accurately assess and attribute its risk-adjusted performance.

Although considerable time and effort are expended on investment manager selection (and rightly so, given its importance), results are often lackluster, if not downright frustrating. While our experience has shown the selection process to be equal parts art and science, it is complex enough to confound even the most skilled and experienced practitioners. Few family investment offices have the internal resources, networks and training to appropriately investigate the managers they hire.

What is a hedge fund?

Among investment options, hedge funds still receive

considerable media attention and are prominent in most families' investment strategies—and this focus is warranted, given the promise of exceptional returns at potentially lower risk. Yet the due diligence burden on family investment offices has never been higher, in light of well publicized recent scandals and outright frauds on top of the general requirement to get your money's worth in a dynamic and sometimes arcane field of investing.

The term "hedge fund" was coined in 1949 by A.W. Jones, whose investing partnership was among the first to buy securities viewed as undervalued while also "hedging," or short-selling, securities believed to be overvalued—in effect positioning the fund to make money in rising and falling markets. Over time, the concept has morphed into a fairly broad and eclectic universe of strategies well beyond this original mandate. Hedge funds today are organized as partnerships of qualified investors and have compensation schemes that include a management fee (e.g., 1% to 2%) and a performance incentive (typically 20% of profits). Some observers would say that hedge funds have become not a unique asset class, but a unique fee structure.

Navigating the many choices

One of the main challenges in seeking quality hedge fund managers centers on the realities of the indus-

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try's business model: The barriers to running a hedge fund are quite low, and consequently there are many funds to choose from. The availability of prime brokerage services makes it easy for a new entity to open its doors. There are few skill-based or operational barriers for fledgling managers; the only real barrier is marketing the fund to raise start-up capital. And even in this area, the prime brokers are willing to offer some guidance in the preparation of marketing materials, facilitate mock due diligence interviews and introduce firms to potential investors. Consider that in an industry of about 7,000 managers, the top 100 made more than three-quarters of all returns for investors since they were founded.

Higher compensation and the pure intellectual sport attached to the hedge fund industry clearly have had the effect of attracting top talent. Alongside top talent, however, are a high number of candidates who may not have the appropriate background or staying power for a highly competitive world. Some newer managers entering the field, for example, have never shorted a stock. How can an earnest family office navigate the potential minefield in search of high-quality hedge fund managers?

Here are the most common pitfalls:

- **“Brands”:** Certain buyers feel more comfortable selecting larger, “brand-name” managers to fulfill their hedge fund mandates. Firm size, however, provides no assurance of delivering outsized returns. In reality, the opposite can be argued with considerable data to support

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it. Brand-name firms are likely to have strong distribution platforms focused on gathering assets. But as assets grow, excess returns typically shrink. In this scenario, a brand name could be considered a liability for those who seek excess returns.

- **Size:** In most hedge fund styles, increasing the size and age of a portfolio tends to produce a drag on excess returns. There are notable areas, such as distressed securities and certain arbitrage strategies, that seem to be less affected by these factors. By and large, however, size and age can become considerable liabilities. In some multibillion-dollar funds, the management fees alone represent several million dollars in compensation per front- and back-office employee.

Hedge fund managers as star athletes

Establishing the right objective is an important first step.

We believe the focus should be on selecting managers who can maximize excess portfolio returns for the longest period possible. In some ways, this is analogous to evaluating private equity managers based on not only internal rate of return (which takes timing of cash flows into account), but also multiples returned on dollars invested (which takes quantity of profits into account).

Selecting hedge managers can be compared with drafting athletes into the professional ranks. Decisions on potential are typically made before the individual has fully matured. The period of compelling excess returns delivered by an investment manager is analogous to the length of an athlete's career. Top athletes, like top investment managers, are able to sustain peak performance for extended periods. Henry Aaron hit 44 home runs in 1957, but he also clubbed 40 of them in 1973—a span of 17 years. By contrast, the average major-league career lasts only a handful of years.

Investors in hedge funds should follow a manager selection methodology that emphasizes structural and qualitative factors to maximize the probability of success.

Newer funds with experienced managers

One of the most important structural factors in determining future performance is the age of the fund at the time of investment. Given the risk of diminishing returns over time, investors should select funds as early in their life cycle as possible—even when the fund is still in the formulation phase. However, this does not mean inexperienced managers should be hired. Preference should be given to managers who have earned their pedigree—developed research methods, honed stock-picking skills and amassed track records—at larger, brand-name firms.

Many future stars have left larger firms because they ended up managing people, not analyzing securities. Managers at newly independent firms have a lot to prove, and this motivation is reflected in their level of effort. Hiring these “boutique” firms carries other benefits. For example, helping to put a firm in business (a “seed investment”) virtually ensures the daily attention of the top talent and the potential to secure more favorable investment terms (liquidity, transparency, risk controls and fees).

One temptation may be to select hedge fund managers based on the criteria used to evaluate traditional, long-only managers. This process tends to be highly quantitative with some augmentation from qualitative factors. We believe quantitative measures are important, but they have limits when evaluating hedge fund managers. It's also advisable to consider simple questions: What is the right benchmark? Is it even mathematically appropriate to consider certain metrics (e.g., standard deviation, value at risk)? Conclusions based on peer group compari-

sons can be perilous when the degree of leverage or the long/short exposure varies from manager to manager.

The 'three Ps'

We regard philosophy, process and people as paramount in evaluating hedge managers. A manager's stated *philosophy* is helpful in forming an opinion as to whether that manager can achieve excess returns and how long those returns might last. Hedge managers should be able to demonstrate a sustainable competitive advantage in how they gather, consider or use information. This advantage may come from a dogged approach to investment research, a focus on an overlooked area of the markets or a unique position in the flow of information.

Process is crucial, especially as it relates to sell discipline and risk control. The best firms seem to be those that can clearly articulate their investment process and point to examples of this process in action within the portfolio. Historical returns have little predictive effect on future performance, but a robust and differentiated research process is repeatable (akin to manufacturing) and can be highly determinative. Understanding "how" returns are generated should therefore be a key focus.

People is the last P, but certainly not least. Here the crux of any investigation is threefold: (1) verifying a manager's integrity through extensive reference and background

checking; (2) assessing the cohesiveness of the manager's team as defined by how long and how successfully they have worked together; and (3) determining whether the manager's interests are in alignment with those of the outside investors. Has the manager placed a substantial portion of his or her net worth in the investment strategy?

A qualitative approach

Hedge funds have earned well-deserved attention from a wide variety of investors, including family offices. Now that they are under the glare of the spotlight, it is incumbent upon investors to fully understand which managers, if any, deserve consideration for their portfolio. In our opinion, the most appropriate approach is to emphasize a comprehensive, qualitative investigation of newly independent and smaller firms. This is in sharp contrast to a highly quantitative approach generally used to select traditional, long-only asset managers, and to the tendency of many investors to gravitate to larger brand names.

How does a family investment office turn this thesis into a reality? This type of hedge fund due diligence requires a major commitment to identifying and researching the managers with the same degree of rigor that they perform when analyzing securities for their portfolios. Needless to say, it is a full-time endeavor. **FB**



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