

A NEEDLE IN A HAYSTACK...

*The Challenges in Uncovering,
Evaluating, and Selecting Top Hedge
Fund Managers*



VERITABLE

6022 West Chester Pike
Newtown Square, Pennsylvania 19073
Tel: 610-640-9551
Fax: 610-640-9554
www.veritablelp.com

Table of Contents

Executive Summary	1
Introduction	2
What, Exactly, Are Hedge Fund Buyers “Buying”?	3
The Challenge of Defining a Selection Methodology for Hedge Managers	4
Evaluating Institutional, Long-Only Managers	4
The Contrast of Selecting Hedge Fund Managers	5
Success in Hedge Manager Selection	6
Critical Areas Managers Should Address	8
Summary	10

Executive Summary

Increasing asset flows into hedge funds and growing institutional interest are putting pressure on industry participants to continue to deliver on the true promise of this asset class. While talented portfolio managers are still being drawn to this lucrative area of the markets, an increasing number of poorly trained and under-prepared managers are also entering, aided by low barriers to entry. The risk for all investors is that too many dollars will chase too few quality managers, thus shrinking potential excess return. With these factors as a backdrop, it is logical for current and prospective hedge fund investors to ask the following questions:

- Are there enough quality managers to handle the inflow of dollars?
- What are the key aspects to focus on when selecting any hedge fund manager?

Specifically, this paper will argue that:

- Selection of hedge fund managers is a fundamentally different process from the methodology used to select more traditional long-only managers. The selection of long-only managers is increasingly a quantitatively driven process, which is logical given the predictable return streams required from these core pillars of a portfolio.
- Successful selection of hedge managers demands a more qualitative approach. Quantitative measures such as VAR and tracking error have less application to the hedge asset class. This is due both to the flexibility afforded to hedge portfolios and to the non-normal distribution of returns produced by the universe of hedge managers.
- The real focus on hedge manager selection should be on finding managers that can sustain peak performance for as long as possible. Because the age and size of most hedge portfolios can diminish excess returns, special attention should be given to boutique managers to fill hedge fund mandates. This will require hiring a firm as early in its lifecycle as is feasible. A large firm pedigree is still important for the firm's principals, but there is no steadfast requirement that the firm itself must be large.
- Excess returns are driven by an investment firm's competitive advantage over its peers. This advantage may come from a unique position within the flow of information or more sophisticated processing of the available data. This edge is best uncovered by a thorough examination of the hedge manager's investment process.

The balance of this paper lays out specific areas of research that need to be performed by hedge fund buyers. The objective is to give the reader a deeper understanding of successful hedge manager selection techniques.

Introduction

As the hedge fund industry zooms past \$500 billion in assets, it may seem that everything is right with this strategy. And indeed many things are. Evidence of the potential for excess returns appears real, and there is growing acceptance within the institutional community that hedge funds are a valid addition to a portfolio.

If the quality of new hedge fund managers does not keep pace with the inflow of hedge fund dollars, investors in this asset class may not derive the returns or benefits they expect.

But there is a darker side to this asset growth: namely, who will manage this gusher of new money? Certainly there are scores of willing candidates, but are there enough high-quality managers to handle this increased asset flow? The answer to this question will have profound implications for clients and managers alike. If the quality of new hedge fund managers does not keep pace with the inflow of hedge fund dollars, investors in this asset class may not derive the returns or benefits they expect.

The challenge in finding quality hedge fund managers centers on the realities of the industry's business model: the actual barriers to running a hedge fund are quite low. The quality of prime brokerage services makes it easy for a new entity to open its doors. There are few competency or operational barriers for fledgling managers, only a marketing barrier. Can enough assets be gathered to make the venture worthwhile?

Higher compensation and the pure intellectual sport attached to this endeavor clearly have had the effect of attracting top talent, and this is still the case. Along with these top talents, however, have entered a growing number of candidates who may not have the appropriate background or staying power for this increasingly competitive world. Some newer managers are entering the hedge fund field never having shorted a stock—managers who were trained during the momentum market of the 1990s and have no discernible advantage in uncovering or evaluating information. Even if some of these newer, less-talented managers have an opposite effect of creating excess return opportunities for the truly talented, a key question remains. How can an earnest buyer navigate this potential minefield?

Some newer managers are entering the hedge fund field never having shorted a stock—managers who were trained during the momentum market of the 1990s and have no discernible advantage in uncovering or evaluating information.

This paper will set forth an evaluation methodology for selecting hedge fund managers from this ever-increasing pool of candidates. We will contrast the process of selecting hedge fund managers with that of choosing institutional, long-only managers. Finally, we will sketch out key evaluation criteria for selecting quality hedge fund managers. The goal is to provide the reader with a framework for separating true manager talent from the rest of the herd.

The proper objective is to select managers who can maximize excess portfolio returns for the longest period possible.

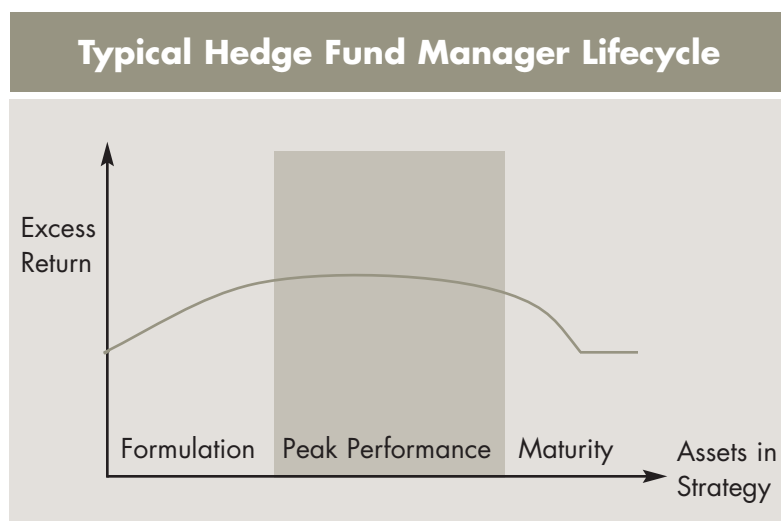
What, Exactly, Are Hedge Fund Buyers “Buying”?

At first glance, selecting quality hedge fund managers seems straightforward. One simply needs to select those managers with a track record of generating excess returns and a reasonable probability of doing so in the future. But with the supply-and-demand components changing so rapidly, hedge fund buyers need to think beyond merely generating excess returns in the near term.

The proper objective is to select managers who can maximize excess portfolio returns for the longest period possible. As increased dollars compete for this pool of money management talent, the key for hedge fund buyers is to find the best managers as early on in their lifecycle as possible. In this respect selecting hedge managers can be compared with drafting athletes into the major leagues. Decisions on future potential often need to be made before an individual has fully matured, and that is a difficult proposition. Raw talent can be quantified, but mental preparation and endurance are more subjective measures.

The period of compelling excess return delivered by an investment manager is analogous to the length of an athlete’s career. Top athletes, like top 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 that represented almost half of his lifetime. This was the case even though the average major league career at that time lasted only a handful of years. Hammerin’ Hank’s achievement came through a combination of raw talent and an adaptation to changing conditions. It was also a by-product of intense focus.

The corollaries to money management (especially hedge management) are clear. 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 merger arbitrage that seem to be unaffected. By and large, however, size and age are the bane of hedge funds (source: Morgan Stanley Quantitative Strategies). Given this very real risk of diminishing excess returns, hedge fund buyers need to select managers when they are still in the formulation phase (see below) to maximize the performance payoff from each manager.



Buyers of hedge funds, interested in the very real benefits of this asset class, need to follow a manager search methodology that will increase the odds of maximizing excess return in their favor.

The Challenge of Defining a Selection Methodology for Hedge Managers

Buyers of hedge funds, interested in the very real benefits of this asset class, need to follow a manager search methodology that will increase the odds of maximizing excess return in their favor. There may be a temptation to select hedge fund managers based on the generally accepted tenets of evaluating institutional, long-only managers. Simply put, this process is a highly quantitative approach augmented by the qualitative aspects of the “three Ps”: philosophy, process, and people. Ultimately, however, such a highly quantitative approach is likely to prove inadequate when evaluating hedge fund managers.

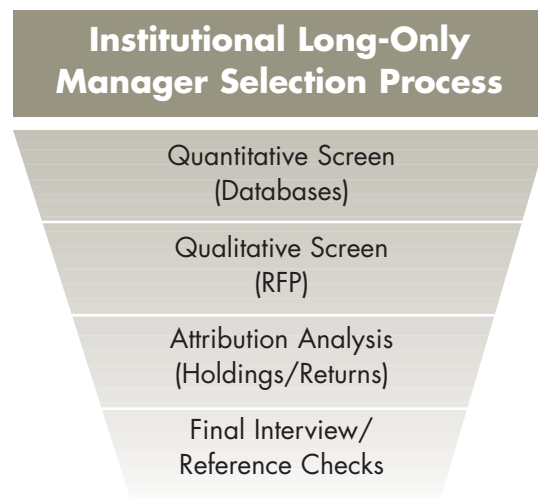
While the selection of institutional, long-only managers tilts more heavily towards science than art, the successful selection of hedge fund managers is a fundamentally different process. While it draws on the concepts of a long-only manager search, there should be less emphasis on the quantitative aspects of a portfolio and much more focus placed on the qualitative aspects.

Evaluating Institutional, Long-Only Managers

Before articulating a hedge manager selection methodology, it is instructive to re-visit the traditional manager search approach. The stakes are high when selecting long-only managers. Since they are often the pillars of a portfolio, these managers need to be reasonably successful in achieving their objectives to support the higher-level asset allocation decision. Given this, a heavier emphasis on quantitative analysis to rationalize portfolio data is generally a prudent approach.

Selecting a suitable long-only manager for a traditional mandate begins with a search through “the database.” Meticulously kept, these institutional databases can be screened for key manager criteria such as:

- Assets under management within a style
- Sharpe ratio
- Downside tracking error
- Returns over a full market cycle



Once a list of potential managers has passed through the initial screen, it is typical for these managers to respond to a request for proposal (RFP) document to further define their approaches. The qualitative information contained in the RFP is supplemented by filtering portfolio data through an attribution system. Holdings-based analysis helps uncover any hidden bets in a portfolio (such as momentum or currency) and lends itself well to the more or less normal distribution of returns produced by the universe of institutional, long-only managers. This technique also helps confirm or contradict assertions made in the marketing process regarding portfolio discipline and approach.

Uncovering quality hedge managers is best achieved through an exhaustive qualitative analysis. Quantitative measures are still important, but they have limits when evaluating hedge fund managers.

Setting all this analysis aside, an essential truth remains: the candidate chosen in an institutional, long-only manager search is likely to be a firm that exhibits modest tracking error and provides the possibility of outperforming a style benchmark by perhaps a few percent per annum (pre-fee and pre-tax). Of course, the majority of managers may achieve the tracking error objective while falling short on the performance goal. This sobering picture is largely due to market efficiencies and the penalty assessed to managers that don't track their benchmarks to a reasonable degree: the loss of a mandate.

The Contrast of Selecting Hedge Fund Managers

Successfully selecting managers for a hedge portfolio draws on some of the same techniques but is ultimately a different approach. Uncovering quality hedge managers is best achieved through an exhaustive qualitative analysis. Quantitative measures are still important, but they have limits when evaluating hedge fund managers. There are some key reasons that the process of hedge manager search should be less dependent upon quantitative aspects.

- **The distribution of hedge manager returns tends to be non-normal.** Employing more traditional risk statistics (i.e., standard deviation and VAR) is less useful when considering hedge manager returns. A major reason is that both of these measures are based upon the normal distribution of returns. With hedge managers, the combination of the relative immaturity of this strategy combined with the managers' flexibility to hold both long and short positions produces a universe whose returns are skewed positively to the right tail.
- **Benchmark cognizance and tight tracking error are also less useful when evaluating hedge managers.** A hedge manager with a strong conviction can short a stock that is prominent within an index, thus giving it a negative weighting. If the manager's decision is correct, such a strategy can have the ironic effect of adding to excess return and tracking error simultaneously. What does tracking error to an index mean in the case of hedge funds? If a manager is providing the desired excess return, it should mean very little. A benchmark for a hedge fund manager is more of a guide post, not a hitching post.

What does tracking error to an index mean in the case of hedge funds? If a manager is providing the desired excess return, it should mean very little.

There are still some key areas in which quantitative detective work produces rewards. These include:

- **Deriving the true sources of return.** In particular, quantitative analysis can help determine whether a few stocks or a timely sector bet may have provided the preponderance of return for a given time period.

By not requiring a manager to maintain arbitrary portfolio weightings to tame benchmark tracking error—positions in which the manager may have absolutely no conviction—investors can receive the full effect of a manager’s talent.

- **Risk controls.** Managers that short stocks or markets are opening the portfolio up to potentially larger downside risk. Quantitative analysis can determine whether the manager has employed short covering strategies in the past, whether those strategies have been consistently applied, and what effect those strategies have had on the portfolio. It is also instructive to study the manager’s long/short ratio over an extended period.

Given that hedge managers are ceded more freedom to generate the desired results, it follows that these managers should be selected on the basis of their inclusion in a multimanager portfolio. Industry research has shown that the performance dispersion among hedge fund managers is far greater than that of traditional mutual fund managers. The correlation between hedge managers is roughly 0.2, while mutual fund managers come in at a much more uniform 0.9 (Source: Morgan Stanley Quantitative Strategies). Such statistics point to much higher single manager risk when employing hedge managers.

Because of this, it is prudent to place hedge fund managers in a well-managed pool. Risk can then be controlled more adeptly at the macro level of hedge portfolio construction by combining multiple managers with weak, to possibly negative, correlation statistics. By not requiring a manager to maintain arbitrary portfolio weightings to tame benchmark tracking error—positions in which the manager may have absolutely no conviction—investors can receive the full effect of a manager’s talent.

Success in Hedge Manager Selection

This paper has advocated finding managers that can generate excess returns for the longest period possible. And that may best happen if they are hired earlier in their lifecycle due to the pronounced negative effects that age and size have on the performance of most hedge portfolios. Hence, for most hedge fund styles, we argue the focus should be on hiring smaller, boutique investment managers.

Certain buyers will likely feel more comfortable selecting larger brand name managers to fulfill their hedge mandates. Firm size, however, provides no assurance of delivering outstanding performance. In reality, the opposite can be argued. Brand name firms are likely to have strong distribution platforms that can gather assets quickly. But as assets grow, excess return typically shrinks. In this scenario, a brand name could be considered a liability when seeking excess returns.

There are other significant issues that will need to be addressed by larger managers eager to enter the hedge business. These include the conflicts of one firm being simultaneously long and short in a single security and the different compensation packages offered to hedge fund professionals. This is not to say that a larger manager cannot add value to a hedge business; it is just that this type of firm needs to overcome an array of obstacles. An in-depth discussion of these obstacles is beyond the scope of this paper.

By “smaller,” we mean firms with lower levels of assets under management. Our preference is for those managers who have earned their pedigrees at larger firms. They are not new to the business but may be recently independent. They understand the importance of investment process and are quite proficient at analyzing essential financial information. Boutique managers offer another compelling benefit: employing them virtually ensures having the daily attention of the top talent at that firm.

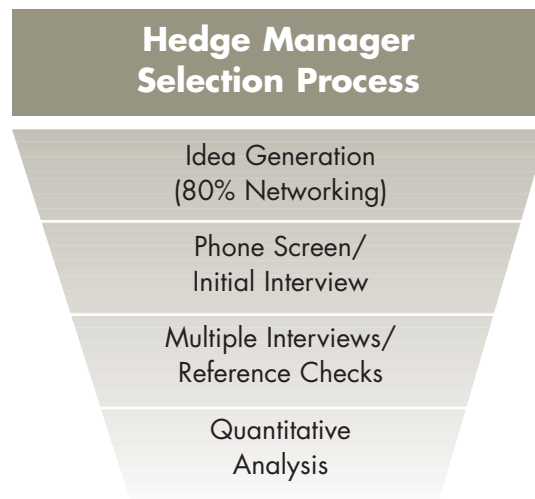
Brand name firms are likely to have strong distribution platforms that can gather assets quickly. But as assets grow, excess return typically shrinks. In this scenario, a brand name could be considered a liability when seeking excess returns.

How does a hedge fund buyer turn this smaller asset manager thesis into a reality? While a precise formula does not exist, it is clear that successfully selecting high-quality hedge managers is more art than science, more qualitative than quantitative in nature. It requires a commitment to researching the candidates with the same diligence with which those managers research the securities in their own portfolios. Gaining access to the information flow is crucial. Having a well-developed network of prime brokers, other managers, and accountants helps uncover important information about current candidates as well as key input on newer names. It is a full-time endeavor.

The focus in selection needs to be on how return is generated. Simply put, does this manager have a sustainable competitive advantage?

When evaluating hedge managers, the three Ps (philosophy, process and people) take prominence. 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. Process is crucial, especially as it relates to sell discipline and risk control. The best management firms seem to be those that can clearly articulate their process and point to continuous examples of this process in action within the portfolio. The quality and motivation of investment professionals is another key factor. Many top managers have left larger firms because they ended up managing people, not securities, thus moving away from their true passion.

The focus in selection needs to be on how return is generated. Simply put, does this manager have a sustainable competitive advantage? 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.



Manager evaluation is all about listening. As managers speak of their core holdings, trends emerge about their thought processes and creativity as processors of information.

Assuming this information is in the public domain, what is it about the manager's ordering of the facts that will provide a competitive edge in the market? The best managers, much like the best businesspeople, possess an uncanny ability to see clearly through the haze of information.

Critical Areas Managers Should Address

A bias towards smaller, boutique managers that can sustain excess return in no way implies that all smaller managers are suitable candidates for hire. Indeed, because the business reputations of their firms may not cast as long a shadow, the scrutiny on these firms is even greater. Smaller managers still need to fully address the following issues:

Assuming this information is in the public domain, what is it about the manager's ordering of the facts that will provide a competitive edge in the market? The best managers, much like the best businesspeople, possess an uncanny ability to see clearly through the haze of information.

- **How well does the manager articulate the investment process?** This may sound odd on the face of it. After speaking with hundreds of different hedge fund managers, though, the hedge fund buyer may have a different perspective. Managers that cannot provide detailed descriptions of their approaches are not likely to be consistent. If the buyer cannot understand the investment approach at the outset of the relationship, it will be difficult to stand by that manager when adverse market conditions occur.
- **Is there consistency in logic and approach?** This is closely related to investment process. One helpful exercise is to ask a prospective manager why the top ten positions within the portfolio deserve such prominence. Does the manager display conviction? Listening to the manager's explanation can provide key insights into the approach used and the consistency with which it has been applied. This is the most telling factor when trying to project the manager's ability to replicate past results.
- **How does the manager generate ideas for the portfolio?** An immediate, and usually lethal, warning sign is a reliance on Street research. So is a reliance on discussions with brokers to uncover stocks that are building momentum; this is better employed as a confirming indicator, not a buy signal. Managers who have broken away from larger firms will no longer be able to count on the findings of a team of analysts who are compensated on the quality of their ideas, offering up their best picks on a daily basis. The best managers can articulate a proprietary process for generating ideas for their portfolios.
- **What is the manager's research process?** A common attribute among superb asset managers is their approach to dealing with company management. The best managers speak often with company managers and, even if the relationship is somewhat adversarial, are seen as knowledgeable investors. We find that good ideas often beget more of the same. As portfolio managers speak with customers and suppliers of one firm, they may gain valuable insights regarding the prospects for a competitor or a firm somewhere else in the supply chain.
- **How cohesive is the investment team?** One of the best methods for determining cohesion is by understanding how various members of the investment team are compensated and their specific responsibilities within the team. Teams that have worked together in the past are particularly desirable, as are analysts and portfolio managers who focus on areas of the market that have served them well in the past.

-
- ***How is the firm's infrastructure being managed?*** The hedge fund manager is in the business of doing one thing—generating consistent, excess portfolio return. In the smaller firms that we select for portfolio inclusion, we like to see non-core activities—delivering K-1s on time, distributing timely, accurate performance reports, managing the technology agenda, and so forth—under the control of a chief operating officer. We want to know if this firm operates smoothly. This factor is just as important as the generation of alpha.
 - ***Does this manager believe in manifest destiny?*** Ambition is a key reason that portfolio managers break away from larger firms and strike out on their own. When it comes to hedge managers, however, too much ambition can quickly shrink excess returns. A key question to be asked of any candidate is, “What level of assets would you be comfortable managing, given your style?” If a manager has dreams of managing \$1 billion in assets (from a starting point of \$20 million) and envisions a series of product line extensions, this is often a danger sign. On the other hand, a manager content to manage a few hundred million dollars without dreams of growing into a mega-sized firm is desirable.
 - ***How does the manager assist in providing portfolio transparency?*** It is important that hedge managers be responsive to investors wishing to fully comprehend the level of risk assumed by the underlying portfolio. A summary document of top holdings produced every quarter is no longer adequate protection for the investor. Some form of portfolio transparency is required to allow investors to make educated judgments about the level of portfolio risk. Such measures can either be calculated by the investor themselves or by a third party firm specializing in their calculation. A manager that refuses to provide at least a reasonable level of transparency may either be nervous about increased scrutiny or have an inadequate back office—both of which are danger signs.
 - ***What are the exact sources of return?*** Historical portfolio returns must be considered in relation to actual market experience. Was there one bet that made the year? The assumption cannot be made that superior security selection led to the relative outperformance of the past. It is vitally important to investigate the largest deviations in relative performance, both positive and negative. Much can be learned from the market's environment and the manager's explanation of the firm's performance within that environment. Examining past trades forensically can shed light on the consistency of a manager's approach.
 - ***How deeply does the manager evaluate the buyer?*** This concept of the seller evaluating the buyer may seem counter-intuitive. But it is interesting to find out whether the manager is evaluating the buyer at the same time the manager is being evaluated. The best managers are looking for business partners in the fickle world of asset management. Managers that do not want assets solely for the sake of gaining them will be more apt to have their own list of criteria when choosing business partners. Conversely, managers who will accept any investor may also be more likely to spend an inordinate amount of time selling rather than managing the portfolio.

In a hedge manager search, the manager plays the game of trying not to be eliminated. The evaluator of a manager needs to be looking for a fatal flaw that precludes selection. This may be a long/short manager that rarely speaks of short positions. Or it may be a convertible arbitrage manager that de-emphasizes credit analysis. Fatal flaws are best uncovered through intense listening and a focus on the areas of analysis mentioned earlier in this paper.

Our experience indicates that the decision to select or bypass a manager is almost always solidified, and sometimes made, while checking references. Given the qualitative nature of this process and the focus on smaller managers, reference checks can be crucial to the hiring process. While the manager's suggested references are dutifully phoned and questioned, this should hardly represent the complete list of contacts. It is important to adopt the role of a private investigator when evaluating a manager's background.

Summary

Hedge funds are beginning to earn well-deserved attention from a wider variety of investors. The increasing institutionalization of this asset class, however, may lead to too many dollars chasing too few ideas and managers. The goal is to find management firms that can increase and sustain their excess return for an extended period. This generally may be accomplished through the selection of smaller, boutique managers selected earlier in their lifecycles. These managers tend to be more focused and nimble.

In our opinion, the most appropriate approach to selecting of hedge managers—and especially smaller managers—is highly qualitative. This is in sharp contrast to the highly quantitative approach generally used to select more traditional long-only asset managers.

Hedge managers need to be able to demonstrate a competitive edge in how they gather, think about, or employ information. The most creative managers—and those who are also the most consistent in applying their creativity—typically are able to generate the potential for excess returns over an extended period.

About VERITABLE

VERITABLE is a multi-family office focused on the ultra wealth business. We provide investment consulting to 150 families representing \$7 billion in assets and we are one of the largest privately-held investment consulting firms in America. VERITABLE has been managing multi-manager long/short limited partnerships for its clients since 1992, with more than \$1 billion in assets in these portfolios. We employ a team of analysts dedicated to finding, evaluating and selecting talent believed to be the most attractive in the alternative asset management field.