CHAPTER 1

Asset Allocation and Fiduciary Duty

Investment Policy Statement: The Roadmap

Diversification is for those investors who don't know what they are doing.

—Warren Buffett

COPYRIGHTED MATERIAL
http://www.pbookshop.com

The Wizard of Omaha takes the approach that a savvy investor should concentrate his money in only his best ideas, but this is a difficult approach for mere mortals. Instead, it is much more advisable to develop a long-term plan that encompasses the investor's goals and expectations and tells how best to achieve these goals. The basic building block for any investment portfolio should be the Investment Policy Statement (IPS). Whether you are a small individual investor, a foundation or endowment, or a multi-billion dollar global pension fund, the initial step before investing the first dollar should be the written guidelines of an IPS. The IPS is now part of accepted best practices.

The Investment Policy Statement serves as a roadmap for investors, consultants, and fund managers. There are four basic purposes of an IPS regardless of the size of the investor's portfolio.

1. Identify the objectives that the investor expects from these funds. Time horizons, liquidity, and risk/return expectations will be quite important as to which investments will be most suitable. The required rate of return should drive much of the design process.

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

2. Define the asset allocation policy. Asset allocation may arguably be the most important part of the IPS.
3. Create guidelines for selecting investment options.
4. Establishes guidelines to monitor the portfolio.

The IPS outlines the how and why of investing in alternative investments. It will provide a detailed explanation of the returns expected, the risk level, and the type of fund the investor is willing to assume. Appendix A contains a sample IPS.

DETERMINANTS OF PORTFOLIO PERFORMANCE

The publishing of the Brinson, Hood, and Beebower research study (1986 and 1991) on the contributions of asset allocation over the long term to investment returns has increased focus on the need for diversification of investment portfolios. Once the time horizon, risk tolerance, and asset allocation policies have been established, the selection of managers becomes a critical part of the implementation of the asset allocation policy. Much of the benefit of a sound asset allocation plan may be undermined or negated by a manager selection process that is ineffective or inefficient. If the selection leads to poorly-performing managers, asset allocation will not save the investor. The Brinson et al. study and results were reprinted in the July-August 1995 *Financial Analysts Journal* during the roaring bull market of the 1990s, in which concerns for diversification were lost in the rising euphoria of the tech bubble.

As a brief review, the study compiled data from 91 pension plans that had complete quarterly data for a 10-year (40-quarter) period, beginning in 1974. The study measured actual and passive returns for the portfolios, which contained allocations to stocks/bonds/cash equivalents. The results showed the average plan lost 66 basis points per year in market timing, and another 36 basis points per year from security selection. Or more succinctly, the study concluded that asset allocation explained 93.6 percent of the variation in a portfolio's investment returns. Another interesting but little discussed result reflected the historical tendency of investors to move to the same policy mix.

Over the past 20 years, this study has been the focal point of many debates on the importance of asset allocation in portfolio management. Further analysis concluded that the actual result of the study was not total return, but volatility. The two are related but invoke an entirely different result that investors must remain aware of.

http://www.pbookshop.com

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

Of the basic four parts of the IPS (objectives, asset allocation policy, investment guidelines, monitoring) the first three have the largest impact on persons contemplating investments in hedge funds. Monitoring deals primarily with the aftermath of the decision process and communication procedures, including guidelines, benchmarking, and reporting results.

One essential thing to be considered in the asset allocation process is the investment impact of hedge funds on the overall portfolio construction. A portfolio that includes hedge funds can offer investors a better risk/return profile than one that relies solely on traditional asset classes.

WHY ALTERNATE INVESTMENTS?

The objectives determine the time horizon and time frame, while asset allocation determines permissibility of asset classes. Historically, the typical asset allocation generally begins with an allocation between the three large asset classes: cash, fixed income, and equities. Investors who face longer-tailed liabilities or intergenerational concerns such as pension funds, endowments, and ultra-high net worth (UHNW) also allocate to nontraditional or alternative investments such as real estate, private equity, and hedge funds. As David F. Swensen, chief investment officer at Yale University's endowment, outlines in his book *Pioneering Portfolio Management*, hedge funds serve certain investors well. Swensen has been highly successful in managing Yale's funds.

http://www.pbookshop.com

Pensions, endowments, foundations, and family offices (UHNW), through a different approach to traditional asset allocation, can be successful buyers of illiquidity. These funds, by being buyers of illiquid assets, gain several advantages in this investment approach, including increasing the return/risk ratio and non correlation of the assets, and targeting absolute returns instead of relative returns. This book does not intend to debate whether hedge funds are a separate asset class but addresses the uses and risks in hedge fund selection in a fully diversified portfolio.

From the standpoint of an Investment Policy Statement, hedge funds are usually classified under alternative investments in the asset allocation process, as private equity and other similarly structured investment vehicles would be. A further breakdown is the classification of absolute return and directional hedge funds. The arguments for and the distinctions between the two subcategories get blurry at times, since many folks believe that a hedge fund's goal is to provide absolute returns.

As stated in the Introduction, the typical structure for hedge funds is some form of limited partnership. Although there are institutions that require the use of Separate Account Management (SAM, discussed in Chapter 8),

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

giving hedge funds more transparency provides investors with the ability to better monitor the risk profile of their entire portfolio. Also, the limited partnership structure may not be a practical option for some entities.

The hedge fund itself may be structured in any number of jurisdictions. It may also be effectively organized in several jurisdictions simultaneously by employing what is called a master feeder structure with a common investment portfolio. In addition to restrictions outlined by an IPS, there are legal and tax issues that may limit how and where an investor may allocate funds to a particular hedge fund. The practicalities of these structures are further discussed in Chapter 7, as well as investor issues in regard to tax status and fees associated with these vehicles.

Traditional asset allocation typically breaks out along the lines of range of percentages to equity, fixed income, and cash, with further breakdowns among domestic, international, and style types. As seen in Table 1.1, historically a typical allocation would be 50 to 60 percent equity, with a token allocation to alternative assets (hedge fund or private equity) and the balance to fixed income and cash—depending on liquidity needs and risk tolerance.

In the past few years pension and endowment funds have seen the effects of the tech bubble, which have led a large number of pension funds to be seriously underfunded. Historically low interest rates have compounded the need to find nontraditional investments with higher risk-adjusted returns. In Figure 1.1, for the period 1987 through 2006, annualized compounded returns and standard deviation are plotted for several of the major equity and bond indexes. Included in the chart is the same representation for a hedge fund index (Hennessee Hedge Fund Index). Leaving aside the issue of survivor bias that does impact hedge fund indexes, Figure 1.1 demonstrates the potential impact of including hedge funds in a portfolio. The hedge fund

http://www.pbookshop.com

TABLE 1.1 Typical Asset Allocation Profiles

	Typical	Family Office	Yale University
Domestic Equity	50%	15%	11%
Foreign Equity	10%	20%	14%
Fixed Income	32%	15%	4%
Hedge Funds	3%	25%	24%
Real Assets	—	10%	27%
Private Equity	—	10%	19%
Cash	5%	5%	2%

Yale University data as of June 30, 2007.

Source: Wilmington Family Office, Chronicle of Higher Education.

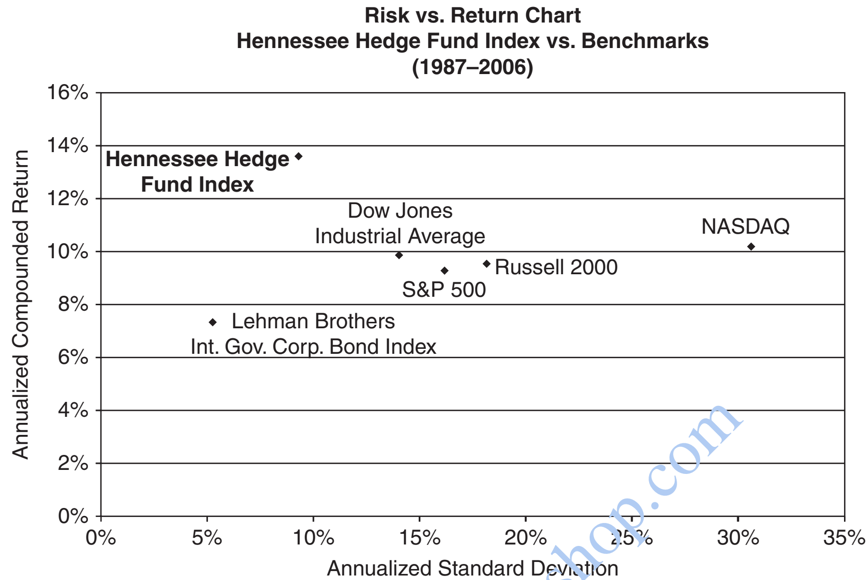

FIGURE 1.1 Risk/Return Comparison of Indexes
Source: Hennessee Group LLC.

http://www.pbookshop.com

index provided over 30 percent higher returns with, on average, half the risk as measured by standard deviation. One can certainly argue from the chart that the starting point of 1987 disadvantages traditional investments (it does), but it also shows that investors can survive bad markets with the downside protection hedge funds offer.

The endowment world is quite aware of this advantage and has taken a more nontraditional approach over the past decade. Asset allocation to U.S. equity and fixed income decreased and funds were shifted to non-traditional hedge funds (real assets and private equity). The result was higher risk-adjusted returns that had low correlations to the traditional equity and fixed income allocations. More to the point, hedge funds are being used to provide equity-like returns with bond-like volatility. As the success of these strategies expanded, so did the popularity of hedge funds. See Table 1.1.

Pension and endowment funds, in an effort to close the funding gap, and ultra-high net worth investors seeking to preserve capital, have quickly warmed to the concept of adding hedge funds to their asset allocation schemes. Pension funds, through Liability Driven Investing (LDI) and the ultra-high net worth investors, are implementing a post-modern portfolio theory of Minimum Acceptable Returns (MAR) that focuses on long term

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

results and not the more typical "liquidity chasing" strategies that dominate much of Wall Street. These investors now invest through index funds or financial futures to achieve beta or market exposure for the more traditional asset classes as cost-efficiently as possible. This allows them to invest larger amounts in noncorrelated strategies that will provide higher risk-adjusted returns above some hurdle rate or MAR, rather than a relative market benchmark. Such successful strategies escape the handcuffs of relative risk over short- and medium-term horizons and seek absolute returns in varied market environments. By focusing on the long term, these investors have readily been supplying liquidity to the short-term oriented folks. Time horizon is the key to unraveling the paradox of accepting idiosyncratic portfolios. The use of a conventional 60:40 (equity: fixed income) type of benchmark may be more or less permanently impaired.

The results, which have been impressive, are not as straightforward or as simple as the reported numbers might lead one to believe. The structuring and positioning of traditional and nontraditional assets require some different analytical tools. The process is more complex than chasing the hot returns of the private asset classes. The long established tools of the Capital Asset Pricing Model (CAPM) and Modern Portfolio Theory (MPT), while still the basic tenets of portfolio construction, do not lend themselves easily to analyzing hedge funds and constructing portfolios with hedge fund allocations.

http://www.pbookshop.com

A CLOSER LOOK AT HEDGE FUND STRUCTURES

Before we can begin to examine the operations and performance of the hedge fund, it's important to first understand the structural nature of a hedge fund. The hedge fund vehicle is typically a limited partnership between the management company serving as the General Partner, or GP, and investors, through an offering memorandum, and subscription documents become limited partners, or LPs, by allocating their dollars to the fund. The structures and documents are covered more fully in the chapter on due diligence (Chapter 7). The main consideration in the IPS is that the document make clear to interested parties the limits or objectives relating to approval of LP structures, leverage limits, allowable strategies, SEC registered managers (hedge fund managers are currently not required to be registered), liquidity issues, and fees. A quick checklist developed from the IPS will provide an initial framework as to whether a given hedge fund will qualify for further scrutiny. Figure 1.2 shows the basic information that will give you the foundation of the work that must be completed to meet the goals and objectives of the IPS (see Appendix A).

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

Fund Name:	
Manager Name:	
Contact:	
Address:	
Phone:	
Fax:	
E-Mail:	

Contact Information	
Private Placement Memorandum Onshore Offshore	
Subscription Documents Onshore Offshore	
Fund Summary	
LP Agreement (onshore)	
Memorandum/Articles of Association (offshore)	
Due Diligence Questionnaire	
FO Due Diligence Write-Up	
Audited Financials (Year _____)	
Presentation	
Historical Returns/$AUM	
Newsletters	
Side Letters	
Form ADV	
Risk Management Update	

http://www.pbookshop.com

FIGURE 1.2 Due Diligence Checklist

Use of Leverage

One of the inherent characteristics of hedge funds is the ability to leverage investments, which provides an efficient use of capital that can then be allocated to produce multiple sources of alphas. Unlike traditional or long-only strategies, since the capital is not leveraged, only one source of alpha is possible. Through the use of leverage, multiple sources of alpha are available. The most basic form of leverage is through Regulation "T," which is determined by the broker-dealers financing the strategy. For U.S. equity strategies, "Reg T" defines leverage maximum at 50 percent, or 2:1—one long and one short for one dollar of capital. This is the simplest form of leverage. In other instruments such as fixed income, foreign equities, futures, and options, lines

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

of credit or bank borrowing might be used to take leverage up from the rather mundane level of 2:1 to 10 or 20:1. As the leverage increases, the risk of the fund also increases. Leverage can be a good source of alpha in a market that is experiencing low volatility; however. the dual edged sword of leverage is that returns can be amplified on the downside as well.

The lessons of the Long-Term Capital Management (LTCM) fund should not be lost on investors. The principals at LTCM, through the mathematical modeling work of their PhDs and Nobel Prize winners, developed sophisticated trading systems to allow them, as they quaintly put it, "to scoop up nickels." Well, as most investors know, it is not highly profitable under normal investing conditions to score outsize returns by scooping up small change. However, if one applies a moderate amount of leverage, the profitability rises exponentially. After applying an enormous amount of leverage, the investor might expect an enormous amount of profit.

The LTCM fund was leveraged on the order of 100:1. The LTCM sophisticated models churned through thousands of data points with a reversion to the mean outlook, which meant they leveraged up positions of outliers to their mean reversion model. Leverage can give the illusion of a successful strategy, when in reality it only increases the risk profile (and fees) of the investor. As investors painfully learned, mean reversion works over a long period of time. In the short run they rarely cooperate, and the market movement can leave the portfolio manager facing margin calls. The size of the leveraged trades in turn suffers from a liquidity squeeze as the margin calls need to be met. Most risk models test for 100 year events. When these 100-year events hit, models are of no use, and many times the correlation of all asset classes goes to 1.00.

Another example of misunderstood or misused leverage that gives investors a false sense of safe risk/return profiles can occur in some municipal bond arbitrage funds. The pitch is an 8 percent return in a low volatility investment. A quick review showed these 8 percent returns came primarily as the result of six times leverage. Similarly, fixed income arbitrage at typically 10 times leverage has long term performance that closely tracks the returns of the long term bond indexes (see Table 1.2). The final result brings into question whether investors are fairly compensated for the level of risk they incur.

For a fund of hedge fund investors, leverage is a bit more complicated but must be understood. A fund of hedge funds (FOHF) is an investment vehicle that typically invests in single strategy hedge funds—essentially a limited partnership owning several individual limited partnerships. FOHF investors must understand whether leverage is applied at the individual hedge fund and/or the FOFH level, and what the limits are to that leverage. This information is typically found in the Private Placement Memorandum (PPM) of the fund. Leverage at the FOHF level increases the cost of the

http://www.pbookshop.com

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

TABLE 1.2 Fixed Income Leveraged Returns

	Fixed Income Arbitrage	Lehman Gov/Corp Index
2002	7.1%	9.8%
2003	10.0%	4.3%
2004	7.1%	3.1%
2005	4.7%	1.6%
2006	6.1%	4.1%
2007	−0.6%	7.4%
3 Yr	*3.4%*	*4.3%*
5 Yr	*5.4%*	*4.1%*
2002–07	*5.7%*	*5.0%*

http://www.pbookshop.com

FOHF and effectively lowers the net returns of the FOF. In effect, if the annual interest cost of the leverage is 4 percent, that is the break even point for the FOHF, and that does not include the other fees associated with the operation of the FOHF.

Generally speaking, it is preferable for any leverage in a FOHF to be applied at the individual HF rather than at the FOHF level. The policies and limits for leverage must be clearly outlined and documented in the IPS. One of the great maxims of short investing is that many times the markets can stay illogical longer than an investor can stay solvent.

Employing the Right Strategy

In addition to the level of leverage risk the investor is able to tolerate, the other main issue is the type of hedge fund strategy the investor wishes to employ. There are many variations of a theme, but the alternative investment industry generally falls into a number of broad major categories, which can then be further subcategorized. Investment strategies employed by a hedge fund can be viewed as: arbitrage strategies, event-driven strategies, fixed income strategies, long-short strategies, macro strategies, multi-fund strategies, sector strategies, and trading strategies. These major strategies may be further identified by investment selection methodology, investment style, geographic focus, and industry focus. Investors need to identify these characteristics and understand the impact on the overall investment portfolio in terms of risk, diversification, and possible sources of leverage exposure.

The issue of benchmarks, which is quite important in tracking how effectively a manager is functioning, also requires different metrics from

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

those of traditional managers. In traditional investments classes, the use of relative return comparison is common. The move to investment vehicles, such as hedge funds, puts an emphasis on absolute returns or Minimum Acceptable Returns (MAR). Also, benchmarking a hedge fund manager can be done through several methods, each providing a further slice of information. The most common would be against the manager's target. For instance, a small-cap long/short manager is typically compared to the Russell 2000 (or a version of it). Secondly, the manager can then be compared to the sub-hedge fund index or against the strategy, that is, long/short hedge funds. The final way is more cumbersome but can be revealing. As you screen managers and gain a further understanding of their style, you can build your own composite of managers that invest in similar ways in similar strategies. The selection and use of benchmarks will be discussed at length in Chapter 7.

THE RISE OF SOCIALLY RESPONSIBLE INVESTING

http://www.pbookshop.com

In recent years we have seen a surge of what is usually described as Socially Responsible Investing (SRI). In the 1970s and 1980s, SRI was chiefly concerned with not investing in weapons, tobacco, alcohol, or gambling. Since then, the definition of SRI has expanded as new investment vehicles appeared. Now, SRI considers not only the traditional "sin industries" but also diversity and workplace issues, environmental or political concerns, and ethical constraints. Hedge funds have sprung up that focus on alternative energy and other environmentally friendly industries.

Funds with an objective of shareholder activism try to get companies and management to make changes that benefit or serve society and shareholders. The IPS must spell out any restrictions or expectations for the investment manager. Those charged with portfolio construction must also account for the various factors that may impact returns, risks, and correlation to other investments held in the portfolio. The impact on the portfolio may need to be quantitatively characterized to inform the fiduciaries in order for them to make reasoned assumptions about their objectives and expected outcomes.

FIDUCIARY RESPONSIBILITY

A fiduciary is someone charged with the legal responsibility for managing investments or investment decisions. Existing ERISA law and the Pension Protection Act of 2006 make it quite clear that the interests of the beneficiaries must be paramount to the administration of pension funds. Those who

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

function as trustees understand that they are governed by similar guidelines under the Prudent Man Rule. The Prudent Man Rule can be best understood by a statement Judge Samuel Putnam made back in 1830: All that is required of a trustee is that he conduct himself faithfully and exercise sound discretion. He is to observe how men of prudence, discretion, and intelligence manage their own affairs, not in regard to speculation but in regard to the permanent disposition of their funds, considering the probable income as well as the probable safety of the capital to be invested. This is the "do no harm" rule for investors. Fiduciaries can be further divided into investments stewards, investment advisors, and investment managers—all of whom have different prospective and legal duties but similar goals in providing a reasonable result for the beneficiaries.

Investment stewards have a legal responsibility to manage the investment process. Stewards can be trustees and investment committee members. The steward is charged with developing the overall investment strategy, deciding on asset allocations, defining the details to execute the strategy, implementing the strategy with the appropriate investment manager, and monitoring the activity and results of the entire process. Many times these stewards are untrained and, while they may be well-meaning, they are generally unprepared for the increasingly complicated task that lies before them. To help them in their stewardship, these people may rely on an outside consultant or advisor.

http://www.pbookshop.com

The investment advisor is a professional who is responsible for advising and managing the comprehensive and ongoing investment decisions. Advisors include wealth managers, trust officers, consultants. and financial planners. The vast majority of stewards are heavily reliant on advisors to assist in executing and managing the stewards' fiduciary duties. An advisor can never delegate his or her responsibility away, but can be a co-fiduciary with investment managers. By following prudent investment practices, the advisor can reduce or limit any liability in his role.

The investment manager is the professional who makes the actual investment decision about which securities or funds to select in order to implement the specific mandate of the IPS. The investment manager, in most cases, is given discretion to buy or sell a security or fund within the guidelines set forth in the IPS. All three fiduciaries must work together using well founded guidance and prudence to discharge their responsibilities to the beneficiaries of the funds.

Pension Protection Act of 2006

The IPS should spell out any fiduciary duty and conflicts of interest that may arise in using these instruments. These are of prime importance to

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

ERISA plans. The passing of the Pension Protection Act of 2006 (PPA) has given plan beneficiaries a basis from which to sue the plan and trustees over poor performance, high fees, and inadequate diversification. Although this threat has always concerned trustees, the panic over plan underfunding is now taking center stage as the Baby Boomer population is heading toward retirement.

The establishment of a written IPS will provide ongoing guideposts to an investor—a structured view of risk tolerance, return expectations, and manager and benchmark criteria that can be used to more effectively choose managers who will be closely aligned with the goals of the IPS. The asset policy table provides guidance and breakdowns as to the types and ranges of investment in the different hedge fund categories. A working document used by those charged with manager/fund selection may also include screening criteria, minimum requirements, monitoring guidelines, and criteria for terminating a manager.

The passage of the PPA has also put the issue concerning fees on the regulators' to-do list for the coming years. Fiduciaries must now pay closer attention to their selection of hedge funds and the criteria they use to evaluate those funds. Over the years, Congress and the press have tried to drum up pressure against hedge fund managers because of their perception that fees are too high. The response from the hedge fund community has been that no one is holding a gun to the investor's head, forcing him or her to invest. Now, the new regulations, mediocre hedge fund performance, and 2 percent/20 percent fee structures may lead to a rise in litigation.

http://www.pbookshop.com

Tips for Fiduciaries

The Department of Labor and the SEC target several key points as they relate to fiduciaries. Both regulators encourage disclosure and review of information to insure objectivity and avoid any potential conflicts of interest. Any use of affiliates or financial arrangements between any of the involved parties must not only be disclosed but also analyzed to protect the interest of the beneficiaries, in order to make sure they are not being subjugated to the financial benefit of any of the involved fiduciaries. Even what seems to be harmless on the surface must be fully vetted and openly disclosed. Other issues, such as soft dollar commission arrangements and trading, must be studied for best execution and price. Regulators will look kindly on all parties executing a signed document that outlines duties and acknowledges fiduciary obligations.

A growing number of services are being offered to help a fiduciary execute his duties in the hedge fund area. Moody's and Morningstar are providing ratings of hedge funds. I do not intend to disparage the workings

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

of any organization; however, I would caution fiduciaries not to hang their hats on these products. For instance, Moody's ratings are geared to be similar to its credit ratings for corporations and the probability of default. Many times bonds retain a nondefault rating until after the company has in fact defaulted, which only serves to give investors a rating in hindsight. Recently this has led Congress to begin examining the method and validity of the these ratings. Now consider that the speed at which hedge funds can go from a viable business to hanging out a "Room for Rent" sign is light years faster than such an event typically happens to a corporate bond. Relying on these largely quantitative reports could prove problematical for a hedge fund investor. It was only a period of weeks and months before the likes of LTCM, MotherRock, and Amaranth went from the penthouse to the outhouse.

Morningstar uses a system similar to its mutual ranking system. As you will see in Chapter 5, the use of analysis that is helpful in reviewing traditional assets has little value in pointing out telltale signs in troubled hedge funds. The lack of transparency that is characteristic in the hedge fund world will do nothing to help the analysis. During the tech bubble the number of mutual funds that had five-star rankings was enormous. As a result Morningstar did in fact revise its mutual fund rating system in 2003, albeit too late for investors.

It is probably worthwhile to provide a brief description of the Morningstar system for rating hedge funds. Morningstar goes through several calculations to arrive at a Morningstar Risk-Adjusted Return (MRAR), which is used to provide an overall rank. Morningstar applies a statistical unsmoothing procedure to remove the first order serial correlation and uses the result to estimate risk-adjusted returns. Noting that investors are risk-averse and dislike downside deviation, Morningstar gives more weight to downside variation when calculating MRAR and does not make any assumption about the distribution of excess returns:

In the MRAR, when funds are graded, return is rewarded and risk is penalized in all cases. MRAR is expressed as an annual return and therefore can be decomposed in the return component MRAR (0) and the risk component MRAR(0)−MRAR(2) or MR−MRAR.

The results of the universe of hedge funds for 3, 5, and 10 years are put into a bell curve with the scores and weighted total score.

Score	Percent	Label
5	Top 10%	High
4	Next 22.5%	Above Average
3	Next 35%	Average
2	Next 22.5%	Below Average
1	Bottom 10%	Low

http://www.pbookshop.com

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

Period	Rating	Weight	Multiples
10 Yr	3	50	1.5
5 Yr.	2	30	0.6
3 Yr.	2	20	0.4
Total			2.5 = Rating 3 Stars (rounds up)

The end product derives a rating ostensibly from length of service and performance. No attention is given to the qualitative factor that can greatly impact the fund.

Again, I do not wish to disparage or single out the products or services of either of these companies. My only concern is to point out the rise in companies that will try to provide some service for a fee, but it may not be sufficient to discharge anyone's duty as a fiduciary. Moody's and Morningstar are quite well known and provide a useful service, but of course there are many others that also provide different levels of analysis. It is also worth noting that the number of folks with the ability to understand, analyze, and interpret the activities of hedge funds is limited. The ability to recognize warning signs or pick the wheat from the chaff does not begin and end with sophisticated quantitative tactics, but rather also makes use of good old fashioned qualitative factors that may not fill a spread sheet. One such service that does combine extensive quantitative and qualitative research in its product is Albourne. Albourne can help fill in gaps in one's own work, but the price tag may be steep for mere mortals. Reports are voluminous but they should not replace an investor's old-fashioned work.

http://www.pbookshop.com

WHERE DO I START?

With a sound investment policy in hand, the next step toward finding a successful investment is to plan the search and selection process. The sourcing of hedge fund managers is key. Narrowing down the thousands of hedge fund managers is the first step in a long journey. The IPS will set criteria for asset size, risk/return, and qualifications of the managers, length in business, and other measures. How you search and get access to those prime managers is your next worry. Whether you are a small pension plan, an endowment, or a wealthy individual, getting a peek into the opaque world of hedge funds may not be easy. One of the main reasons Yale, Harvard, and Duke have been able to expertly execute their hedge fund strategy is that they are constantly hounded by new, old, and yet to be launched hedge funds. The search, in effect, comes to them. Using different databases and

P1: a/b P2: c/d QC: e/f T1: g
c01 JWBT047-Stavetski January 14, 2009 3:56 Printer: Yet to come

developing a network will become important assets in helping an investor execute a successful strategy.

It is crucial to remember that regardless of whether you are looking at a single fund or building an entire portfolio, you need to follow a consistent process that provides you (or your board) with a level of confidence that the due diligence process was extensive and rigorous. No one wants to read about his or her hedge fund selection on the front page of the financial pages for spurious reasons.

http://www.pbookshop.com

http://www.pbookshop.com