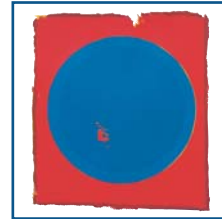


# Perspective



October 2006

## Look Before You Leap: Navigating Through Hedge Fund Implementation Choices

### The industry continues its evolution

The idea of making a hedge fund allocation is no longer as exotic as it once was. As with international investing, what was once new and different has slowly gained acceptance with fund sponsors as a means of furthering portfolio diversification and enhancing fund performance. Continued growth in the number of hedge fund managers as well as institutional assets under management points to this on-going trend. Sources<sup>1</sup> estimate there are now between \$1.2 trillion and \$1.5 trillion in hedge fund assets under management in at least 8,000 funds. In response to investor demand new hedge fund strategies and fund structures are being created, making investment choices more complex than ever.

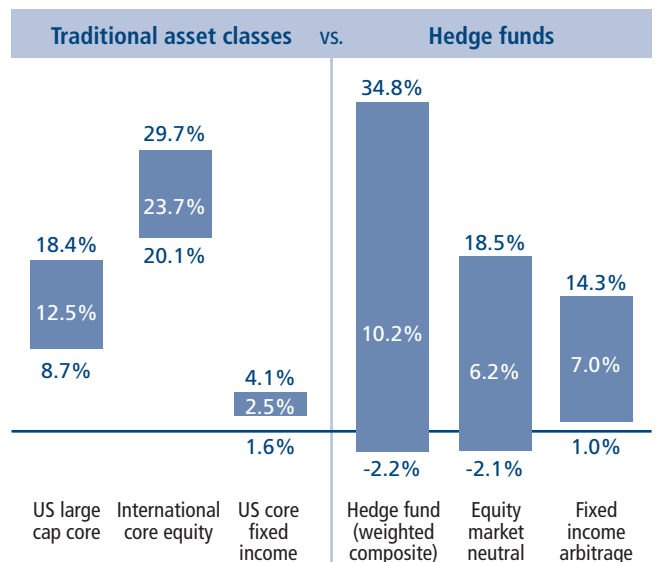
Sponsors can access three main fund structures: single strategies, fund-of-funds and multi-strategies. Each structure has its advantages and disadvantages, and a sponsor must evaluate its organization's strengths and weaknesses in relation to each fund structure.

There are a number of key challenges to be addressed by investors considering any hedge fund structure. Industry statistics have long shown that there is a much wider dispersion in the performance of hedge fund managers than in the traditional asset classes, which points to the steeper penalties associated with making a poor investment choice. Investing skills are scarce, and this is a highly competitive market.

Research to determine the integrity of investment managers' people and processes is always challenging, and even more so in hedge funds with their private partnership structures and more complicated investment strategies. Nevertheless, the desire to properly diversify a hedge fund allocation among the various strategies is a key consideration. Yet, there are associated costs in accessing proper diversification, which range from building in-house expertise to "outsourcing" due diligence to a third party provider.

### Large alpha potential but at greater risk

Manager selection expertise is critical  
3-year period ending June 30, 2006 (p.a.)



The numbers in white in each bar represents 50th percentile.  
Data: Hedge Fund Research, Mercer Investment Consulting

<sup>1</sup> Source: Hedge Fund Research

How does an investor select from among the available set of hedge fund structures and implementation vehicles?

In a perfect world, every investor would have an ideal set of characteristics that they would like embedded in their investment structure. While no one structure can provide all of these desirable traits, investors need to balance their unique objectives and maximize the number of characteristics each structure offers.

### Ideal set of characteristics

- **Access to the “best” managers:** Every investor wishes access to the best-performing managers, yet capacity constraints, account minimums and investor requirements can restrict access.
- **Full transparency:** The ability to review a manager’s portfolio is a key fiduciary responsibility among investors. But until recently, hedge fund investors had to be content with an opaque investment process.
- **Intra hedge fund diversification:** High dispersion of results requires investors to seek strategy diversification, yet diversification raises investment costs (fees and due diligence).
- **Institutional “level” client servicing:** Institutional investors receive superior client servicing from their traditional managers, but many hedge fund managers do not have the culture nor the infrastructure to provide this level of service.
- **Streamlined fees:** Every investor wishes to minimize fee structures to increase return, yet strategy, evaluation, liquidity, diversification and asset size all affect fee terms.
- **Flexible liquidity:** The ability to obtain liquidity is a key component in selecting any strategy, yet hedge fund strategies restrict liquidity based on a variety of factors.
- **Customization capabilities:** Each investor has unique return and risk objectives, and the ability to customize a portfolio towards those objectives are critical.
- **Ease of due diligence and portfolio construction:** The level of manager due diligence is much greater than a traditional product given that performance is primarily based on manager skill (alpha) and less reliant on market performance (beta). Combining various strategies into a well-diversified portfolio is critical to maximize alpha yet minimize risk.

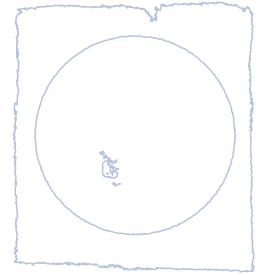
#### Ideal characteristics

	Access to “best managers”	Full transparency	Intra-hedge diversification	Institutional “level” client servicing	Streamlined fees	Flexible liquidity	Customization	Due diligence
Single strategies	●	○	○	○	●	○	●	○
Fund-of-funds	◐	○	●	●	○	◐	◐	●
Multi-strategy	◐	○	◐	◐	◐	●	○	◐

Legend ● Best of group ◐ Acceptable ○ Poor

## Fund structures

Investors have access to three types of hedge fund structures, each one having a distinct set of characteristics: single managers, fund-of-funds, and multi-strategy.



### Single-strategy direct investing:

Single-strategy organizations have built an expertise in a specific hedge fund strategy or group of similar strategies (such as fixed income investing). Most organizations offer a commingled type of investment vehicle, although some firms offer investors customized accounts as part of the negotiation process.

Investors may choose to build their own “hedge fund portfolio” by combining various single strategies into an overall hedge fund allocation. Because of the considerable due diligence effort required, the typical investor will require significant in-house expertise to evaluate and select a series of strategies. Additionally, expertise is required to correctly allocate assets among the selected strategies to achieve the proper return-risk profile. Lastly, expertise is necessary to monitor the investments continually.

One strategy gaining greater acceptance is to invest in a small number of single managers as satellite funds around a core allocation to a diversified fund-of-funds.

#### Advantages

- Higher potential for both return and risk
- Wide array of investment choices, including access to the “best” managers
- Investors can better customize their exposure to the risks and potential rewards they seek
- Investment fees are typically lower than other types of vehicles

#### Disadvantages

- Requires do-it-yourself due diligence and manager networking (select and monitor investments)
- Access to managers can be difficult due to account minimum restrictions
- Requires capability to construct an efficient, diversified portfolio
- Access to managers may be limited due to pre-selection process (that is, managers avoiding sponsors with demanding liquidity and transparency requirements)

## Fund-of-funds:

In a fund-of-funds arrangement, a third-party provider develops a set of portfolios composed of various single hedge fund strategies (such as market-neutral, event-driven, or global-macro) to achieve a certain return-risk profile. The fund-of-funds provider is responsible for the selection and termination of the underlying managers, negotiating fees and constructing the portfolio. Additionally, the provider will conduct extensive due diligence not only on the investment strategy but the manager's operational capabilities.

Most providers have developed several pre-set portfolios to match an investor's objectives and constraints. Some can also customize a portfolio based on the investor's unique requirements.

### Advantages

- Diversified array of funds
- Third party provides ongoing due diligence, operational risk assessment and consistent reporting
- Often have access to hedge funds that have closed to outside investors
- Potential to negotiate shorter lock-up periods and better terms

### Disadvantages

- Charges "extra" layer of fees, typically 1 percent management fee plus a performance fee (5 percent to 10 percent) over a hurdle rate. Imbedded in the gross return are the management and performance fees paid out to each underlying manager. In a multi-strategy fund, those underlying managers net their results before investors pay any performance fee, but in a fund-of-funds, all incentive fees are calculated separately. So an investor can wind up paying higher fees for poor performance
- Little investor contact with the hedge fund managers
- Difficult to be nimble in rebalancing managers due to lock-up periods

## Multi-strategy hedge funds:

In a multi-strategy vehicle, all the hedge fund strategies offered within the portfolio are offered by a single firm. Many of the firms offering multi-strategies are either traditional firms seeking to extend their portfolio management expertise to include hedge funds or single-strategy firms seeking broader appeal by offering multiple strategies. In either case, the portfolio management teams for each product work for a single firm. Similar to fund-of-funds, multi-strategy firms can offer various portfolios at different return-risk profiles or can customize a portfolio to match an investor's investment objectives.

### Advantages

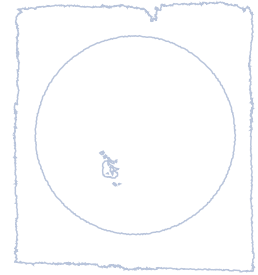
- Offers a variety of strategies from one firm
- No second layer of investment fees
- Institutional-quality client servicing and reporting
- Nets performance fees so an investor does not "pay" for poor performance

### Disadvantages

- Manager may have difficulty attracting and retaining the best talent
- Array of funds offered is usually less diversified than those of a fund-of-funds provider
- Risk of "group-think" or concentration risk
- Exposed to the operational risks of a single firm

## Implementation choices

The choice of a fund structure is the first step in the process. The next step is for an investor to select among several implementation choices. Similar to the fund structure decision, each choice has advantages and disadvantages that investors must evaluate given their requirements.



### Separate accounts:

#### Advantages

- Allow for a higher degree of customization, tailoring the risk and return characteristics
- Fully transparent through prime brokerage system
- May allow for negotiated fees
- May provide layer of security against fraud or malfeasance

#### Disadvantages

- Many managers do not offer separate accounts
- Minimum commitment is usually significantly larger than commingled vehicles (for example, most funds-of-funds require \$100 million to build a separate account)
- Consult tax attorney for potentially severe tax consequences, such as Unrelated Business Income Tax (UBIT)

### Commingled vehicles:

#### Advantages

- Usually have lower minimum investment requirement than separate accounts
- Virtually all hedge fund managers offer commingled accounts
- Standardized reporting

#### Disadvantages

- Less flexibility on terms such as fees, lock-up, and transparency
- Investors have less control over assets, and thus higher potential for manager fraud

### Transparent platforms:

#### Advantages

- Set up as separate accounts, so most of the benefits of separate accounts are captured
- Third-party due diligence can provide a level of security
- Platform provider may provide risk analytics and better aggregate reporting than do-it-yourself

#### Disadvantages

- Limited number of managers available
- Investors must become familiar with the platform provider's due diligence efforts
- Added layer of fees

## Making the best choice for your organization

When it comes to hedge fund structure selection and implementation, there is no one right choice. Rather, the unique characteristics of a fund sponsor should be given thoughtful consideration in determining whether the requisite resources are in place for a particular implementation strategy.

The following questions can help focus the hedge fund implementation decision:

- How does your investment committee or board of trustees view hedge funds? Are they experienced investment professionals or lay people in need of education? Do they have contacts within the industry?
- Who will educate your board? How much time can be allotted to this process?
- Do fund sponsors have previous experience with non-traditional asset classes such as private equity or real estate? What lessons can be learned from prior investment decisions?
- Does the fund have enough staffing resources to dedicate to hedge fund investment implementation and monitoring? How much work can be done in house vs. external sources? Does the investment committee have the time to consider this each quarter?

### What is a transparent platform?

Typically hedge fund managers have control of their clients' assets. Within this system, the expected safeguards are independent prime brokers and independent auditors, but there have been notable failures. Thus, a growing trend in the hedge fund market is the use of separate account trust structures to reduce the risk of fraud and operational problems. In this paper, we refer to the platforms created to establish trusts for multiple investors within a fund as "transparent platforms." The assets remain under the custody of the trust, controlled by an independent trustee and custodian, and the trading managers (i.e., the hedge fund managers) execute trading strategies but are never in position to transfer assets outside the trust.

## Conclusion

While the hedge fund allocation decision is a key component to the investment process, the actual implementation of that decision involves analyzing various fund structures and implementation choices, each with its own advantages and disadvantages. The best approach depends on the asset size of the fund, the risk tolerance of the committee, cost and available resources.

The nature of hedge fund strategies, vastly different in scope coupled with a high reliance on manager skill to produce alpha, presents a challenge. Dispersion of manager performance is quite high relative to traditional asset classes, and selecting the right manager and properly diversifying the portfolio are critical.

Sponsors should first examine the ideal characteristics most relevant to their organization, and then turn to the advantages and disadvantages of the various fund structures and implementation choices. While there is no one right answer, proper due diligence is necessary in meeting fiduciary responsibilities and critical to achieving the sponsor's ultimate objectives.

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