ALTERNATIVE MULTI-MANAGER MUTUAL FUNDS

PERFORMANCE STILL WEAKER THAN EXPECTATIONS

The Philosophical Debate

How much performance do you "lose" when you take a typical hedge fund strategy and run it within the constraints of a mutual fund?

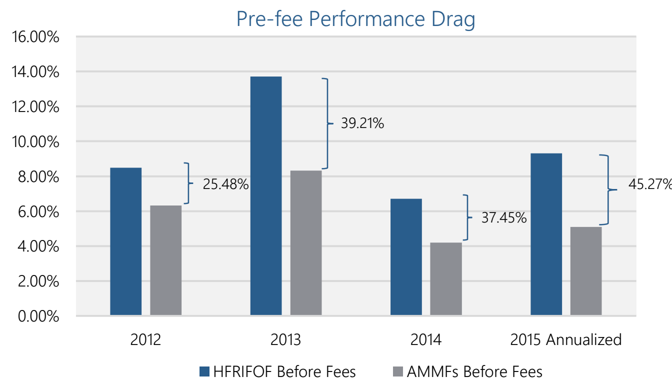
At a conference two years ago, the head of a multi-billion dollar hedge fund was asked the question, "why not start a mutual fund?" His response was that they'd looked closely at the issue, but concluded that the inability to use leverage and derivatives would cost 600-800 bps in performance. For a fund that is known for consistent performance of 600-800 bps over LIBOR, he quipped that "there are easier ways to get LIBOR returns."

Ask the sponsor of an alternative multi-manager mutual fund (AMMF), and the canned response is "well, you might lose some performance since you can't invest in illiquid assets, but you make it back in fee savings." Prior to 2012, AMMFs were considered to have only B or C managers – the better players, it was argued, would never run money with daily liquidity at 1%. Those early AMMFs tended to perform poorly. Starting in 2012, however, new entrants could make the claim that they were getting top tier managers to run silos within the overall portfolio. This new approach was the purported solution to historical performance drag and would level the playing field with institutional hedge fund portfolios.

So, who is right?

How Much Performance Is Lost Before Fees?

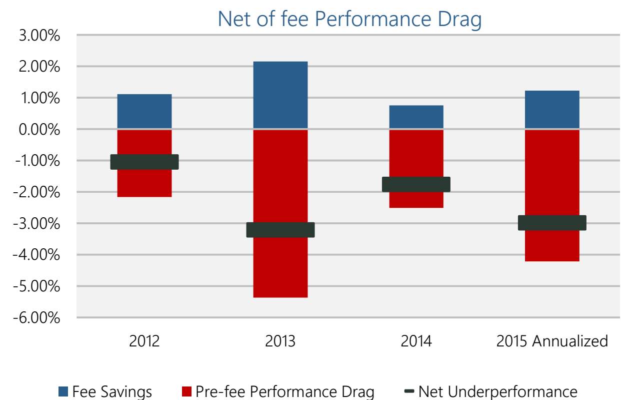
In the following chart, we compare the annual pre-fee returns of the HFRI Fund of Funds index to that of the universe of AMMFs we track. For the HFRIFOF, we add back estimated management and incentive fees at both the fund of funds and hedge fund level.[1] Over the past three and a half years, pre-fee performance of AMMFs has been 350-400 bps lower on average – a surprisingly high 25-45% of pre-fee returns.



[1] The HFRIFOF returns were grossed up on an annual basis assuming an annual FOF management fee of 1% and an underlying hedge fund fees of 1.5% and 20%. The AMMF returns were grossed up using an average of the all-in fees and expenses reported on each fund's most recent prospectus.

How Much is Made Back in Fee Savings?

The next question is how much is recovered in fee savings. The average expense ratio of the AMMF universe is approximately 250 bps per annum. We estimate the all-in expense of a typical fund of hedge funds at approximately 400 bps per annum, which implies fee savings of around 150 bps per annum. As shown below, lost performance has exceeded the fee savings by 200-250 bps per annum, resulting in net underperformance of 200-250 bps per annum:



Conclusion

The results above are not per se an indictment of the AMMF model. Liquidity is extremely valuable for many investors – some estimate the illiquidity premium at 3-5% per annum. Factoring in liquidity, AMMFs arguably outperform funds of hedge funds. And a minority of AMMFs have actually outperformed the HFRIFOF net of fees – a clear win for investors. Further, some strategies – such as equity long/short – are more conducive to the constraints of the 40 Act structure and in theory should have comparable results.

The industry will continue to evolve. Yes, AMMFs can now point to "A List" managers who subadvise the portfolios. However, many institutional investors have raised concerns that investors in AMMFs are getting either the "B Team" or "B Strategy" at the "A List" firm. So far, the magnitude of performance drag suggests that there is some truth to this.