



HEDGE FUNDS: SAUCE FOR THE GOOSE...AND THE GANDER?

JULY, 2007

In recent years, enormous endowments like those of Harvard and Yale, as well as many large foundations, have been devoting increasing portions of their investment portfolios to “hedge funds” and other alternative investments. As widely reported, many of these large institutional investors have also experienced stellar risk-adjusted returns, attributable in substantial part to their alternative investments. Many smaller foundations and endowments have largely avoided alternative investments, assuming that they are too exotic, or too risky, or that the necessary resources to select and monitor them are not available at reasonable cost. In our view, on close examination, this assumption usually proves unfounded: there is a place for hedge funds, and perhaps other alternatives as well, in the investment portfolios of many mid-sized foundations and smaller foundations with investment assets of at least \$25 million.

Hedge Funds: What are they?

The term “hedge fund” describes a form of investment vehicle, typically a privately-offered limited partnership or limited liability company, intended for institutional investors and wealthy individuals who are able to meet a large investment minimum. A hedge fund does not represent or constitute a single asset class; instead, different hedge funds follow any number of different strategies that may or may not involve short selling, leverage, derivatives and other specialized investment techniques. Interestingly, today some “hedge” funds actually don’t hedge their market exposures. Hedge funds can include either absolute return or directional strategies such as equity long-short, merger arbitrage, and global macro, as well as many other investment strategies and approaches. No matter what approach, the vast majority of hedge funds charge an incentive fee, typically at least 20% of profits, in addition to ongoing management fees.

Hedge Funds: Why should any Foundation or Endowment Consider Them?

A common viewpoint is that hedge funds have the potential for high return and therefore inherently also have high investment risk, in terms of both volatility and potential loss of the invested principal. Certainly, some kinds of hedge funds may be used to pursue a high return strategy with an attendant higher risk level, and that can be appropriate for a selected portion of an investment portfolio. However, not all hedge funds fit into this high octane category. Moreover, hedge funds have other important uses in addition to seeking relatively higher returns.

One such use is actually to achieve risk reduction, to the extent a selected hedge fund is uncorrelated or has low correlation with other assets held in an investment portfolio. In this regard, it is worth noting that many long-only managers have an explicit or implicit goal of exceeding a defined benchmark index, and as a result their performance is often well correlated with that of the benchmark. By contrast, hedge fund managers frequently are not sensitive to any benchmark index and, as a result, freely pursue investment strategies that are not highly correlated with an index or with other portions of an investment portfolio. Furthermore, contrary to common understanding, the investment risk inherent in the long-short strategy adopted by many hedge funds is often materially smaller than that of a pure long-only equity



portfolio. Also, a hedge fund following an absolute return strategy may, if successful, produce positive returns in both up and down equity or fixed-income markets. Certain hedge funds may also fit in as part of an inflation hedging strategy. In short, hedge funds come in many colors, and one or more of those colors will often be a useful component of an investment portfolio's palette. Just as there are many distinct types of mutual funds (from low-risk money market funds to high-risk sector products), there is a wide spectrum of hedge funds to consider.

In evaluating whether hedge funds are likely to add value, an appropriate starting point is to take an inclusive view of all of the investment and spending goals of a foundation or endowment. This will include consideration of the desired rate of return and appropriate level of risk, liquidity and spending needs, existing portfolio investments, size of the portfolio and other factors specific to the investor. Then, it's appropriate to evaluate on a total portfolio basis whether one or more hedge fund strategies may help to achieve those goals in a more effective manner (i.e., with a higher expected return at the same risk level, or the same expected return at a lower risk level) than using only traditional stock and bond investments. In our view, for a foundation or endowment with at least a \$25 million total investment portfolio, hedge funds, especially absolute return hedge funds, should be given serious consideration for inclusion in that portfolio. (For these smaller investors, it may be necessary to invest in funds of hedge funds, which do carry an extra layer of expenses, but even in this case important diversification benefits can be achieved.) For investment portfolios of \$50 million or more, hedge funds, including directional hedge funds, will almost always serve as appropriate portfolio components. While the size of the portfolio may influence choices regarding the appropriate hedge fund mix, e.g., between directional and absolute return and between hedge funds and funds of hedge funds, hedge funds should not be viewed as inappropriate per se merely due to an investor's smaller size.

Hedge Funds: How Should the Key Issues be Addressed?

Hedge funds can pose risks not typically associated with traditional stock and bond investments. Due to their relatively unregulated nature and a general lack of transparency, as well as other structural and operational features, hedge funds do require a substantial degree of analysis and evaluation. Limited liquidity of the investment and the broad authority afforded the general partner or managing member are other important features an investor must take into account. Following is a discussion of what we regard as the most important issues, along with our approach in addressing them.

Risk Control: Evaluate the People, the Process and the Structure

In the hedge fund context, investment loss may result from dishonesty, lack of skill and/or judgment, or both. Recent highly publicized examples include the Bayou Fund, which appears to be a clear case of fraud, Amaranth, which appears to have been attributable to poor risk controls and judgment, and several others along similar lines. These examples do not, however, taint the entire hedge fund landscape; there are many, many hedge funds that do not suffer from these problems. The key, of course, is to be able to find them, assess them, and then have confidence in that assessment. It is therefore necessary to perform, or rely on a trusted consultant to perform, a thorough due diligence process that examines the hedge fund's



managers and investment process, as well as the legal structure, organizational resources, and features of the investment. In general, this involves gaining an understanding of the sources of risk and expected return, the amount and nature of any leverage, the risk controls the manager has in place, and what might go wrong under what sets of circumstances. More specific factors usually include the following:

- Background and reference check on key personnel
- Verification of claimed assets with custodian/prime broker
- Examination of audited financials and confirmation from auditor
- Close review of private placement memorandum, limited partnership agreement, and subscription documents
- Evaluation of structural features such as conflicts of interest, limitations on redemptions, key man provisions and any side letters

The process of evaluating and controlling manager risk involves not only a close examination of a particular fund, but also consideration of how the strategy followed by that fund may correlate or be uncorrelated with other managers in the alternative portion of the overall portfolio. It is equally important to consider the degree of correlation with the remaining portion of the investor's total overall portfolio.

Performance Expectations

As with any investment, past performance of a hedge fund manager is no guarantee of future results. However, an assessment of anticipated future performance may be particularly difficult with respect to any hedge fund manager, because benchmarking hedge funds is notoriously difficult (due to survivorship bias and other defects of available hedge fund indices) and the possibility that shifts in strategy have occurred or will occur and will not be readily apparent except, well after the fact, from the results achieved. Also, because hedge funds almost always have high fees (the traditional 1% management fee and 20% carried interest have each increased in many cases to considerably higher levels), to achieve the desired after-fee returns it is necessary to find exceptional managers, not just above-average or good managers. Of course, even an exceptional manager may not be able to overcome a top-end fee structure, so it will usually be prudent to avoid those with unusually high fees. With the number of entrants in the hedge fund provider space increasing dramatically during the past few years (and the asset levels of many existing funds increasing enormously), it has admittedly become more difficult to separate the wheat from the chaff, and sometimes even to find the right haystack. However, in our experience, many exceptional managers still exist and can be found through diligent research, networking and intensive use of industry contacts.

Trusting Valuations

In determining the value of an investment in a hedge fund, an investor will normally rely on a valuation provided by the general partner or fund manager. How can an investor know that valuation is likely to be correct? Our view is that, while the inclusion in a portfolio of some non-traded or illiquid assets often presents valuation challenges, various external confirmations or checks can provide a substantial degree of confidence with respect to the portfolio as a whole.



One such confirmation, of course, should come from annual financial statements audited by a reputable independent public accounting firm with considerable experience auditing hedge funds. (We would not recommend investing in a hedge fund that is not audited by such a firm.) This will often also be helpful in complying with the American Institute of Certified Public Accountants (AICPA) practice aid adopted last year that addresses audit considerations for alternative investments, by serving as high quality evidence to substantiate the accuracy of hedge fund valuations. It is also helpful if valuations provided by the fund are initially prepared for the fund by a reputable hedge fund service provider not affiliated with fund management. An investor's adviser should, with respect to funds recommended by the adviser, also be able to obtain confirmation of the approximate value of the assets held by the fund's custodian and/or prime broker(s) on its behalf on a periodic basis, which should be reasonably accurate unless the fund holds a meaningful amount of non-marketable investments. If more precise valuation is a critical concern, then the investor may wish to consider only investing in those hedge funds that invest substantially all of their assets in marketable securities.

Jeopardy Investments

Private foundations and their managers are potentially subject to federal excise taxes if they invest foundation assets in such a manner as to jeopardize the carrying out of any of a foundation's exempt purposes. Notwithstanding the general public's view of hedge funds as exotic and risky investments, foundation managers are normally able to conclude that the jeopardy investment prohibition will not preclude investing in hedge funds, provided that appropriate due diligence is performed to understand and evaluate the nature of each particular fund, and that where the fund fits into the foundation's overall investment portfolio is appropriately considered with ordinary business care and prudence. Trustees or directors of endowments, trusts or other institutional investors who are not covered by the jeopardy investment rules but who are subject to prudent trustee or other fiduciary standards are also usually able to authorize investments in hedge funds after conducting an appropriate evaluative process, with the advice of such experts as they may deem necessary.

Liquidity Concerns

Many foundations and endowments have annual distribution requirements or goals, as well as an ongoing need to pay current expenses, which will require that a portion of the overall investment portfolio be highly liquid. Hedge fund interests are not liquid, since there is no market for them and redemption rights are the only available exit. Of course, they also typically do not make any substantial periodic cash distributions. The normal way that an investor addresses this constraint is to plan to meet the required liquidity needs from other portions of the investment portfolio. However, many hedge funds do offer a degree of liquidity, often consisting of quarterly redemption opportunities after an initial lock-up period, typically of one or two years, that may be a supplemental source in the event of unexpected cash needs. An investor highly concerned with liquidity could choose not to invest in any hedge fund with longer lock-up periods or less frequent redemption opportunities. It is worth noting, though, that some funds charge lower fees for investors who agree to more restrictive redemption provisions and that there has been a trend in recent years toward longer lock-up periods.

Unrelated Business Taxable Income (“UBTI”)

Foundations and endowments, as well as most other types of otherwise tax-exempt investors, are subject to federal income tax on any unrelated business taxable income (aka “UBTI”) they may earn in excess of a nominal exclusion amount. (Some states also tax UBTI.) In the context of hedge fund investments, we have seen this issue addressed in one of three ways.

First, and most common, many U.S.-based fund managers set up an offshore hedge fund in a favorable tax jurisdiction, such as the Cayman Islands or Bermuda, for investment by U.S. tax-exempt investors. These offshore funds, because they are classified as corporations for U.S. tax purposes, block any UBTI from reaching their tax-exempt investors. Although some investors have expressed concerns about the offshore nature of these investments, the fund managers or advisers usually remain within U.S. jurisdictional reach, offshore custodians and auditors are normally affiliates of reputable corresponding U.S. companies, and the relevant foreign jurisdiction generally has clear and detailed laws intended to protect investors. Consequently, the offshore fund approach has gained wide, general acceptance among U.S. tax-exempt investors, as well as foreign investors who often will invest in the same funds.

Second, and considerably less common, some U.S.-organized hedge funds allow tax-exempt investors to opt out of any UBTI by checking a box on the subscription agreement. Of course, opting out of the UBTI not only avoids the adverse tax consequences, it also precludes participating in any economic benefit from the UBTI such a fund may realize. This approach is therefore likely to be appropriate only if a fund is not expected to earn any substantial portion of its total return from UBTI.

Finally, some hedge funds permit U.S. tax-exempt investors to invest in them alongside taxable investors, without any ability to opt-out of UBTI, but do not expect to generate any material amount of UBTI. It’s worth noting in this regard that “leverage” does not necessarily produce UBTI. Leverage in the form of acquisition indebtedness, including margin purchases, will result in UBTI. However, leverage achieved through many derivative transactions, including short sales, generally will not result in UBTI, provided the particular derivative in question does not involve a borrowing or deemed borrowing of money by the fund. As a result, it is not uncommon for hedge funds that use substantial leverage to produce only insubstantial, or no, UBTI. Therefore, this third approach is often a viable alternative; as in the case of other issues noted above, comprehensive pre-investment due diligence will enable the investor to evaluate the potential for UBTI from any prospective hedge fund investment.

Entrance Requirements

Many hedge funds require very substantial minimum investments. However, the stated minimums are often reduced significantly for an investor referred by an adviser or consultant who has a pre-existing relationship with the hedge fund manager. The actual minimum for different funds that may be appropriate should be viewed in the context of the investor’s overall allocation to hedge funds in making appropriate choices. For example, if a foundation with \$50 million in total assets concludes that it is appropriate to invest \$5 million in hedge funds and the otherwise appropriate funds each have \$3 million investment minimums, then adequate

diversification within the hedge fund component may not be achievable by investing in separate funds, and a single hedge fund of funds may be a more appropriate choice. By contrast, a \$100 million foundation that wants to allocate \$15 million to hedge funds may be able to achieve adequate diversification among hedge fund managers by investing \$3 million in each of five separate funds pursuing distinct, different strategies. In general, the ability to choose that route will often be preferable, because it avoids the additional layer of fees inherent in a hedge fund of funds.

Legal entrance requirements also need to be considered. Hedge funds usually seek to qualify as exempt from registration as investment companies by relying on an exemption contained in either section 3(c)(1) or section 3(c)(7) of the Investment Company Act of 1940. Section 3(c)(7) is the more difficult hurdle, generally requiring a foundation or endowment to have more than \$25 million in investment assets in order to be classified as a “qualified purchaser.” However, in a no-action letter released in March, 2007, the SEC has offered some relief for certain foundations that meet specific requirements, agreeing not to challenge their treatment as qualified purchasers and allowing them to invest in hedge funds if they have at least \$5 million. Also, hedge funds that rely on section 3(c)(1) are still quite common. Therefore, the legal entrance requirements are often not an insuperable hurdle even for smaller foundations, although they may serve to limit the available opportunity set.

The Costs of an Investment Review

Admittedly, reviewing and evaluating prospective hedge fund investments can involve a lot of time and effort. However, evaluating prospective stock or bond investments, if done properly, is also a resource-intensive process. In both cases, foundation or endowment management can prudently delegate the evaluation process to an appropriate expert, whether internal or external. To the extent review of a potential hedge fund investment may involve more document review from a legal perspective, there are many service providers with appropriate expertise, and the fundamental issues are similar from fund to fund. With experience and advice, these issues become less of a challenge over time, and they certainly should not serve as an obstacle preventing participation in a desirable investment opportunity.

What about Private Equity or Other Alternative Investments?

Many of the issues noted above are also inherent in private equity and other alternative investments, but each such investment will present them in its own way, and may also present other issues. For example, private equity funds and hedge funds may have similar legal structures, but private equity funds are entirely illiquid, have a much longer required time frame, raise other issues such as the need to diversify by vintage year, usually do not have an offshore alternative and may not have any other structure intended to block UBTI, and frequently have quite different fee arrangements. Also, the best returns have often come from the larger private equity funds, to which smaller investors may simply not be able to gain access. The chief characteristic that private equity funds share with hedge funds, along with other alternatives, is that they may help an institution in achieving its overall investment goals in terms of return and risk by filling an appropriate role in the overall portfolio. However, that can



only be determined by deciding on those goals and constraints and then reviewing prospective investments to determine where they fit, if at all, into the chosen asset allocation.

What's Really Different about the Large Institutions?

Very large foundations and endowments have more resources, more access, and more opportunities, and they may well, in the aggregate, be able to use hedge funds and other alternative investments more effectively by finding the best managers and being able to obtain access to them. However, there are hedge fund managers that can provide exceptional returns and that are still open and available. Indeed, smaller investors can actually have an advantage over the behemoths, because the smaller investors can access the small to mid-sized hedge funds, which can be the best performers. The largest foundations and endowments, by contrast, will often invest with the huge funds whose managers have established themselves and made their reputations over many years, yet may now no longer be as hungry, and certainly cannot be as nimble, as they were in years past when they managed much smaller pools of assets. Smaller and mid-sized foundations need not assume they are foreclosed from finding highly beneficial opportunities in this space, and should not conclude that the risks or due diligence costs are too high. In our experience, quality hedge fund opportunities are out there, and we expect that to continue to hold true. We encourage those investors not to give up on this area just because they are not Harvard or Yale.