SEI Knowledge Partnership
Insights for Investment Managers

7 Ways to Reinvention

Evolving and Enhancing the Funds of Hedge Funds Model

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SEI's 2012 funds of hedge funds (FoHF) survey was conducted in June 2012 by the SEI Knowledge Partnership. Online questionnaires were completed by senior managers at 220 institutions including institutional investors, investment consultants and FoHF managers.

The level of involvement with FoHFs ranges from organizations wholly dedicated to these products to organizations where FoHFs represent a relatively small slice of overall assets. Investors participating in the survey reported a median of 9.0% of their assets were held in FoHFs. Consultants reported a median of 3.1% of assets in FoHFs.

"The reports of my death are greatly exaggerated"—Mark Twain

While predictions of the industry's demise appear to be off the mark, the need for innovation is undeniable.

"...Funds of Hedge Funds Fight to Stay Relevant..."

"...FoHFs Manage Historically Low Percentage of HF Assets..."

"...The End is Nigh for Smaller Funds of Hedge Funds..."

Judging by this sampling of recent headlines in investment industry websites and publications, it would be easy to conclude that funds of hedge funds (FoHFs) are headed toward eventual extinction. There is no doubt that many are showing signs of duress as they face serious challenges—and this could spell potential trouble for the hedge fund industry overall. FoHFs have been the conduit for billions of dollars in hedge fund investments, and the core to many hedge fund portfolios. If the ranks of FoHFs thin out, smaller or less sophisticated investors—institutions and high-net-worth investors alike—may not have other ready pathways for hedge fund investing save the opportunity cost of investing directly in hedge funds.

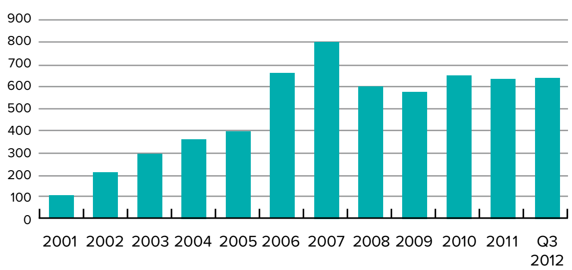
Yet, dire as the situation may seem to those FoHF managers who are watching their assets dwindle and fees severely curtailed, the bigger picture is far more nuanced, complex and indeed, optimistic. The FoHF industry is by no means monolithic. Rather, it is a mosaic of fund structures that vary widely in their investment strategies, methods, client services, and business approach, as well as in their level of growth. Based on our recent survey of institutional FoHF investors and fund managers, along with our review of the latest thinking in the industry, at SEI we believe that the fund of hedge funds model may have more resilience and adaptability than some observers seem to think. With this paper we hope to stimulate thinking and dialogue on ways FoHFs can not only survive, but adapt themselves appropriately to remain prescient and even thrive in the years ahead.

A Troubling Trajectory

Viewed from 10,000 feet, FoHF trends suggest an industry on the ropes:

- **Stagnant AUM.** While single-manager hedge funds came roaring back after the financial crisis, rebounding to $2 trillion in assets by the end of 2011, FoHF assets have been more or less flat. Total assets managed by FoHFs fell from their 2007 peak of $798 billion to less than $644 billion as of year-end 2011, according to Hedge Fund Research, with no clear turnaround in sight [Figure 1].

Figure 1—Assets Under Management (AUM) by Funds of Hedge Funds ($ Billions)



Source: Hedge Fund Research

It is important to note, however, that the official AUM tally may understate the actual amount of assets in the hands of FoHF managers, as it oftentimes excludes assets in managed account structures, which have grown substantially in popularity. This AUM tally also neglects to include the myriad of FoHFs created and sponsored by family offices, pension consultants and other intermediaries who are not themselves FoHF firms. Anecdotally, some FoHF firms report that 80% of the new assets they manage are in managed accounts, and assets on managed account platforms grew by nearly 23% in 2011, according to InvestHedge.[1] The upshot is that, as data on managed accounts assets become more widely available, the industry's overall AUM trends may look far better. Still, while some FoHFs are indeed seeing continued asset inflows, many are experiencing outflows.

- **Declining market share.** According to the research firm eVestment/HFN, assets held in FoHFs were equivalent to 36% of those held in single-manager hedge funds at the end of 1Q 2012, down from 38% at the same period last year and 49% three years ago.
- **Revenue starvation.** Many FoHFs are still working to recoup the steep losses they suffered in 2008. Those failing to hit their high water marks have not earned performance fees for three to five years, yet must deal with a cost structure under severe pressure—a scenario that is clearly not sustainable.
- **Disgruntled clients.** The average FoHF gained 11.5% in 2009 and 5.7% in 2010, taking steps to regain investor confidence. But in 2011, the average FoHF lost 5.7%, leaving clients with a loss of confidence that even a subsequent 3% first-quarter uptick could not eliminate.[2] Limited transparency had been another hot button for many investors, although many FoHFs since 2008 had made it a practice of offering full manager-level transparency. With the industry's growing reliance on institutional clients, who now represent 60% of FoHF asset flows, up from 45% only a few years ago, FoHFs are more vulnerable than ever to the growing expectations of major institutions, which have more options than ever to access hedge funds without needing to access the FoHF vehicle.[3]
- **A value proposition under fire.** The added layer of fees charged by FoHFs has eroded returns while adding to the pressures of meeting risk and return expectations and the non-correlation, diversification benefits FoHFs work to deliver to justify their fees. Some FoHFs have also taken fire for unintentionally diversifying away the alpha of their underlying strategies, putting investors in the position of paying high costs for beta.

- **DIY investors.** Institutional investors, particularly small and medium-sized institutions, have commonly relied on FoHFs when they did not have sufficient in-house expertise to perform hedge fund manager selection, due diligence and risk management. Many used FoHFs as a first step and interim solution to gain the investment acumen necessary to evaluate and ultimately invest in direct, single-manager hedge funds. Now many institutions feel they have the necessary tools and in-house investment acumen—often supported by their pension consultant(s)—to invest directly into hedge funds despite the additional oversight and resources necessary to properly evaluate those investments. Some larger and more experienced investors, such as the $76 billion Columbus-based Ohio Public Employees Retirement System and the $50 billion Massachusetts Pension Reserves Investment Management Board, have also been shifting (or "diversifying") assets from FoHFs to direct investments in single or multi-strategy hedge funds.[4]

- **Heightened competition.** Consultants and single-manager hedge funds are increasingly disintermediating FoHFs by offering competing advice and services and even acting as FoHF managers themselves. For example, the consulting firm of Towers Watson was recently hired by a U.K. pension plan, the Willis Pension Scheme, to invest a portion of its hedge fund portfolio with multiple managers on a fiduciary basis.[5] Similar stories are cropping up frequently in industry news. "Given the *de minimis* margins post-2008, the hedge fund industry and those firms creating, offering access to, and constructing hedge fund portfolios are all shape-shifting themselves to the evolving needs of the institutional investor. In some ways, everyone is doing everyone else's job with the nuanced "edge" tied to access, capacity, lower fees, customization and outsourced bespoke programs. The industry shifted from independent firms offering clearly defined funds and products to all firms offering a myriad of hedge fund solutions, utilizing any vehicle or structure necessary to win coveted institutional assets," said Rachel S.L. Minard, Founder and CEO of Minard Capital, which advises firms on marketing to institutions.

- **Intensifying fee pressures.** In recent industry panel discussions with major institutional investors, the message has been loud and clear. As put by Joseph A. Dear, Chief Investment Officer of CalPERS, "Only a few managers" with outstanding alpha generation can "…justify their high fees. For everyone else, it's negotiable."[6] Anecdotal evidence confirms that many FoHF managers are substantially whittling down management and performance fees, in some cases settling for minuscule management fees or waiving them altogether for larger clients.

The net result of all this *Sturm und Drang* can be seen in the wave of attrition and consolidation in the ranks of FoHFs, especially among smaller and mid-sized firms. FoHFs managing more than $1 billion were the only group whose numbers grew in 2011, according to a study by PerTrac; reflecting a "bigger is safer" attitude among their mainly institutional client base, that group grew by 18% last year. Meanwhile, the number of FoHFs with $500 million to $1 billion in assets shrank by 5.9% during 2011 while the $250 million-to-$500 million category saw a contraction of nearly 16%.

For some larger funds and financial firms, the squeeze on small and mid-sized managers has presented an opportunity to buy scale or enter the FoHF arena by snapping up firms for attractive multiples. In recent months, for example, long-only manager Franklin Templeton bought a majority stake in K2 Advisors and the Man Group acquired FRM.[7] Those in the industry are wondering who will be next, and expect this consolidation to continue well into 2015.

No Longer Relevant? Not So Fast...

This litany of troubles has led some to predict the demise of the FoHF business—but not the structure—within the next decade. Other industry observers, however, point out that the universe of hedge fund managers and strategies has continued to grow in size and complexity. Even among large institutional investors, few have all the internal capabilities needed to deal with the full spectrum of investment issues and possibilities. And even the most sophisticated investors still need advice and expertise in areas from manager selection and due diligence to risk management, performance attribution, and monitoring. With over 55 pension consultants in the U.S. actively deploying their clients' assets into hedge funds (and FoHFs), the intermediaries or pension consultants are also facing pressure in their fiduciary obligation to ensure the hedge funds they recommend reflect the best interests and objectives of the plan's investment goals.

Some positive signs can also be discerned beneath the surface of industry AUM data. The ten largest FoHF firms (as opposed to funds) registered a 2.6% increase in AUM during the course of 2011, according to InvestHedge data.[8] Indeed, 47% of the FoHFs with more than $1 billion in assets saw positive asset growth in 2011, and the total AUM in this group increased by some 10%.[9] Clearly, some firms are doing well, even if business pressures are forcing some others to slash expenses or close up shop.

SEI's survey data adds another dimension to the story—one supporting the conclusion that FoHFs won't be disappearing anytime soon:

- Three-fourths of all investors and consultants agree that "The current FoHF business model is still relevant for many investors."
- One-third of investors report that FoHFs are their only hedge fund investments, and another third describe them as "core" to hedge fund portfolios.
- 72% of investors and consultants believe that "FoHFs still play a valuable role in institutional investment portfolios."
- Four out of five investors surveyed (and almost two-thirds of consultants) see FoHFs as an ongoing component of portfolios, rather than as a way station on the road to direct hedge fund investing.
- An important attitudinal signpost is the expectation, expressed by 84% of investors and consultants, that "FoHFs will exist 20 years from now."

According to our findings, many investment professionals still view FoHFs as a vital resource for smaller investors. More than 64% of consultants and 39% of investors named "getting around small portfolio size" and "limited organizational resources" among the top three reasons for investing in FoHFs; in fact, that rationale garnered the highest response among any of the reasons named. But anecdotally, even large investors say they need to leverage their internal resources with the kind of specialized expertise that experienced FoHF managers have to offer. Interestingly, FoHF investing does not preclude the contributions of the institution's pension consultant nor the effective leveraging of internal resources alongside the FoHF investment. By not being mutually exclusive, FoHF firms have been, for well over a decade, and remain "strategic partners" with their investors, evaluating the FoHF investment alongside their overall portfolio. This is a mandatory step in evaluating overall portfolio risk.

"There are four notable risks in hedge fund investing: headline, business, operational and investment. Each requires targeted acumen in understanding its effect within the context of the overall portfolio," noted Rachel Minard.

Confronting Dissatisfactions

Despite the broad vote of confidence by investors and consultants, the picture painted by survey results is not altogether reassuring for FoHF managers.

Consistent with reports of industry-wide outflows, nearly 44% of investors reported lowering their allocations to FoHFs over the past three years while 26% said their allocations had increased. Among those who said they had lowered FoHF allocations, most reallocated those assets to direct hedge fund investments, which, Minard confirmed, "is a natural matriculation of the hedge fund industry and not necessarily an abandoning of the FoHF model. Much more so, this seismic shift is simply the industry's need for finding efficiencies and higher ROI for the fees charged and greater infrastructure required to effectively evaluate the risks in sizing hedge funds into a well-diversified portfolio."[10]

Looking ahead, investors were evenly divided when it comes to planned allocations, with about 30% expecting reductions and the same percentage anticipating an increase over the next three years. Consultants are particularly bearish, with nearly 64% saying they expect to recommend lowering the percentage of portfolio assets allocated to FoHFs.

Why the exodus? Several reasons stand out.

- Three out of four investors and consultants say that returns over the past three years have been "underwhelming"—but they are not alone, as almost half of the FoHF managers surveyed also agree with them.
- Fees are a hot button, with 69% of investors and consultants agreeing that "FoHF fees are generally too high for the value delivered."
- Nearly a third of investors and consultants report that diversification benefits of their FoHF investments were not "as advertised."
- Almost 41% disagree that FoHFs have generally met their transparency needs.

Responses to attitudinal questions sound other cautionary notes. While one-third of investors and consultants disagree with the statement that "FoHFs are no longer competitive," more than one in five agree with that statement. Investors and consultants are also divided on whether FoHFs "only make sense for smaller, resource-strapped investors," with 36% disagreeing and 29% in accord with that statement.

Reality Check

Survey results show a marked disconnect between investor/consultant and manager responses on some key issues—and in some cases, a surprising level of divergence.

For managers, this lack of agreement presents some challenges. Clearly, greater dialogue with clients is needed to further understanding. Some focused analysis might be of help in this regard; for example, how much does it really cost institutional investors to build in-house the capabilities that FoHFs seek to provide? For managers, these findings also suggest opportunities to differentiate themselves by showing how they are addressing clients' hot-button issues.

Investors & Consultants		Managers
34% Disagree	FoHFs are no longer competitive	71% Disagree
37% Agree	FoHFs offer good value relative to the costs of overseeing a hedge fund portfolio in-house	78% Agree
34% Agree	FoHFs have provided the level of transparency investors need	63% Agree
69% Agree	FoHF fees are generally too high for the value delivered	22% Agree
31% Disagree	Diversification benefits are as they were advertised when the FoHF investment was made	4% Disagree

Envisioning the Industry's Future

FoHFs are already busy adapting to business pressures and client demands. Industry media are rife with reports of funds that are negotiating fees and repositioning strategies. But critical as these efforts are to help maintain investors' interest and confidence, they may not go far enough.

A key finding of our survey echoes what a number of analysts and consultants have been saying: two-thirds of investors and consultants agree with the statement that "Funds of hedge funds must reinvent their business model if they want to survive."

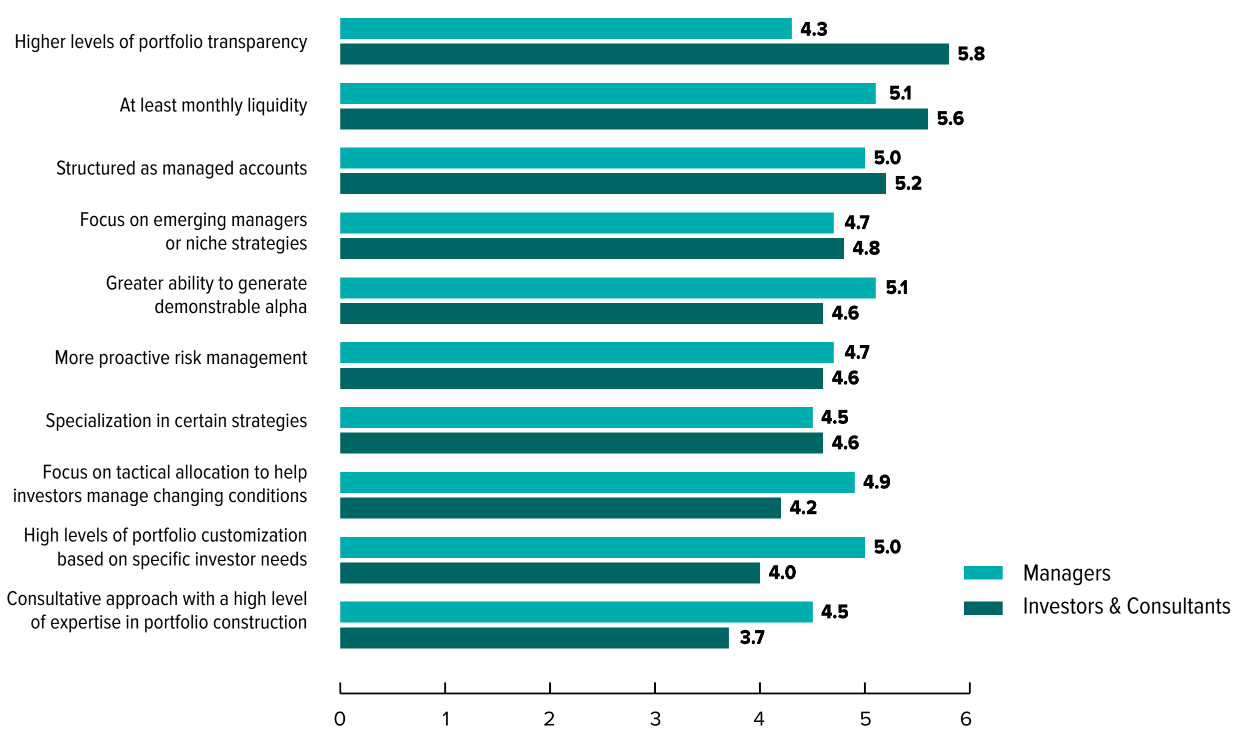
Significantly, FoHF managers are emphatically not in denial on that score. More than half of those we surveyed also see the writing on the wall, agreeing with the need for a major overhaul.

What investors and consultants seem to have in mind is a level of reinvention that goes far beyond mere tinkering. More than seven in ten believe FoHF due diligence and portfolio construction processes are already of institutional caliber. The pattern of survey responses suggests that investors are looking for more radical change—and many managers are hearing the drumbeat.

The question is, what might the future look like for FoHFs? A call for innovation is one thing. Giving it shape, direction and impetus is a longer-term proposition. But as our survey shows, investors and consultants already have ideas as to where the FoHF business model should go (Figure 2).

Figure 2—Rating Potential Innovations

Question: How effective would each of the following be in making funds of hedge funds more competitive? (Average rating on 1-10 scale, from least to most effective)



Source: 2012 SEI FoHF Survey

Seven Ways for Reinvention

1 More customization.

Of all the ideas our sample of investors and consultants raised, this theme came up most often—perhaps because the industry is already moving toward what the industry publication *Hedge Fund Intelligence* has labeled "the new age of customized institutional investing." One of the largest and fastest-growing FoHFs, Prisma Capital Partners, is already managing 60% of its assets in a customized format.[11] Investcorp is another FoHF manager with more than half of its assets in custom portfolios.[12]

However, our survey findings telegraphed mixed signals on how effective this approach would be in making FoHFs more attractive if widely used. When we asked investors to rate potential innovations, "high levels of portfolio customization" ranked number nine on the list of the top ten measures cited. Moreover, while managers are bullish on the concept, with 70% agreeing that the ability to customize is a major advantage for FoHFs, only 22% of investors and consultants saw it that way.

Still, greater customization is a relatively straightforward measure that clearly appeals to some investors. This direction also makes practical sense, in that investors have grown more sophisticated and more concerned with matching assets to their liabilities. As no two investors have exactly the same asset/liability profiles, commingled portfolios are by definition less than ideal.

The question is how to translate this broad notion of customization into specifics and to determine if the current FoHF firms of today have the investment insight, judgment and experience to construct customized portfolios when some of those strategy requests are not in the FoHF's wheelhouse. FoHF solutions have many elements—from manager selection and strategic advice to portfolio construction and risk management—all of which can be mixed and matched to clients' specific objectives. Customized and enhanced reporting is an obvious first step. Managers could also offer greater customization in terms of underlying managers, transparency and liquidity—and our survey suggests that such measures could pay off for FoHF managers.

When we asked survey recipients to rate the effectiveness of potential changes to the FoHF model, investors and consultants rated "higher levels of portfolio transparency" and "at least monthly liquidity" at the very top of the list.

Portfolios might also be customized to take advantage of underlying fund managers' particular strengths and capabilities. If, for example, a FoHF manager is particularly impressed with a hedge fund manager's shorting prowess, he might apply leverage on the short side of the portfolio in an effort to boost overall portfolio returns or decrease volatility. Moving up the customization scale, more ambitious FoHFs could work closely with key clients to better define the performance characteristics they seek and develop portfolios tailored to specific outcomes—a resource-intensive approach, but one that some investors mentioned as a requisite for FoHFs that want to be competitive. This is not simply a matter of packaging, but speaks to FoHFs' broad abilities (or need for broader ability) to provide complete investor solutions—one of the keys to competitiveness, according to investors and consultants we surveyed.

2 Access to emerging managers and niche strategies.

With an eye to increasing the value they add, more than a few FoHF managers are shifting away from well-known, name-brand hedge fund managers and toward emerging managers and strategies. In effect, they are positioning themselves as talent scouts who specialize in discovering up-and-coming managers and interesting, little-known strategies. Some go even further by helping talented managers set up shop, acting as a sponsor to provide additional risk management, compliance, back-office and marketing services. In fact, at least six of the top ten FoHFs have dedicated programs for seeding new funds.[13]

This approach has dual appeal to investors, giving them a way to get in early with talented managers and capacity-constrained strategies while potentially paying lower fees than they would with more established managers. "Most sophisticated hedge fund investors have been allocating to the bigger hedge fund names for years; in many cases, returns have been lackluster and fees for these brand names have not diminished. A natural next step, then, is to supplement the larger core investments with non-correlated, directional niche (or smaller) hedge funds that complement the core positions while providing the much-coveted idiosyncratic risk smaller hedge fund managers often provide," commented Rachel Minard.

Having the ability to place assets with otherwise inaccessible managers can be a game-changer. One telling comment offered by a survey respondent addressed what a competitive FoHF is not: "A fund of 100 hedge funds that everyone knows already."

Our survey indicates that this capability is one that many investors are explicitly seeking from FoHF managers. More than 54% of the investors and consultants we surveyed named "access to lesser-known or emerging managers" as one of the top three reasons for investing in FoHFs.

3 More proactive risk management.

Since 2008, investors have clamored for strategies that can help portfolios withstand broad-based market downturns. Some FoHFs are competing by making risk management integral to their offerings. Dozens of hedge funds have launched strategies designed to hedge tail risks, giving FoHF managers the ability to blend them into a new breed of diversified risk-focused strategies.

Some research-oriented FoHFs have developed sophisticated risk overlays for hedging out currency, equity, or interest rate risks in their portfolios. Among our survey respondents, investors, consultants and managers alike see more proactive risk management as a moderately effective way to increase the competitiveness of FoHFs. Strategies that focus on tactical asset allocation were also rated as having some measure of promise; although, evidenced in 2009 and again in 2011, the ability to tactically shift the portfolio to reflect macro-thematic trends is extremely hard to achieve and can result in "momentum investing" type volatility.

Regardless of the nature of their investment strategies, FoHFs could consider a variety of ways to give investors more information—and potentially, greater confidence—concerning the risks they are taking. Industry media reports indicate that the ability to keep a closer, more watchful eye on risks is one factor driving institutions to bypass FoHFs in favor of direct hedge fund investments. FoHFs may be able to counter this trend by working toward real-time aggregation of risk data, providing more sophisticated analysis, and employing more advanced risk-hedging techniques.

4 Greater portfolio specialization or concentration.

FoHFs arose partly from investors' need for a convenient, multi-strategy vehicle for long-term diversification. FoHF managers are now being widely criticized for too often diversifying away their alpha, in effect charging premium fees for beta. In fact, half of the investors and consultants we surveyed feel that FoHFs actually over-diversify, and 37% of managers agree.

This provides a rationale for FoHF portfolios that are more concentrated in specific investment strategies or themes, providing unique exposures that capitalize on a FoHF manager's focused expertise and are uncorrelated to broad markets.

Investor responses suggest that they are less enamored with multi-strategy approaches than in the past, and more interested in strategies that represent strong manager convictions and distinctive opportunity sets, with the potential to produce differentiated returns.

Sizing hedge funds in a portfolio today has also prompted this change. Where multi-strategy FoHFs served a valuable service in vetting the cross-correlation issues and benefits within the allocation, today most institutions view their hedge fund investment as part-and-parcel of their overall asset allocation. So the cross-correlation exercises now give greater flexibility and credence to direct hedge fund investing and the penchant for evaluating risk across the portfolio, not solely within each strategy or category.

5 Updated packaging.

Some of the loudest buzz in the FoHF industry is around the notion of "funds of one," whereby clients invest in underlying managers via separate managed accounts rather than commingled, off-the-shelf funds. Not only does this approach enable FoHF managers to tailor their manager selection and underlying fund mandates to client objectives, it also lets them adapt to clients' transparency and liquidity preferences. *Pensions & Investments* recently reported that the $25 billion Pennsylvania State Employees' Retirement System, for one, is shifting all of its hedge fund assets to customized separate accounts run by FoHF firms.[14] Managers are quickly hopping on board the trend. Permal Group, for example, has reportedly established managed account relationships with nearly half the managers in its universe.[15]

Some funds are taking a flexible, solution-oriented approach, blending managed accounts, derivatives and quantitative products in response to investors' risk budgets, volatility targets, or other criteria. A number of the investors and consultants we surveyed also expressed interest in the inclusion of more registered products (mutual funds and UCITS) in FoHF strategies, a strategy that might help some FoHF managers broaden their appeal to smaller institutions and wealthy individuals.

6 More consulting and advice.

Institutional investors are increasingly looking to hedge fund managers as a source of intellectual capital and assistance in managing their entire portfolios.[16] Institutional investors are actively looking to leverage their internal capabilities with specialized expertise that will help them improve their asset allocation, risk management and investment outcomes, according to Daniel Celeghin, a partner with the consulting firm Casey Quirk & Associates. To succeed in the long run, Celeghin suggested that FoHF managers redeploy their skilled resources, utilize their consultative, customized relationships and market themselves "not as a product, or as a service, but as platforms delivering asset allocation and portfolio construction solutions to clients."[17]

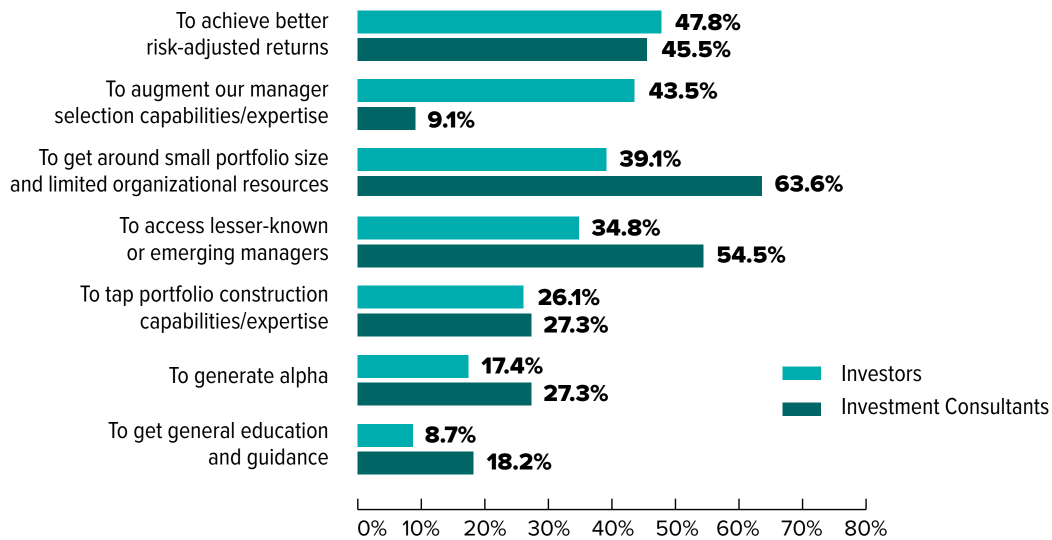
For FoHFs, this is a double-edged sword. Some consultants and single-strategy hedge funds have been disintermediating FoHFs by providing advice on manager selection, due diligence, monitoring, and other areas that have generally been within the purview of FoHFs (although a majority of investors think having a consultant actually build and offer a FoHF product is a conflict of interest, our survey shows).

Some FoHFs are now fighting back by unbundling their services and offering research and counsel on a purely advisory basis, seeking to become trusted advisors who can offer knowledge consultants may not have. This gives FoHFs a way to leverage their expertise in manager selection, portfolio construction, or specialized strategies. FoHFs may also have capabilities to bring value to clients by reviewing their entire portfolios and recommending ways to improve overall performance or risk management. Others have been hired to perform transition management functions as clients move all or some FoHF assets to single-manager funds—a somewhat Pyrrhic gain, but a source of revenue nonetheless.

While investors and consultants were understandably not as keen as managers on the idea of FoHFs stepping into a consultative role on portfolio construction, FoHFs might find greater receptivity to more focused advisory offerings. Our findings also show that investors and consultants don't currently see FoHFs as a source of advice on portfolio construction expertise or general guidance (Figure 3, p. 13); this is a perception that FoHFs will need to address if they hope to significantly expand the consulting end of their business.

Figure 3—What Do Investors Seek?

Question: What are the top three reasons your organization invests in funds of hedge funds?



Source: 2012 SEI FoHF Survey

7 More flexible, creative fee structures.

Are FoHF fees too high for the value delivered? Yes, say two out of three of the investors and consultants we surveyed. Even though 56% of the managers in our sample disagree—and even though the traditional “1 and 10” FoHF fees, layered on the “2 and 20” charged by underlying funds, is no longer the norm—fees remain a lightning rod for investors’ unhappiness. Large investors are already using their clout to negotiate lower fees, but discontent with the industry’s pricing model remains. So what can managers do to ease hard feelings while keeping their operations in the black?

Rather than contemplating an across-the-board reduction of fees, the industry might reach for more creative solutions, such as:

- **Varying fees with the scope of mandates.** For example, management fees could vary based on an *à la carte* approach, with added charges for advisory, risk aggregation, or special reporting services.
- **Different fees for different strategies.** A high-value-added niche or opportunistic strategy can command a significantly higher management fee than a garden-variety multi-strategy model. Fees might also be varied by product maturity, fund resources, resource intensity, capacity constraints and competitor pricing.
- **Pegging performance fees to performance.** This might be a high-risk approach for managers, but it gets to the crux of investors’ discontent. Managers could charge a standard base-level performance fee while making the upside contingent on alpha, beta and correlation outcomes.
- **Cutting performance fees.** Surprisingly, this suggestion was voiced by several managers, suggesting that for some, asset retention trumps profitability in this intensely competitive environment.
- **Raising hurdle rates.** Suggested hurdle rates generally ranged from 5% to 10%, with some respondents suggesting LIBOR + 5%.
- **One flat fee.** This structure is already used by some FoHF managers, especially for large institutional mandates.

What FoHF fee levels would be "fair"?

Our survey posed this as an open-ended query. Not surprisingly, we found that the answers depend on whom you ask, and that consultants take the toughest stance on the question. The unexpected result is how close investors' responses were to the status quo.

	Management fee (avg %)	Performance fee (avg %)
Consultants	0.69%	5.45%
Investors	0.95%	7.72%
Managers	1.03%	7.37%

Defining Competitiveness

When investors and consultants are directly asked what makes a FoHF competitive, one thing is evident: fundamentals matter. The advantages of having an experienced team, a well-defined investment philosophy, and world-class processes were cited over and over again. In their responses, investors and consultants also hammered on the "V" word—value, in the form of demonstrable alpha and uncorrelated returns. What's more, of all the possibilities we posed for reinventing the FoHF model, investors gave the highest ratings to "greater transparency" and "at least monthly liquidity"—demands they have been voicing for years. That is a message that FoHF managers have already heard, and need to heed.

Still, our findings suggest that there is room to carve out a new vision of FoHF competitiveness. While investors and consultants expressed clear (and somewhat diverging) views of the reasons why they currently invest in FoHFs (Figure 3, p. 13), they also voiced considerable interest in more complete and customized solutions. As one respondent put it, "The competitive firm will have scale, resources and competence, offering a flexible investment platform that allows working closely with clients to truly understand their specific requirements in order to create tailored investment solutions."

Broader, more flexible access to investment strategies was another recurring theme. "The competitive FoHF of the future will be more of an alternative assets platform with different investment structures and an ability to invest across the spectrum of alternative assets," said one investor. Some respondents go even further, seeing the competitive FoHF as a partner equipped to offer a comprehensive array of hedge fund investment offerings, strategies and services. As one put it, FoHFs can strengthen their value proposition by helping clients with "all aspects and stages of hedge fund investing programs"—from participating in early-stage hedge fund seeding to offering a broad spectrum of diversified, thematic and customized funds of funds, all with a higher level of transparency and liquidity.

FoHFs can serve institutional needs, as well as their own interests, by positioning themselves to help fill gaps or address risks within a comprehensive investment strategy. For example, clients who elect to go "direct" with single-fund managers may find themselves with less-diversified hedge fund portfolios than they would wish; FoHFs are natural candidates to solve that problem.

Another profound issue is that of opportunity cost. While an institution, with or without the support of its pension consultant, may invest in direct hedge funds, the additional insight and risk diagnostic a FoHF provides would need to be subsumed by pension committee members, many of whom are ill-equipped to identify, let alone properly manage, the risk variables associated with hedge fund investing. The question, then, becomes one of fiduciary responsibility and what investment decision best reflects the stewardship of those pension assets and the obligation of the investment board to properly manage them.

Conclusion

When all the positives and negatives are weighed, the industry's challenges read as both an opportunity and a call to action—even the chance for a new term to be coined. Perhaps the now clichéd terms—strategic partner, FoHF, fund-of-one, bespoke platform, outsourced CIO, customized SMA (separately managed account)—are fodder for a new term that brings together the customization investors want, the holistic risk assessment required in hedge fund investing with the third-party oversight a FoHF provides. Our findings show that FoHFs' core value proposition remains relevant to institutional investors, despite evidence that the industry is in decline. However, FoHF managers need to address widespread dissatisfaction with their performance and fees, as well as concerns regarding transparency, liquidity, and over-diversification. While managers appear to be well aware that they face numerous challenges, our survey findings reveal a significant disconnect with investor and consultant attitudes concerning FoHFs' overall competitiveness and value added, as well as the obligation for FoHFs to be fee-competitive if new assets are to be won.

At this point, it is crucial that FoHF managers and, indeed, the FoHF industry at large, look beyond their short-term survival and profitability and think seriously about their long-term future. Perhaps the most significant finding of our survey is that two-thirds of institutional investors and consultants—as well as a majority of managers—agree that FoHFs "must reinvent their business model in order to survive." We hope this paper has paved the way for various tactics and techniques for FoHF managers to accommodate this changing tide.

Survey results also suggest that investors and consultants are already considering a variety of directions in which the FoHF model could move. Those ideas include providing greater customization, more concentrated or specialized portfolios, an intensified focus on niche strategies, and increased use of managed accounts, as well as a completely revamped fee structure.

Beyond that, our findings also show potential for FoHFs to step up to a new role wherein they serve as trusted advisors and enablers who help investors manage their overall portfolios.

It's clear that many FoHF managers have gained deep knowledge of great potential benefit to investors—and not just when it comes to FoHFs' traditional areas of strength, such as manager evaluation and selection. FoHFs could also help investors be more strategic in their allocations and more proactive in their approach to managing risks.

The upshot is that FoHFs find themselves in a rare window of opportunity, an inflection point in the global hedge fund industry where innovation is welcomed. This is a time when key decision-makers and influencers are not only looking for meaningful and, potentially, even radical change, but are keenly interested in what develops next. That openness to possibility may be the best news the FoHF industry has heard for some time.

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1 Freedom Valley Drive
Oaks, PA 19456

610-676-1270

seic.com/ims

managerservices@seic.com

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