Funds-of-hedge-funds Sector Overview July 2010

KEY FACTS
Sector name: Funds-of-hedge-funds
Review period: 1 April 2009 to 31 March 2010
Number of rated funds: 45
Dispersion of ratings:
AAA - 3
AA - 27
A - 14
NR - 1
UR - 0
TR - 0

Sub sectors
Funds-of-hedge-funds
Funds-of-alternative investment-funds

This is our eighth year covering funds-of-hedge-funds (FOHFs). In the past, we have covered each fund according to its own annual cycle, but this year, for the first time we have reviewed all the funds at the same time to better compare FOHF performance records. We continue to look at FOHFs against their own objectives, but 2008 threw many off course, and therefore it has been necessary to take a closer look at a FOHF's performance relative to other funds with a similar approach and strategy mix.

We have also created a new section containing five Ucits III-regulated funds-of-funds and a UK-authorised fund-of-alternative-investment-funds (FAIF) - the Gartmore MultiManager Absolute Return Fund. The five Ucits III-regulated funds-of-funds are the Thames River Absolute Return Fund, Collins Stewart Alternative Strategies Fund, Iveagh Wealth Fund, Legg Mason Permal Global Absolute Fund and HDF Global Equity Fund. The review covers a total of 51 funds.

Market background

The hedge fund industry has seen a meaningful recovery in total funds under management following decent absolute performance and net inflows in the second half of 2009. According to HFN's statistics, the hedge fund industry's total assets reached $2.042trn by the end of December 2009 after net inflows of $116.29bn since April 2009. Subsequently, liquidity constraints on FOHFs have eased.

However, they have not been cleared up entirely, and we still have two funds that we are unable to rate because their approach to dealing with the liquidity mismatch, and the severity of it, makes interpretation of performance unclear. In particular, we are not rating FOHFs where side pockets or redeeming share classes, which pay in kind until illiquid hedge fund holdings payout, amount to more than 20% of NAV.

FOHF managers have taken a variety of steps to improve liquidity in portfolios, including investing with hedge fund managers by way of managed accounts, restricting investment to the more liquid strategies, and setting up new funds-of-funds that invest in Ucits III-regulated products. Investing with a manager by way of a managed account rather than through its established hedge fund gives the FOHF greater transparency and some control of the mandate, helping with the management of overall portfolio liquidity.

Permal has made the biggest push towards investing through managed accounts. Currently, about 25% of its AUM are invested through 63 separately managed accounts. One of the group's funds (Permal Multi-Manager Advantage Multi-Strategy Fund) was restructured in January to invest exclusively in separately managed accounts. At the time of our review in May 2010, 89% of its portfolio was invested through separately managed accounts compared with around 20% two years ago. The fund's managers report that strategy allocation shifts have become easier to implement since the portfolio was restructured. Permal has been successful in getting separate accounts, because of its size, giving it bargaining power with hedge fund managers, and because of its focus on strategies that are amenable to them.

Allocations to long/short equity hedge, global macro and commodity trading advisers (CTAs) have increased since 2008 as FOHFs have taken action to improve portfolio liquidity. Some of the increase in macro and CTAs was in response to their outperformance in 2008. However, we have seen a number of FOHFs change their investment approach to focus on these strategies and/or rule out the less liquid strategies such as distressed, activist and credit arbitrage. For example, Antarctica Global Opportunities is also focusing more on long/short equity hedge and global macro funds, while the GEMI fund has also stopped investing in asset-based lending as a strategy since the beginning of last year, and is currently unwinding exposure. Some funds, such as Haussmann Holdings and Permal Investment Holdings, have always had a bias towards global macro and equity hedge. There is also a survivorship effect, since some of the funds that had exposure to less liquid strategies lost their ratings (eg, Antarctica Market Neutral Fund, Theta Multistar Low Volatility and DGC Pendulum), while those focused on the more liquid strategies have generally maintained ratings.

In general, strategies that struggled most in 2008 performed best in 2009. For example, convertible arbitrage, distressed credits and long-biased equity hedge, particularly those focused on emerging markets, performed very well. Likewise those that delivered positive returns in 2008 performed worst in 2009, namely, short-biased equities and CTAs.

Looking forward, the managers we spoke to have mixed views, but a number of them think that low-beta equity hedge fund managers should do well. Permal's Rob Kaplan makes the point that we have had two years of stock returns driven almost entirely by market direction, during which there has been limited differentiation by stock-specific issues. This leaves good opportunities for stockpickers, in his opinion.

Funds of Ucits III funds and FAIFS

Gartmore MultiManager Absolute Return is a sub-fund of a UK-authorised Oeic whose portfolio includes hedge funds and Ucits III low- and flexible-beta funds, taking advantage of the greater investment freedom offered to UK-authorised funds under the FSA's proposals on FAIFs in its March 2007 consultation paper. When the paper was issued, investment in offshore unregulated investment vehicles by a UK-authorised fund posed a taxation problem for fund managers. However, the door was opened to these funds following the 2008 Budget and the new tax regime for FAIFs announced by the UK Treasury. This allows them to elect to be taxed as onshore funds even if more than 20% of the portfolio is invested in offshore unregulated funds. In this case, the taxation of offshore income moved from the fund to the investor.

HDF Global Equity Fund was included in last year's FOHF directory because it used to invest up to 40% of its portfolio in hedge funds. However, during 2009 the manager removed all hedge fund holdings from the portfolio and, at the end of October, HDF Global Equity Fund changed to a Ucits-regulated product. Of the other five funds that are not FOHFs, four of them are managed by groups that have, or have had, FOHFs rated by us in the past. We currently rate 11 Permal and three Thames River FOHFs. We used to rate the Arundel Premier Fund on behalf of Iveagh before the group stopped managing FOHFs, and we used to rate three Collins Stewart funds-of-funds that invested in hedge funds before they were restructured in 2008. Gartmore is the only group that has not had a fund in this directory in the past, and its MultiManager Absolute Return Fund is a FAIF (and part of a UK-regulated Oeic structure) rather than Ucits III-regulated.

These funds are a diverse group. The Gartmore MultiManager Absolute Return Fund, Thames River Absolute Return Fund and Collins Stewart Alternative Investment Strategies Fund are the closest to a FOHF. Gartmore's is the only one that includes unregulated open-ended hedge funds in its portfolio (as well as closed-ended hedge funds and Ucits III absolute return and flexible-beta funds), and it is managed for absolute returns. The managers of the Thames River Absolute Return Fund and the Collins Stewart Alternative Investment Strategies Fund apply the same investment processes as for the Thames River Sentinel and Collins Stewart Absolute Return Plus FOHFs, respectively (including full operational due diligence on all new holdings), except that the investment universe is different. Their approach is entirely bottom-up, and they select from those Ucits III funds that are close replicas of a hedge fund. This is in complete contrast to the Iveagh Wealth Fund, which aims to generate high real returns from active asset allocation, and the managers look for whatever investment vehicle provides a market return most efficiently. This leads them to invest most of the portfolio in ETFs. A small portion of the portfolio may be invested in Ucits III absolute return funds, but these are viewed primarily as cash-plus alternatives rather than alpha drivers. The Legg Mason Permal Absolute Fund is managed similarly to the Iveagh Wealth Fund, with a large portion of the portfolio invested in ETFs to facilitate active allocation. However, Permal expects to generate some alpha from selection of Ucits III absolute return and flexible-beta funds as well as closed-ended hedge funds.

The HDF Global Equity Fund is perhaps the least comparable, which is somewhat ironic since we rated it as a FOHF until the third quarter of last year. In contrast with the others, the fund is managed relative to an equity market benchmark (the MSCI World index), and has a bias to mainstream long-only equity funds. HDF aims to generate outperformance by a combination of fund selection and top-down allocation. The allocation of up to 40% in Ucits III flexible-beta funds helps to reduce exposure when the team considers market risk to be high.

We said in our sixth edition that the basic idea of FOHFs is sound, that is, the provision of manager diversification and pursuit of absolute returns. The new funds of Ucits III funds and FAIFs also give you this, but with better liquidity (for retail investors). In an environment where the interest earned by savers is low, and in which market timing has been important, FOHFs and these new vehicles play an important role for investors.

Randal Goldsmith
Lead analyst

Rated funds-of-hedge-funds

Acropolis Multi-strategy Fund	AA
Antarctica Global Opportunities Fund Limited	AA
Argenta Offshore Fund Ltd.	A
Blue Elite Fund LP	A
Blue Elite Fund Ltd	NR
Bonhote Alternative Multi-Arbitrage	A
Bonhote Alternative Multi-Performance	A
GAM Diversity	AA
GAM Multi-Emerging Markets	AA
GAM Trading II	AAA
GEMI Fund Ltd	A
Haussmann Holdings N.V.	AA
HDF Eurovest Ltd Class B (EUR)	AA
HDF Global Opportunities	AA
HDF Multi Reactive	AA
HDF Multi Strategies	AA
Lynx Selection Holdings Ltd Euro	A
Permal Asian Holdings	A
Permal Emerging Markets Holdings NV	A
Permal European Holdings NV	AA
Permal Fixed Income Holdings NV	AA
Permal Investment Holdings NV	AAA
Permal Investment Partners, L. P.	AAA
Permal Japan Holdings NV	AA
Permal Long Short Global Equity Holdings	AA
Permal Macro Holdings	AA
Permal Multi-Manager Funds - Advantage Multi-Strategy Fund	AA
Permal Multi-Manager Funds - Natural Resources Fund	AA
Prima Capital Fund	AA
Prima Opportunity Fund	AA
SAAF I (CH) Diversified Alpha Fund (USD)	A
Thames River Alternative Strategies Fund - Sentinel Fund	AA
Thames River Alternative Strategies Fund - Warrior Fund	AA
Thames River Alternative Strategies Fund - Warrior II Fund	AA
The Absolute Fund	AA
Theta Deep Value Fund	A
Theta Multistar Medium Volatility Fund	A
Trocadero Capital Holdings	AA
Turnstone European Fund	A

Rated Funds of alternative investment funds

Collins Stewart Alertnative Strategies	A
Gartmore MultiManager Absolute Return Fund	A
HDF Global Equity Fund	AA
Iveagh Wealth Fund	AA
Legg Mason Global Funds plc - Legg Mason Permal Global Absolute Fund	AA
Thames River Absolute Return Fund	AA