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ISSUE

Answers to several of the key questions investors need to address when considering an investment in hedge funds.

# MEASURING UP

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## Who Should Invest in Hedge Funds?

Yanni Partners first addressed the potential merits of hedge funds in the Fall 2002 edition of *Measuring Up*, entitled Hedge Fund Investments. In that issue, we defined hedge funds as pools of assets that are generally unconstrained and seek consistent positive returns regardless of the market environment.

In the five years since that first *Measuring Up*, hedge funds have attracted considerable attention from investors, regulators and the media. This attention has led many investors to inquire about the suitability of hedge funds for their portfolios. In this edition of *Measuring Up*, Yanni Partners will answer several key questions that investors need to address when considering an investment in hedge funds.

### **Are hedge funds appropriate for my portfolio?**

The first consideration is overall portfolio size, as hedge funds are restricted and can only accept investments from investors that meet specific requirements. For institutional investors, the most important requirement is meeting the SEC's definition of a Qualified Purchaser (QP). Institutional investors with more than \$25 million in investable assets are considered QPs.

An institution that meets regulatory requirements must determine whether hedge funds fit into the objectives and guidelines that govern its portfolio. Hedge funds are used in portfolios primarily to

enhance diversification. A modest allocation to a diversified portfolio of hedge funds can help to maintain the total portfolio expected return while reducing the portfolio's downside risk. While consistent, lower risk return is a universal goal for investors, an institution must consider the unique features of hedge funds before determining the suitability for its portfolio.

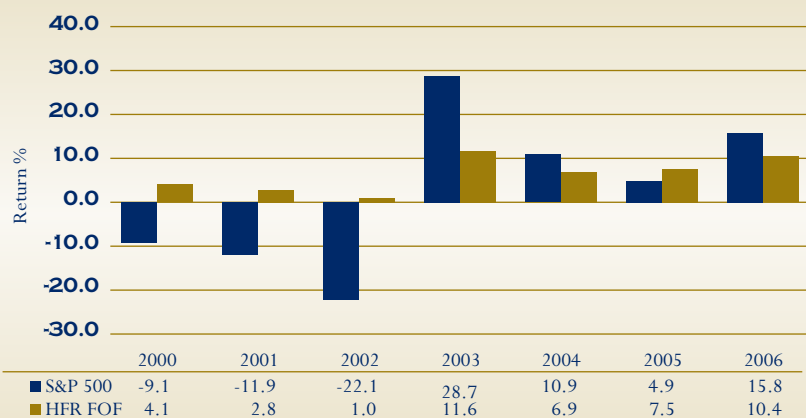
### **What kind of returns should I expect from hedge funds?**

Yanni Partners' current capital market assumptions estimate an annualized return of 7.0% over the next ten years. Consistent with our capital market assumption methodology, we expect hedge funds to earn a premium over short term fixed income investments while slightly trailing the returns of equity markets.

Hedge funds are expected to generate slightly lower returns than equities because most, but certainly not all, hedge fund managers seek to eliminate (or hedge) some of the risks in their portfolios. The tradeoff between risk and return dictates that the



FIGURE ONE  
Calendar Year Returns



cost of eliminating risk is lower expected returns. This relationship is shown clearly in *Figure One*, which shows annual returns for both the S&P 500 and the HFR Fund of (Hedge) Funds Index for 2000 through 2006. This seven year span included three years of equity losses, 2000-2002, and four years of positive equity returns, 2003-2006. While equity markets experienced volatile returns during the bursting of the tech bubble and the subsequent economic recovery, hedge funds posted lower, yet positive, returns each year. The consistent positive performance is the most significant benefit that hedge funds provide for a portfolio, as it helps to stabilize the portfolio and protect capital during periods of economic stress.

One debate that continues to evolve among investors, hedge fund managers and academics is the primary source of hedge fund returns. Many research papers have investigated the issue of hedge fund returns and attempted to determine whether the returns were due to skill-based “alpha” generation or a combination of market (beta) exposures. The source of return is critical for hedge fund investors, as no one would voluntarily pay expensive hedge fund fees for “beta”-driven returns that could be obtained through low-cost index funds. Academic studies have shown that hedge fund returns can be recreated to some extent by combining exposures to various global equity and

fixed income markets. Several firms have either already launched or are in the process of launching hedge fund “index” products based on models that build an inexpensive portfolio of various beta exposures and seek to replicate the benefits of hedge funds at a fraction of the cost. The performance of these products to date has tended to trail actual hedge fund returns, suggesting that hedge funds cannot be recreated perfectly using only beta sources. At minimum, hedge fund managers appear to generate some level of skill-based alpha over standard market benchmarks.

### What risks should I keep in mind when considering hedge funds?

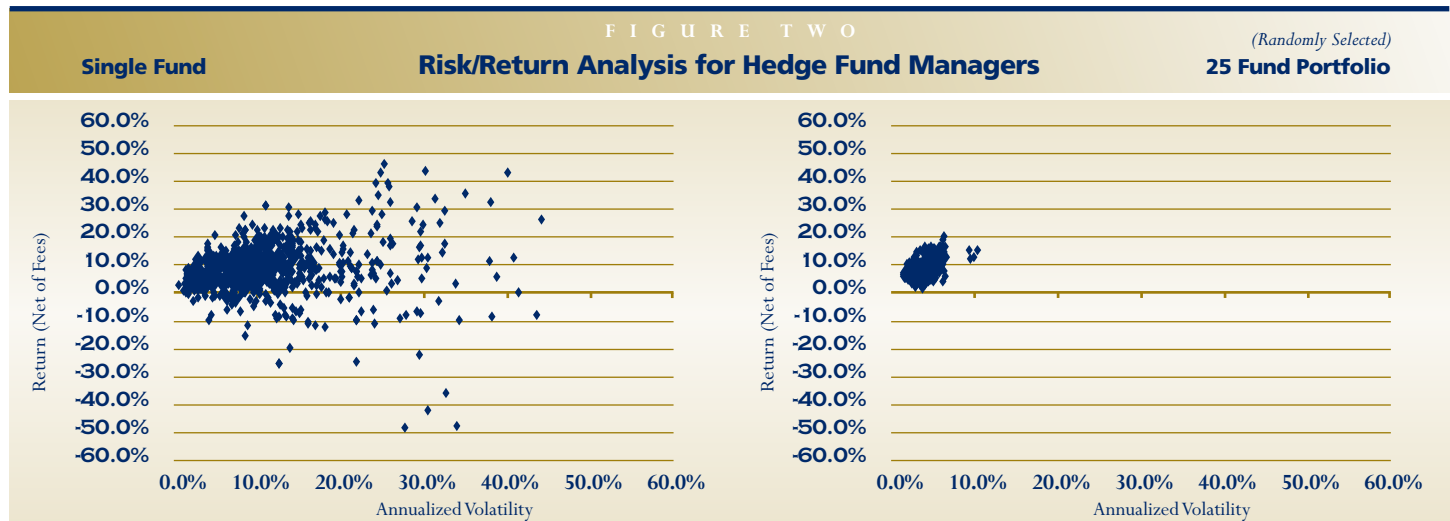
In addition to standard investment risks, hedge funds present a number of risks that are somewhat unique to the asset class. One such risk is due to the limited transparency into the underlying securities held in hedge fund portfolios. Most hedge fund managers are very protective of both their investment strategies and the positions in their portfolios, so they share only limited information with their investors. Hedge fund managers argue that the limited transparency protects their trading strategies and may actually be a benefit to investors. If a successful hedge fund manager has developed a proprietary trading strategy that consistently generates strong risk adjusted returns, it is in the manager’s and the investor’s best interest to limit disclosure of portfolio positions. Then the manager can continue to follow the trading strategy and generate strong returns. Some hedge fund investors have started to demand more transparency from managers, which has benefits and costs for the investor. Greater transparency gives the investor a much better idea of where their capital is invested as well as fulfilling increasingly common requirements from auditors. The downside of demanding greater transparency is that it may prevent the investor from gaining capacity with some of the “best” hedge funds, as those managers are unlikely to disclose their portfolio positions.

Hedge funds also impose liquidity constraints on investors, which can increase the risk of the investment by preventing the investor from withdrawing its funds in a timely manner. Initial lock-up periods between one and three years are common and prevent investors from withdrawing capital until the period expires. Most hedge funds also impose restrictions on capital withdrawals after the lock-up period, allowing withdrawals on a specific schedule (quarterly) with required written notice (45-90 days is common).

Organizational risk is probably the most important risk consideration for hedge fund investors. Organizational problems are widely believed to be a more common cause of hedge fund failures than investment problems. Investors attempt to identify organizational risks by completing thorough due diligence before investing. Complete manager due diligence should include an evaluation of the investment strategy, firm infrastructure, service providers (administrator, auditor, legal representation, etc.), and firm personnel. The goal of such thorough due diligence is to avoid investing in hedge funds that are more likely to struggle and potentially go out of business.

## Should I consider individual hedge funds or a fund of funds?

For most institutional investors a fund of hedge funds (FOHF) offers an attractive option for making a diversified investment in the asset class. Very large institutional investors have additional opportunities, including separately managed accounts and direct hedge fund manager selection, but Yanni Partners believes that FOHF managers offer benefits for institutions of all sizes. FOHF managers provide diversification, experienced manager due diligence and selection, strategy and manager allocation, and ongoing monitoring of the hedge fund managers in the portfolio. Successful and well respected FOHF managers also provide access to hedge funds that are closed to new investors. The service a FOHF manager provides is essential to managing the unique risks of hedge fund investing. Diversification helps to moderate the potentially volatile returns of individual hedge funds. Consider *Figure Two*, which shows a risk versus return chart for both individual hedge fund managers and for portfolios of 25 randomly selected hedge funds (simulating FOHFs). The portfolios of hedge funds, despite being selected at random, clearly offer a better risk/return profile than individual hedge funds.



Source: Returns and dispersions data represent returns from 1/2001 to 12/2006 of hedge funds in the Hedge Fund Research (HFR) database. Courtesy JPMorgan Alternative Asset Management.

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Comprehensive manager due diligence, selection and monitoring practices executed by experienced investment professionals help to minimize the risks associated with lack of transparency, limited liquidity and organizational factors.

The biggest drawback of FOHF managers is the “second” layer of fees that the managers charge on top of the underlying hedge fund fees. For most investors that desire hedge fund exposure, the second layer of fees is essentially irrelevant. The FOHF manager provides a service that would be more expensive to replicate than the manager’s standard management fee. For example, an investor making a \$10 million allocation to a FOHF manager can expect to pay approximately 1.25% in management fees to a FOHF manager. It is literally impossible to replicate the staff, investment expertise and risk management tools of an institutional quality FOHF manager for \$125,000 per year. FOHF managers spread their costs among many clients, making a FOHF a cost effective solution for many institutional investors.

## **How can I monitor and benchmark my hedge fund manager after investing?**

It is important that investors monitor hedge fund or FOHF managers on a regular basis. Manager returns

should be reviewed at least quarterly and compared to a peer universe of other hedge funds utilizing similar investment strategies. Peer universes offer the best benchmark for manager performance. Hedge fund indexes can be used as a general benchmark, but most indexes include such a variety of investment strategies that a direct comparison is of limited value. Investors can also monitor the correlation of the hedge fund or FOHF managers’ returns versus equity and fixed income returns to determine if the manager is performing as expected.

In addition to performance, it is also important to review organizational updates to be aware of personnel changes, changes in assets under management, and changes in investment or risk management processes. All of these factors contribute to organizational risks and should be monitored on an ongoing basis.

## **Conclusion**

Hedge funds can provide diversification benefits to many institutional portfolios, but they represent an often misunderstood investment option. Hedge funds are not appropriate for every institutional portfolio. Yanni Partners is prepared to offer additional education on hedge funds and will help clients determine if a hedge fund allocation would be appropriate for their portfolios.



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