Lessons learned from the old and wise over two decades-plus of hedge fund investing

FoHF veterans share their pearls of wisdom

By Niki Natarajan & Siobhán Hallissey

"You hear the tree falling but not the forest growing." This is the art of hedge fund investing: compounding returns achieved by avoiding the losses.

This, of course, assumes that one knows which hedge funds to pick in the first place. And the majority of those institutional investors buying hedge funds today seem to believe that manager selection is a simple process that can be outsourced to the most cost-effective bidder.

Only time will tell if this strategy is valid, but talking to some of the stalwarts that have been around for two decades or more provides an in-

teresting insight into how they achieved their returns, survived turbulent markets, and now — as the fund of fund (FoHF) wrapper looks like it could become a collector's item — how many (though not all) would do it all over again.

Over the past 20 years, hedge funds — as shown by this graph (right) of the InvestHedge US Equity FoHF composite index compared to


Mark Jurish


Dariush Aryeh


Thomas Alessie

the S&P 500 — have had a soothing effect on volatility. Taking global equity FoHFs, it would seem that hedge funds even outperformed the MSCI indices, a trend that perhaps explains why finally everybody wants hedge funds.

But having a story to tell, a shop window to visualise and a track record to boast of is a good way to 'prove' the potential for a FoHF to do more in the increasingly bespoke world of multi-manager investing. There are currently 51 funds of hedge funds, managed by 33 underlying firms, that are 20 or more years old and are still reporting data to the InvestHedge Database, the oldest being Leveraged Capital Holdings (see box, page 27).

The fund with the greatest cumulative returns of 23,685% since January 1974 is Haussmann Holdings, which celebrates its 40th anniversary soon. On an annualised basis, this fund, now run by a committee from Notz Stucki, Mirabaud Asset Management and Banca del Ceresio, has returned 14.96% per annum since inception. Notz Stucki's NS Selection SICAV, launched in January 1985, has seen cumulative returns of 2,316% and annualised returns of 11.93%.

Launched in July 1984, Jones Commodities' High Sierra Partners I had cumulative returns of 10,477.5% and annualised returns since inception of 17.6%, while Millburn Corporation's Millburn MCO Partners, launched in January 1981, had cumulative returns of 2,707% and annualised returns of 10.89% since inception.

It would seem, however, that the current trend among investors is to eschew longer-term performance, preferring short-term manager selection short-cuts that save on fees. As Karim Leguel, chief investment officer of Rasini Fairway Capital, whose The Stafford Fund is celebrating its 20th birthday this year, points out

that misses the original point of hedge fund investing. "Most of the current industry focus is on short-term returns (and alpha), while the origin of this business was [based] on long-term returns and alpha," he says. Since inception in April 1993, The Stafford Fund has racked up 320% returns, annualising at 7.44%.

"The key to good long-term performance is compounding returns, which means avoiding big losses," says Dariush Aryeh, chief in-

vestment officer of Fundana. "Experience has shown us that, usually, large drawdowns come from any combination of leverage, illiquidity, concentration and arrogance," he added. Fundana's Prima Capital Fund has appreciated 285.9% since inception in April 1993, annualising at 6.98%.

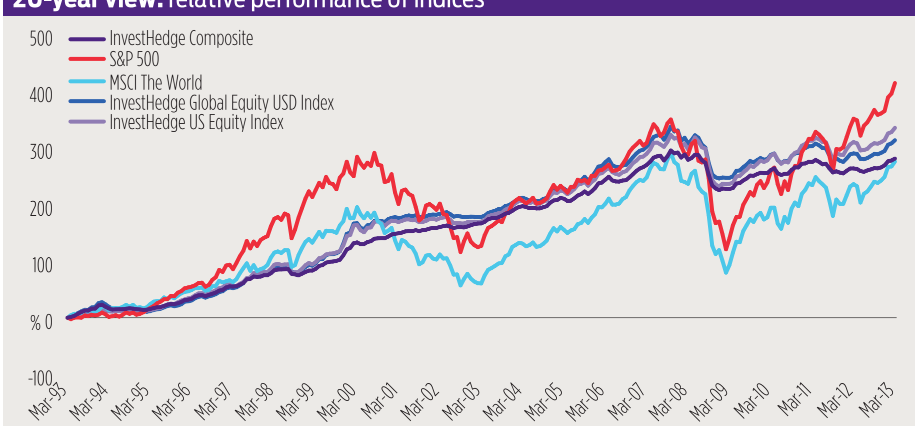
"It is extremely hard to invest to make returns and protect capital when returns are judged on a monthly or quarterly basis, but it is possible — as Egerton, Sierra Europe, Lansdowne UK, Pennant, AKO and many 'tiger cubs' have shown — to produce a lot of alpha, strong returns and protect capital by investing over a longer-term framework," Leguel says. "I would tell any new investor to focus on the initial selection and then, unless anything changes, stick to your manager over the long term… and stay away from 'fashions, trends and flavours of the month'."

Lessons like these learned from those expert FoHFs still in the business two decades later could provide an interesting perspective and perhaps some important pointers for the new generation of manager selectors.

Interestingly, a high proportion of those FoHFs that are turning 20 this year are ones that have focused on smaller, niche or emerging managers, such as Raisini and Fundana, or — in the case of Larch Lane Advisors' Larch Lane Absolute Return Fund I — seeding as well.

Mark Jurish, who founded Larch Lane in 1999, has always had the same objective. "Very early in my career, I recognised the value of investing in early-stage hedge funds… Our edge has always been in identifying and investing

20-year view: relative performance of indices



Source: HedgeFund Intelligence Database

in very experienced, high-quality early-stage hedge fund managers," Jurish says.

Looking forward to the next 20 years, it would seem that the firm, which is now independent of Old Mutual, will be doing more of the same. "We will continue to focus on identifying and investing in high-quality, early-stage hedge fund managers that have higher alpha potential than their larger, more established peers. This should enable us to achieve our long-term risk/return objectives," he says. Since inception in April 1993, the Larch Lane Absolute Return I fund has generated cumulative returns of 361.4% that annualise to 7.95%.

That said, as markets have evolved and become more volatile and highly correlated over the past few years, Larch Lane has had to focus more than ever on providing quality risk-adjusted returns by using very liquid instruments and strategies. And although early-stage hedge funds continue to attract assets, Jurish has witnessed a significant percentage of the flow of hedge funds by institutional investors into the industry's largest hedge funds.

"Although the market often recognises a hedge fund firm's success by the size of its AUM, some of the industry's most successful hedge funds are those that limit their growth, focus on the quality of their research, and the depth of their client relationships. Size is often times your enemy," states Jurish.

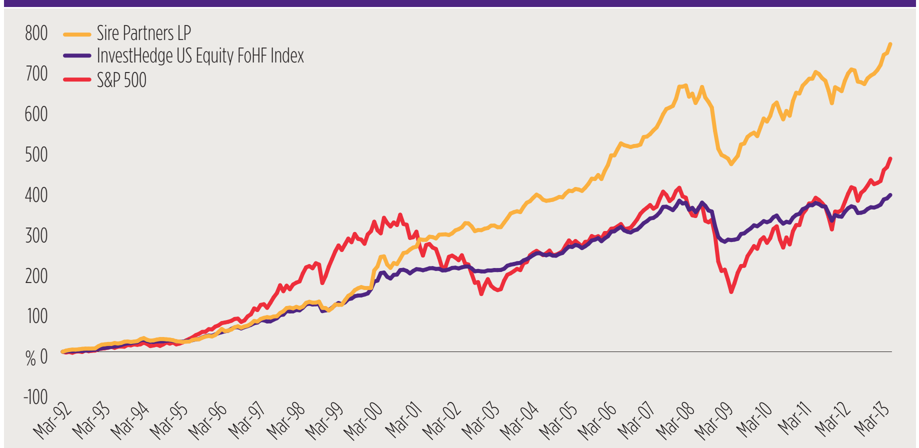
"[And the other thing I have learned is] that I never forget is that if an investment looks too good to be true, it probably is," he adds. This sentiment is echoed by Leguel and Charles Abrecht, chairman of the investment committee and the original portfolio manager of Fairway Partners' The Stafford Fund, which merged with Rasini's global equity fund in 2011.

"[Our advice is to] understand what you invest in and if it's too good to be true then it is not true. We avoided Madoff and other similar situations thanks to this point of view."

The Stafford Fund was started to source the best talented managers in both the long-only and hedge fund worlds, but it morphed quickly into only hedge funds given the superior talent in the space and their ability to manage cycles. "Stafford's edge is the consistency in its search for fundamental managers focused on strong stock-picking. The fund focuses on directional managers and does not use ones that use high leverage to generate returns," say Leguel and Abrecht.

Over the past 20 years, the Fairway Rasini business started as a high-net-worth offering but then developed into a full European institutional FoHF firm with advisory service as the expertise became of interest to private banks, corporates

Performance: Sire Partners



Source: HedgeFund Intelligence Database

and other institutional investors. "Over time, we expanded internationally to London and New York and developed a more institutional framework for selecting managers," explains Leguel.

"Overall, the basic strategy has not changed and we continue to invest in fundamental stock-pickers still hungry to deliver returns when markets are benign and protect when the environment gets tough. Our portfolio, however, has become slightly more concentrated over the last several years," adds Abrecht.

Fundana, also celebrating its 20th birthday, sees itself as first and foremost an entrepreneur, a stance it is planning to stick with for the next two decades. "Our aim is to continue growing at an organic and sustainable pace by offering our clients a very specific expertise in strategies like equity long/short," says Aryeh.

"As entrepreneurs, we had a strong desire to become independent, with the aim of creating a great fund which would give access to the best money ma nagers in the world," says Cédric Kohler, head of advisory at Fundana. He believes that his Geneva-based firm's edge is its deep pool of industry contacts and a disci-

plined and repeatable investment process that focuses on simple strategies.

"To be consistent with our approach, invest only in what we understand, avoid being fooled by high-flyers/fads and finally to stay humble [are Fundana's lessons]," says Aryeh, who founded the firm with Thomas Alessie in 1993. "Our biggest satisfaction is to have been able to fulfil our fund's performance objective over the last 20 years – outperforming equities with half of the volatility – and to display indisputable integrity by, for instance, honouring redemptions for all clients throughout every crisis," he adds.

Looking back, Aryeh believes that the most daunting challenge for Fundana over the past 20 years was to resist the temptation of manufacturing performance via leverage, concentration or illiquidity. "It was blatantly in high demand at some stages," he notes. But Aryeh and the team accepted a long time ago that, in any given year, there would always be someone with better performance. "However, as you go through the cycles, these providers tend to go out of business," he adds.

"Fundamentally, you need to understand how and why your manager is making money so that you understand which risks you are taking. Process, above all else, is the most important factor, not just the performance," notes Kohler.

"[For us], the biggest change came from technology: 20 years ago, we spent two days faxing our first monthly report to investors. Since then, technology has enabled us to constantly develop new tools to help us select managers (HedgedIn), manage portfolios (Portfolio Simulator) and provide useful transparency to our investors (risk-factor exposures)," Aryeh reveals.

The smoothing effect of hedge funds and the performance enhancement of the smaller manager space is highlighted when examining the US equity space. One such example is Optima Fund Management's Optima Fund, which was launched in January 1989 and has a cumulative return of 728%, which annualises to 9.11%; but in particular Sire Partners' performance since inception in January 1992 is worth a look (see graph above).

Celebrating its 21st birthday, the fund, which focuses on equity long/short, has a cumulative return of 760.7% and an annualised return of

10.66% since inception. "Sire has demonstrated an ability to create portfolios of idiosyncratic stock-pickers with a commitment to proprietary research who outperform the S&P 500 Total Return index with lower volatility and less than 100% net market exposure over the long run," explains Judson Reis, president of Sire Management Corporation.

One of the fund's greatest achievements was outperforming the S&P 500 index with lower volatility than the S&P 500 itself. "[We believe] that manager volatility does not have to lead

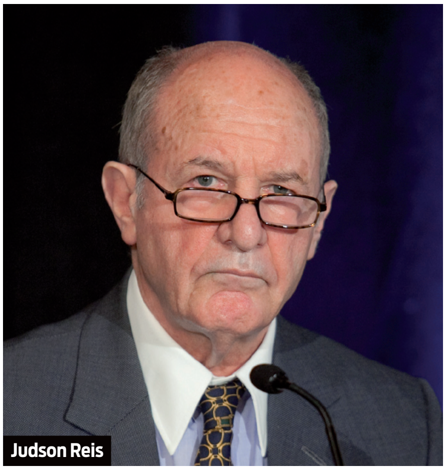
to portfolio volatility," he says. Reis started investing in hedge funds for his own portfolio in 1986, while he was still an investment banker. In 1991, after 25 years in investment banking, Reis thought about turning his portfolio of eight hedge funds into a business by getting paid for a little bit of the advice he was giving to friends and family anyway.

Reis believes that Sire has three main edges. The first is the ability to make decisions about managers on a qualitative basis, rather than just based on statistics. "This led us to invest with some excellent managers very early in their careers, in some cases on day one," he says. Second, the team is willing to concentrate at both the manager and portfolio level, while the third factor is that the firm takes a long-term investment horizon.

Selling is much more difficult than buying, states Reis, adding that deciding whether or not to withdraw is more difficult to get right than whether or not to invest. "We have made mistakes on both sides: overstayed our welcome with some managers and left others when we should have known better," Reis reflects.

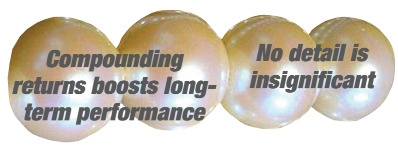
The world has changed over the past 20 years, but to Reis the three main challenges that have arisen are: the need to identify truly exceptional investment talent among the plethora of hedge funds in existence; not letting short-term results lead to poor decisions; and finding like-minded, patient investors with long-term investment horizons. "Other challenges include investors' mistakenly equating size with safety and the institutionalisation of the industry that has resulted in many managers changing course to focus on lower volatility rather than higher returns," observes Reis.

One of the core disciplines at Sire is due diligence, with the firm often finding potentially costly holes in the underlying manager's own


Judson Reis

prospectus. "Our due-diligence processes have evolved and become more disciplined. As the business became more institutionalised and regulated, we developed detailed investment and operational due-diligence protocols, including having a private investigator on retainer," says Reis.

Andre Visser's La Fayette Holdings Fund is also celebrating its 21st birthday. Visser's original plan was to offer a small group of private investors – 'friends and family' – the same performance *pari passu* to his own personal investments, but the firm ended up winning a mandate from the Sainsbury's pension fund in 2004 around the time it entered its institutional phase in the business's development



that saw assets increasing significantly to almost $6 billion.

After a turbulent 2008, the firm returned to its private wealth management roots of performance. Although now, La Fayette Opportunity and its feeder, La Fayette Holdings, have been restructured with a global value approach, mixing traditional and alternative investments, where low volatility is no longer a prime objective, explains Visser. The funds now target absolute returns over the medium to long term with a net long bias to equities. Underlying active positions were cut by half towards 25 high-conviction ideas, with the top seven core managers running more than 50% of the assets.

"The challenge was not only to navigate market conditions, but also, too often, unfortunately, to navigate black boxes, style drifts, excessive leverage (at the underlying manager level), fraud and illiquid positions. Working out of these illiquid positions has been a lengthy distraction, perhaps the main challenge," admits Visser, whose La Fayette Holdings Fund has re-

turned a cumulative 453% since inception in January 1992, which annualises to 8.38%.

Visser's story is an interesting one, showing how different types of investors want different things. With more than two decades in hedge fund investing, Visser's network and smaller asset base allows him to access funds that are generally closed to new investors. If he had to do it all over again, Visser would probably not start a fund of hedge fund business in the traditional sense, but he would be tempted to start an advisory firm with a focus towards investing with global equity managers who have a record of superior performance, even at the expense of lesser diversification.

From his experience, a prospective investor in hedge funds, or indeed in any alternative investment, needs to establish a special relationship with the investment manager built on trust and an understanding of the investment strategy. "[The investor] needs to make sure that the interests of the manager and those of the investor are aligned. In this regard, co-investment by the hedge fund manager of a substantial portion of his wealth alongside his investors is a must, particularly in equity strategies, and limiting the assets under management is expected to allow for continued performance," he states. But to Visser, one of the most vital elements in long-term relationship building is transparency and frequent open communication to sustain a spirit of high integrity.

The future for most FoHFs definitely has a component of customisation, something that Larch Lane has started to see. "While many clients invest directly in our funds, we've also seen many more mandates where we serve in an advisory role, working with clients to customise portfolios that best meet their risk, return and liquidity objectives," says Jurish. The other trend that has emerged is that today's environment heavily favours large, brand-name firms, and more investors are attempting to build out their own investment programmes and 'go direct', notes Corbin Capital Partners' Craig Bergstrom. "Whether the latter trend continues or not remains to be seen; however, it is clear, in our view, that any new entrants would face huge challenges in this environment," he adds.

Despite the fact that there are more challenges in today's FoHF world than when Jurish first formed Larch Lane, he believes that there is still a market for those FoHFs that capitalise on a specific niche, strategy or focus. "Markets are more complex, barriers to entry are higher, and the environment is more competitive. There are also challenges in the hedge fund world as smaller funds struggle to raise capital – something we know well because of our hedge fund seeding business, but as investors in early-stage hedge funds, we've been able to capitalise on a specific niche," he notes.

Rasini Fairway's Leguel agrees. "I would start a fund of funds as I believe there still is a need for products that offers exposure to hedge funds delivered by skilled and experienced teams. We can argue on the correct fee level but not on the need and demand for comingled products," he says. To Leguel, funds of funds can offer the following services in a very effective way: diversified exposure

to hedge fund betas and alphas in a more efficient way than through direct investments; concentrated portfolio of different alphas in same strategy or across different strategies; and niche funds of funds including emerging managers, and those focused on strategy and/or region.

Reis of Sire Management Corporation, however, says he would not start a FoHF in today's environment. "[There are] too many compromises required to raise significant capital. We know of one firm, now five years old, that let limited partners buy the majority of the firm, at a very low price, to get started. Other investors require terms from new firms that are inimical to long-term investment success," he explains. Regulations and compliance are onerous and costly for a start-up, too, he adds.

That said, the majority of those managers that launched funds of funds 20 years ago or more that were interviewed would do so again. As Fundana's Aryeh points out: "While it is more challenging to find the most talented managers nowadays, the environment was actually much worse in 1993 when we started. Remember that in late 1992, Soros had just bankrupted the Bank of England and hedge funds were depicted as pirates."