Hedge Funds in High Net Worth Portfolios

By Susan B. Weiner, CFA

There's more than one way to invest responsibly in hedge funds. That's a lesson from RINET Company, LLC and The Colony Group, LLC, two Boston-based wealth management firms. RINET typically puts its clients in hedge funds of funds. Although it sometimes relies on its own due diligence, The Colony Group prefers direct investment in hedge funds in which its wholly owned subsidiary, Colony Funds, LLC, serves as general partner. Yet RINET's and Colony's approaches to due diligence overlap. Both delve deep into the quantitative and qualitative details. Without extensive due diligence, clients could lose everything to fraud, deviation from strategy, or reckless investing.

Improving the Trade-off between Risk and Return

RINET and Colony don't believe in taking big risks with hedge funds. In fact, they use them to improve the trade-off between risk and return in client portfolios. Historical data shows that you can reduce risk and enhance returns by adding non-traditional investments, such as hedge funds, private equity, and real estate, said Chief Investment Officer David S. Beckwith, CFA, of RINET. It's a way of pushing out the efficient frontier.

Over time, clients with a traditional mix of stock and bonds can expect a return of 7½%-8% with an implied volatility of roughly 10% (as measured by annual standard deviation), said Beckwith. But with more broadly diversified portfolios that include non-traditional investments, they could earn the same returns with an implied volatility of about 6%, or they can boost their returns by 100 basis points without increasing volatility. “Even if you don't capture the full upside, if you protect more significantly against the downside on an annual basis, you should be able to come out well ahead over the long run.”

At The Colony Group, Executive Director Elisabeth L. Talbot, CFA, CPA, also stressed the risk-return trade-off. “Our clients have accumulated enough assets to be intrigued by the prospect of less volatility with returns that nevertheless remain quite attractive.” Generally, they are seeking “negative correlation with equities.” While fixed income investments can also reduce overall volatility, their absolute returns do not compare favorably with those of hedge funds, she noted.

The SEC requires individuals to qualify as accredited investors to use hedge funds. At a minimum, they must have annual income of $200,000 and net worth above $1 million. But The Colony Group typically reserves hedge fund investments for clients with at least $5 million in investable assets. “People with less than a certain level of assets shouldn't assume the risk,” said Talbot. She

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qualified her statement by saying that the ideal client profile depends on the type of the potential hedge fund investment. Lock-up periods, illiquidity, investment risks, and the clients' risk tolerance are just some of the considerations.

RINET includes hedge funds—or similar investments—in its five model portfolios that vary according to the investors' risk tolerance. Depending on risk level, its hedge fund allocation ranged from 15%-25%, an overweight to its benchmark's 5%-15%, as of year-end 2007. A large majority of clients with investable assets of $10 million and up, the firm's core clientele, have hedge fund exposure, said Beckwith. Clients with $2 million to $5 million have more limited exposure, depending on whether they are comfortable with implied risk and liquidity constraints, and meet minimum levels of both committed investment in the fund as well as total investable assets. Clients with as little as $1 million typically go into hedge-like mutual funds—for example, those that use long-short strategies.

Funds of Funds versus Becoming a General Partner

Like many wealth managers, RINET typically puts its clients in funds of funds rather than in individual, single-strategy hedge funds; the former make up the majority of the 15 hedge fund vehicles currently carried on the firm's approved list. "It adds an extra layer of due diligence, still offers transparency to the underlying fund, and tends to produce very attractive risk-adjusted returns after all fees" said Beckwith, referring to the activities of the manager of a fund of funds. That complements the research conducted by three senior analysts (including Beckwith) and one junior analyst at RINET. The firm maintains an open platform, so they can find the best possible managers, said Beckwith.

Diversification is another advantage of a fund of funds approach. RINET's fund of fund managers typically invest in a variety of funds and strategies, including between ten and 40 funds, said Beckwith. Consequently, no one hedge fund exceeds a 2% weighting within the firm's model portfolios. While RINET favors funds of funds, it sometimes uses individual hedge funds.

The Colony Group considered investing in funds of funds, but was concerned with the fact that the layering of fees—paid to the fund of funds manager on top of the fees for the component funds—can eat into investment returns, said Talbot. An even bigger concern was the lack of transparency of any hedge fund's underlying assets. Hedge fund managers are notorious for their reluctance to disclose specific holdings and to explain in detail how their "black box" works.

Colony Funds, LLC became a general partner in a hedge fund so that Colony Funds could better understand and control its clients' hedge fund investments. The biggest advantages of this strategy? It lets Colony hire and fire the subadvisor, control fees, and exercise the greater level of control that comes with

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being a general partner," said Talbot. This greater level of control, for example, allows The Colony Group to avoid many of the overly restrictive lock-up and other features that apply to most other hedge fund investments, an approach that clients greatly appreciate.

The Colony Group's first hedge fund is the Dakota Fund, a long-short, single-strategy equity fund. The fund is available only to investors with more than $5 million in investable assets. After two years, it has about $17 million in assets. The Colony Group is talking with several strategic partners about additional hedge funds.

Identifying Candidates for Investment

It's a lot tougher to find a good hedge fund than to find a good mutual fund because many of them are available only by word of mouth. "The really good ones are hard to get into. They're available only on a referral basis," said Talbot. Accordingly, "the identification of candidates is an ongoing challenge for the investment advisor," she added.

Beckwith agreed, saying that RINET relies on a network of contacts, including clients and fund managers, to identify good hedge funds. After identifying the funds, due diligence starts.

Digging Deeper into Hedge Funds

Due diligence of hedge funds covers the same basics as due diligence of traditional investment managers, plus some additional wrinkles. "Our overriding considerations are the historical performance and the level of risk," said Talbot. "One important measure is standard deviation, the expected variability of returns." The Colony Group also looks at correlation with the S&P 500 as well as the fund manager's alpha. RINET also considers all of these characteristics. "The correlation characteristics are an important part of the model portfolio construction and are a key underpinning of the mission to reduce annual volatility of the portfolios," said Beckwith.

Many managers overlook the importance of tax efficiency for high net worth investors. Many funds offer attractive pre-tax returns, but if they engage in a lot of short-term trading or short-term arbitrage it hurts the taxable investor's bottom line. "Our bias is toward managers with strategies appropriate for high net worth investors," said Talbot.

Good due diligence includes both quantitative and qualitative research, said Beckwith. It starts with the performance record, traditional concerns such as

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philosophy and process, and extends to ownership as well as the firm's regulatory, compliance and back office activities.

Beckwith examines factors such as how a fund performs in good and bad markets, whether the fund sticks to its strategy in stressful markets (such as August 2007), and whether performance makes sense in light of the fund's philosophy. Some questions are unique to hedge funds, said Beckwith, for example those pertaining to how extensively or effectively a fund uses leverage or how capable its prime broker is in supporting a short sale strategy.

Ongoing Monitoring

Scrutiny doesn't end once clients invest in a hedge fund. Both RINET and Colony see ongoing review of performance and face-to-face interviews as critical. If all goes well, the results will show up in a more attractive risk-return tradeoff for clients.

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