Key findings of the Edhec 'European alternative multi-management practices' survey[1]

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Abstract
This article provides the key findings of Edhec European Alternative Multi-management Practices Survey. It provides a detailed summary of the results of the survey of the 61 multi-managers carried out, as well as details of the research performed both by Edhec and numerous other professional and academic institutions in the area of alternative multi-management.

1 This article is a summary of the key findings of Edhec 'European Alternative Multi-management Practices' survey released in December 2003. This survey is a combination of a permanent 'industry and academic intelligence' carried within Edhec Risk and Asset Management Centre and an in-depth analysis of the responses to questionnaires sent to a large number of industry representatives. The work has been carried by a team led by Noël Amenc with the support of Anne Delaunay, Jean-René Giraud, Félix Goltz, Lionel Martellini and Mathieu Vaissié. The 110 pages report is freely available in PDF format on www.edhec-risk.com.

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Hedge funds have recently been at the centre of numerous debates, either as alternatives to traditional long-only investments, or because of the very specific risk they carry due to their trading strategies and a fairly unregulated environment. If hedge funds have built the success we know of, based on the very concept of superior and absolute performance, the appetite institutional investors now have for such investment vehicles might grow from a very different angle and is not without impact upon the industry.

Funds of hedge funds, and more generally alternative multi-management, can be considered as the natural gateway for investing in hedge funds. By their capacity to mutualize an investment process that requires very specific skills, funds of hedge funds have positioned themselves as the most optimal way for institutional investors to access pools of hedge funds.

Edhec Risk and Asset Management research centre has been carrying extensive research on alternative investments, notably in the areas of risk management and multi style, benchmarking and indices, and multi class asset allocation. With this survey, we intended to bring to the industry the results of our numerous research programmes and attempt to analyze the gap between current industry practices and the most recent research in the area of alternative investments.

A pan-European initiative

In the summer of 2002, questionnaires for the Edhec European Alternative Multi-management Practices Survey were sent to the top 500 European asset managers, alternative multi-managers, and institutional investors. The purpose of the study was to get a better understanding of multi-management market within Europe. The study generated responses from 61 European alternative multi-management companies, representing a total volume of € 136 billion of alternative assets under management at 31/07/02. It is important to note that our sample covers a wide variety of actors that are not usually included within surveys on multi-management practices, such as Funds of Hedge Funds (FoHF) managers who are actually marketing FoHF products, advisors to direct investors in hedge funds, and direct investors in hedge funds who have similar preoccupations to FoHF managers.

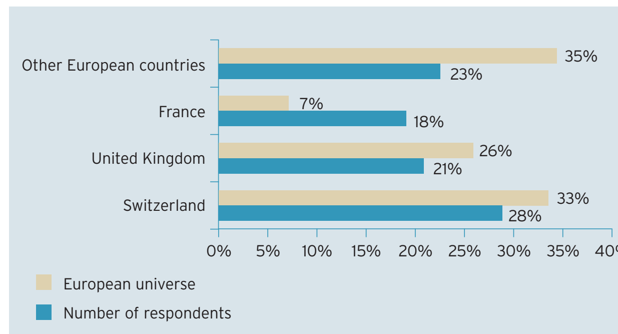

Figure 1: Breakdown of alternative multi-managers by number
Source: Edhec European Alternative Multi-management Practices Survey, December 2003

The breakdown by country in the sample corresponds fairly well to the breakdown of the firms that compose the alternative multi-management landscape, notably as far as the dominance of the U.K. and Switzerland is concerned (see Figure 1).

We do, however, note that answers from French asset managers are overrepresented in comparison to their weight among the leading firms. This can be explained by higher return rates to our questionnaires, as it was issued by a French institution.

Figure 2 represents the breakdown of our respondents with regard to their average assets under management. We can note that 26 respondents (42% of the sample) manage more than € 1billion, which is not inconsistent with the fact that the 50 largest FoHF manage 90% of global assets[2]. Our sample does not therefore suffer from any size bias.

Facts and figures on the European alternative multi-management market

Traditionally, the sales arguments for alternative multi-management were based on absolute performance and the superiority of alternative alphas. This strategy led multi-managers to propose diversified funds using the best managers.

2 'Asset Management Focus', Freeman & Co., Q1 2003

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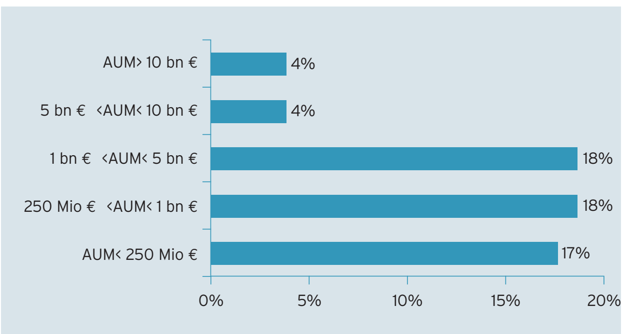

Figure 2: Breakdown of respondents by size
Source: Edhec European Alternative Multi-management Practices Survey, December 2003

While these offerings are still present in the European market, they have nevertheless been giving way progressively, over the past three years, to a more relative approach to alternative performance which corresponds more to the concerns of institutional investors, who are devoting an increasing share of their assets to hedge funds for diversification reasons and for the quality of their betas.

This 'beta benefit' logic has led the alternative multi-management industry to offer FoHF by strategy, which allow investors to choose the risks to which they wish to be exposed and those they wish to guard against within a multi-style/multi-class diversification logic. As such, 64% of the professionals surveyed do offer FoHF by strategy today. Moreover, the relativizing of alternative performance has given rise to the creation of a large number of hedge fund indices. These indices, which are created from funds, the most widely used being HFR (27%), CSFB (27%) and Zurich (13%), unavoidably present serious problems due to their lack of representivity and the biases of the data used, resulting in potentially severe inconsistencies (See Figure 3).

Finally, in a desire to respond to a demand for benchmarked investment management, a significant number of multi-management firms propose 'investible' indices. The criteria for constituting these indices are not based on representivity, but on performance, liquidity, or fund availability.

This confusion between FoHF and indices is not conducive to objective measurement of performance and risks in the alternative universe and, as such, has led Edhec to propose hedge fund indices of indices whose principles and construction technique guarantee better representivity and purity. More globally, the poor quality of the data available leads operators to implement private solutions (managed accounts, external risk

Investment Styles	Max differences	Date	Indices and corresponding returns		
Convertible Arbitrage	7,55%	Dec 01	EACM (-6.93%)	vs.	Hennessee (0.62%)
CTA	5,09%	Feb 99	CSFB (-0.54%)	vs.	HF Net (4.55%)
Distressed Securities	6,99%	Feb 00	EACM (1.23%)	vs.	Zürich (8.22%)
Emerging Markets	19,45%	Aug 98	MAR (-26.65%)	vs.	Altvest (-7.20%)
Equity Market Neutral	5,00%	Dec 99	Hennessee (0.20%)	vs.	Van hedge (5.20%)
Event Driven	5,06%	Aug 98	CSFB (-11.77%)	vs.	Altvest (-6.71%)
Fixed Income Arbitrage	10,48%	Oct 98	HF Net (-10.28%)	vs.	Van Hedge (0.20%)
Funds of Hedge Funds	8,01%	Dec 99	MAR (2.41%)	vs.	Altvest (10.42%)
Global Macro	14,17%	Oct 98	CSFB (-11.55%)	vs.	Altvest (2.62%)
Long/Short Equity	22,04%	Feb 00	EACM (-1.56%)	vs.	Zürich (20.48%)
Merger Arbitrage	2,71%	Sept 01	EACM (-4.32%)	vs.	HF Net (-1.61%)
Relative Value	10,47%	Sept 98	EACM (-6.08%)	vs.	Van Hedge (4.40%)
Short Selling	21,13%	Feb 00	Van Hedge (-24.30%)	vs.	EACM (-3.17%)

Figure 3: Maximum monthly return differences by investment style (from January 1998 through July 2003)
Source: Edhec Risk and Asset Management Research Centre

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control system, thorough due diligence, etc.), with their cost favoring consolidation of the market around the major players. The latter are capable of coping with the requirements of institutional investors in the area of transparency and in controlling the risks of investing in hedge funds. Today, the 25 leading FoHF represent almost 70% of alternative multi-management.

A summary of the major trends in the alternative multi-management market would not be complete if we did not mention the development of structured products, which constitute a major innovation for the distribution of FoHF. Structured products allow private or institutional investors to be offered a capital guarantee when faced with the extreme risks to which hedge funds are exposed.

Unlike structuring on traditional investments, the structured product offering aims less to protect the investor from market risk than from the risk of the investment management itself. It thus favors the marketing of FoHF to investors who are concerned about the quality and security of their counterparty.

In addition, structured products very often provide a solution to getting round the regulatory difficulties that hinder the marketing of investment vehicles that are located offshore or cannot satisfy the criteria laid out by the European regulators for managing or holding funds.

The question of the value-added of alternative multi-managers

The main question the Edhec survey is trying to answer is voluntarily provocative and of a nature to give rise to debate. Why, in spite of their undeniable diversification qualities, do hedge funds represent less than 5% of the assets of institutional investors?

More specifically, do FoHF, who hold themselves out as the natural gateway to alternative investment, provide sufficient value-added to convince investors to transform their investment desires (89% were considering investment through FoHF before the end of 2003, according to a recent study by the Hennessee Group), into reality? Although the right quantity of hedge funds in a portfolio, according to various professional and academic studies, is between 15 and 25%, depending on the strategies and risk profiles desired by investors, it is curious to note that a large number of institutional investors limit their share of hedge funds to 5% of their allocation. And, clearly, 5% of hedge funds in a portfolio do not change its profile.

To answer this question, Edhec investigated the current European alternative multi-management market and analyzed the responses of the professionals according to the three areas of a multi-manager's value-added, asset allocation and portfolio construction, fund selection, and reporting and investor information.

Asset allocation and portfolio construction

While diversification is the leading motive for investing in hedge funds, its seems that European FoHF do not wholly take into consideration the diversification potential of the different hedge fund strategies in their portfolio construction strategy.

Figure 4 shows that 42% of the respondents offer funds with specific diversification objectives defined in relation to other asset classes. While, for example, 80% of British alternative multi-managers offer FoHF by strategy, only 40% propose funds that satisfy precise diversification criteria. Multi-managers' lack of attention to the diversification properties of hedge funds is probably linked to the confusion that exists between the fund selection tasks, which constitute the original value-added of the FoHF, and those relating to allocation or diversification by style.

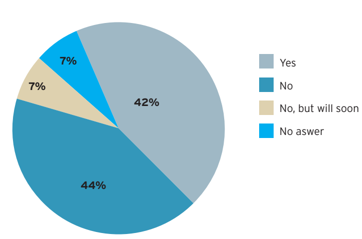

Figure 4: Do you offer FoHF with specific behavior or diversification objectives in relation to other asset classes?
Source: Edhec European Alternative Multi-management Practices Survey, December 2003

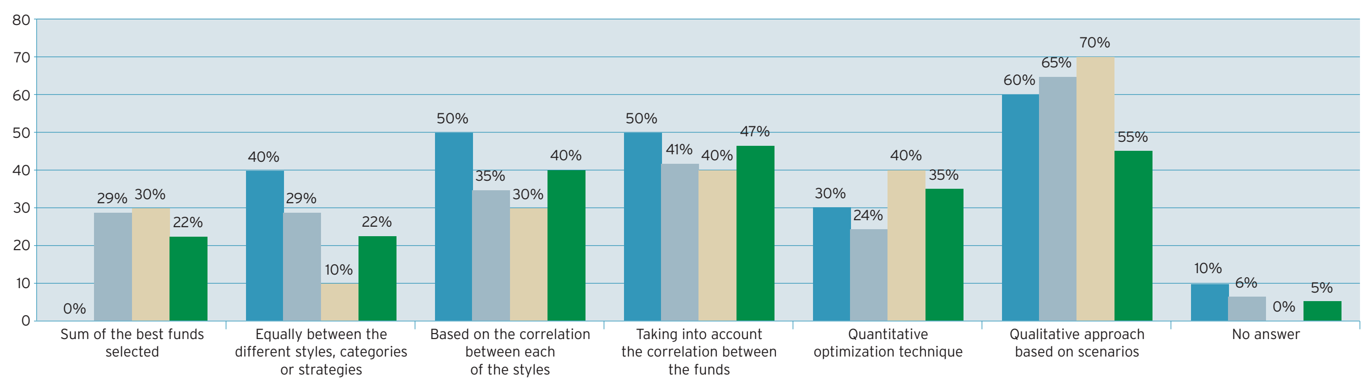

Figure 5: How do you construct your portfolios for multi-strategy or multi-style funds?
Source: Edhec European Alternative Multi-management Practices Survey, 2003

While a significant majority of European FoHF (75%) have a team dedicated to portfolio construction and/or return forecasts for hedge fund styles, one cannot help but observe that numerous European multi-managers continue to confuse portfolio allocation with the choice of the best managers (22%). Only 13% combine a quantitative approach with a qualitative portfolio construction approach, even though it is the only method that allows scenarios on extreme market conditions to be taken into account while at the same time disciplining and formalizing the manager's intuitions.

65% of European multi-managers do not use a quantitative approach in the area of strategic portfolio allocation, despite the benefits of such approaches being highlighted by academic research. Only 47% of the professionals questioned take the correlation between funds into account to organize the diversification of their portfolio (See Figure 5).

More worryingly, in spite of the crises in 1998, only 13% of European multi-managers have integrated an extreme risk measure and scenarios on extreme market conditions into their portfolio construction process.

We also note that the vast majority of FoHF (76%) include more than 15 funds in their portfolio, even though all the academic and empirical studies have shown that beyond 10 or 15 funds, depending on the strategy, the increase in the number of underlyings made the FoHF lose their diversification qualities and increased their extreme risks. Finally, both observation of the market and the comments of the multi-managers approached conclude that inter-style tactical allocation offerings based on the predictability of hedge fund styles have experienced little growth. It is probable that the growing success of alternative index trackers will, in time, encourage the setting up of offerings of that kind.

Fund selection and due diligence

While most alternative strategies exhibit abnormally distributed returns, the vast majority of hedge fund selectors continue to use tools from traditional investment management to evaluate their performance. 82% consider the Sharpe ratio and only 4% calculate an Omega ratio, despite the fact that the latter is more appropriate for the alternative universe (See Figure 6).

The performance databases play a central role for 67% of the participants, even though these databases contain numerous biases and it is easily shown that the choice of a database, and thus the choice of particular biases, influences the performance of the funds selected.

In spite of these data problems, 44% of the respondents give quantitative analysis a significant role in fund selection, even if, in the end, the weighting accorded to the analysis does not exceed 37% on average. If a majority of respondents internalize their fund selection process, it is interesting to note that one third of

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Total Europe	Very Important	Important	Not very important	Not considered
Sharpe Ratio	35%	47%	11%	5%
Sortino Ratio	18%	40%	11%	25%
M2 or SRAP Ratios	2%	13%	27%	51%
Drawdown Ratio	47%	33%	9%	5%
Return/VaR	24%	35%	15%	22%
Information Ratio	27%	22%	18%	29%
Return	5%	0%	0%	0%
Semi-deviation	4%	0%	0%	0%
Historical Sharpe ratio data	4%	0%	0%	0%
Tracking error ex-ante	4%	2%	0%	0%
Correlation	4%	4%	0%	0%
Standard deviation	5%	0%	0%	0%
Beta	4%	2%	0%	0%
Alpha	4%	2%	0%	0%
Omega	2%	2%	0%	0%
B VaR	2%	0%	0%	0%
Skewness & Kurtosis	2%	0%	0%	0%
BULL/BEAR	2%	0%	0%	0%
Rolling 3 year annualized returns	0%	2%	0%	0%
Recovery Time	4%	0%	0%	0%

Figure 6: Which quantitative indicators do you use when monitoring manager performance?
Source: Edhec European Alternative Multi-management Practices Survey, 2003

respondents outsource the selection partially or fully (See Figure 7).

European multi-managers highlight detailed, qualitative analysis of fund operations in their selection and monitoring process.

However, while this willingness is clear and unanimous, it does not always correspond to the reality of the means and procedures implemented, notably in the areas of due diligence and risk monitoring. If we examine the hierarchy of criteria, it is curious to note that the quality of reporting and risk control of the underlying funds is essential in the eyes of the managers who themselves do not always have tools or skills of that type. For example, one-third of European FoHFs do not have a dedicated team for risk analysis (See Figure 8).

It should be noted, in the same spirit, that, for want of a capacity to genuinely reassure themselves on the transparency of the funds in which they invest, European multi-managers rely more on the reputation of their counterparty's service providers (prime brokers, custodians, auditors, etc.) than on the operational analysis itself, notably for off-balance sheet operations, which is not considered important or indeed not taken into account at all by 27% of the respondents.

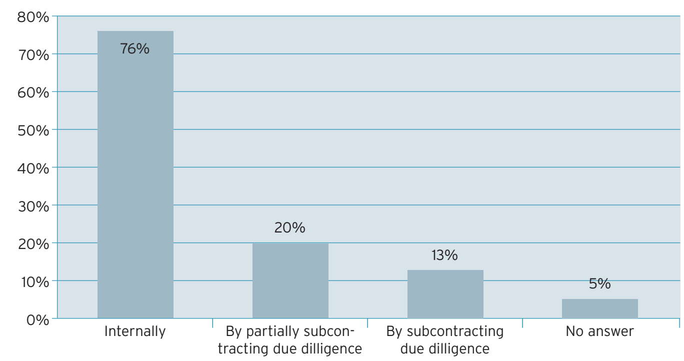

Figure 7: How do you select managers?
Source: Edhec European Alternative Multi-management Practices Survey, 2003

76% of FoHF do not set up 'managed accounts', regardless of the amount of assets entrusted to the managers selected.

More generally, we could set out the problem of the economics of the profession of alternative multi-manager. Projecting the costs of a due diligence process cannot be sustained by FoHF with assets under management that amount to less than U.S.$ 200 million, opening the path to external providers of services.

Risk and performance reporting

Being consistent with their fund selection process, multi-managers favor mean/variance reporting rather than reporting that takes all the moments of return distribution into account.

Europe

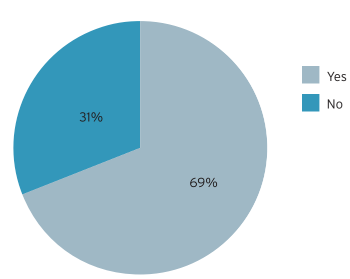

Figure 8: Do you have a specialized risk analysis department?
Source: Edhec European Alternative Multi-management Practices Survey, 2003

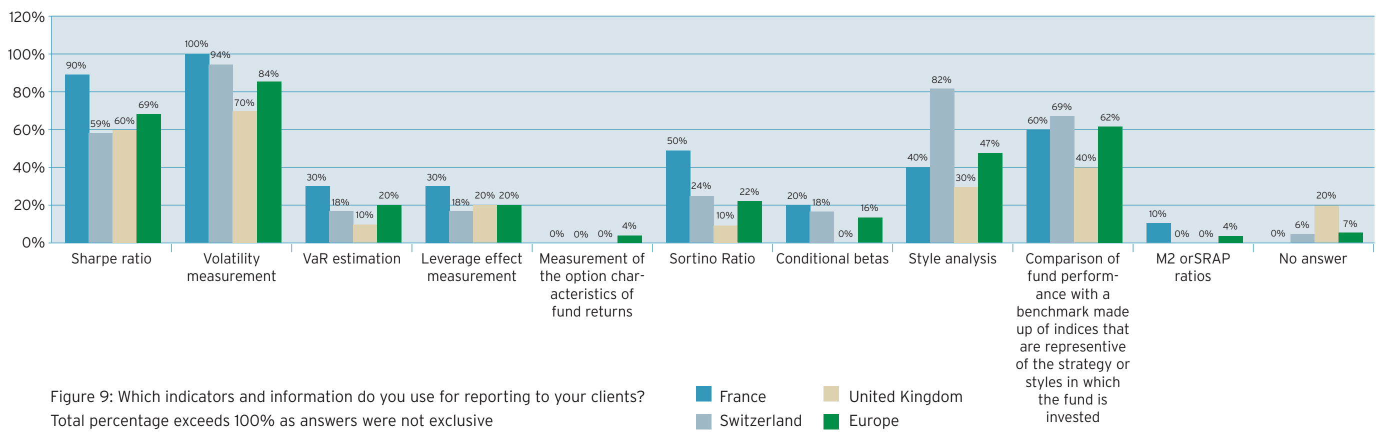

Figure 9: Which indicators and information do you use for reporting to your clients?
Total percentage exceeds 100% as answers were not exclusive
Source: Edhec European Alternative Multi-management Practices Survey, 2003

The Sharpe ratio (69%) is well ahead of the VaR (20%) or the Sortino ratio (22%) among the indicators that are favoured in the performance reporting of European FoHF (See Figure 9).

It should be stressed that volatility is considered by 84% of multi-managers to be the major concern of their clients. However, this concern does not result in information on the diversification qualities of FoHF. FoHF are considered to be volatility reducers not because they are exposed to interesting risk factors within the framework of multi style/multi class diversification, but simply because they exhibit low volatility by themselves, even if this entails a magnification of extreme risks that are neither measured nor documented. Only 20% of respondents give information on the leverage effect of the fund. This insufficiency could lead to erroneous performance analyses, notably when a comparison with hedge fund indices is carried out, which is the case for 62% of FoHFs.

Finally, while studies on the failures of hedge funds have shown that certification of their performance significantly reduced the failure rate, it should be noted that only 13% of the respondents have implemented certification by an independent third party.

Conclusion

What is clear from this study is that the current institutionalization of hedge funds, and the move from absolute performance to diversification benefits, can not simply be understood as a change in scale and client objectives, but merely as a profound modification of investor's requirements, impacting several dimensions of the industry:

- The need for the industry to adapt tools and methods usually developed to serve the needs of long-only investors to support the specific risks hedge funds are exposed to.
- The impact on the economics of the entire value model with the confirmation of funds of hedge funds as a main provider of liquidity to investors.
- The likely specialization of actors focusing on clearly designated areas of added-value such as fund selection or asset allocation.
- The need to take into consideration the constraints and minimum requirements for risk management infrastructure and superior due-diligence processes that are required to satisfy institutional investors' desire.

These challenges are hitting the alternative multi-management industry as never before and will probably result in a radically different landscape over the coming years.