

# FUND OF FUNDS MANAGEMENT: HEDGE FUNDS

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## Introduction

A fund of funds is a portfolio of different funds and strategies that is designed to meet a range of risk/return objectives. The main advantage of such an approach is the reduction of capital risk through diversification. Such an approach, while increasing the overall costs, has the effect of reducing the overall volatility and limits the risk of a fund failure.

Among other asset classes, the fund of funds approach is widely used by managers to diversify the risk inherent in absolute return funds. This is an ideal approach which allows investors to gain the benefits absolute return funds can offer without significantly increasing the aggregate risk profile of the overall portfolio.

The following guide explains the process by which an absolute return fund of funds is formed, what type of historical returns these funds have had and what steps are required of a manager in order to ensure the fund's assets are properly invested.

Thomas Miller Investment (TMI) manages its own absolute return fund of funds called Gibbs Hill. This is an exclusive fund of funds administered on behalf of TMI clients. You can learn more about Gibbs Hill by visiting the Thomas Miller Investment website or by contacting the TMI team at: [invest@thomasmiller.com](mailto:invest@thomasmiller.com).

## Fund of Funds Approach

### Qualitative Process

There is a standardised approach to fund of fund management. As mentioned earlier, there are a number of well-known providers whose role it is to identify the most efficient combination of hedge funds that not only maximises the overall return but also minimises the risk. Since the biggest risk a fund can present is failure, considerable resources are committed by fund of funds managers to examine the market expertise, investment strategy, portfolio management, risk management, investment discipline, business model and integrity of the absolute return fund manager. At this stage the manager is also expected to reveal the parameters in terms of risk per trade, risk per sector, gearing and overall portfolio risk.

Since the majority of funds are unregulated it is important that the fund of funds manager is able to show that it has conducted a thorough review of the absolute return fund manager's internal controls, including interviewing the fund's attorneys, auditors and prime brokers. It is also normal for thorough background checks to be conducted into the senior management's education, experience, business and personal records. Fund of funds managers also expect absolute return fund managers to invest a large part of their personal wealth in their funds, thereby aligning their interests with those of other investors.

## Quantitative Process

This qualitative analysis is supplemented by a quantitative analysis of monthly returns to ensure that the return characteristics are what would have been expected given the investment strategy of the fund. The underlying model used by a fund of funds manager is designed to produce an expected absolute rate of return. This expected rate of return would differ according to the mix of hedge fund strategies used.

The above processes are designed to reduce the likelihood of an investment in a fund that fails through fraud or incompetence. While not major investors in Long Term Capital Management, fund of funds managers learned considerably from its demise and many of the processes described above were introduced to minimise the risk of capital loss in the future.

Investments in fund of funds are normally made at a month end at a net asset value calculated by an independent administrator. Most managers of fund of funds, however, gather the same underlying data in order to agree the calculation. Fund investment returns are, similar to the majority of asset classes, calculated by applying an industry standard approach, using the monthly net asset values.

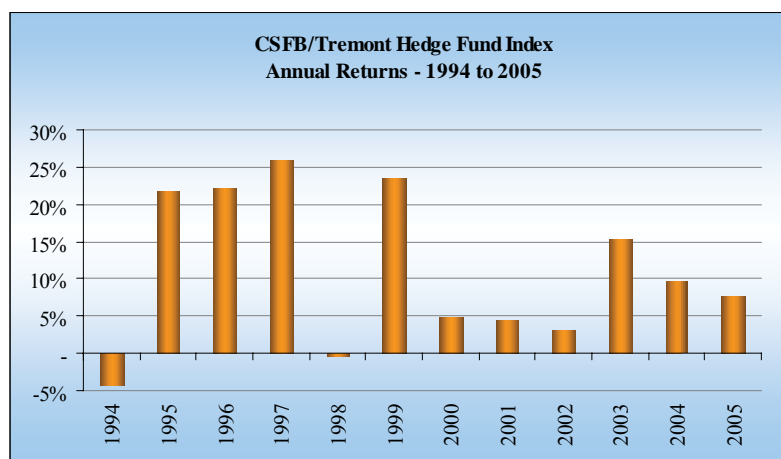
The majority of fund of funds managers open their funds for investment monthly, although the more successful managers sometimes restrict access to quarterly investments. In addition, the majority of managers, in order to reduce the impact of fund flows on performance, require initial investments to be subject to minimum lock-up periods, in some cases of up to twelve months. Such terms are, however, almost always negotiable.

## Fees and Returns

Since the qualitative and quantitative processes require a significant infrastructure commitment, management fees are high and it is quite normal for a fund of funds manager to charge 1% to 1.5% of assets managed. In addition some managers also charge a performance fee for returns over and above a pre-agreed level. Different funds, however, have been

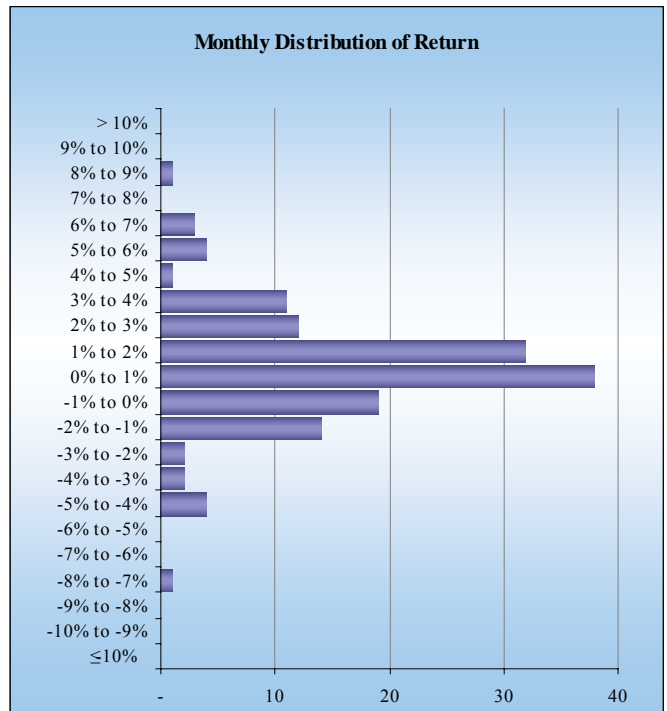
designed for retail and institutional investors. Funds designed for retail investors usually have higher management fees than those designed for institutional investors and often have entry or front-end fees.

The returns of the CSFB Tremont Hedge Fund Index, net of fees, are shown in the chart below:



The chart to the right is a monthly distribution of returns over the last twelve years. It shows how consistent and successful the fund of funds approach has been at dampening volatility, producing positive returns and meeting the objective.

Both this chart and the preceding chart are to a limited extent biased to survivorship (the returns of failed funds are currently not included). While over the years many funds have failed, the impact such funds have had on the investment returns has almost been balanced by funds that have been wound up because the manager has been successful in creating sufficient wealth to retire. In addition, with over US\$700 billion invested in absolute return funds, only a catastrophic failure of a complete strategy, involving a large number of funds, could have had a significant effect on investment returns.



## Regulation

Whilst the majority of offshore funds are formed in jurisdictions that do not have robust regulatory environments, well managed absolute return funds and fund of funds are subject to professional audits by reputable auditors with appropriate expertise. Such reports are key documents in the qualitative review process carried out by fund of funds managers.

Thomas Miller Investment always undertakes the necessary review of these audit reports in its search for viable absolute return fund managers and considers this to be a vital part of the fund manager selection process.

### Regulatory information and risk warnings

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