

Do funds-of-funds deserve their fees-on-fees?

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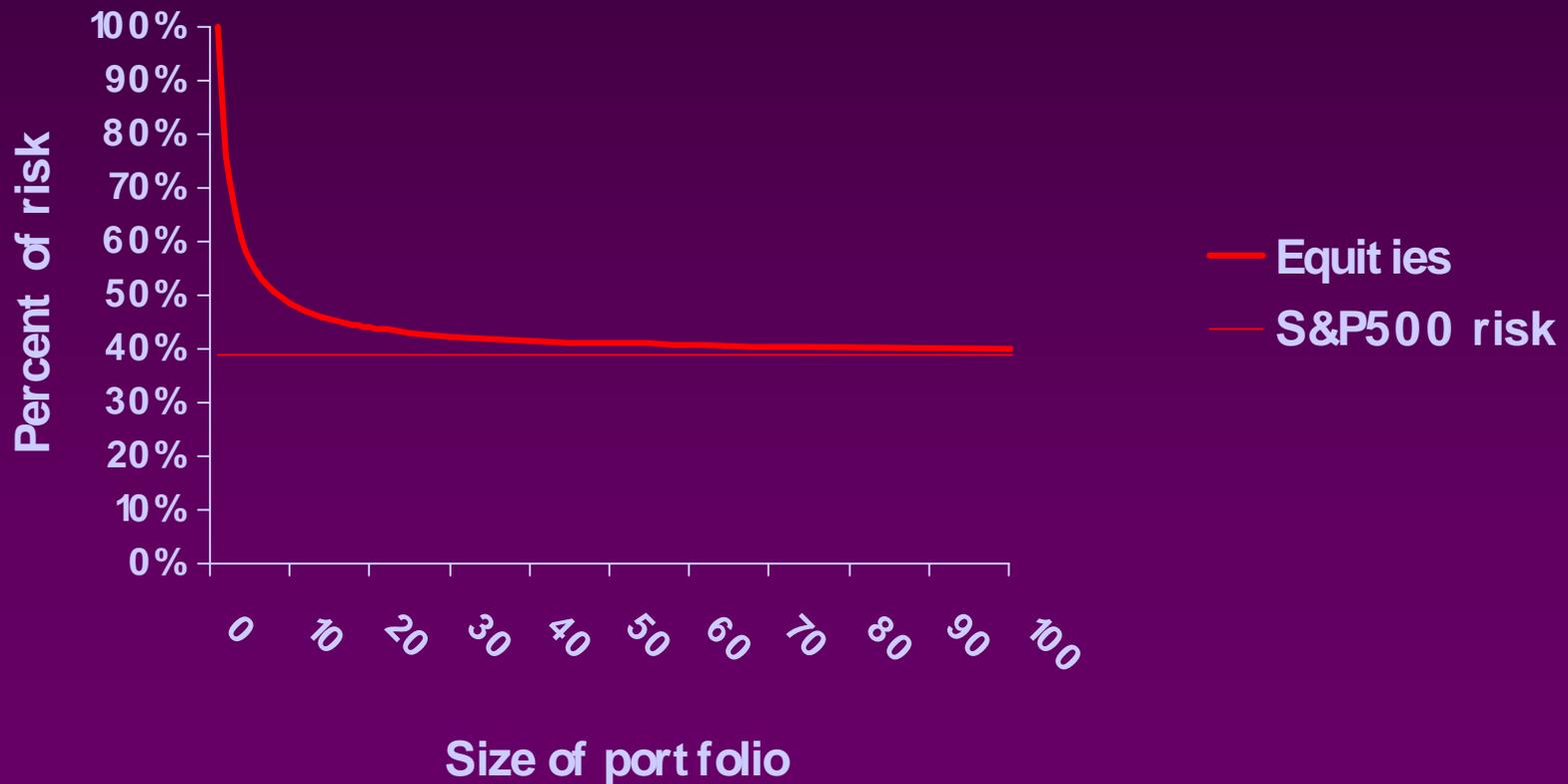
Overview

- ✦ Historical context for funds of funds
- ✦ Role of due diligence
- ✦ Willingness to pay argument
- ✦ Pesky data issues

The History of Hedge Funds

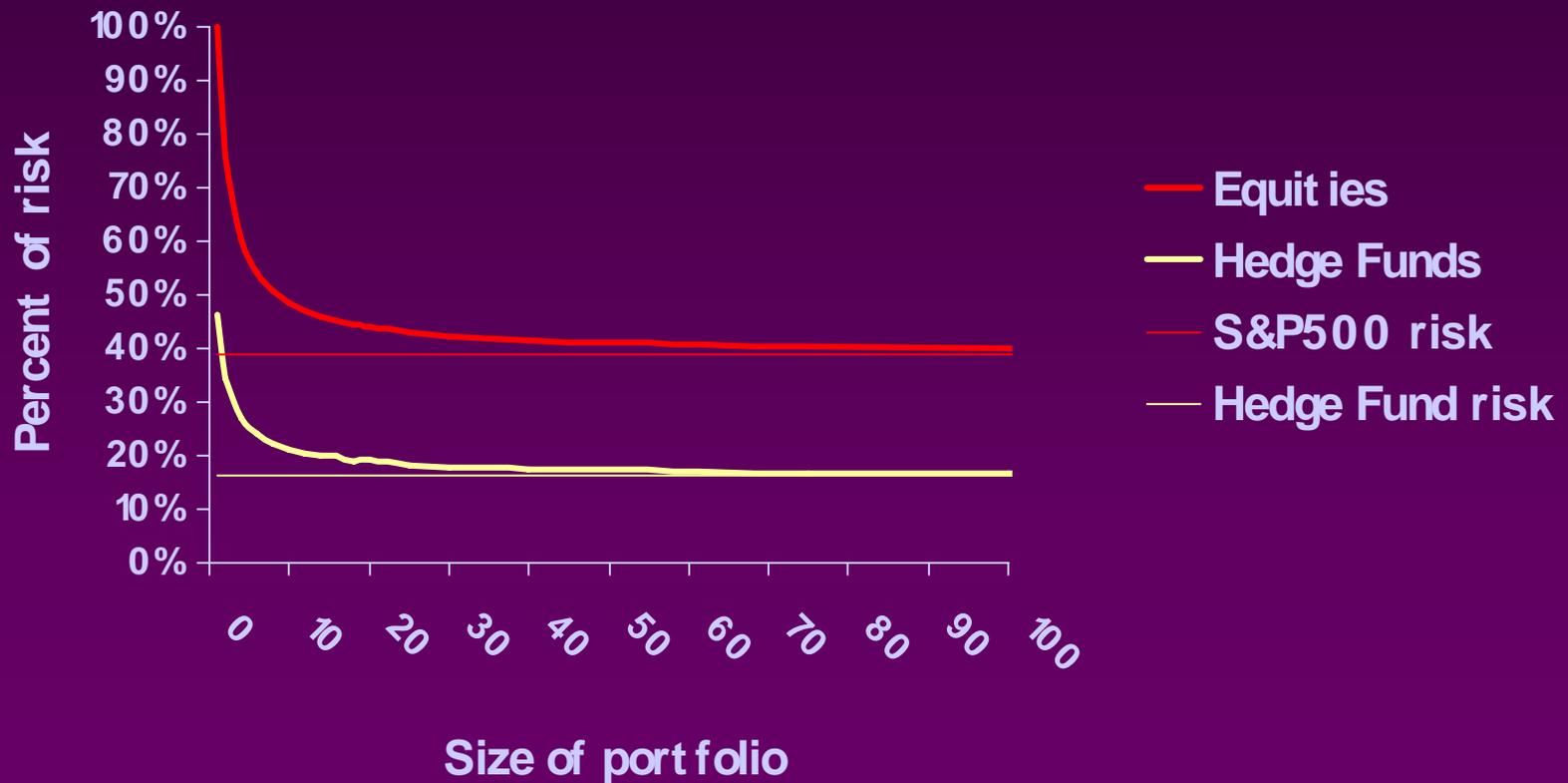
- * The first hedge fund: Alfred Winslow Jones (1949)
 - * Limited Partnership (exempt from '40 Act)
 - * Long-short strategy
 - * 20% of profit, no fixed fee
 - * Used short positions and leverage
- * “Hedge Fund” (Fortune magazine 1966)
- * Tiger Fund (Institutional Investor 1986)
- * George Soros \$3.2Billion raid on the ERM (1992)
- * CalPERS (2000)

Financial Risk

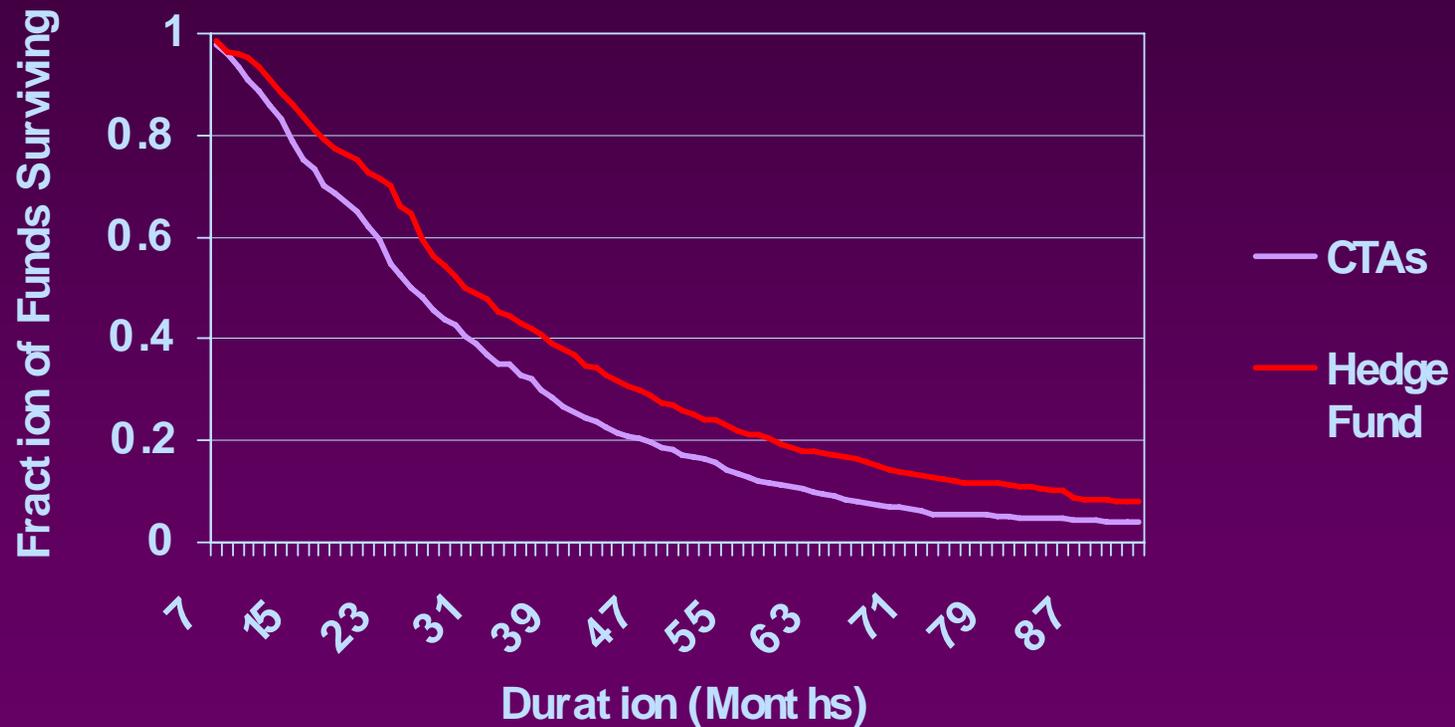


Source: Elton and Gruber 1995

Effect of Diversification: Hedge Funds

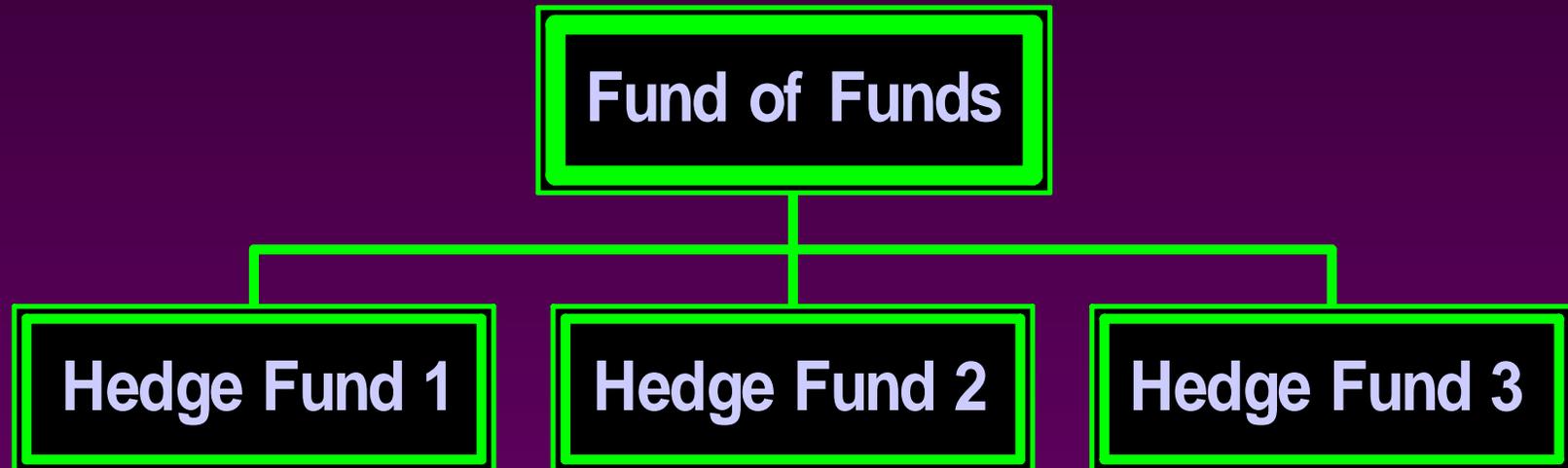


Operational Risk

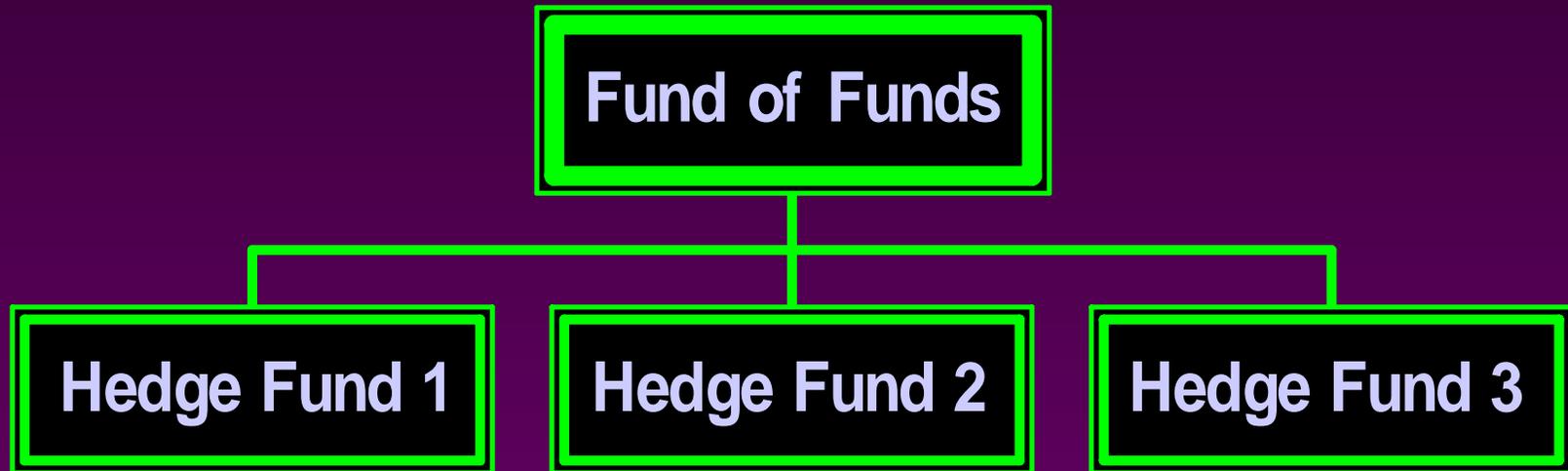


Source: Tremont TASS (Europe) Limited

Funds of Hedge Funds

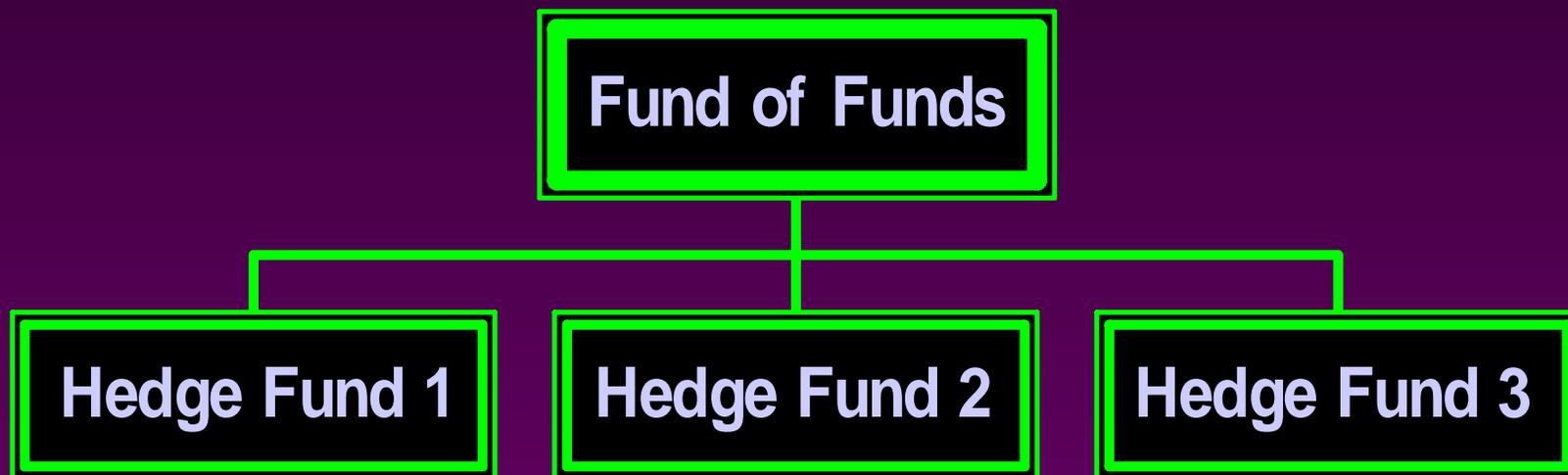


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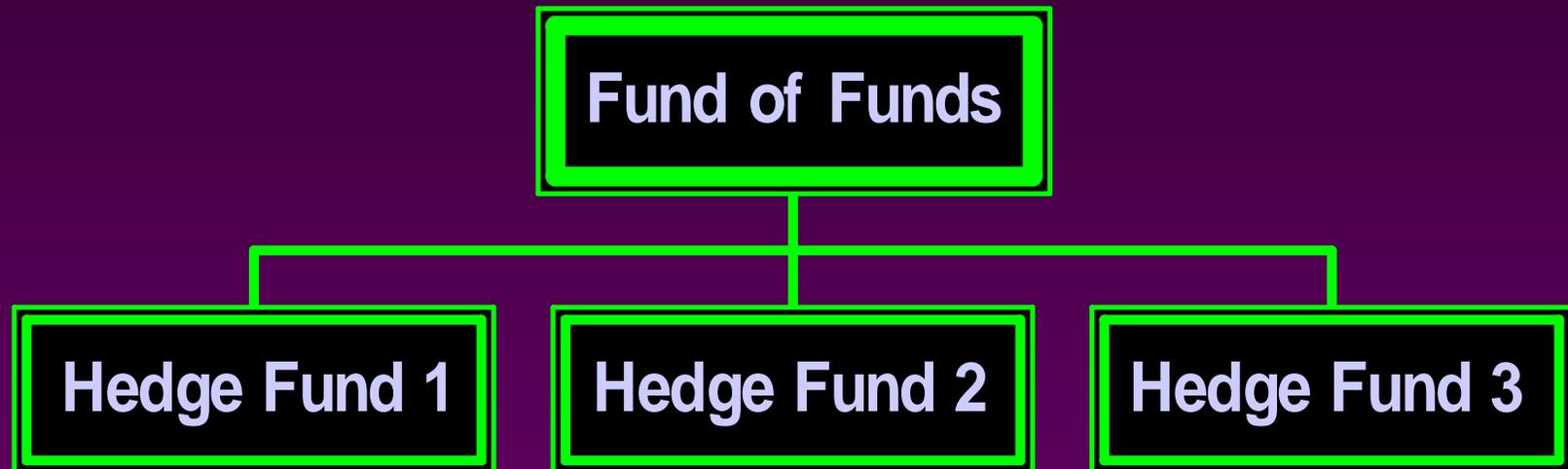
Funds of Hedge Funds



✧ Provides

✧ Diversification – lower value at risk

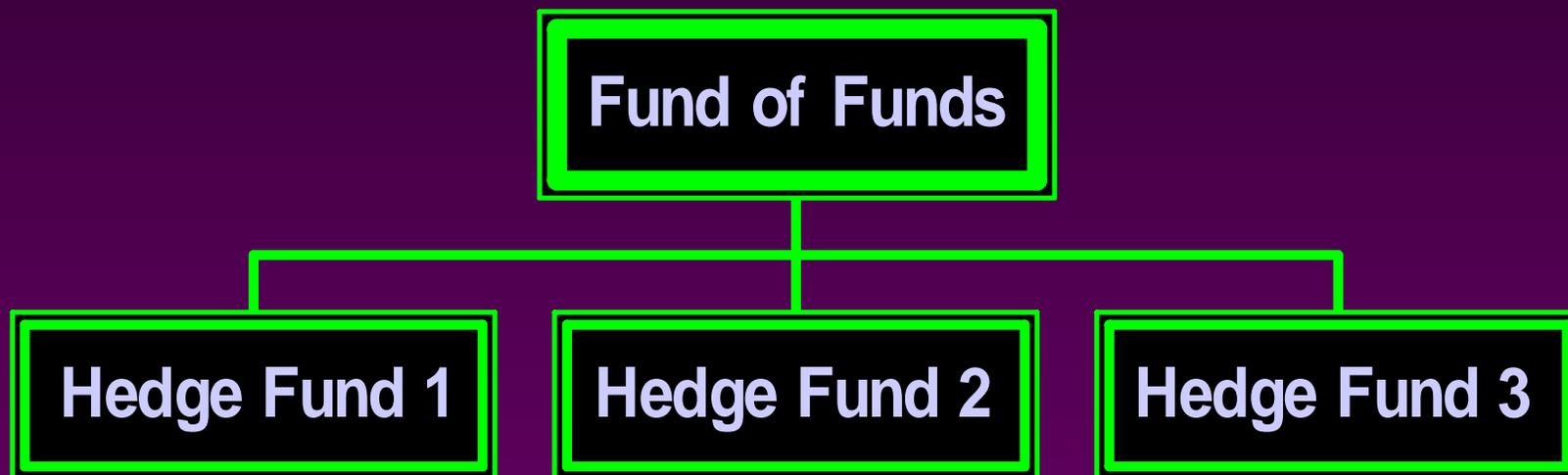
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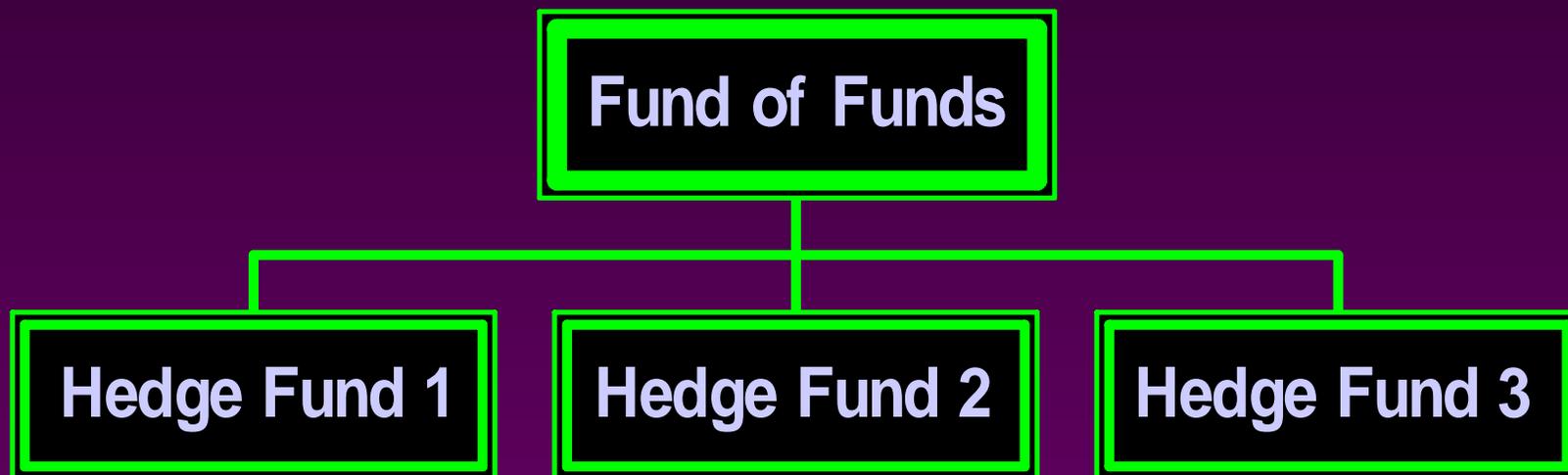
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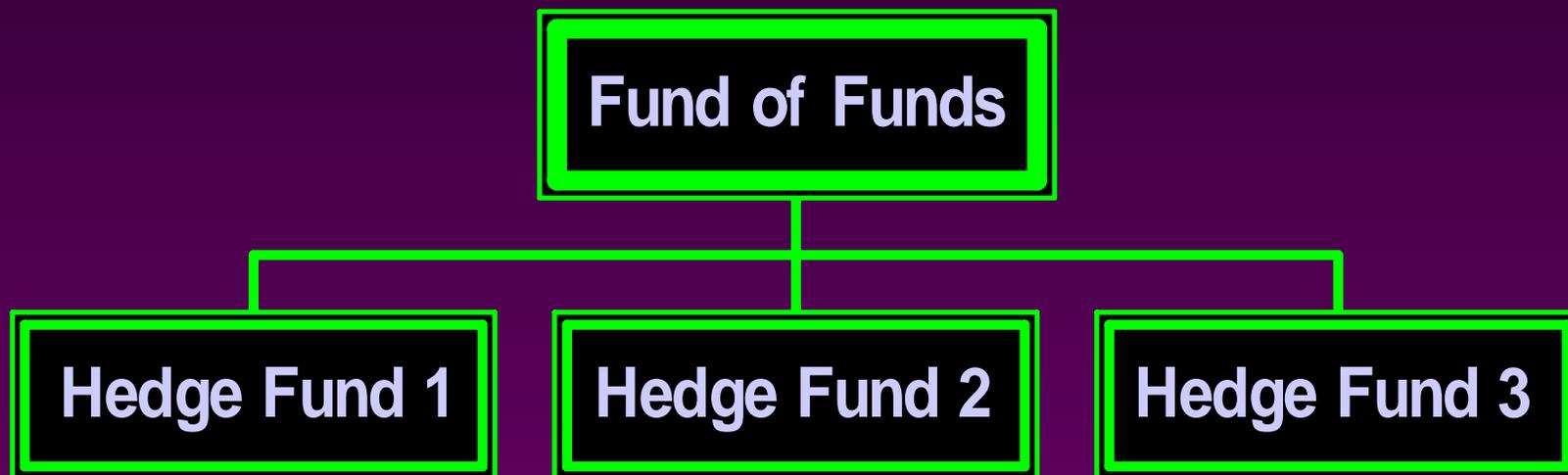
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Institutions love FoF

* Spectacular growth of Funds of Funds

2000:	15% of all Hedge funds were FoF
2003:	18% of all Hedge funds were FoF
2005:	27% of all Hedge funds were FoF

* Institutional attraction of Funds of Funds

- * Risk management
- * Due diligence

Funds of funds are different

	Fund of Funds			Hedge funds			Difference (t-value)
	N	Mean	Std. Dev.	N	Mean	Std. Dev.	
Return (month)	797	0.61%	0.56%	3239	0.97%	1.41%	-11.65
Std. deviation	797	2.60%	2.33%	3239	4.30%	0.02%	-20.60
Lower 5% fractile	797	-3.47%	4.20%	3239	-6.54%	6.55%	16.31
Assets (\$M)	827	\$119	\$591	3378	\$128	\$549	-0.38
Personal invest	862	31%	46%	3439	42%	49%	-6.19
Management fee	862	1.51	0.75	3439	1.40	0.79	3.81
Incentive fee	862	9.06	7.64	3439	18.46	5.91	-33.69
Minimum invest (\$000)	856	\$370	\$850	3335	\$780	\$5,060	-4.44

Willingness to pay argument



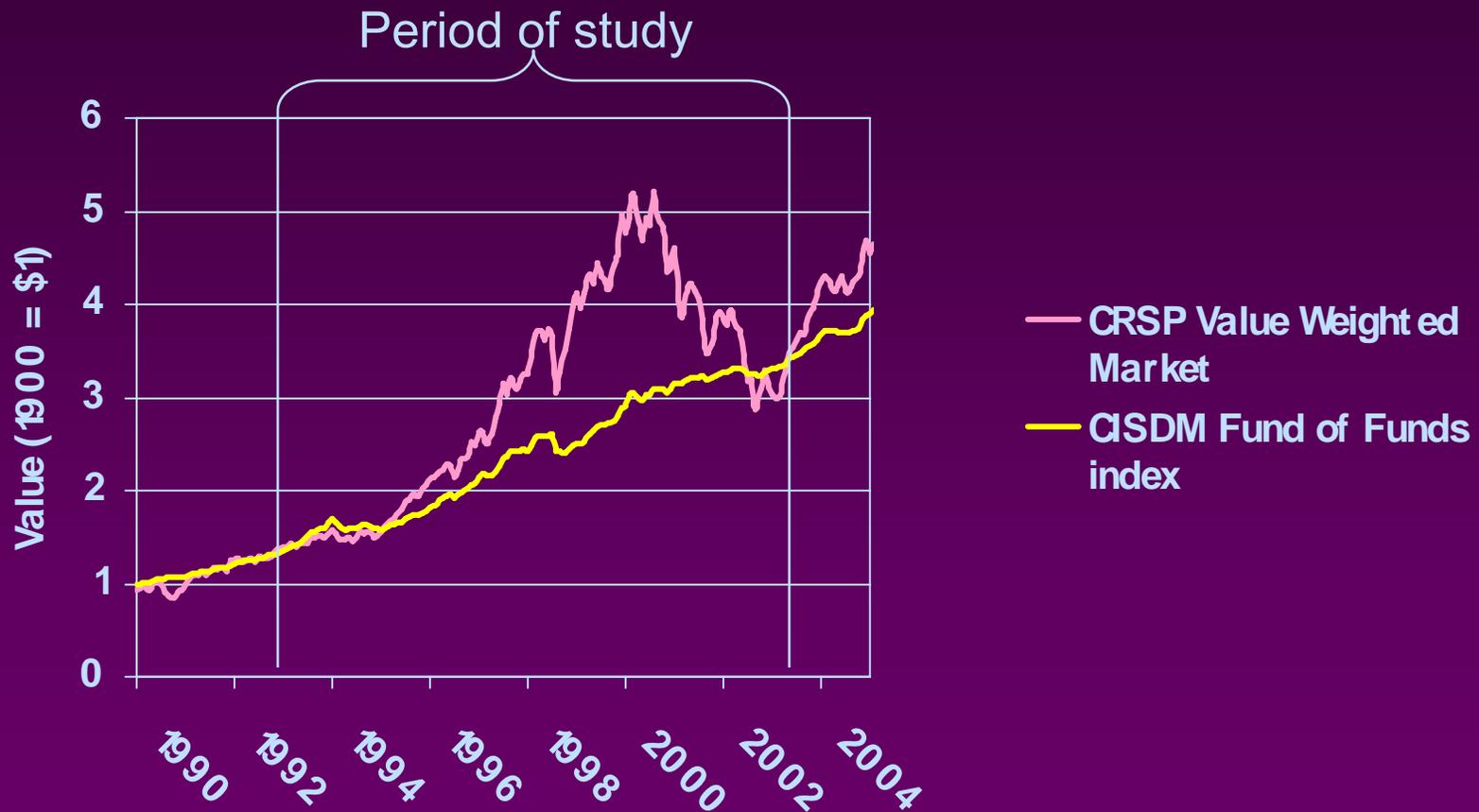
- ✳ New Yorkers wait half an hour to cross the Brooklyn Bridge to avoid a \$4.50 toll
- ✳ We infer that New Yorkers value time at less than \$9.00 an hour

Funds of Funds and the Market



Source: CRSP and CISDM

FoFs dominate the market in period of study



Source: CRSP and CISDM

Median Monthly Returns by Year

	Funds of Funds	Excluding Funds of Funds	All Hedge Funds
2000	0.20%	0.27%	0.40%
2001	0.16%	0.31%	0.25%
2002	0.04%	0.29%	0.09%
2003	0.72%	1.15%	0.88%
2004	0.39%	0.12%	0.45%
2005	0.28%	0.28%	0.34%

Source: TASS Tremont

Median Sharpe Ratios by Year

	Funds of Funds	Excluding Funds of Funds	All Hedge Funds
2000	0.114	0.076	0.132
2001	0.139	0.162	0.116
2002	0.042	0.099	0.071
2003	0.862	0.413	0.611
2004	0.397	0.055	0.317
2005	0.223	0.110	0.213

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Median Sharpe Ratios by Scale

All Funds of Funds in TASS universe

	Smallest	Q2	Q3	Q4	Largest	All Funds
2000	0.043	0.133	0.106	0.097	0.171	0.114
2001	0.083	0.081	0.156	0.236	0.201	0.139
2002	-0.001	0.096	0.027	0.030	0.055	0.042
2003	0.819	0.823	0.931	0.877	0.831	0.862
2004	0.348	0.342	0.401	0.403	0.412	0.397
2005	0.237	0.234	0.221	0.213	0.215	0.223

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Median Sharpe Ratio by Style

	1992-2005	1992-2005 (excluding 2003)
Convertible Arbitrage	0.254	0.197
Dedicated Short Bias	-0.018	0.022
Emerging Markets	0.168	0.120
Equity Market Neutral	0.174	0.185
Event Driven	0.349	0.278
Fixed Income Arbitrage	0.307	0.265
Global Macro	0.109	0.068
Long/Short Equity Hedge	0.210	0.156
Managed Futures	0.070	0.055
Multi-Strategy	0.338	0.286
Fund of Funds	0.259	0.133
Total	0.207	0.147

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- * Who is the median fund?
- * Tell me, so I can invest in it!