



GLOBAL STRATEGY & INVESTMENT CONSULTING

FUND OF FUNDS

A BRIEF OVERVIEW

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PREPARED BY : ASHWANI BATRA





FUND OF FUNDS / MULTI – MANAGER FUNDS / PACKAGED FUNDS

Fund of Funds, sometimes referred to as Multi-manager funds, is a fund that invests predominately in a number of underlying funds rather than directly in stocks & shares, as traditional funds would do. The fund mainly invests in unit trusts, open ended investment companies (OEICs), and exchange traded funds (ETFs) and other collective investment schemes. The concept of FoFs believes in handing over the matters of selection of funds over to an expert rather than making the choice of a fund or selection of funds yourself.

Fund of funds like fund of mutual funds, fund of hedge funds, fund of private equity funds, investment trusts in real estate dominate the market.

The main characteristics and benefits of fund of funds are as follows:

Asset Allocation -- Asset association is the method to choose different types of assets to be used i.e. equities, fixed interest and/or property. It also involves deciding on the geographical spread within the fund as from year to year there is a large gap between the world's best and worst performing markets. This is done on the basis of a clients risk expectations and risk appetite.

Fund Manager Selection – Manager selection is a key attribute in an investment class like FoFs which draws on a wide variety of research in order to first select the best fund managers available within each sector and then to monitor the managers on an ongoing basis to ensure that the fund contains the optimum mix of assets, geographical split and underlying fund managers.

Diversification – This is the most common technique to reduce risk because due to the range of fund managers and asset/geographical sectors within the resulting portfolio we have, a fund of funds will provide investors with increased diversification and therefore generally reduce a portfolio's risk and exposure to any one single fund manager.

Reduced Paperwork – As the fund manger takes complete responsibility, all investors receive only one set of documentation related to the one fund Although investors in a fund of funds have exposure to a number of managers in a portfolio, who are monitored and actively managed, this is effectively only treated as a single fund holding. A directly managed portfolio of individual funds can, on the other hand, rapidly generate large volumes of paper.

However, one disadvantage this investment class faces is the double fees that the fund manager charges due to the two sets of management fees associated with them as compared to the directly managed portfolios. But this double charge is compensated by large discounts that the fund manager is able to negotiate because of the large fund size which reduces the overall cost. Also if you were to manage your own portfolio, without the same tools and research available, initial charges would be incurred when funds are switched by individuals. These can be reduced or even eliminated using the discounts available to the fund managers, further reducing the cost of this type of actively managed fund. Invariably, charges would be higher as it is difficult to reduce the effect of two levels of management fees but these potentially high costs have to be offset against the advantages to individual investors.



Different structures of funds of funds

There are two main structures for funds of funds.

Pooled Fund of Funds - This is a structure which is specialized for investment in private equity funds. It typically consists of a standard limited partnership in which investors pool their capital. All investors in this limited partnership structure invest in the same set of GP interests from this pool of capital, in proportion to their commitments.

Advantages:

- A broad selection of funds of funds are available for investors to choose from at any one time which includes funds of funds that provide broad exposure across private equity, and specialized sector, style, stage, or geographically focused funds.
- An investor can get exposure to private equity with a very small commitment to start with.

Disadvantages:

- The strategy is inflexible with respect to the adverse changes in the investment environment. Usually the strategy is based upon some objective on which the fund of funds managers convinces investors to commit capital.
- Once the choice to invest in a specific fund of funds has been made, all investors in that structure invest in the same assets, and small to mid-sized investors have limited influence over how the fund of funds directs its investment strategy.
- The fund of funds deploys the collected capital too quickly due to which investors are overexposed to a specific vintage year and returns of private equity, hedge fund may vary significantly by vintage year.

Proprietary Fund of Funds / Segregated Account - This is a structure established jointly by the fund of funds manager and the investor and the purpose is to meet the latter's legal, tax, strategic and other needs.

Advantages:

- The investor can have significant influence over the amount of control of the investment strategy and execution that it wishes to have.
- The strategy can be adjusted during the investment period. Such adjustments may be needed in response to changes in the investment environment, such as macroeconomic shocks or increasing competition in the original areas of focus. In addition, adjustments may be useful to address changing investors' needs
- Depending on the investor's needs and interests, the communication can involve a deep transfer of knowledge on private equity investing to the investor.

Disadvantages:

- It requires some additional effort on the part of the investor to identify the fund of funds manager to work with and to determine the optimal investment structure.
- The investor needs to make a minimum commitment so that establishing and managing a customized offering is worthwhile both for the investor and for the fund of funds manager.

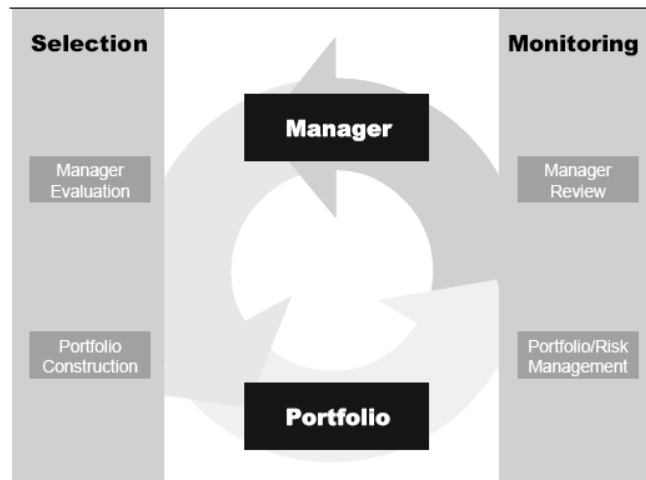
Investment Process

There are three key attributes required to manage a successful fund of funds.

- 1) Manager Selection
- 2) Portfolio Construction
- 3) Portfolio/Risk management techniques

All of these activities have clearly defined objectives and a series of well-defined processes. Essential to the success of each activity is a team of directly qualified professionals with extensive experience in trading and managing risk.

Exhibit-1



Source: UBS Warburg

“Steinhardt says the distinguishing characteristics were the manager investing his assets solely in his own fund, having a long track record, and being successful in a variety of economic climates. The manager was intense, intellectually superior, and motivated by performance – not growth of assets under management.”



Manager Selection is the key

Identification of the right personnel

The first step in the process of manager selection is the search for talent or skilled personnel which is the single most important investment process. In such a process, the help of an existing fund of funds manager who has superior information on key staff in the main investment centers will give a competitive advantage. This is because one aspect of manager selection is reputation which is probably the closest thing to brand recognition. An existing fund of funds manager from the organization will be inside the 'information loop' of high-caliber investment management personnel of the investment business. This will enable him to spot talent early in the evaluation process.

Due Diligence

Due diligence is the most important aspect of the investment process for an investor investing in a fund directly or a fund of funds which includes quantitative as well as qualitative judgment. Due diligence includes a thorough analysis of the fund as a business, validation of manager information and it covers operational infrastructure, financial and legal documentation, affiliates, investment terms, investor base, reference checks.

Track Record

The due diligence done by the fund of funds manager shows the capabilities and experience and his value proposition. As most of the equity fund managers talk about their superior stock picking skill, most fund of funds managers claim to have superior fund picking capabilities. In fact, an investor assesses the due diligence capabilities of the fund of funds manager in advance by assessing the level of experience of the fund of funds managers in the field of absolute return strategies. That is why most fund of funds managers will list the fund managers' number of years in the industry in the marketing prospectus.

Manager Evaluation

Manager evaluation is not only the most important step but also the most cumbersome one. This is because investment is essentially a people and relationship business. By allocating funds to a manager or a group of managers, the investor expects to earn better returns with the help of the skills of the manager or managers and not necessarily in a particular investment strategy.

There is no definitive guide to manager evaluation. Below are few of the factors:

- Intangibles: integrity, lifestyle and attitude
- Strategy: identifiable opportunity sets, embedded market risks, definition of investment process market knowledge in defined strategy
- Experience: portfolio management ability, risk assessment and management ability, strategy implementation, experience of different market conditions, understanding of the impact of market flows, overall trading savvy
- Assets: size (critical mass versus manageable amount), ability to manage growth, quality of investors
- Operation: back office infrastructure and reliability; fee structure; decision and execution process; quality, stability, compensation and turnover of staff.

Manager evaluation is important because the difficulty and effort of collecting information creates significant barriers to enter the fund of funds business. So fund of funds managers with an operating history of a couple of years might have a competitive advantage over those who recently enter the industry.



Manager selection

While selecting a fund of funds manager, an organization would test manager's capabilities on many different fronts like:

- **Differentiated Strategies:** Managers with capabilities of developing differentiated strategies that can deliver long-run out performance with comparatively less risk. Examples of these strategies include activism, micro-cap/nano-cap strategies, litigation/patent exploitation, global macro strategies and off-index emerging market strategies. The organization will also look out for managers whose background/team provides them a unique competitive advantage within their strategy.
- **Concentrated Portfolios:** Managers should be able to construct relatively concentrated portfolios. Their stock selection method should not be such that we end up getting a portfolio which is almost a replica of the index. Managers with superior long-term returns are essential. Risk can be reduced through manager diversification and through the inclusion of different styles/strategies and geographies that are not closely correlated.
- **Varied Business Structures:** However, decisions to include managers should be based upon the uniqueness of the strategy and the investment acumen of the manager, rather than business structuring decisions.
- **Research Intensive Approach:** The overall approach of each and every manager's activity should be research based. The manager should understand the objective of the fund and his every action should be in sync with that objective and fully supported by comprehensive research.

Manager Review

Manager review is the final step of the whole manager selection process. This is quite a dynamic and iterative process where the consensus views among investors and fund professionals are taken. As mentioned earlier, the investment business depends upon relationship between the investor and the fund managers where the investors try to participate in the skills of the fund manager with the aim of maximizing their profits. So this part of the whole process is vital for the fund committee where the investors give their opinion about the fund managers they are looking to manage their money.

Portfolio Construction

Establishing Portfolio Objectives

Before recommending or constructing any specific portfolio, one should thoroughly discuss with the clients their investment objectives and constraints.

Before investment, one should identify:

- Return objectives
- Volatility objectives, in terms of standard deviation & maximum draw downs
- Downside risk tolerances & minimum expected annual rate of return
- Correlation objectives (positive, negative or neutral to specific indices)
- Time frame for the measurement of these factors
- Liquidity requirements
- Any constraints with regard to asset classes or specific strategies

Once these parameters have been established, the next step is to set target sector and strategy allocations – a top-down approach which aims to maximize the probability that the client's objectives are achieved.



Setting Target Sector and Strategy Allocations

The next step includes extensive statistical analysis to identify which underlying market events can affect the returns of a fund portfolio. The fund develops conceptual frameworks for each style that enable them to become proactive and react in different market events. By using a portfolio framework built around forward-looking scenarios and allocating across a broad range of alternatives, the fund manager successfully constructs portfolios following the fund objective. This also provides thorough understanding of a very broad range of factors that affect the fund returns.

Categories of Fund Styles

This section gives a brief about the different styles of funds available to choose from for the investment.

Structural Alpha – In this style, the fund manager looks for cheap and expensive securities within an asset class and constructs long and short portfolios. In each, they are taking advantage of not just a momentary mispricing but rather a structural inefficiency in the market. For example, bonds are issued cheaply by companies because they have significant tax and accounting benefits for the issuer but little appeal to any investor. The fund manager capitalizes on such situation and based on extensive research takes positions. Because of the efficiency, these managers are correct most of the time and therefore make modest gains on each transaction, sometimes using substantial leverage to magnify these returns.

This style works very efficiently when the markets are smooth and the volatility is comparatively low but in times of market crises like high volatility, liquidity crunch and widening credit spreads, structural alpha managers can often make losses and correlations between managers can suddenly increase.

Manufactured Alpha – In this style of fund, the managers use their ability to judge the direction of the markets to make money. They have no structural advantage to help them but rather they have to rely on their skills to manufacture alpha. This approach depends on pure judgment which makes it either momentum driven or valuation driven. This style makes money in the volatile emotional markets where investors are panicking and the fund manager makes money from being calm and composed. Assets used in such style of investments vary considerably and managers trade highly liquid assets and change positions rapidly according to the market. Managers following this style cannot be expected to predict the next market crisis but they can be expected to react very rapidly to the crisis and to make money as events unfold.

Hedges – This style of funds focus on providing protection against the inherent risks in the structural alpha group where changing markets tend to lead to negative return distributions. These styles often provide an efficient hedge against market crises, since they are either positioned short in the equity market or long the short-term interest rate futures contracts or they adopt a trading style that inherently or explicitly buys optionally from the market.

Beta-Dominated – These strategies tend to derive much of their return potential from the market beta i.e. either from equities, emerging markets or from credit markets. The beta can be directional in long bias equity positions (where the net long exposure drives the beta) or it can be indirect (where the beta is to the liquidity flows into the region).



Building Absolute and Relative Return Portfolios

Conservative Absolute Return Portfolios (Diversified)

Objective: Seek to generate returns of Libor + 6-8% per annum, measured over 2 to 3 years, with a standard deviation of below 8%. They are designed in such a way that they have no correlation or beta with either fixed income or equity markets and these portfolios are built to maximize the Sharpe Ratio.

This can be achieved in the following ways:

- a. Focusing on structural alpha managers as these styles have the highest expected Sharpe ratio
- b. Minimizing tail risk, by using hedges.
- c. By manufactured Alpha when markets are not behaving efficiently.

Aggressive Absolute Return Portfolios (Opportunistic)

Objective: Seek to generate returns of Libor +8-12% per annum, measured over 3- 5 years, with a standard deviation of below 15%. The portfolios are designed with a purpose to build zero betas but risk can become more concentrated at times and so the portfolio can have losses. Returns are generally evaluated over a long holding period owing to the higher potential volatility.

This can be achieved in the following ways:

- a. Focusing on manufactured Alpha.
- b. Adding exposure to static return generating strategies

Equity sector Relative Return Portfolios

Objective: The aim of this kind of a portfolio is to match or outperform traditional equity markets when they are rallying, and to control downside risks in negative periods for the market. These funds are designed in a way that they tend to show some kind of a directional relationship to the equity markets. Managers who employ long/short equity strategies along with long term investments construct such kind of portfolios.

Risk Management

Risk management is a benefit which is offered by fund of funds to its investors with the purpose to identify risk issues and take necessary actions to minimize their adverse impacts.

The first step in the process of risk management is risk/investment monitoring which includes activities to make one aware of the risk environment and then risk management which includes actions taken to reduce or eliminate a risk once it is identified.

Fund of funds risk management can be broadly separated into two areas:

Investment risk

The investment risk management can be further divided between portfolio level and fund/manager level.

Business risk

The business risks concerns the non investment risks of the fund of funds which includes operations, legal issues, and compliance matters.

In order to make investment monitoring and risk management successful, insightful knowledge of the individual strategies is required prior to an investment. This includes evaluating a lot of possibilities of current and future risks, analysis of past data and finally manager's experience.

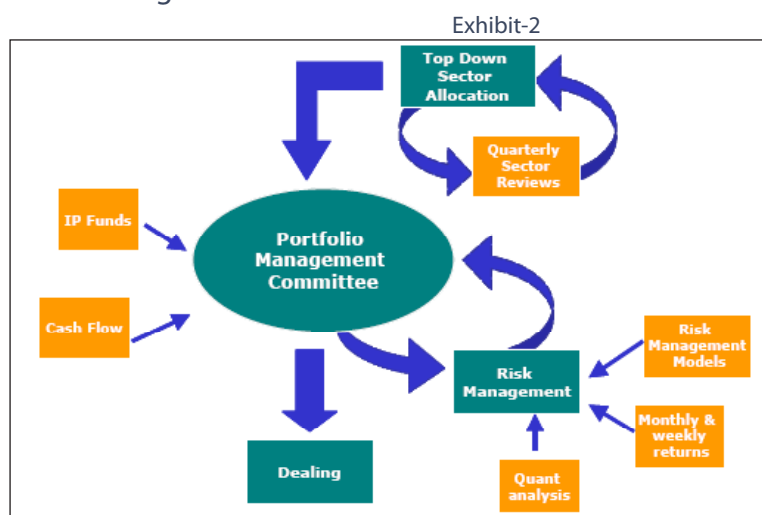
Continuous monitoring of positions, P&L, and risk leads to:

- Dynamic understanding of the strategy and the manager's behavior in various market circumstances.
- The application of the strategy to be followed and continuously evaluated in real time in different market environments.
- Detection of previously unrecognized risks in the investment strategy.
- Quick recognition of style changes, undesired bets, and increase of leverage employed by the manager.
- A decrease in probability of fraud risks.
- The possibility of trading manager control, risk management and risk adjusted allocation within the portfolio.

In fund of funds, risk management focuses on two questions:

- (1) Is the individual fund manager maintaining an investment discipline consistent with what was represented to that fund of funds manager?
- (2) Are the risks and exposures carried by the fund manager still in line with the risk range at the time of allocation, or has the environment shifted so that they now represent a change in the risk-reward characteristics of the strategy?

Here is the Portfolio Management Process



Source: FRM



Future Outlook

A report on investments in all the investment classes states that the future of investing will be different and more efficient and the amount of capital inflow will be huge.

The Brave New World: Winning Product Strategies for a Changing Global Market, report says that active alternative investments, including hedge funds, will more than double to around \$11 trillion by 2011 and less liquid assets, such as private equity and real estate, and new asset classes, such as infrastructure, are among those that will see overall assets under management soar 150% over the next five years. Specifically, alternative investments will see \$2.5 trillion in new flows globally and across all segments over the same period.

Some recent trends in the investment industry

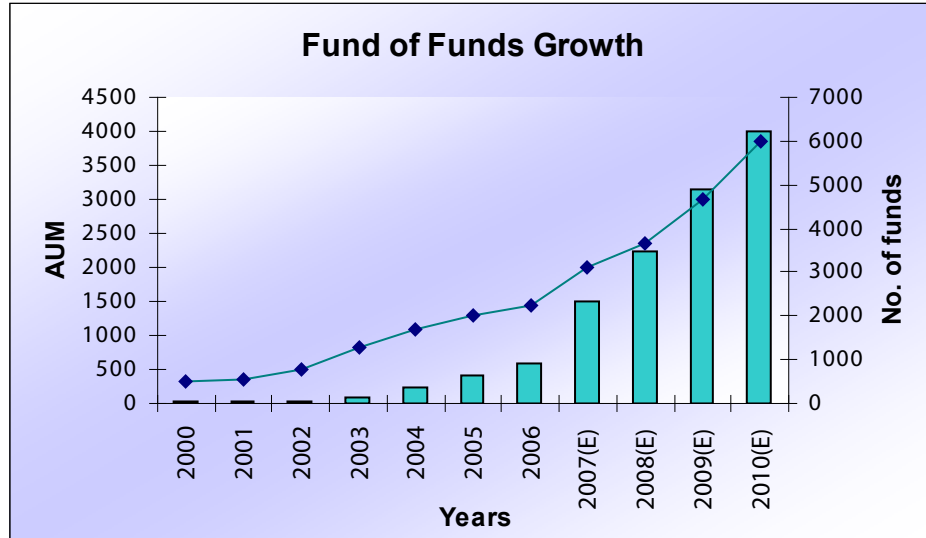
- Total hedge fund asset levels increased by 8% to \$2.593 trillion from \$2.401 trillion in the first quarter of 2007.
- Long/Short Equity assets increased 7.7% to an estimated \$766.5 billion and in the first half of 2007 long/short equity funds attracted \$48 billion in new allocations.
- Fixed Income focused fund assets reached an estimated \$468.5 billion and fixed income funds experienced near record liquidations of \$3.9 billion.
- Emerging market funds increased 14.2% to \$279.3 billion, emerging market equities with \$5.4 billion in new allocations and total assets in emerging market debt focused funds rose \$75.7 billion.
- Distressed fund total assets rose to \$191.7 billion, an increase of 10.8% over Q1 2007 with \$34.2 billion in new assets.
- Total assets in funds with a global investment focus increased 8.92% in Q2 2007 to \$1.276 trillion, which includes \$57.5 billion in new assets.
- Total assets in funds investing in European markets increased 7.6% to \$403.2 billion which includes \$14.6 billion in new assets
- Total assets in funds investing in US markets increased 7.6% to \$699.4 billion which includes \$40 billion in new assets.
- Assets in funds investing primarily in Latin America increased by 17.4% to \$11.8 billion. Assets in Latin America focused funds have risen an estimated 73.2%.
- Total fund of fund assets increased 9.4% to an estimated figure of \$1.250 trillion which includes \$74.5 billion in new assets.

Looking at the major trends in recent times, all investment classes will be flooded with billion of dollars and more investment opportunities coming into the market in terms of differentiated products will push the pace of growth of all the financial markets. As more and more people will get into the market, the liquidity will increase which will excite a lot of people (supported by good returns) but at the same time, volatility will be a worry. Consequently, products like Fund of Funds (FoFs) with benefits like reasonable returns with less risk will be preferred.

Fund of Funds has already shown an upward trajectory since its introduction but in times to come more and more investors will accept it because of its many benefits.

Growth Potential

Exhibit-3



Source: HFR, GSIC Research

Exhibit-4

	2000	2001	2002	2003	2004	2005	2006	2007(E)	2008(E)	2009(E)	2010(E)
Asset under management(bn)	20	25	35	85	240	400	600	1500	1500	1500	4000
No. of Fund of Funds	525	550	800	1300	1700	2000	2225	3115	3650	4675	5990

Source: HFR, GSIC Research

Industry is witnessing a recent trend in the growth of fund of funds (FOF) which serve many purposes for the investors like undertaking due diligence, scrutinizing funds for investment styles and risk management by diversification. Also, they facilitate the offering of hedge fund exposure to investors who may not be able to satisfy the high financial requirements of investing directly in hedge funds. By now some 35% of investments in the hedge fund sector are through FoFs.

This class of investment has seen a robust growth of about 42% (CAGR) in assets under management in the last fifteen years and about 37% (CAGR) in the last six years. Looking at this trend, it seems that this class of investment is setting up for a big rally. Also, the growth is seen in the number of funds (FoFs) operating in the market along with asset under management which shows that many managers as well as investors are accepting this investment class very quickly. The growth in the number of funds has been about 23% (CAGR) in the last fifteen year with 27% (CAGR) in the last six years.

In future, the expected growth in both, asset under management and the number of funds (FoFs) in the market, does not seem to hold back. Infact it looks as many risk averse investors will opt for this investment class over directly investing into hedge funds, private equity funds or real estate fund. The only hindrance this investment class is facing is the cost of investment. As the FoFs charge double fees as compared to many funds operating in the market, many investors ignore this investment class.



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