PERFORMANCE DRAG OF ALTERNATIVE MULTI-MANAGER MUTUAL FUNDS

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Well-documented advantages of alternative mutual funds include daily liquidity, lower all-in fees, greater regulatory oversight, lower minimum investment requirements and the absence of partnership K1s. These features make alternative mutual funds a viable investment for defined contribution plans and retail investors, an untapped multi-trillion dollar market for hedge fund managers.

The opportunity for fund of funds managers is clear. Post-crisis, funds of hedge funds faced a sharp decline in profitability due to a combination of disintermediation, declining fees and rising costs (e.g. customization). Gone are the days of managing a highly profitable co-mingled fund of hedge funds where each incremental dollar of revenue drops to the bottom line. Defined benefit pension plans – long-time investors in funds of funds – are in steady decline; by contrast, defined contribution plans are growing rapidly and current exposure to alternatives is *de minimus*. Alternative multi-manager mutual funds (AMMFs) could represent a new dawn for funds of funds: co-mingled, highly scalable vehicles with strong potential investor demand.

However, mutual funds are far less flexible than hedge funds: all registered funds have structural limitations on leverage, shorting, illiquid assets, concentration and other criteria. This contradicts a core tenet of the hedge fund industry: that talented managers perform better with fewer constraints. In fact, many early hedge fund managers were former mutual fund managers in search of a less constrained investment vehicle. By definition, structural constraints almost certainly will result in a performance differential over time: the question is, by how much? This paper looks at the evidence to date, some of the underlying causes, and raises some pertinent due diligence questions for potential investors.

1. PERFORMANCE DRAG: EVIDENCE TO DATE

There is a limited amount of live data on AMMF performance. Of the thirteen funds that we currently track, only three have track records that extend back more than a year or two. Only five of thirteen have full year track records for 2012, while eight have full year track records for 2013. Any conclusions below should be taken in this context.

With that caveat, the chart below shows the full year performance of those five and eight funds, respectively. The magnitude of the performance drag is noteworthy: the average AMMF underperformed the HFRI Fund of Hedge Funds index by 311 bps in 2012 and 420 bps in 2013, net of fees (the return figures are for institutional share classes only). The average AMMF also underperformed an index of liquid hedge funds (HFRX Global Investable Index) by approximately 200 bps in each year.

AMMF	Inception Date	2012 Performance	2013 Performance
Absolute Opportunities Fund	Oct-08	-1.04%	-2.36%
Absolute Strategies Fund	Jul-05	0.27%	-0.99%
Arden Alternative Strategies Fund	Nov-12	-	6.59%
Hatteras Alpha Hedged Strategies Fund	Sep-02	2.00%	10.22%
Neuberger Berman Multi-Manager Fund	May-12	-	9.85%
Palmer Square Absolute Return Fund	May-11	1.19%	6.08%
Principal Global Multi-Strategy Fund	Oct-11	5.96%	5.46%
Russell Multi-Strategy Alternative Fund	Aug-12	-	3.17%
	Average:	**1.68%**	**4.75%**
	HFRIFOF:	**4.79%**	**8.95%**
	Performance Drag:	**-3.11%**	**-4.20%**

Full Year Performance Comparison 2012-13

This is particularly surprising given that all-in fees in AMMFs are 150-250 bps lower than those in fund of fund funds; all things being equal, this should lead to higher performance. While the average AMMF charges slightly more than 200 bps per annum with no incentive fee,[1] the typical fund of hedge funds has all-in fees of 3.5% to 4.5% (75-150 bps per annum on top of underlying hedge fees of 1.6% and 20%, on average). On a fee equivalent basis, the performance differential rises to 448 bps in 2012 and 681 bps in 2013.

	2012	2013
Average AMMF Return	1.68%	4.75%
Estimated All-In Fees	2.13%	2.13%
Estimated Pre-Fee Returns for Subadvisors	**3.81%**	**6.88%**
HFRI Fund of Funds Index Return	4.79%	8.95%
Estimated All-In Fees	3.70%	4.74%
Estimated Pre-Fee Returns for Hedge Funds	**8.49%**	**13.69%**
Fee Equivalent Performance Drag	**-4.68%**	**-6.81%**

Estimated Fee Equivalent Performance Drag 2012-13

2. WHAT EXPLAINS THE PERFORMANCE DRAG?

When the HFRX Global Investable Index was launched over a decade ago, performance drag initially was over 400 bps per annum, primarily due to adverse selection bias. That differential has come down over time, but still is persistently 100-200 bps per annum. Other liquid hedge fund strategies – investable hedge fund indices, managed account platforms, 130/30 funds, and UCITS products – have each underperformed hedge fund counterparts by around 200 bps per annum. This supports the general rule that liquid alternative strategies have a persistent long term performance drag relative to actual hedge funds. (See The Performance Drag of Liquid Hedge Fund Strategies at www.beachheadcapital.com).

1 Most funds currently include fee waivers and/or rebates to bring down all-in fees. The average rebate among 13 funds included in the study currently is 48 bps per annum. Note that fee rebates generally have a finite life, so a relevant due diligence question is the extent to which fee rebates will continue going forward.

In the AMMF space, performance drag is likely to arise in two forms. First, following the HFRX example, hedge fund managers most eager to manage sub-accounts at reduced fees may be of a lesser quality. This may explain in part why the Hatteras Alpha Hedged Strategies Fund, the only fund with a ten year track record, underperformed the HFRIFOF since inception by 134 bps on an annualized basis since inception (including negative alpha of 1.8% given somewhat higher beta) and suffered much more pronounced drawdowns during the crisis (down 31.6% in 2008).[2] On the surface, the current pool of subadvisors appears to be much more credible than the early participants in the investable hedge fund indices.

A more serious issue, then, is that high quality managers simply may not be able to deliver comparable returns within the constraints of the '40 Act structure.[3] While it is impossible to make an apples-to-apples comparison,[4] one indirect method is to compare the performance of AMMFs to a portfolio of hedge funds managed by the same subadvisors. Here we find that AMMFs have on average underperformed an equally weighted basket of the "flagship" hedge funds of the subadvisors by over 200 basis points.[5] On a pre-fee basis, the differential rises to over 500 basis points.[6]

Why is this? In addition to investment constraints, hedge fund managers have a strong incentive to avoid cannibalizing their core businesses; therefore, given the general absence of incentive fees, the most attractive or capacity constrained trades are likely to wind up in higher fee vehicles.[7] Irrespective, given the importance of the hedge fund managers' reputations in marketing AMMFs, it is reasonable for investors to require AMMF managers to break down performance by subaccount relative to the most comparable hedge fund managed by the same subadvisors.

A final and important distinction is that AMMF managers directly pay the subadvisors: unlike in a fund of hedge funds, each dollar of subadvisory fees comes directly out of the pocket of the AMMF manager. AMMF managers therefore have a strong incentive to select subadvisors who will work for 1% or less. A fair question for any AMMF sponsor is how many subadvisors/strategies were rejected due to high fee expectations, and why this does not lead to adverse selection.

CONCLUSION

In conclusion, while it's still very early in the game, our analysis indicates that AMMFs are likely to be subject to a persistent performance drag over time. Based on the more robust data pool from other liquid alternatives, our expectation is that the performance drag should be around 200 bps per annum, net of fees. Fortunately, since return

[2] The institutional share class of the Hatteras fund was not introduced until late 2011, whereas the retail share class was introduced in 2002. The retail share class is referenced here.

[3] This is the principal reason the SEC does not permit prospectuses to show the hedge fund track records of the subadvisors. In fact, only one of the AMMFs (Balter) requires the subadvisors to run portfolios substantially identical to their hedge funds and therefore is permitted to disclose the track records of the subadvisors' hedge funds in the offering documents.

[4] Due to a lack of transparency of manager weights in AMMFs and strategy overlap between AMMF sub-advised accounts and predecessor hedge funds, among other issues.

[5] More precisely, of the eight funds with full year performance for 2013, we have return data for the flagship hedge funds on at least 70% of the managers of four of them. Those AMMFs underperformed an equally weighted portfolio of the available hedge funds by an average of 314 bps, net of fees. Assuming that the AMMF managers are paid 100 bps of the management fee, the fee equivalent differential is 214 bps on average.

[6] At a conference in 2013, one prominent multi-strategy hedge fund firm analyzed the expected performance differential in their flagship fund and canceled plans to create a '40 Act fund after determining that they would suffer an 800 bps drag.

[7] Note that one possible window into this may be which managers advise assets of wholly-owned offshore subsidiaries. In general, offshore subsidiaries can pay management and even incentive fees to managers without disclosure at the fund level. This is a relevant due diligence question for any funds with offshore subsidiaries.

information is readily available on ’40 Act funds, it will be much easier to make ongoing comparisons, and we look forward to updating this analysis in the coming year or two.

This does not mean that AMMFs are necessarily inferior to hedge funds of funds. The structural advantages are very real, and will be worth more than 200 bps per annum for many investors. Further, investors who previously have been precluded from investing in hedge funds may find AMMFs to be a valuable diversifier.

As of early 2014, the evidence suggests that the performance drag will be higher than many investors realize and that the (real) advantages of greater liquidity, lower minimums and reporting simplicity are likely to come at the cost of diminished returns.