Steben & COMPANY

November 2015

The Importance of Manager Selection within the Alternative Investments World

John Dolfin, CFA Chief Investment Officer | Steben & Company, Inc.

Christopher Maxey, CAIA® Senior Portfolio Manager | Steben & Company, Inc.

Given the increasingly complex world of alternative investment products (alts), we will discuss in this white paper the importance of manager research and due diligence.

Investors of all stripes recognize that choosing the right fund managers may matter a great deal more going forward than in the past, when passively owning a diverse array of assets generally achieved longer-term objectives.

Traditional alts such as hedge funds have evolved from a modestly-sized investment niche in the 1990's to a more fully embraced "asset class" sought after by institutional investors, especially after many hedge funds delivered positive performance during the equity bear market of 2000–2002. More recently, with the introduction of '40 Act "Liquid Alternatives" that are convenient and accessible to non-accredited investors, interest and demand for these products continues to grow. This growth is understandable. In a post-quantitative easing environment of frothy equity valuations and ultra-low fixed income yields, investors are challenged to make returns within a traditional portfolio context.

Framing The Alts Analysis Dilemma

Previously, in the long-only mutual fund and ETF world, an investor would try to choose the right style of manager to fit a given environment. Think of a Morningstar style box where a given equity manager resides somewhere within the spectrum of specializing in small-cap versus large-cap; growth versus value; and international versus domestic. Once an investor placed an allocation, that investor would have a well-defined ability to benchmark each manager against an appropriate style index. Diversify across asset classes, styles, sectors and geographies and a well-balanced portfolio could generally be produced.

However, trying to place an alternative fund into a simple categorization can lead to a messy outcome due to funds having a multitude of distinguishing characteristics. These include single-manager versus multi-manager choices, mixed equity beta profiles, and different strategy intentions. Alternative investment managers are much less constrained than traditional asset managers, and therefore tend to deliver more dispersion in their return profiles.

So how should one compare and benchmark alternative funds? Is examining a Morningstar or other database tear sheet really enough? And while there certainly may be more product choices in the alts space today, might investors ultimately emerge less satisfied from their alternative investment choices?

The Goal & Purpose of a Fund of Funds Manager

The answers to these questions can be found in the following assertion: a quantitative comparison of alternative managers must be supplemented with solid qualitative due diligence and a diversified set of managers. Historically, fund of funds (FoF) firms filled this role, and regardless of whether the FoF's ultimate product is delivered to investors in a Limited Partnership, a Closed-End Fund, or a Mutual Fund vehicle, the definitive goal is to offer both manager selection expertise and access to a diversified blend of quality managers that an investor otherwise might not be able to find and/or could not access due to large minimum investment requirements.

Expressed another way, the purpose of a FoF is to improve the chances of picking managers that perform better than average on a risk-adjusted basis over the long run. The fees of a FoF vehicle may certainly be worthwhile to investors if it helps them avoid "bad apple" hedge funds that take unacceptable risks or are outright frauds.

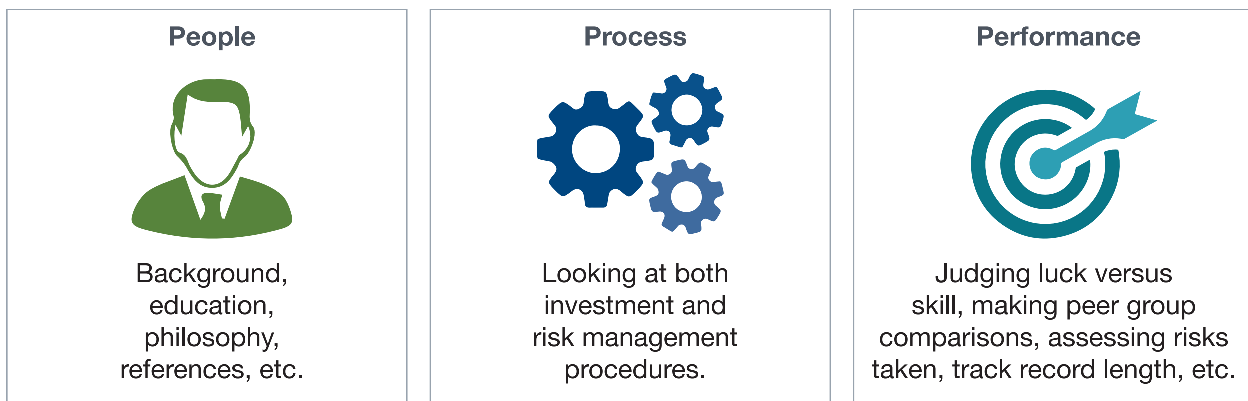
The FoF vehicle becomes even more valuable if, via appropriate manager diversification, it can deliver a resilient return stream across a variety of different market environments.

Such a result generally requires a repeatable investment process and a practiced balance of manager selection and portfolio construction. And not every FoF firm does both well. The remainder of this paper will address requirements for those that can adequately marry both disciplines.

Proper Due Diligence & Diversification is Paramount

Proper Due Diligence of Alternative Managers Goes Far Beyond
"Checking The Box" of Desired Manager Attributes

Solid Investment Due Diligence Starts with an Analysis of the "Three Ps"



Moving from database screening, to extensive in-person interviews, followed by a variety of other follow-up analysis, the basic goal is to answer four overriding questions of any given manager:

- Can a manager be trusted?
- What sets this manager apart from others, and what risks are inherent to the approach?
- Is a manager skillful enough to deliver actual alpha?
- Does the manager offer a natural fit within the overall portfolio?

Can a manager be trusted?

The first of these questions obviously involves a heavy modicum of qualitative judgment, but the key is to maintain objectivity and avoid chasing managers based solely on past performance. The tenure of a given manager, the overall organization of a firm, the position-level transparency offered, and thorough reference checking can help supplement the subjective impression that a given manager exudes. Can a manager articulate a clear philosophy and investment methodology that makes sense and credibly fits a fund's past track record? If a manager is difficult in the interview process, the manager seldom becomes easier to deal with later on. And with so many different funds to select from, a good rule is to "Avoid hubris, ego, and lack of transparency." This toxic trio of factors tends to end badly and it is often prudent to just say: "Next."

What sets this manager apart from others, and what risks are taken with that approach?

The second question delves deeply into the nature of the investment strategy, and focuses on issues of risk unique to that strategy. These include concentration risk, directionality risk, complexity risk, illiquidity risk, and leverage risk. It is important for a manager to avoid being overly restrictive in managing the portfolio, thereby hampering their ability to deliver attractive returns. However, a manager should also not act recklessly or take unreasonably large risks. Either path could lead to fatal mistakes. Ideally, there should be a reasonable balance of risks taken to generate returns in a sustainable fashion over time. The purpose of risk management is to help a manager become rigorous, repeatable, and consistent.

Is a manager skillful enough to deliver actual alpha?

An assessment of a manager's skill is important because skill is more likely to lead to sustained long-term outperformance, while luck generally runs out in due time. Strong past performance is not always an indicator of skill. It is important not to confuse a benign environment for true skill. As a simple example, compare a long-biased equity long/short hedge fund with a low net-exposure equity long/ short fund. In an equity bull market, the long-biased fund may well be the outperformer of the two. But this is not necessarily due to greater stock selection skill. The long-biased fund had the wind at its back during a rising market. In a flat stock market, the long bias is of no advantage, and in a falling market, it is a headwind. In the long run, over a full market cycle, a more skilled low-net exposure manager may well perform better than a long-biased manager.

Skill also involves the ability to adapt to evolving market regimes, although we would caution that too much style drift leaves the investor uncertain of the manager's expected return profile over time.

Does the manager offer a natural fit within one's overall portfolio?

The fourth question is specific to a desired return profile and investment goals of the particular portfolio. If a FoF is designed to be a diversifier to a traditional long equity and long bond portfolio, it should include a proportionally larger allocation to managers with low betas and low correlations to equity and bond indices. Furthermore, in order to reduce the volatility and improve the Sharpe ratio of a multi-manager portfolio, it is advantageous to select managers with low correlations to each other. When considering a new manager, one should ask, what purpose does a manager potentially serve and does it duplicate exposures already in the portfolio? Is that manager a core allocation, a peripheral allocation or otherwise useful as a hedge? At this point, it is common to utilize quantitative tools that may reveal various style biases for a given manager that are not always intuitively obvious. It is also important to ensure that a given manager remains the strongest choice in a given strategy or style after making the allocation. It is crucial to build a style peer group for every given manager, and then to monitor each manager in relation to those peers.

Overall, within the qualitative due diligence process, it is important to listen well and be observant. The smallest miscues by a manager during an interview might reveal a compelling reason not to invest. Several subtle qualitative considerations follow:

- It is important to understand where a given manager is within a typical hedge fund life cycle. Is the manager substantively invested on a personal basis? Is the manager still hungry and motivated with a strong sense of fiduciary duty to the firm's clients? Or have assets under management grown so large that the manager is more motivated to view a fund's management fee as a cash cow?
- Understanding a manager's outside interests and lifestyle may reveal an indirect fact that will ultimately become important to a potential or existing investment. For example, it may not a great time to invest with a manager who is in the throes of a messy divorce. Too many distractions are never a good thing.
- Minor personnel changes within the firm can also carry potential importance. When one person walks out the door, others may follow. What was the cause?

A Second Integral Step: Operational Due Diligence

Even when investment due diligence is performed properly, the job of a FoF manager is not over. There is the important additional step of operational due diligence (ODD). A manager may be smart and well intentioned, but that manager can still suffer problematic valuation errors, regulatory penalties, or other outcomes that are distasteful to an investor due to the manager's lackluster operational practices. At this stage the important ODD questions revolve around:

- Quality of support personnel: Chief Operating Officer, Chief Financial Officer, Chief Compliance Officer, Controller, etc.
- Systems and IT infrastructure
- Firm compensation structure incentives and personnel stability
- Trading and operational processes
- Valuation and NAV accounting
- Interaction with service providers
- Legal, regulatory and compliance issues

Some might consider ODD to be straightforward in nature, but it is much more than that. As a sampling of operational questions that might result in the removal of a manager from the selection process, consider the following questions:

- ? How many trade errors has the firm historically experienced, and how has the firm handled these situations?
- ? What is a firm's policy regarding personal trading by employees?
- ? Does the strategy entail heavy use of over-the-counter derivatives, and if so, how is documentation and counterparty risk for these derivatives handled? Who has final authority on establishing mark-to-market valuations for these derivatives?
- ? Is the overall documentation around a given fund product fair to investors in terms of its fee and liquidity provisions relative to the underlying fund strategy, or are fund documents too heavily tilted in favor of the manager?
- ? Has a firm been involved in any litigation or regulatory investigations or incurred any regulatory fines? Has the firm ever suspended redemptions or imposed redemption gates?
- ? How often have service providers changed and what do both current and past service providers say about their experience working with a manager?
- ? How does the compensation structure function work at the firm? This question can be critical to a team's successful interaction. In a fund with multiple portfolio managers (PMs), it is possible that some PMs are profitable while others are not. In the calculation of incentive payouts for key personnel, do the internal managers bear this incentive compensation "netting risk" or is this netting risk borne instead by the investor? Different firms are set up differently and there are pros and cons with each firm structure.
- ? How does a manager invest its fund's unencumbered cash? Too few ask this question, but it can be very important in certain circumstances.
- ? How significant are soft dollar expenses in relation to fund assets? At many firms, soft-dollar expenses are trivial, but at others these indirectly allocated expenses may represent as much as an additional 100 basis point annual return drag to net performance.
- ? Are any assets in the portfolio so difficult to value that accrual accounting is utilized? How many Level 3 assets reside within the portfolio? What are the valuation policies in place regarding these assets? This question is particularly important given that the manager may have an incentive to overstate difficult-to-value assets in order to generate more fees.
- ? Has a manager ever had to restate monthly performance or experienced large disparities between an initial monthly performance estimate and the finalized monthly performance as calculated by an outside administrator?
- ? How late in the year do investors receive their tax forms and audited financial statements?

Not all of these granular ODD questions will reveal important considerations, but some will. And we believe you have to ask all of these questions (and more) to formulate a full picture of a firm.

Manager due diligence certainly matters, and the difference between those who do it well and those who don't will eventually show up in the numbers. The academic evidence to support this assertion can be found in part within a 2008 study by Brown, Fraser, and Liang, whereby the authors discovered that across the 1994–2008 period, the smallest fund of fund groups, which presumably lacked due diligence resources, systematically underperformed larger firms with better due diligence resources.[1]

Summary

As a final analogy, consider that some people can service their own car, and they may save a few dollars doing so; but most people require an expert to avoid leaving an inadvertent wrench in the engine. The alternative asset management industry is no different. Expert due diligence and portfolio construction both have a value just like the services offered by an expert mechanic.

This paper has touched upon the difficulty of alternative investment benchmarking, the role of fund of funds in selecting alternative investments, and the relative complexity of these solutions.

We believe that deep dive qualitative and quantitative due diligence can help minimize mistakes and disappointing outcomes in the alternatives world.

Here at Steben & Company, we stand ready to answer any further questions from you on this important topic.

1. Brown, Fraser & Liang, "Hedge Fund Due Diligence: A Source of Alpha in a Hedge Fund Portfolio Strategy," Working Paper, New York University, 2008

The views expressed in this material are those of Steben & Company ("Steben") and are subject to change at any time based on market or other conditions. These views are not intended to be a forecast of future events, or investment advice. Investors are cautioned to consider the investment objectives, risks, and charges of funds before investing. This does not constitute an offer to sell or solicitation of an offer to buy any security.

The information is provided for educational purposes only. Steben does not make any representation or warranty, express or implied, as to the information's accuracy or completeness, and accepts no liability for any inaccuracy or omission. No reliance should be placed on the information and it should not be used as the basis of any investment decision. This information may not be reproduced or distributed without the prior written consent of Steben.

RISK CONSIDERATIONS: Managed futures, hedge funds, and funds of hedge funds and other alternative investments are not suitable for all investors. Their investment programs are speculative and performance can be volatile. An investor could lose all or a substantial amount of their investment. They involve a high degree of risk and often engage in leveraging and other speculative investment practices that may increase the risk of investment loss. In addition, they can be highly illiquid; are not required to provide periodic pricing or valuation information to investors; may involve complex tax structures and delays in distributing important tax information; are not subject to the same regulatory requirements as mutual funds; and often charge high fees which may offset any trading profits. Diversification does not ensure a profit or guarantee against a loss. Alternative investment managers typically exercise broad investment discretion and may apply similar strategies across multiple investment vehicles, resulting in less diversification. Trading may occur outside the United States, which may pose greater risks than trading on US exchanges and in US markets.

Additionally, alternative investments often entail futures, forwards contracts and swaps trading, which involves substantial risk of loss and may be volatile. Other risks inherent in an investment in alternatives include short sales, options, derivatives, junk bonds, emerging markets and limited regulatory oversight.

There may not be a secondary market for an investor's interest in alternative investments, and none may develop. There may be restrictions on transferring interests in some types of alternative investments.

For more information and insight on alternative investments, please visit

www.steben.com/education-and-resources

Steben & Company, Inc.
9711 Washingtonian Blvd., Suite 400
Gaithersburg, MD 20878
www.steben.com
240.631.7600

Please contact Steben & Company if you have any questions about this Paper.