Taking the hedge fund plunge

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While fund managers increasingly show interest in launching their own hedge fund products, most super funds have, up until now, viewed hedge funds cautiously, preferring to first improve their understanding of the different investment strategies involved.

Diana Mitrache, Towers Perrin's hedge funds research manager, says interest in hedge funds has been heating up because some can offer better risk adjusted returns and because various hedge fund strategies have a relatively low correlation with traditional asset classes.

"The process we see now is a bit similar to what we saw with private equity years ago. It took a while for funds to invest in the asset class, and then they gradually notched up exposure as investors became comfortable. The same thing is occurring with hedge funds now," says Financial Risk Management (FRM) Australia senior vice-president Derek Goodyer.

He notes that over the past year and a half, his firm has contacted numerous super funds with assets of around $500 million and while all expressed interest in varying degrees, most said they wouldn't be making a decision for at least the next three to six months.

Frontier Investment Consulting senior consultant Kristian Fok says although around a quarter of his clients have shown an interest in hedge funds, only one or two super funds have actually gone the extra step and made an investment.

Mitrache, however, believes that the benefits of hedge funds need to be balanced against the risks of including them in a portfolio because they are complex products and their success is often dependent on the skill of the manager.

Like many other asset consultants, Mercer Investment Consulting's executive director Tony Cole says his firm advises its clients to consider fund-of-funds because of their diversification benefits. His super fund clients that have decided to make an allocation have selected the fund-of-funds approach, he says.

Fok says investing in an individual hedge fund can be more risky than the fund-of-funds route because manager performance varies substantially and the same strategy may not always work.

However, fund-of-funds are a way of diversifying this risk and benefiting from specialist managers' expertise in selecting and monitoring hedge funds, as well as their ability to gain access to products which otherwise may not be available.

Goodyer says: "Super funds really need to use a well-resourced specialist with an in-depth understanding of the underlying hedge fund strategies and experienced staff who can go out there and do the face to face investment and operational risk due diligence necessary to select managers."

However, while fund-of-funds may be the preferred choice initially, InvestorWeb Research's senior investment analyst David Smythe believes there will be a shift towards specialist hedge fund managers once knowledge of, and confidence in, hedge funds develops.

As Smythe notes, one trend clearly noticeable in the market is for local fund-of-fund managers to form alliances with more experienced overseas partners, which assists them in building their own knowledge and experience.

Relationships have been formed between Rothschild and Grosvenor Capital, Colonial First State and Harcourt Investment Consulting, BNP Paribas and Fauchier Partners, and Swiss-based RMF and Absolute Capital.

It is estimated that there are currently 33 different hedge fund products on offer in Australia, compared with 6,000 on a global basis. But this number is expected to grow.

Van MacDonald Global Partners – a joint venture between Australian-based MacDonald Asset Consulting and US-based Van Hedge – is the latest entrant with three products.

Investor Select, which is based in New York and manages US$250 million funds, is another new contender, as is BNP Paribas, which recently launched two offerings managed by Fauchier Partners.

In addition, Credit Suisse Asset Management recently said it was considering introducing its own global long-short equity fund-of-hedge funds.

Chief investment officer of Ausbil Dexia Michael Wilson says his firm will also consider offering two hedge funds, a fund-of-funds and an equity long-short.

With the number of offerings surging, it's not surprising that more asset consultants and research houses have started monitoring the various hedge fund and fund-of-funds performance. Also, Standard & Poor's and Morgan Stanley Capital International have announced plans to create hedge fund indices aimed at providing transparent benchmarks.

Head of distribution at Absolute Capital Joshua Goben estimates that there is about $500 million invested with hedge funds in Australia. Funds-of-funds have captured about $200 million of this, with the Public Sector Superannuation and Commonwealth Superannuation Schemes (PSS/CSS) being responsible for half the amount.

In February this year, PSS/CSS, with assets of $10 billion, allocated $100 million to hedge funds, spilt evenly between FRM and US-based Harris Associates.

AvSuper, a fund for aviation employees, has earmarked about $28 million in a global equity long-short fund following an asset allocation study, while Queensland-based Host Super allocated $7 million, or 2.5 per cent of its $275 million in assets, to Australian-based hedge fund manager Barclays Global Investment's Australian equity market neutral fund.

Other super funds taking the plunge include Orica Group Superannuation, which invested three per cent in a hedge fund managed by Warakirri's Absolute Return Fund, Sunsuper, which opted for a long-short fund, and Westscheme, which has allocated three per cent.

While Funds SA is still considering whether to take the plunge, the $300 million Master Superannuation Fund announced that it planned to invest around five per cent of its portfolio in an Australian domiciled global fund-of-funds as part of its allocation to alternative investments.

Retail industry super fund, REST, has adopted a single fund strategy and has invested about $120 million with one manager.

Van MacDonald Global Partners' managing director Scott MacDonald says another fund which has also made an allocation to hedge funds is the Queensland-based Club Plus with its allocation to PM Capital. So has Amcor Super fund, which spilt allocations between Warakirri, Grosvenor Capital and Coastal Magnum.

Mercer's Cole says a fund's allocation to hedge funds will be influenced by what its focus is. "If the role of hedge funds is to reduce risk, then you should invest selectively in a hedge fund that reduces risk, but, if what you are looking for is a return kicker, you should look for a fund-of -funds that aims to maximise absolute returns."

MacDonald suggests an average allocation of between two per cent to five per cent to hedge funds, with a realistic re-weighting for all portfolios out of fixed income and equities, given rising interest rates and soft equity markets which will have a 'long only' or traditional manager exposure.

"At a two per cent exposure this would equate to around $14 billion moving into hedge fund strategies, as current Australian exposures to hedge funds is less than half a per cent of the estimated A$700 billion funds under management," he says.

However, Goben says: "On a broad market basis, the jury is still out as to whether or not super funds should make an allocation to a hedge fund product as a component of an alternative asset allocation or whether they should drill down to a sector specific portfolio, such as equity long-short (equities) or relative value (fixed income)."

He raises two issues that are key factors for the growth of hedge funds in Australia: the relative underperformance of traditional asset classes going forward, and the level of education and research support fund-of-funds providers are able to give asset consultants.