Part 3: Why Hedge Fund of Funds provide an ideal entry point

Financial markets remain gripped by high levels of volatility and the credit crunch spread far beyond the boundaries of high-risk instruments culminating with record financial writedowns. Hedge funds were not immune to the lack of liquidity in the market, demonstrated by the collapse of hedge funds Peloton Partners and Carlyle Capital (among others). In this final instalment of our hedge funds insight series, we take a look at how the investment environment has changed for hedge fund or fund of hedge funds investors.

The market turbulence has demonstrated the benefits of a multi-strategy approach when it comes to hedge fund investing. Unlike those instances mentioned at length in the press, all hedge fund strategies did not unanimously suffer from the recent financial turmoil. Whilst some hedge funds felt the pain from the spike in volatility and lack of liquidity in the markets in the first quarter of 2008, a number of strategies, such as global macro managers and short sellers, provided solid returns.

The recent sell-off in equity markets has also highlighted the importance of risk management and exposure management. As the hedge fund industry and associated assets under management grew over the last few years, their participation in equity markets increased and the correlation between hedge funds and equity markets rose for most strategies. As most institutional investors are allocating to hedge funds for diversification, investors should be cognizant of this increased equity correlation and should put a premium on hedge funds or fund of hedge funds which offer lower correlation and beta to equity markets. These funds should be the best positioned to potentially protect capital during periods of equity market sell-offs.

The recent events are a good reminder of how important a thorough investment and operational due diligence process can be to a successful hedge fund program in order to provide diversification and avoid major hedge fund blow-ups. Organisational due diligence and especially financing due diligence, i.e. the necessity to ensure that managers have well thought-out financing and swap agreements in place, is more important than ever before.

Last but not least, the recent market turmoil has emphasised the benefits of a multi-manager approach to hedge fund investing. Investing through fund of hedge funds can provide professional oversight, access to closed managers, portfolio construction and monitoring of managers. A well constructed portfolio with the proper process can provide manager and strategy diversification, which can lead to more stable returns that complement an investor's existing portfolio. In addition, if underlying hedge fund positions are sized appropriately in the portfolio the impact from any one manager can be mitigated, protecting investors in case of a manager collapsing in a portfolio.

Whilst the current environment present some challenges, it also presents a number of opportunities for hedge fund investing. Examples of strategies which could potentially benefit from the current environment would be relative value type strategies – especially those that can capitalise on volatility – or managers focusing on distressed securities.

In conclusion, the optimal portfolio allocations will depend on an investor's constraints and objectives, but fund of hedge funds are likely to remain the starting point for most institutional investors, providing important manager and strategy diversification benefits. In addition, fund of hedge funds are an efficient solution to organisational, monitoring, and selection problems. Today, more importantly than ever, hedge fund investors should spend the right amount of time and resources to analyse hedge funds' financing agreements, their counterparty risk and operational robustness.

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