

Multistrategy Funds Post-Amaranth

Investors will demand better due diligence, less leverage

By Phyllis Feinberg

While the blowup of Amaranth Advisors is certainly not the death knell for multistrategy hedge funds, investors will be much more careful and ask a lot more questions before they put their money into these funds, particularly about their diversification and leverage.

"From an investor's point of view, it's going to represent an opportunity to further the issue of transparency," says Stewart Massey, founder of Massey Quick & Co in New Jersey. "I expect investors will undertake a review of their due diligence process."

The Amaranth situation has highlighted the need for diversification," says James McKee, director of hedge fund research at Callan Associates in San Francisco. "More diversification is needed to keep the asset class alive."

Risky business

The main issues that now confront multistrategy hedge funds and their investors, according to Rodger Smith, a consultant at Connecticut-based Greenwich Associates, "are the concentration of risk, the deployment of risk and how much do you include in one strategy."

In the long-only equity business, he says, "a manager has a limit to how much he will invest in any one sector. Multistrategy funds need to tell investors how much they'll invest in each sector. They want diversification of risk—diversification is the friend of the investor."

How much leverage a multistrategy fund uses will be very important to investors. "Concentration risk and leverage risk are crucial," says Smith. "Amaranth was not a classic multistrategy hedge fund in terms of the concentration [of the portfolio] and the leverage it used."

Leverage can be a problem for some investors. "Some multistrategy funds are fairly dependent on leverage," says Massey, who is also head of the endowment of the College of Wooster in Ohio. The College has 82% of its assets invested in hedge funds, but not in multistrategy funds.

"We stayed away from multistrategy funds because we couldn't get the transparency we wanted and we couldn't get comfortable with the leverage in the funds we reviewed," says Massey.

Leverage and volatility

The leverage can lead to increased volatility. "Volatility, whether on the upside or downside, is disturbing to investors," says Massey.

"Many investors are seeking slow, steady, reliable returns. Some would rather receive a 10% return with low volatility than a return of 15% with much higher volatility."

Pension funds "should demand diversification guidelines [from multistrategy hedge funds] and ask how the leverage will be deployed," says Smith. "Some multistrategy hedge funds won't give that information—then it's buyer beware."

Steve Nesbitt, a founder of Cliffwater LLC, which specializes in alternative investment consulting to institutional investors, says "the lesson from Amaranth is one of risk management—it does not necessarily have to do with multistrategy funds."

The situation is "not unique to multistrategy funds," says Nesbitt. "It can happen to single strategy funds, too." He says his firm will still look at multistrategy hedge funds for its clients with the right due diligence.

"Risk management is a problem for all hedge funds," he says.

'Cadillac of risk management'

"Amaranth was the darling of risk management—it had the Cadillac of risk management systems," says one consultant who didn't want to be named. "And then they had a bad case of style drift."

Moreover, he points out, "there are good multistrategy funds and there are good ones that make bad decisions later on."

Allocating money to a multistrategy fund is an easy way out, and can provide "all your diversification in one fund," says Jeffrey Dierks, managing director of In Trust Advisors in Tampa, Florida. "But if you have all your eggs in one basket, you can lose a lot of money."

In Trust manages the In Trust Advisors Multi-Manager Fund, a fund of funds that has stayed away from investing in multistrategy hedge funds. "With a single strategy fund, you can understand it better, and if something goes wrong, you only lose a little money," says Dierks.

Funds of hedge funds will also come in for closer scrutiny, in particular the ones that were invested in Amaranth, including funds from blue chip firms such as Goldman Sachs and Morgan Stanley.

"I think it will have an impact on funds of funds," says Massey. "Amaranth was in many funds of funds, and people trusted them to conduct due diligence on the underlying managers. Investors will take the opportunity to

review the due diligence and risk management practices of their fund-of-funds managers."

Amaranth "is an example of how important it is to monitor the underlying managers in a fund of funds," says Joyce Heinzerling Davis, general council of Helios Funds, a New York-based fund of funds managed by Archery Capital.

"Amaranth's disclosure said they would have a more diverse portfolio than they had," she says. "This is what happens in the race to chase returns."

No contagion

Some industry observers think investors may have reacted too quickly to Amaranth's problems. "When a manager does badly, if you like them you should continue with them, not bail out when they're under water," says Gideon Nieuwoudt, head of hedge fund research at Watson Wyatt in New York.

"Multistrategy funds that do better than funds of funds take a lot of risk and have more volatility in their performance," he says. "The impact is not nearly as much as if a big stock plummeted in value. Large cap domestic equity [portfolios] can have huge drops."

Nieuwoudt also points out that "there hasn't been a contagion here. Investors should be careful not to draw too large a conclusion [from the situation]."

However, some comments Callan's McKee made in a hedge fund report that went out to clients at the end of 2005 have proved quite prescient:

"Multistrategy funds with white-hot performance can become a universally popular choice for generating absolute returns. In such settings, that manager's confidence or even arrogance grows, depending on the firm's culture. Indeed, under favorable conditions where underlying strategy returns seem reliably uncorrelated with each other, multistrategy fund managers may express that confidence by applying more leverage to boost their 20% incentive profits than they would with stand-alone strategies.

"Subsequently, when circumstances dramatically change, history has shown that multistrategy funds may not necessarily be better equipped than unlevered funds of funds to protect capital, despite their compelling pitch."

More hedge funds, styles

Kevin Quirk, a founding partner of Casey, Quirk & Associates, thinks that a new model



for hedge fund diversification will emerge. He envisages hedge fund firms that offer multiple products in different asset classes, but in separate funds, not in one multistrategy fund.

"They won't necessarily have one product or one fund," says Quirk. "There will be more hedge funds with many different styles. They will have multiple investment capability and multiple product capability and distribution capability as well."

However, he says, "I'm not saying multistrategy funds are going away. But it is difficult to do and there will be select firms with the ability to pull it off."

He also believes that funds of hedge funds will continue to be popular. "In the institutional market, the vast majority of investors don't have the resources to effectively navigate the hedge fund space, so they will use funds of funds," he says.

McKee's 2005 report to Callan's clients offers a pertinent conclusion of the issue and a warning:

"Fund sponsors seeking direct exposure to such funds in lieu of funds of funds should size such direct allocations accordingly. That is, while well-diversified funds of funds can represent a significant allocation for a fund sponsor, the maximum allocation to an individual multistrategy fund should be materially less, all things being equal.

"As with single strategy funds, a multistrategy fund investor should still pay close attention to where the closest exit is." ♦

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