Rethinking the Role and Implementation of Hedge Funds

Steven Hall[1] & Jack Gray[2]

Brookvine Pty Limited

November 2010

1 Steven Hall is the CEO of Brookvine Pty Limited.

2 Jack Gray is a Director of Brookvine Pty Limited and an Adjunct Professor of Finance at the Paul Woolley Centre for Capital Markets Dysfunctionality at the University of Technology, Sydney.

BROOKVINE

Investment design & fund raising specialists

Brookvine Pty Limited
ABN 53 098 072 390
Australian Financial Services Licence No. 246450

Overview[3]

This paper is divided into four connected parts:

Part 1: ***Conventional Wisdom on Fund of Funds*** argues that the net benefits of Fund of Hedge Funds (FoHFs) remain strong due to the scarcity of skills needed to effectively structure and manage a hedge fund program.

Part 2: ***An Integrated Total Portfolio Context*** offers a framework for investors to use when looking afresh at their approach to total portfolio management.

Part 3: ***Fund of Hedge Funds vs Customised Advice and Implementation*** discusses the merits of investing in hedge funds via FoHFs versus a more tailored, directly implemented program.

Part 4: ***A Checklist to Prequalify Fund Advisors or FoHFs*** constructs a checklist to assist investors when selecting a FoHF or a provider of customised hedge fund advice and assistance.

[3] Brookvine believes in and so represents managers whose investment strategy and business models are aligned with comments in this paper. This includes various fund-of-funds. It is also an active supporter of certain direct hedge fund investments and managers more explicitly targeting an alternative beta.

Conventional Wisdom on Fund of Funds

Or Why David Swensen and Warren Buffett are Wrong... for Us

Jack Gray

Experts R Us?

Conventional wisdom has it that all types of Fund-of-Funds (FoFs) are at death's door. Conventional wisdom is always conventional, occasionally wise, and oftentimes wrong.

In different ways both Swensen and Buffett have spoken against FoFs. Swensen thunders that "No one should invest with a FoF at all. If you're a fiduciary you should know where the money is going. If you can't do it yourself you shouldn't do it."[4] In the context of investment bankers Buffett too is unambiguous, declaring that if he needed investment bankers he wouldn't do the deal.

At their peak, experts in investing, music, football, or carpentry simply cannot understand how lesser beings (us) struggle to do what they do. Their defining mark, making it look easy, seduces us into mimicry, to pretend we can be like Dave and Wazza. But our heroes have *non-replicable* and immeasurable comparative advantages. These include deep investment insight and experience, highly talented support staff, non-bureaucratic organisations, powerful influence, and a massive informational edge that flows from their strong networks which guarantee their position at the pinnacle of the food chain. Where on that chain can Australian superannuation funds expect to be?

" With Asian private equity Australian funds do recognise the importance of local networks and so rely more on FoFs. But in London or New York they act as if networks will welcome them because they share a common language (almost true) and a common culture (far from true)."

The crucial role of networks is reflected in another conventionally wise view: in venture capital, increasing returns to networks are believed to so dominate that both hunters and gatherers of venture capital will fail if located more than a mile from Sand Hill Road, Silicon Valley. When it comes to Asian private equity Australian funds do recognise the importance of local networks and so rely more on FoF structures. But in London or New York they act as if networks will welcome them because they share a common language (almost true) and a common culture (far from true). The flaw in that conventionally wise view was exposed over the past two decades when Australian financial services firms were made painfully aware of their proximity to the bottom of the food chain; a position of which they were blissfully unaware.

4 FTfm, 30/3/09

DIY… The Drivers

Do-It-Yourself, *aka* insourcing, today's dominant Australian institutional investing fashion, is a conventional response to increasing size and complexity. Some have recognised the fashion's lack of wisdom as a growing number of US funds under $2b, and recently a $7b fund, shuffle down the 'rent-a-CIO' path, outsourcing all investment management from asset allocation through to security selection, often to a single manager. Between 2004 and 2008 the number of not-for-profit US funds to outsource their total investment management nearly tripled.

" DIY doesn't eliminate agency costs... internal management also acts in its own interests."

DIY is justified by a panoply of arguments, many with equally strong rejoinders. Principal among them is an expected saving on costs, especially a reduction in agency costs. The common bias towards directly observable costs means that non-measurable indirect opportunity costs such as the potential under-performance that can flow from mediocre selection, structure and implementation are heavily discounted or even ignored. DIY doesn't eliminate agency costs because to varying degrees internal management also acts in its own interests. Insourcing also creates agency frictions, albeit different ones.

Insights on the nature of the firm add some clarity to the in/out-sourcing debate. Long ago Coase wondered why firms exist; why we do not contract directly in the market for all goods and services?[5] His Nobel-Prize winning answers centre around the lowering of transaction costs: the costs of developing and enforcing contracts, the costs of uncovering and interpreting information, and critically the costs of *co-ordinating* and acting on that information. In general firms do this better and more cheaply than the direct alternative. At first blush this favours FoFs when seen in the role of the firm. The key question is which of the fund or the 'firm' has the talent, temperament, culture and structure to best gather, co-ordinate, interpret and act on information. In a competitive marketplace that combination of skills is extremely scarce. No doubt Swensen and Buffett do have the 'right stuff'. Very, very few others do.

" To effectively structure a bespoke SMA of hedge funds demands far more than one or two quick visits a year. It demands a deep understanding of... evolving hedge fund strategies, their organisations' culture and people, and the dynamics and networks of the industry."

Underlying the DIY fashion are two human and organisational behaviours each with an explicit (rational) basis smothered by two implicit (non-rational) biases. Both behaviours are evident in institutional superannuation funds and in the retail fashion for self managed funds. The first is *overconfidence*, reflected in our universal belief that we're top quartile in almost all human characteristics, including the ability to choose the best managers. Second is the *illusion of control*. Nearly 20

[5] Standard models of investment markets ignore financial intermediation.

years ago the anthropologists O'Barr and Conley in their study of decision-making in US pension funds saw this illusion as "the dominant feature of the relationship between fund and managers... funds believe they control quality through selection and evaluation... managers believe they control selection and retention by pandering to the ignorance and insecurity of fund executives. Each group succeeds in patronising the other to their mutual benefit." The illusion also underlies the belief that DIY provides total transparency and that total transparency is intrinsically 'good'. But if funds know not what to do with an obfuscating flood of data the supposed comfort it generates is a dangerous illusion.

Funds of Hedge Funds (FoHFs)

Conventional wisdom has it that many FoHFs 'blew up' in 2008. Some did; most didn't. The characteristics of the 'didn't's' ranged from adequate diversification and reasonable portfolio construction, to superior risk control and due diligence processes, to having the skill to select, monitor, structure and learn from the better hedge funds. Disillusionment with FoHFs[6] also stems from their being oversold as 'absolute return', 'defensive' and/or 'market neutral'. The implicit message was that they would deliver in *all* states of the market, notwithstanding explicit specifications on the expected volatility of outcomes. Hedge they did; completely hedge they didn't.

Conventional wisdom further has it that FoHFs appointed excessive numbers of hedge funds to accommodate new business flows and to hedge against large draw-downs. Some did; most didn't. The academic literature claims that in excess of 20 hedge funds is a sign of 'diworsification', heralding a predictable degradation of alpha. However, there are around 12 relatively distinct hedge fund sub-strategies, ranging from dedicated short bias, to managed futures, to fixed income arbitrage. The confluence of style variation within each sub-strategy and performance uncertainty suggests that around three hedge funds per sub-strategy, for a total of around 40, is probably close to 'optimal' and certainly far from over-diversification.

The literature also largely ignores many real-world frictional effects, and is necessarily based on data about median funds only. Because top quartile hedge fund performance exhibits a degree of persistence, gaining access to them has a positive expected outcome. One disingenuous argument against FoHFs allows for no distinction between the 'good' and the 'bad' while simultaneously emphasising the importance of selecting only the 'good' individual HFs. Naturally, not all FoHFs are the same.

Which of an Australian super fund or a 'good' US FoHF is more likely to identify, research, access, deal with, monitor, structure, customise, and

[6] Through 2009 FoHFs' aggregate AUM shrank by 10%, just as performance recovered.

extract meaningful information from top quartile hedge funds? Merely monitoring HFs demands close on-the-ground experience. Stephen Brown of NYU estimates that initial operational due diligence costs roughly $US100k per hedge fund. To effectively structure a bespoke separately managed account of hedge funds demands far more than one or two quick visits a year. It demands a deep understanding of existing and ever evolving hedge fund strategies, their organisations' culture and people, and the dynamics and networks of the industry.

Finally, conventional wisdom has it that FoHFs don't add value net of fees. A recent paper provides empirical support that undermines that 'wisdom'.[7] The authors' returns-based analysis attributes returns to 'static beta (SAA)', 'dynamic beta (TAA)', and 'manager selection (alpha)'. Merging HFR & Lipper data over the period 2000-2009 they draw two surprisingly strong conclusions:

- "… overall FoHFs, unlike mutual funds, succeed in overcoming their double fee structure, and add value across market regimes…"
- "… the outflows from FoHFs… cannot be attributed to a collective failure of FoHF managers to deliver on their promises."

The most significant source of excess returns is SAA which explains 45% of the level of returns and 68% of the variability. Second is manager selection that is more difficult to capture as evidenced by its greater cross-sectional volatility. Third is TAA which has a marginal impact on returns, but that may be due to poor liquidity in the past.

Conclusion

So are fund of hedge funds worth it? Rational answers should compare their cost, base and carry, and agency costs with both the direct costs of DIY and the *indirect* opportunity agency costs of the consequences of inadequate skill, temperament, experience and networks. Only a modest number of FoHFs and US endowments have the 'right stuff' needed to successfully craft and implement a portfolio of hedge fund strategies. In the context of venture capital, Josh Lerner of Harvard advised funds to first spend 20 years learning about venture capital before doing it themselves. Would that that unconventional wisdom were more conventional.

[7] "Do FoHFs Really Add Value?", Serge Darolles & Mathieu Vaissie, Lyxor AM, September 2010.

An Integrated Total Portfolio Context

Steven Hall

Introduction

Since the "Volcker recession" nearly three decades ago investment markets have seen a long decline in nominal interest and bond rates as inflation has slowly but steadily fallen. This led to a much more stable and predictable investment and economic environment. The combination of these factors favoured a traditional long only approach to investing in equity, property and fixed income, and a one dimensional strategic approach to asset allocation.

" Today... investors need more diversity, more scope to derive active returns and better protection against significant market downturns... allocations to hedge funds and other more specialised strategies, together with an integrated and flexible approach to asset allocation, are critical."

Today we are faced with an extended period of increased economic volatility and high levels of uncertainty. Investors need more diversity, more scope to derive active returns and better protection against significant market downturns. In this context, allocations to hedge funds and other more specialised strategies, together with an integrated and flexible approach to asset allocation, are critical.

The Leading Edge in Multi-Manager Investing

Some of the sharpest thinking in multi-manager investing is found amongst certain fund of hedge funds and select North American endowments and foundations. They pursue many differentiated investment opportunities and are extremely well diversified. They are willing and able to be more contrarian in their allocations and have greater scope to act on select opportunities for active management. Many employ proprietary risk management technology across their total portfolio and have a systematic process for combining multiple asset classes and strategies into a coherent, integrated whole. Typically they eschew traditional broad-based funds in favour of more idiosyncratic risk taking. They pay less heed to the competition, particularly in the short term, and rotate allocations within and across broad asset classes, often making substantial shifts to reflect changing market and economic circumstances. Critically they minimise organisational barriers to good investing. Their leadership and culture actively encourages interactions and actively discourages silo thinking.

These institutions are often adept at harvesting bottom-up insights from their specialised managers and integrating these with in-house strategy views; a process that can lead to real insight and the identification of excellent investment opportunities. There is real power in this "second order" manager service which sees specialist managers engaged not only as providers of investment management services but also as a provider of ideas and investment opportunities outside their specific mandate.

Few Australian superannuation funds are sufficiently resourced to implement such strategies without specialist advice, yet a standard balanced fund can be better positioned for uncertainty and volatility by integrating hedge funds and more specialised investments into a total portfolio context rather than treating them as a carve-out allocation.

A Case for Integrated Thinking

Investment funds can and should extract value from each of the following:

- On-going changes to asset allocations including a preparedness to make large and quick opportunistic allocations (often at times of great stress)
- Dynamic management of exposures within asset classes (by which net and gross exposures vary constantly)
- Extracting and integrating manager insights into their in-house strategy and tactics.

To do that well funds should integrate hedge fund allocations and more specialised investments into a total portfolio. Yet in the case of Australian superannuation funds allocations to hedge funds and other specialised strategies are typically carved out of a "standard" portfolio as "alternatives." This "toe in the water" approach to alternatives may have been adopted with prudent intentions but in fact missed the point of the role of alternatives. At best it results in meaningless allocations and at worst in meaningfully sub-optimal allocations. Further their impact on portfolio exposures is often considered in isolation from the aggregate portfolio.

Instead hedge funds and specialised strategies could be *integrated* into a portfolio in at least five distinct ways, as in Table 1.

Table 1: Integration of Hedge Funds and Other Specialised Opportunities

Role Within a Portfolio	Examples of Types of Strategies
1. **Public Markets Allocation**: As a substantial component of mainstream assets, eg. equity, fixed income/credit and other core allocations	Hedged/tactical equity, with the capacity to vary gross and net exposure; and long only equity with a very concentrated and specific focus.
2. **Absolute Return Allocation**: Separate component targeting attractive risk-adjusted returns and lower volatility than most traditional asset classes.	Blend of hedge funds targeting a low aggregate beta to both equity and credit markets, actively managed to add value from asset allocation and manager performance.
3. **Alternative Beta Allocation**: Niche alternative strategies that provide a genuine source of lowly correlated "beta".	Strategies with risk and return drivers fundamentally distinct from those of equity and credit markets, eg., insurance-linked securities.

Role Within a Portfolio	Examples of Types of Strategies
4. **Opportunistic Allocation**: Opportunistic strategies expected to generate long term returns in excess of equity markets. Attractive investment opportunities often arise in areas that are temporarily out-of-favour or distressed, lack institutional focus or are undergoing significant change.	Opportunistic and multi-strategy funds targeting outsized returns, typically with exposure to less liquid investments and variable beta to equity, credit and interest rate markets. A higher degree of manager and strategy concentration may be desired to properly capitalise on attractive market opportunities.
5. **Total Portfolio Core Allocation**: As a part of a broad-based fund designed to deliver a return in excess of a conventional balanced fund. It has differentiated exposures and derives considerable value add from active asset allocation and investment in niche and specialised strategies across a broad range of asset classes	A newer breed of multi-manager &/or multi sector funds. They have sophisticated investment resources and offer exposure to a full range of alternative and mainstream asset classes. They have a significant allocation to hedge funds and specialised strategies, very active and tactical asset allocation and an explicit target to deliver returns in excess of conventional balanced funds with diminished risk, eg., so-called all-weather, independent endowment and new balanced funds

Impact on Core Allocations

A material impact on risk and return requires higher exposures to hedge funds, exposures that should incorporate not just active allocations to individual hedge fund strategies but also integrated tactical decision-making within and between traditional and more liquid alternative allocations.

An integrated approach is likely to have a substantial impact upon core allocations to equities and fixed income/credit through strategies that are:

- More “alpha” oriented and hence less dependent on broad markets
- Able to dynamically adjust both gross and net exposures as partial protection against significant market downturns
- Able to capture “full toss” opportunities when they arise by virtue of less restrictive mandates.

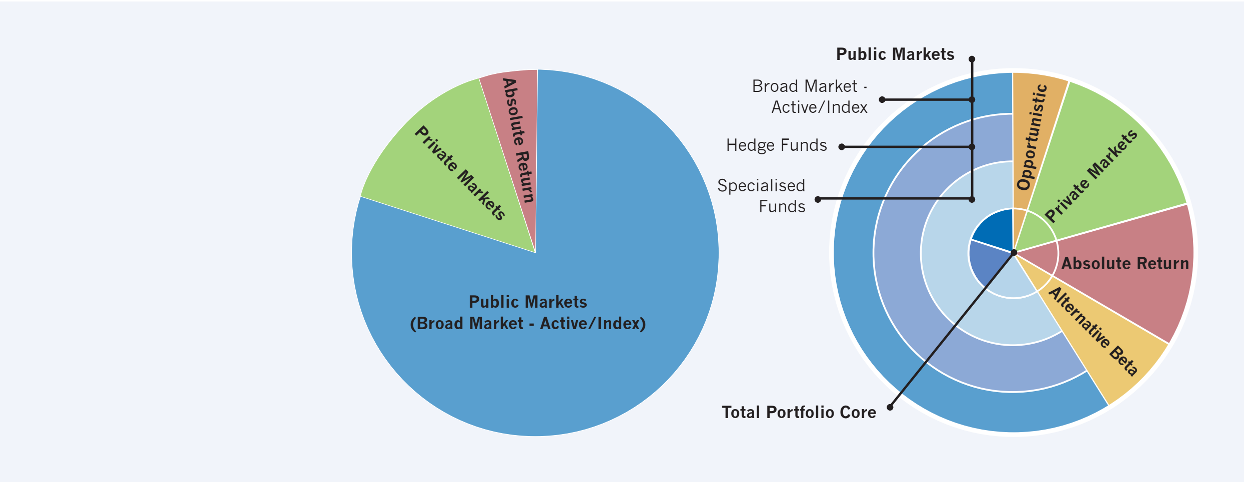
Of course all allocations need to be considered in the context of the overall tolerance for illiquidity. Different funds have different lockup and notice requirements and investors have to make sure they don’t risk a liquidity mis-match and are being compensated if they are giving up liquidity. Nonetheless that integration likely provides more and richer opportunities and hence greater diversification, better protection against market downturns, improved opportunities for asset allocation and the prospect of capturing outsized opportunistic returns.

For example within fixed income/credit allocations some offshore funds allocate to segments such as corporate, asset-backed, direct origination and mortgages. They diversify across a wide spectrum of instruments with exposure to distressed and under-performing opportunities in publicly traded, private and directly originated investments. They include long and short investments. At times (such as now) when market experts are divided whether there will be significant increases in future inflation or a second downturn in the global economy, a long/short position within a diversified credit portfolio could mitigate the risk of loss due to rising interest rates.

> *" Success requires branching away from conventional long only investing and adopting a more flexible, collaborative and integrated approach... However that demands... skill, experience, temperament and resources that few investors have."*

Skill in asset allocation at a sub-strategy level is crucial. The best investors will distinguish themselves by being in the right sub-strategies, as the environment will be ripe to reward certain strategies and punish others. While there is no substitute for talent and motivation, a B+ manager in a strategy with substantial wind at its back will likely substantially outperform an A+ manager in a strategy with headwinds.

Chart 1: Traditional versus Integrated Total Portfolio Thinking



Conclusion

Success requires branching away from conventional long only investing and adopting a more flexible, collaborative and integrated approach to asset allocation. However that demands appropriate skill, experience, temperament and resources that few investors have.

Fund of Hedge Funds vs Customised Advice and Implementation

Steven Hall

Introduction

Successfully implementing and integrating a multi-manager hedge fund program is extraordinarily difficult. Investors not only need to identify, assess, vet, engage and manage multiple specialist managers across many diverse disciplines, but also to know how and when to rotate and re-allocate capital.

It takes resources, skill, access and the development of relationships of trust to invest successfully with hedge fund managers who are skillful and intelligent risk takers. The importance of being in the right networks cannot be overstated. Investors also need to be astute judges of newer and emerging managers where substantial and proven premiums are available. The capacity to understand investment risks and exposures matters greatly, even more than underlying position transparency. Successful investors also need specialised skills in strategy design, portfolio construction and allocation, and the expertise to comprehend fully what managers say and what can be derived from their activity.

A Role for FoHFs

A series of top tier FoHFs in the fields of credit, equity, low beta absolute return and more opportunistic strategies provides a good basis for a substantial amount of the allocation to hedge funds. This may complement some directly held hedge funds and specialised investments. Although some investors are now allocating directly into hedge funds, the role of FoHFs is not about to be eliminated. Quite likely a top tier FoHF will have a bias away from "brand name" and broad-based funds and a more active role in allocating capital that is likely to well complement directly held hedge funds. There also may be merit in engaging more than one FoHF depending on specialisations. With an appetite to increase allocations to more opportunistic strategies, often in the midst of a crisis, an integrated hedge fund program of this type can generate a sizeable competitive advantage even for a fund of modest size.

> *"Although some investors are now allocating directly into hedge funds, the role of FoHFs is not about to be eliminated."*

Yet like the rest of the world Australia seems averse to FoHFs. To be fair, some FoHFs and their Australian domiciled funds were found wanting through the Global Financial Crisis and events such as Madoff, Petters and Amaranth. For example:

- Some oversold the size and particularly the reliability of returns.
- Some top-rated funds failed to manage growth and the quality of their businesses – they suffered from rapidly increasing FUM, overly diversified portfolios, corporate change and loss of key personnel.
- Fees were too high, not least performance fees without hurdles.
- Currency management was poorly implemented – several leading Australian-domiciled funds were under-hedged when hedging was most needed.
- The mix of investors was poorly maintained – those FoHFs that had exposure to lower quality retail and HNW segments suffered from mass withdrawals to the detriment of longer term investors with more patient capital.

A more recent criticism of FoHFs is that much of their beta exposures could be picked up elsewhere and more cheaply. Analysis of FoHF performance in aggregate may well support this contention. Nonetheless there is a small group of top tier FoHFs with a demonstrated ability to generate active returns with very low exposure to traditional market betas. Unfortunately studies of, and insights into, top tier FoHF performance are scant. Unsophisticatedly replacing FoHF capital with increased allocations to either traditional assets or to a small number of direct hedge fund allocations is unlikely to generate better outcomes after fees (on a like for like comparison with respect to strategy and exposure).

"...a FoHFs approach may not be optimal for larger, better resourced funds. It makes sense for larger funds to consider a more customised directly managed program..."

Indeed, a small group of FoHFs has prospered since the Crisis. While the global industry as a whole has lost over 50% of its assets since June 2008, a smaller group are winning accounts and growing through: (i) their ability to customise; and (ii) the now more obvious strength of proper alignment of their business models. Indeed the line between consultants and FoHF managers is increasingly blurred as institutional investors continue to push managers toward new responsibilities.

Customised Advice and Implementation

A FoHF approach may not be optimal for larger, better resourced funds. It makes sense to consider a more customised, directly managed program especially when:

- Specific risk/return/liquidity objectives are not met by an existing commingled fund;
- Desired specific exposures or limits on exposure are unavailable in commingled strategies;
- The fund blends internally managed exposures with outsourced exposures and wants to avoid doubling up; and/or
- It is important for the fund to have segregated assets.

A customised structure may well include a mix of direct hedge fund and specialised fund of fund investments. Ideally it should be measured with respect to its success in selecting managers, active asset and manager allocation decisions (together with their timely and efficient implementation), and in facilitating an integrated approach to total portfolio management.

Conclusion

There is a full spectrum of hedge fund advisory and implementation services available these days, and the line between consultants and FoHF managers has never been more blurred.

A Checklist to Prequalify Hedge Fund Advisors or FoHFs

Steven Hall

Introduction to the Checklist

Below we provide a simple framework for helping investors decide whether the organisation and implementation of a hedge fund program stands a real chance of success. Used as a 'checklist' these questions should improve decision-making regarding specialist advice and implementation. The checklist should be applied to a prospective asset consultant, specialist adviser or FoHF (whether offering fund investments or full customisation). It is designed to prompt a speedy appraisal of the integrity and stability of their business, and their capacity to provide the requisite hedge fund services.

Failure to get satisfactory answers exposes investors to the very real risk of getting their hedge fund program 'wrong'. Satisfactory answers to most if not all these questions will better focus investors on gauging investment acumen amongst a very small set of prequalified service providers.

Table 2: Advisor/FoHF Checklist

Issue and Rationale	Questions to Ask
1. **Investment Performance** Performance history in line with investment objectives is critical. It should validate an active contribution from both asset allocation and manager selection. If there is no commingled fund the record should be for a composite based on all representative accounts to avoid "cherry picking". Further, the past 5 years provides an opportunity to develop useful insights by uncovering whether or not the manager made "good" investment decisions.	– Is the track record in line with the objectives? – Does attribution align well with the investment proposition? Is significant value added attributable to both asset allocation and manager selection? – Can you adequately explain periods of varying performance? – Was currency hedging appropriately implemented for non-USD accounts? – Did you have a meaningful and direct exposure to strategies that were short sub-prime? – Have you made other large and successful contrarian shifts in allocations?
2. **Risk Management** A sophisticated risk function should oversee the vetting of the risk systems of individual managers and the aggregation and modelling of aggregate portfolio exposures. The risk function should be separate from investment decision-making and have a separate veto. It must have real standing and authority within a firm.	– Is there a separate risk management function and is it adequately resourced? – Does it have a power of veto over investment decisions? – Does it have real standing and authority in the organisation, or is it subservient to the portfolio management function?

Issue and Rationale	Questions to Ask
3. **Operational Due Diligence** A separate operational due diligence function should focus on key areas of operational vulnerability likely to lead to failure. It should be separate from the risk function and investment decision-making and have a separate veto.	– Is there a separate operational due diligence function and is it adequately resourced? – Have you invested in a fund that failed for operational reasons or due to fraud?
4. **Independence, Focus and Alignment** Investment teams in large institutions that derive the greater share of their FUM from a captive relationship or offer multiple and disparate investment products are likely challenged to be excellent risk takers. The investment team should own a substantial share of the business and should, over time, derive the majority share of profits and be the majority owners. Each of the key investment team should have invested a significant amount of their net wealth in the AUM of the business.	– Is the business independently operated? – Does the business focus on the management and implementation of hedge fund programs? – Is there a path by which the senior investment team derive the majority share of profits and own the majority of the equity? – Do all key investment professionals invest sufficiently in their own funds? – Does the stability of the business depend on one key client relationship?
5. **Team** It is preferable that the firm's founders remain actively engaged in investment activities, the senior team averages over 20 year's experience and the track record is almost fully attributable to the senior team who will advise on &/or manage funds. To capitalise on 'network returns' the team needs to be located in key global hedge fund centres.	– Is the senior team of the first generation? – Does the senior team have full attribution of the track record? – Is there a minimum 20 years' average experience among senior investment decision-makers? – Will the organisation suffer from the sudden departure of any key investment professional? – Is the team located in key global hedge fund centres?

Issue and Rationale	Questions to Ask
6. **Quality of the Client Base** A firm with FUM of $5-$10b has ample room for future growth. To the extent that investors are not investing with and along-side patient, long term capital they are unnecessarily exposed to the whims of less stable capital. Finally a firm with multiple legacy portfolios and clients with widely varying investment objectives is unlikely to give new or existing investors adequate focus.	– Is the aggregate value of assets under advice, management and/or implementation below $10b? – Is at least 75% of FUM derived from long term patient capital (ie., not HNW or retail distribution channels)? – Are the majority of individual investment accounts aligned in their investment objectives and manager configurations? – Were redemptions effectively controlled during the Global Financial Crisis?
7. **Quality of the Manager Roster** It is difficult and time consuming to discern the quality of investment decision-making. There are some leading indicators, however, including a bias towards niche strategies versus broad-based and multi-strategy funds, low–moderate correlations between individual managers in the same broad strategy, a preference for smaller sized and emerging managers over "brand name" funds, and a history of being an early entrant into now well established brand names. The latter is important to gain deep access to information regarding underlying risks and exposures.	– Does the manager roster favour niche strategies over broad-based and multi-strategy funds? – With few exceptions, are the correlations between individual managers in the same broad strategy group well below 0.75? – Is there a preference for smaller sized and emerging managers over "brand name" funds? – Was the firm a very early entrant into most (if not all) "brand name" funds it holds?

Issue and Rationale	Questions to Ask
8. **Non Investment Alpha/Knowledge Transfer** Investors can derive enormous value through application of the firm's knowledge and technology. A genuine knowledge-sharing partnership should include for example, access to detailed manager due diligence material and research underpinning asset allocation and strategy decisions. It provides a means to benchmark and compare best practices in investment strategy, risk management and organisational development. There is also enormous value in leveraging risk management and modelling tools to model a total fund position. A senior investment professional should anchor the relationship and there should be a clear basis on which to measure the success of knowledge-sharing.	– Will due diligence material and risk management and modelling tools be made available to my fund? – Will the risk tools enable me to monitor and manage risks across the entire portfolio? – Will a senior investment professional anchor the relationship? – Will I have direct access to your asset allocation and asset class specialists? – Will you help me source co-investments, rising star managers etc? – Will I be able to clearly measure the success of the knowledge-sharing?

Conclusion

Checklists are particularly effective tools for decision-making in complex and ambiguous environments. Decision-makers can easily be overcome by detail and ambiguity and either forget basics or ignore them as too trivial. Checklists are not meant to nor can they replace judgement, rather, they augment it.