

**OVERCOMING THE SHORTFALLS OF THE TRADITIONAL APPROACH TO INVESTING IN HEDGE FUNDS**

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*Hedge fund returns have outperformed balanced fund portfolio returns over time. However, investors have been disappointed with hedge funds' performance in 2008/09, exacerbated by high fees, lack of control of assets, in the extreme, incidents of outright fraud. This research paper argues that the price dislocations still present in the market combined with a flexible approach to investing, mean the prospect for hedge fund returns has never been better. However, there are lessons to be taken from the experience of 2008 and resolving the structural flaws of hedge funds will be one important step forward in the chase for higher, more stable returns.*

In 2008, hedge funds failed to deliver on their stated objectives. Negative returns, suspension of redemptions, fund wind-ups, and frauds such as Madoff, combined with hedge fund managers' high fees and performance bonuses have led to strong criticism of hedge funds.

However, given the extent of the global financial crisis which began in 2007, overall hedge fund performance demonstrates the robustness of most hedge fund managers and their strategies. Diversified portfolios of hedge funds delivered returns in line with, or better than, the typical balanced fund despite short selling restrictions, free-falling equity markets, and prime broker collapses.

As markets normalise and liquidity increases from historic lows, surviving hedge funds will be well placed to take advantage of larger distortions in financial markets, particularly with less competition in the sector. The underlying investment philosophy of hedge funds of delivering returns which have low correlations to traditional investments and with managers' interests aligned with that of the investors to protect capital remains appealing. However, some of the structures available to investors have proven to be flawed. By investors improving their understanding of what drives hedge fund returns, a more intelligent and efficient structure for hedge fund investing can be developed, focussing on resolving the issues of high fees, lack of transparency and limited investor control.

By de-constructing hedge fund returns and using structures that provide more protection and control, investors can capitalise on the increased opportunity set available to hedge funds, while ensuring appropriate fees, transparency and protection for investors are in place.

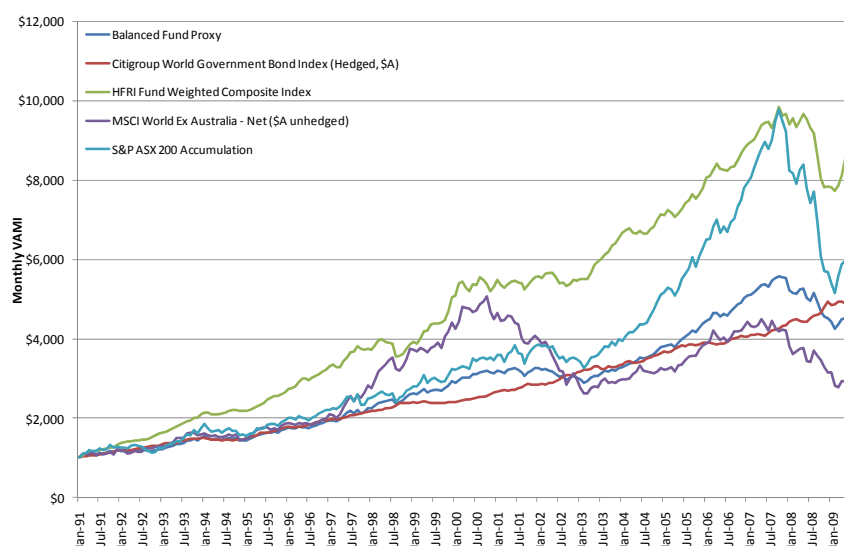
## Hedge Funds – the story so far

There is no universal definition of what a hedge fund actually is. Many people treat hedge funds as a separate asset class like stocks or bonds but, in reality, the term hedge fund is used to describe a collection of heterogeneous investment strategies which use a combination of short selling, derivatives, and leverage. Hedge fund managers may invest in stocks, bonds or other securities which are more complex (like convertible bonds) that exhibit characteristics of both bonds and stocks and are difficult for traditional long-only managers with tightly defined investment constraints to invest in. In some instances, but not always, individual hedge fund manager returns depend *primarily* on a manager’s ability rather than broader market movements, and they offer investors the potential to deliver returns that have low correlation to stock and bond market returns, as demonstrated below.

## Historical Hedge Fund Returns

Overall, diversified portfolios of hedge funds (as measured by the HFRI Fund Weighted Composite Index<sup>1</sup> (in USD)) have demonstrated very attractive risk and return characteristics over an 18.5 year period. There has only been one occasion when the HFRI Fund Weighted Index (in USD) fell as much as equities, which was in the liquidity crisis of August 1998 at which time Russia defaulted on its sovereign debt. In calendar year 2008, the HFRI Fund Weighted Index (in USD) fell by half of the amount of equity markets, as measured by the MSCI World Index, and about the same as traditional balanced funds.

Figure 1: Hedge fund composite returns versus other investments (31/12/1990 to 30/6/2009)



Note: \* Balanced Fund Proxy = 10% UBSA Bank Bills, 10% Mercer Unlisted Property pre tax, 25% MSCI World ex Australia Unhedged, 35% S&P ASX 200 Accumulation, 20% Citigroup WGBI. Rebalanced Monthly.

<sup>1</sup> Please refer to the Hedge Fund Research website for index construction methodology.

Figure 2: Annualised returns, annualised standard deviations and correlations

Asset class	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
HFRI Fund Weighted Composite Index (USD)	32.19%	21.22%	30.88%	4.10%	21.50%	21.10%	16.79%	2.62%	31.29%	4.98%
Citigroup World Govt Bond Index (AUD Hedged)	18.47%	11.06%	14.76%	-2.66%	20.10%	10.66%	10.46%	10.43%	0.78%	10.10%
MSCI World ex Australia Index (AUD unhedged)	20.85%	5.38%	24.92%	-7.98%	26.84%	6.70%	42.18%	32.82%	17.56%	2.49%
S&P ASX 200 index (AUD)	29.22%	-3.20%	40.05%	-8.76%	21.10%	14.35%	12.67%	9.80%	18.74%	6.36%
Balanced Fund Proxy*	18.74%	2.56%	23.04%	-3.61%	19.78%	10.45%	18.01%	15.15%	12.61%	6.87%

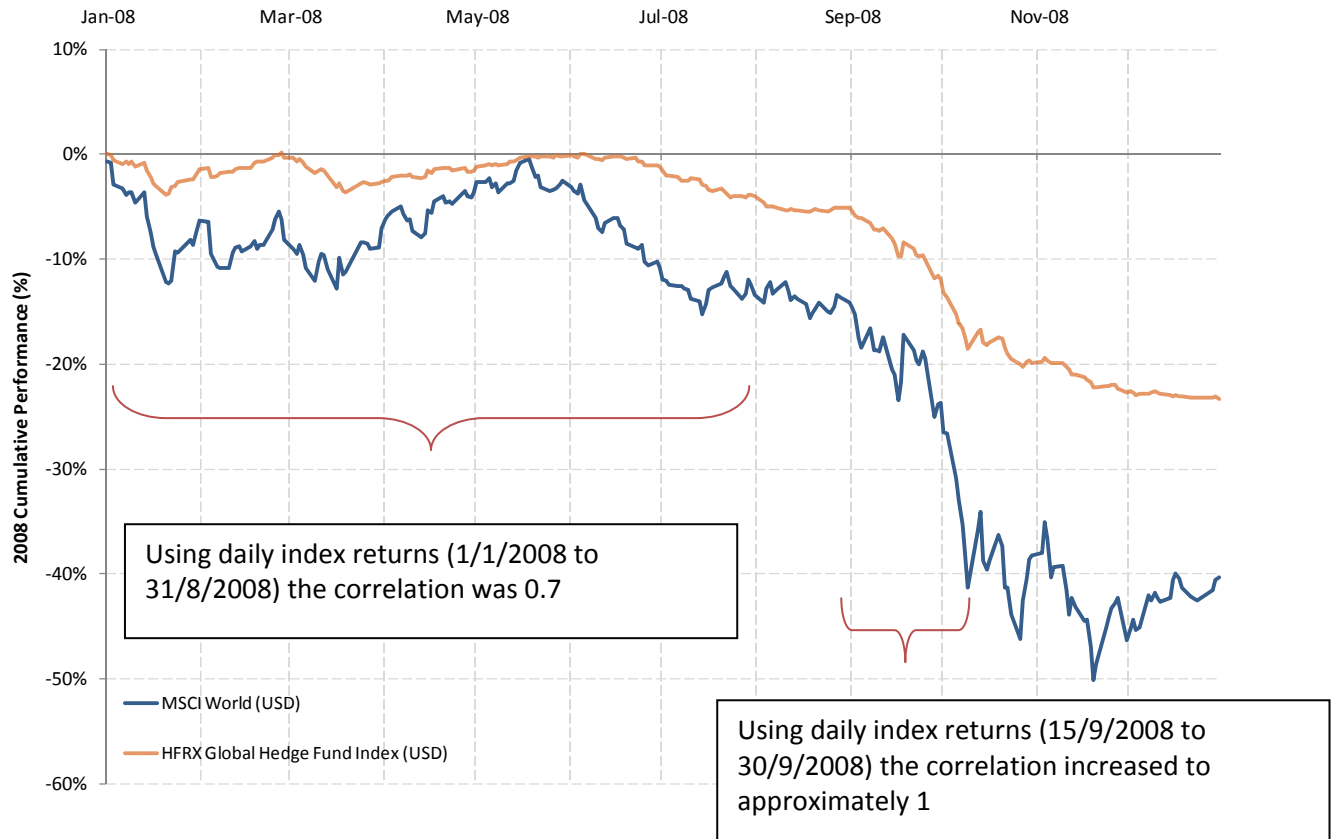
Asset class	2001	2002	2003	2004	2005	2006	2007	2008	2009 to end June
HFRI Fund Weighted Composite Index (USD)	4.62%	-1.45%	19.55%	9.03%	9.30%	12.89%	9.96%	-19.03%	9.46%
Citigroup World Govt Bond Index (AUD Hedged)	7.37%	11.22%	5.58%	8.96%	7.54%	3.93%	7.02%	13.42%	0.50%
MSCI World ex Australia Index (AUD unhedged)	-9.64%	-27.13%	-0.28%	10.42%	17.39%	12.02%	-2.14%	-24.88%	-8.79%
S&P ASX 200 index (AUD)	10.36%	-8.77%	14.61%	27.99%	22.83%	24.22%	18.59%	-38.45%	9.08%
Balanced Fund Proxy*	4.23%	-6.93%	7.91%	15.74%	15.80%	14.66%	10.06%	-18.21%	0.43%

Asset class	From 31/12/1990 to 30/6/2009		
	Return (p.a.)	Standard deviation (p.a.)	Correlations to HFRI Fund Weighted Composite Index based on monthly returns
HFRI Fund Weighted Composite Index (USD)	12.30%	7.20%	
Citigroup World Govt Bond Index (AUD Hedged)	9.00%	3.10%	-0.1
MSCI World ex Australia Index (AUD unhedged)	5.90%	13.30%	0.5
S&P ASX 200 index (AUD)	10.40%	13.30%	0.7
Balanced Fund Proxy*	8.50%	7.00%	0.7

As shown in Figure 2, throughout their history, a diversified portfolio of hedge funds (after fees) have outperformed every asset class and combination of asset classes. Falling equity markets, while reducing the performance of hedge funds, appear to be only one factor which can impact hedge fund returns. In calendar year 2008, it was a tightening of liquidity conditions, accompanied by necessary but unpredictable government intervention (e.g. orchestrating a bail out for Bear Stearns but permitting Lehman Brothers to fail (15 September 2008); and various global governments led by the US restricting the use of short selling (September 2008) which also contributed to the diversified hedge fund portfolio losses.<sup>2</sup>)

<sup>2</sup> A&Q Industry Research, 2009

Figure 3: 2008 performance of HFRX Global Hedge Index (USD) versus MSCI World (USD)



Importantly, most diversified portfolio of hedge funds are implicitly or explicitly targeting a higher return than sovereign bonds, and have delivered at least historically (as shown in Figure 1). Any asset allocation decision to hedge funds needs to consider the actual risks and return characteristics of the investment rather than what has been historically observed.

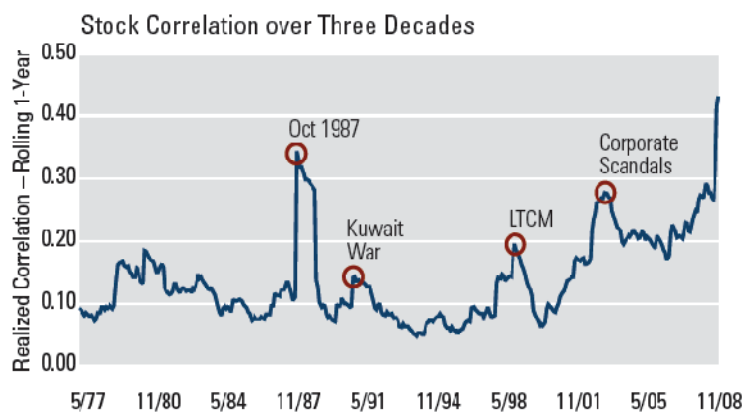
### The future return potential of hedge funds

The return potential of hedge funds remains strong. Much of the herd behaviour of investment market and the impact of government regulations and constraints create massive inefficiencies which unconstrained investors (e.g. hedge funds and some long-term investors) can - and do - exploit. Opportunities currently abound across asset classes and between securities and sectors within asset classes, and even more so in non-traditional investments, such as convertibles, in which certain hedge funds specialise in trading.

These opportunities are currently present as a reflection of the recent market environment. Hedge funds are similar to long only active managers in many respects, including that the opportunity to deliver returns is linked to the level and changes in the level of stock dispersion within the market.

AllianceBernstein showed that reduced stock dispersion (or high stock correlation) had a significantly negative impact on the active manager's ability to outperform in 2008<sup>3</sup>. As Figure 4 below shows, stock correlation in 2008 was at historical highs. The correlation between stocks is expected to reduce going forward, allowing more opportunities for active managers to exploit the spread between individual stocks and deliver greater returns.

Figure 4: Stock correlations at historic highs



Universe is largest 1,900 US Stocks.  
Source: Wellington Management

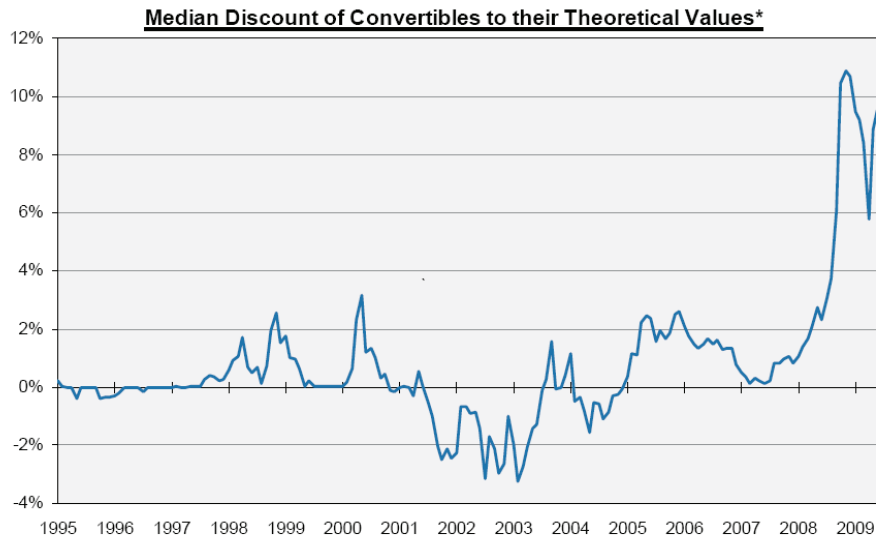
In addition to capturing the prospect for higher active management returns from higher dispersion between securities, hedge funds may also benefit from investing in other less efficient areas of the investment markets. According to the HFRX Convertible Bond Arbitrage Index, the average fund was down approximately 58% in 2008. This sell-off of convertible bonds was unprecedented in its magnitude, as managers were forced to unwind positions in very illiquid markets. This caused many convertible bonds to trade at significant discounts to their theoretical values<sup>4</sup>. For the first half of 2009, the HFRX Convertible Bond Index returned 20.4% and posted a further 6.7% gain for the month of July 2009. It is important to note that convertible arbitrage managers typically use techniques which mitigate the exposure of the convertible bond to movements in the underlying stock and credit.

As shown in Figure 5, at 30 June 2009, convertible bonds remained at theoretically cheap levels due to the significant amount of issuance – AQR Capital Management stated that global issuance was up four-fold in the first quarter of 2009, albeit off a low base, thus keeping convertible bond prices attractive.

<sup>3</sup> Alliance Bernstein, "No Time to Be Passive – Get Active Now" (January 2009).

<sup>4</sup> AQR Capital Management, June 2009, "The convertible bond market dislocation of 2008: Creating opportunities in 2009 and beyond"

Figure 5: Median discount of convertibles to their theoretical values



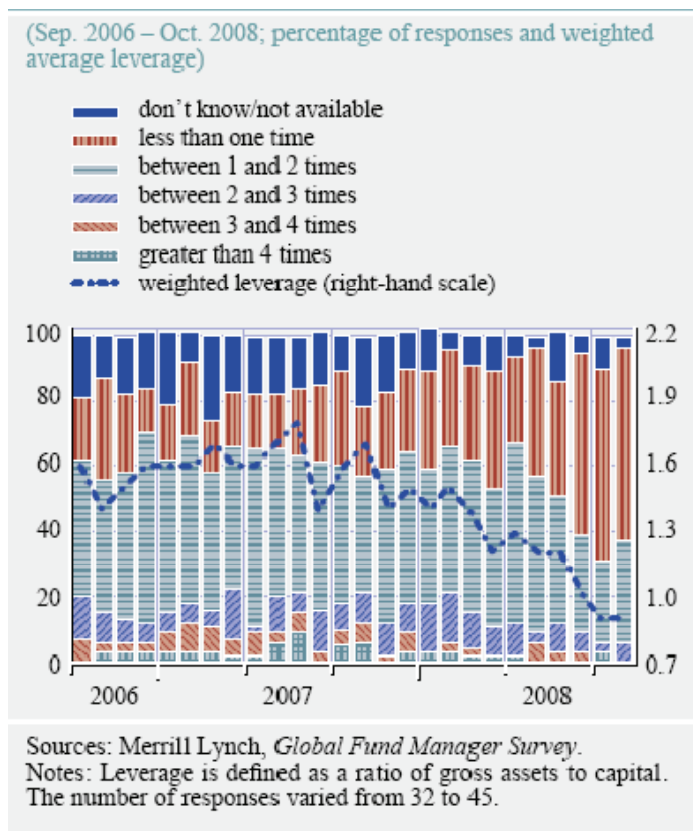
\* This represents the median cheapness of the universe of convertible bonds that have a moneyness of above 0.65  
 Source: AQR Proprietary Models. Data updated through 06/30/2009. Theoretical values are hypothetical in nature.  
 Please see important disclosures on the last page.

As a result of the unprecedented government response in 2008/9, liquidity is now returning to the financial system and there is evidence to suggest hedge fund redemptions have stabilised.

Figure 6 shows that the majority of managers are unlevered – that is, their gross asset exposure does not exceed their capital – and those that do employ leverage are around the level of one and two times. This is a marked decline from historic levels and reflects the deleveraging of the hedge fund industry. Generally hedge funds have less access to leverage in the present environment, however, there are two things in their favour: first, the opportunities are so great that less leverage (if any) is needed to generate very attractive risk adjusted returns; and, second, there are far fewer hedge funds<sup>5</sup> and much less competition in the hedge fund space from investment banks, which should make capturing these inefficiencies much easier for those who have survived.

<sup>5</sup> CreditSuisse Tremont, 2009, “One for the History Books: Hedge Fund Performance in 2008”

Figure 6: Leverage of hedge fund managers



With little transparency into the level of future corporate earnings and the end of the deleveraging cycle difficult to predict, it is not the time to be reducing a portfolio's diversification.<sup>6</sup> As shown above, hedge fund strategies offer diversification benefits to a portfolio through their low volatility and long term low correlations to existing strategies.

Many institutional investors' experience has shown that what have been classified as hedge fund techniques can lessen a balanced fund portfolio's dependence on one economic scenario: the perfect world of improving global growth and stable inflation rates which fuel equity markets.<sup>7</sup>

If a less than perfect scenario unfolds, like slowing growth or rising inflation, there is a very real chance that most traditional balanced funds will not achieve their performance objectives. Few would contest that moving away from this dependence would be of great benefit by dampening an investment portfolio's losses in times of recession and facilitating the compounding of positive returns which is the key to generating wealth.

<sup>6</sup> Michael O'Dea, April 2009, "Don't get rid of Hedge Funds, get control of them", *Investment and Technology*

<sup>7</sup> JANA internal research

## De-constructing hedge fund returns

Investors have a wide range of potential investment opportunities from buying shares in listed companies, investing in the perceived security of government bonds, to investing in retail shopping centres to name just a few examples. Despite the variety and complexity of investment options, there are in essence only a few drivers of return and these extend to diversified portfolio of hedge funds. Although this is going back to investment basics, this is often overlooked when in fact it ought to be the starting point of ensuring adequate portfolio diversification.

Figure 7: Hedge fund return drivers

Traditional market exposures	<ul style="list-style-type: none"> <li>• Growth, credit cycles, and public debt drives</li> <li>• Corporate earnings</li> <li>• Interest rates</li> </ul>
Liquidity risk	<ul style="list-style-type: none"> <li>• Compensation for giving up the ability to rebalance, reinvest, cash flow management</li> </ul>
Manager skill	<ul style="list-style-type: none"> <li>• Security selection</li> <li>• Market timing</li> <li>• Control value add (e.g. private equity)</li> </ul>
Underwriting risk	<ul style="list-style-type: none"> <li>• Event risk (what if company X does not buy company y)</li> <li>• Writing options</li> <li>• insurance</li> </ul>

Source: Citigroup<sup>8</sup>

The generation of returns from exposures to traditional markets – that is, benefiting from owning financial claims on growing earning streams or by what other investors are prepared to pay for those earnings (i.e. beta) – accepting illiquidity, and accessing true manager skill – that is, profiting from exploiting momentary mis-pricings of securities/markets (i.e. alpha) – is common to both hedge funds and traditional investment managers.

However, hedge fund managers can also generate returns by underwriting risk. Also referred to as alternative beta, underwriting risk at its essence involves charging a premium to assume the risk of a potential large loss. This is not necessarily an undesirable exposure – insurance companies earn revenue and serve an important function in society by assuming event risk. A well run insurance company can be profitable, particularly given scale and exposure to a well diversified set of possible events.

When investors pursue short option strategies or purchase high-yield bonds, they take on similar risks and, as compensation, sellers of options earn an explicit premium. Many of these opportunities can only be exploited by those with the ability and expertise to use derivatives, short selling and leverage. To date, this has been the exclusive domain of hedge fund managers.

<sup>8</sup> Vineet Budhraj and Ryan Meredith, 2006, "Asset Allocation: A New Paradigm", *Citigroup Alternatives Investments Journal*



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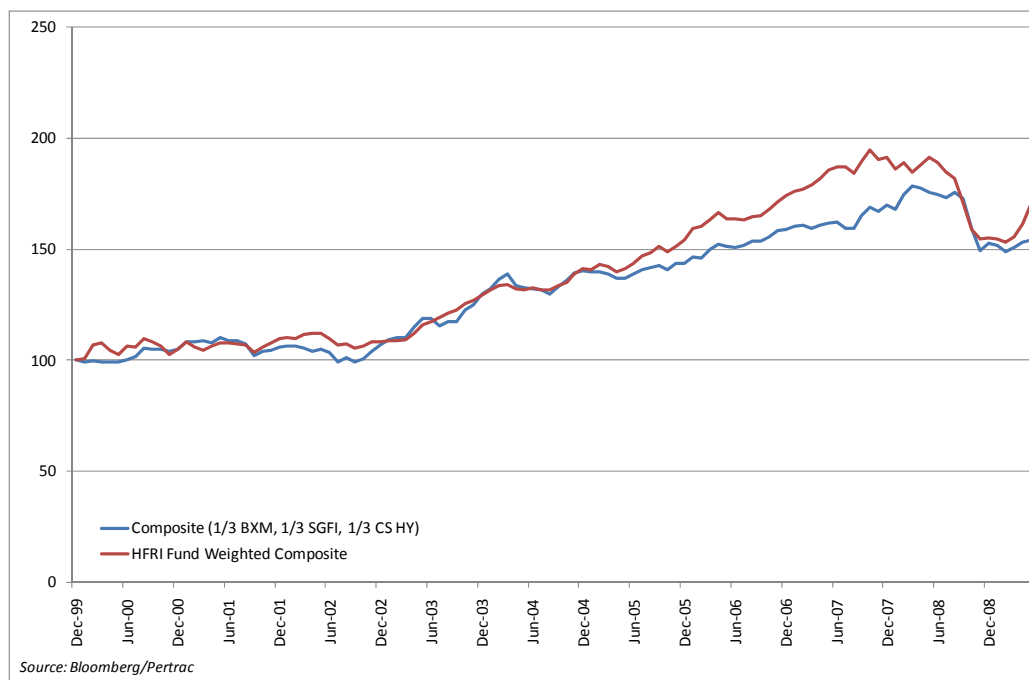
To illustrate the different return drivers, Figure 8 contrasts the HFRI Fund Weighted Composite Index against a naïve strategy index. The latter is comprised of an equal weighting of:

- Credit Suisse High Yield index – representing one form of traditional beta);
- the SGFI index<sup>9</sup> - a commodity trend following model, the SGFI index is a systematic approach to capturing inherent returns by assuming the risk that commodity hedgers seek to transfer. The index takes long or short positions in each of 25 different futures markets depending on a long-term trend following system. The manner in which the SGFI gains exposure to the market can be compared to the payoff function of an option straddle. When there is significant price movements (up or down), the index earns a positive return.; and,
- the BXM Index – which “buys” the S&P500 and then writes a call option in return for a premium.

Each index is represented in US dollars.

The SGFI and BXM indices represent “underwriting risk” using the techniques of taking on risk from commercial hedgers in the case of SGFI or explicitly writing options in the case of the BXM. Both indices could be viewed as a type of passive strategy as there is no active decision as to whether option premium is high or low or markets are cheap or expensive. The skill lies in designing the rules of the index and executing in derivative markets.

**Figure 8: HFRI Fund Weighted Composite index versus Naïve Strategy Index**



<sup>9</sup> Lars Jaegar, Pietro Cittadini, Michel Jacquemai, 2001, “The saisGroup Futures Index (SGFI) – A New Passive Futures Investment Strategy”

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Over the time period considered (December 1999 to May 2009), the naïve strategy index returned 4.7% per annum with 6.8% annualised volatility against the HFRI Fund Weighted Composite Index of 5.8% per annum with 7.1% annualised volatility. The difference in performance can be explained by:

- other market exposures (that is, those market exposures not captured in the naïve strategy mix e.g. global equities);
- manager skill, which may exist in the HFRI Fund Weighted Index (that is, stock selection and ability to make money from timing allocations to investment markets);
- investment management fees; and,
- an illiquidity premium, which again the naïve benchmark does not capture because it is invested in liquid strategies only whereas the HFRI Fund Weighted Index has the ability to invest in less liquid areas of the market.

Notwithstanding that the naïve strategy portfolio has no ability to change with the hedge fund industry, it does raise an interesting question as to whether there is a less expensive way to gain exposure to hedge fund return drivers.

**Reward alpha but begin by understanding it**

Alpha-beta separation is founded on the principle of disaggregating portfolios into market exposure and manager skill. This allows the un-bundling of fees into the lower-fee beta and higher-fee alpha components, resulting in far lower fees in a total portfolio context and ensuring that managers do not earn performance fees on returns generated from the portfolio's passive market exposure.

For example, a long short equity manager that maintains a 60% net long exposure to the S&P 500 equity market over time should expect a return of 6% attributed to simple market exposure if the S&P 500 increases by 10%. Under today's hedge fund industry convention, the manager would get paid 20% of any performance above zero. In this case, the manager would generate a performance fee of 1.2% for passive exposure to the equity market. This is not an appropriate remuneration structure.

It is possible to take the approach of alpha-beta separation one step further, by identifying the underlying risk premium that certain hedge fund strategies capitalise on, before manager skill comes into play.

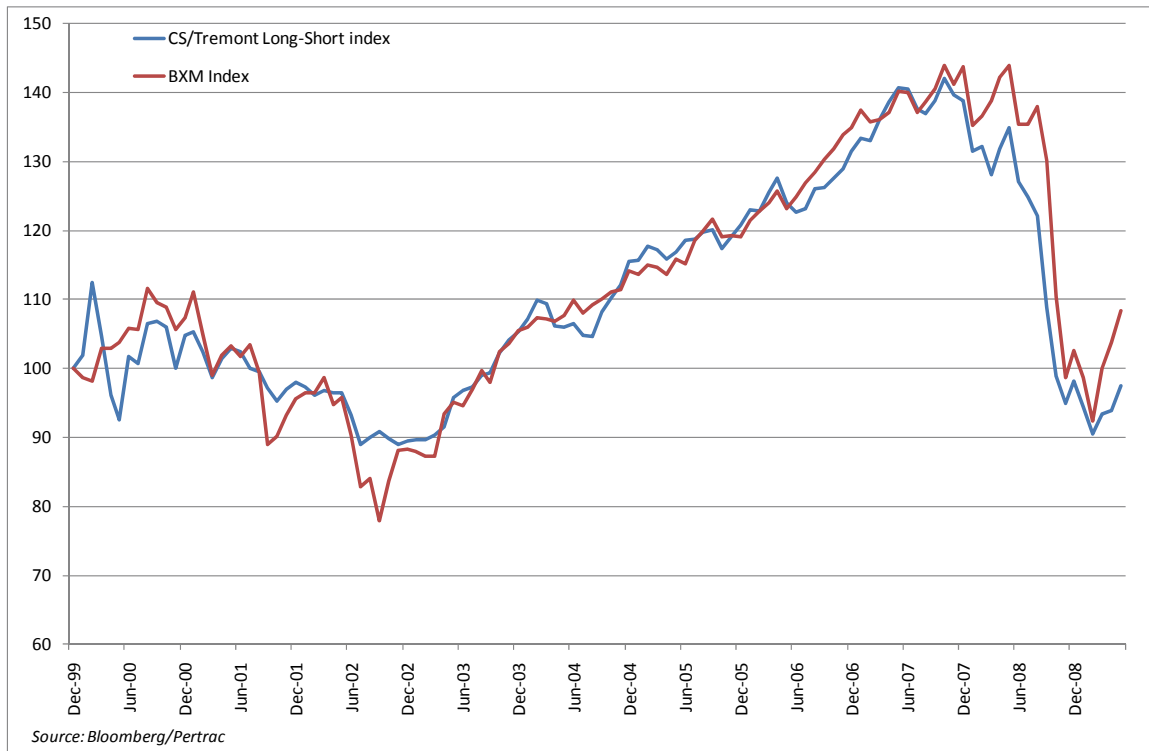
*Example 1 - Long short equity*

As an example, take the performance of Credit Suisse Tremont Long Short Index (USD) which tracks the performance of a number of long short equity managers<sup>10</sup>, against a the BXM index, the simple buy write strategy over the S&P 500 Index, described in the previous example. As Figure 9 below illustrates, this naïve strategy has tracked the performance of the long short equity index quite closely over time.

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<sup>10</sup> Please refer to the Credit Suisse/Tremont website for index construction methodology.

Figure 9: Long Short Equity returns versus Buy Write Strategy



Individual long short equity manager returns will vary from the performance of Credit Suisse Tremont Long Short Index, therefore investors will benefit from selecting the better managers. However, exploring ways to capture the average long short equity return via a systematic rules based approach raises the minimum acceptable rate of return for all managers, as it provides a reasonable and easily investable alternative.

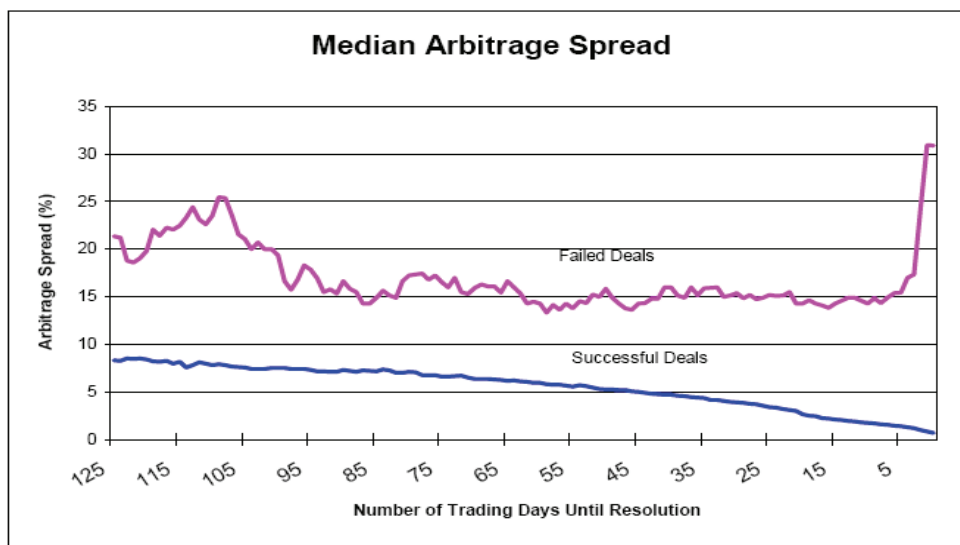
### Example 2 - Merger Arbitrage

Merger arbitrage is an investment strategy that involves investing in securities of companies involved in mergers and acquisitions. Tender offers for a merger are usually made at a significant premium to the pre-announcement share price. After the deal announcement, the target company's stock typically trades at a discount to the offer value as there is a possibility that the merger will fail and the stock price will drop back to the original pre-announcement level. If the deal is successful, the merger arbitrage manager profits from this uncertainty spread. However, if the merger fails, the arbitrage manager incurs a loss, typically greater than the profits obtained if a deal succeeds. In this way, the return of the merger arbitrage strategy is the risk premium for taking exposure to deals that are not certain to complete successfully.

Skilful merger arbitrage managers can enhance returns by avoiding the deals that are unsuccessful. In 2001, Mitchell and Pulvino completed a study that looked at returns from investing in all available

merger deals from 1963 to 1998 (4750 deals) with a pre-specified entry and exit strategy<sup>11</sup>. The returns that result had very similar characteristics to the returns of most merger arbitrage hedge funds over the 1990 to 1998 time frame for which live hedge fund data is available. In this way, the returns of this group of hedge funds can be largely replicated by investing in all announced merger deals, as it appears that the deal premium shown in Figure 10 appears to reflect the risk of the merger not proceeding to completion.

Figure 10: Median arbitrage spread



**Figure 1:** This figure plots the median arbitrage spread versus time until deal resolution. The arbitrage spread is defined to be the offer price minus the target price divided by the target price. For failed deals, the deal resolution date is defined as the date of the merger termination announcement. For successful deals, the resolution date is the consummation date.

Other hedge fund strategies are more complex and less easy to replicate, compared to the above examples. However, as investors' understanding of hedge fund strategies develops, a natural consequence will be an improvement in the way in which manager skill is measured, portfolios are constructed, and hedge fund managers are compensated.

Unlike traditional risk premiums (equities, bonds etc), alternative betas like Merger Arbitrage require a higher level of expertise in the use of derivatives and short selling in order to extract the excess returns. However, the fact that they appear systematically replicable implies that returns from the strategy may not entirely be due to manager skill. If true, the ramifications are significant in reducing fees and raising the bar for hedge fund managers to demonstrate that they do in fact have skill which is difficult to isolate and replicate.

Performance fees will most likely remain a feature of the hedge fund industry in the medium term, however using more sensible hurdles ensures that managers are only rewarded for genuine skill and not for passive beta or alternative beta exposures.

<sup>11</sup> Mitchell and Pulvino, 2001, "Characteristics of Risk and Return in Risk Arbitrage"

## Hedge fund investment risks

It is important when considering an investment in hedge funds to evaluate the major risks involved and have a strategy to address and manage them. These include:

- **Strategy risk:** Strategies can go out of favour due to a change in market conditions or environment. For example, merger arbitrage strategies have less investment opportunities as merger and acquisition activity slows.
- **Correlation risk:** In times of market stress, some strategies become more correlated to the mainstream markets and, in particular, equities.
- **Leverage:** Leverage, which magnifies both positive and negative returns, is employed by hedge funds to different degrees.
- **Low liquidity:** A reduction in the liquidity of markets can affect both returns (through higher trading costs) and constraints on the ability of managers to finance some positions.
- **Process risk:** Particularly in times of market stress or a change in market fundamentals, a previously successful investment management or risk control process may break down. From time to time, specialist managers have blown up, especially those using models or processes that rely on historical correlations or relationships in the markets. A good example is the challenges faced by quantitative strategies (whether long only or long/short) in August 2007 and through to 2008 due to deleveraging by market participants and short selling restrictions.
- **Style drift:** The risk of managers drifting away from their stated investment style and process is greater for specialist hedge funds given that managers usually rely on a narrowly defined strategy to add value.
- **Personnel:** Many hedge fund managers are relatively small in terms of total staff numbers, and the loss of key personnel is often more disruptive than for traditional managers.
- **Transparency and Corporate Governance Risk:** The level of disclosure of portfolios and transactions is significantly less for hedge funds than traditional portfolios.
- **Operational Risk:** Some of the major risks of hedge fund investments are operational (back office, transparency, valuations, etc), given the use of short selling and wider use of derivatives.

Volatility (as measured by standard deviation) is in some instances a very poor measure of risk. Volatility of portfolios can be artificially reduced by including allocations to less liquid investments. The valuation of some securities which do not trade on exchanges may not reflect the true market clearing value of those securities, and periodic valuations may make those securities appear to have lower correlation properties than is in fact the case. A simplistic example is an investment in residential property. A home-owner may have a recent valuation of his/her property but unless it is actually auctioned, there is no knowing the market clearing price for the property – and the result can vary significantly depending on the day.

A further reason volatility is a poor measure of risk, particularly for hedge funds, is due to non-linear risk/return payoffs of certain securities, like options, commonly used by hedge fund managers.

### Resolving structural issues

Adhering to simple principles that are particularly pertinent for investing in hedge funds can mitigate a number of risks and resolve many of the structural flaws apparent in some areas of the hedge fund industry in 2008:

1. **Limit the hedge fund manager's ability to transfer cash** out of the prime broker / custody account. Without ownership of the individual securities at the investment fund level, there should be very high operational due diligence hurdles to avoid incidents of fraud.
2. **Demand position level transparency** from an independent source and employ appropriate third party risk management systems. This enables a clearer picture of the risk in the portfolio at the manager level and at the aggregate portfolio level. Do not rely on the manager to provide this data.
3. **Ensure that liquidity being offered is the liquidity of the underlying instruments.** Do not invest in investment vehicles that run a liquidity mismatch between their underlying manager vehicles and obligations to counterparties (e.g. FX hedging counterparties) or investors. Some Fund of Hedge Fund (FOHF) managers offer monthly liquidity despite the FOHF itself investing a portion of its assets in hedge fund managers with lock ups. As a result, the FOHF may be unable to meet redemption requests and, worse, not be able to pay foreign exchange hedging currency margin calls due to insufficient cash being available, leading to the closure of these currency hedges, and some FOHF portfolios being left exposed to the vagaries of the currency markets.
4. **Avoid managers/strategies that employ too much leverage.** The degree of leverage which is too much will depend on the hedge fund strategy but highly leveraged strategies have blown up in the past and are at risk of doing so again in the future.
5. **Invest in exchange traded instruments wherever possible** as this mitigates counterparty risk.
6. **Pay fees that are reasonable, appropriate and commensurate with the managers' skill** and re-investment into research (often an investment in future excess returns). Investors should avoid paying performance fees simply to get returns from equity or credit market exposure. Performance fees may be desirable in circumstances where the benchmark is well defined.
7. **Align the risks of the investment with the remuneration of the manager.** There is little sense in paying away 20% of the upside but assuming all of the downside.

Issues around transparency, asset ownership and control can be addressed via an investment in a managed account platform whereby the investor, rather than the manager, has the fiduciary control over the underlying investment positions created by the investment manager. This is very similar to the use of a custodian account for most investors with traditional mandates.

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Until recently, managed account platforms have not played a significant role in institutional or retail exposures to hedge funds, however given the issues experienced in the hedge fund industry in 2008, managed account platforms will likely play an increasingly integral part of the solution for investors wanting to benefit from hedge fund investing, but have concerns over the key issues of fees, transparency and control.

**Conclusion**

Diversified portfolios of hedge funds have outperformed balanced fund portfolios since credible records began in December 1991. However, investors have been disappointed with recent experiences of hedge funds, exacerbated by high fees, lack of control of assets and, in the extreme, incidents of outright fraud. With price dislocations still present in the market and a flexible approach to investing, the prospects for hedge fund returns have never been better. There are lessons to be taken from the experience of 2008 and resolving the structural flaws of hedge funds will be one important step forward in the chase for higher, more stable returns.