Sociology explains changing role of funds of funds

Aug 22nd, 2010 | Filed under: Hedge Fund Industry Trends, Today's Post | By: Alpha Male

The rise and (oft reported) fall of funds of funds have been a fundamental trend in the hedge fund industry over the past few years. So fundamental, in fact, that sociologists have now taken notice. A recent academic paper by Edward Smith of the University of Chicago examines the birth and recent travails of the funds of funds industry through a sociological filter.

Smith argues that by acting as a buffer between end investors and hedge funds, funds of funds have facilitated the growth of unique, idiosyncratic hedge funds – the funds that many point to as the life blood of the hedge fund industry.

In sociology-speak, Smith writes:

“...relational flows in markets are more than conduits for goods and capital. Embedded in these flows are expectations held by one party with respect to another...by identifying places in the market where expectations are least likely to flow, researchers may be able to pinpoint segments primed for organizational variation, innovation, and change.”

While this surely sounds like humanities gobbledygook to you MBAs, CFAs, and CAIAs, read on. Smith makes some useful observations about our industry – the kinds of observations that can really only come from an industry outsider.

**LTCM and the rise of funds of funds**

Based on extensive interviews with fund managers and a thorough review of performance data, Smith concludes that funds of funds were largely “intermediators” prior to LTCM. In other words, their role was to aggregate managers and basically just deliver them to end investors.

However, he continues, LTCM changed all that.
“Following the 1998 crisis, funds of funds reacted to an opportunity to capitalize on investors’ worries and calls for increased due diligence. It was in this reaction that funds of funds began a role shift, from intermediaries to mediators.”

Unlike an “intermediary”, a “mediator” filters information between two parties. Funds of funds, writes Smith, began to take a more active role in picking managers – managers, that end investors would probably not have otherwise selected because they were too niche. They did this, in Smith's view, by

“…recasting themselves in the eyes of potential investors by being on the same (buyer) side of the market…not simply conduits for investor capital, but as investors themselves.”

Sound familiar to anyone?

By doing this, funds of funds “carved out room for new and different hedge funds”, ones that might have scared off end-investors had those investors been forced to invest directly.

Smith quotes one interviewee who summed up the post-LTCM environment as a time of diversity...

“When funds of funds really started controlling a significant bit of the capital in the market, I think hedge fund managers all of a sudden had a lot more discretion about what they were doing. You weren’t answering anymore to the individual investors and the consultants they worked with. So, yeah, it was kind of liberating in that way. I had a lot more power as a portfolio manager.”

Smith correctly assumes that end investors (pensions, endowments, family offices etc.) get nervous when they see screwy, idiosyncratic hedge fund strategies. But funds of funds, with their mandate to diversify-away idiosyncratic risks, often love these screwball managers who seek alpha in off-the-beaten-path locations.

By “mediating” end investors’ demands to fully understand the strategies of underlying manager, funds of funds effectively reduced transparency in the hedge fund industry. While this may sound like a negative development, it actually paved the way for the explosion of idiosyncratic single-manager hedge funds that exploited previously untapped market inefficiencies (thus, as an aside, creating more efficient markets for all).

Madoff and the (reported) demise of funds of funds

So what happens if you remove the influence of funds of funds? As we have reported on these pages, funds of funds have hit a soft spot recently and some research suggests their influence is waning.

Smith warns that the process works in reverse. Few funds of funds means that end investors would once again come to dominate the landscape. The result, he says is an increase in transparency and a resulting drop in “atypical” underlying managers, come with negative consequences…
“By increasing transparency, funds of funds thus forgo their status as mediators and revert to serving an intermediary function...When that portfolio contains atypical entities, the fund of funds manager has no choice but to cut those funds loose...When a fund of funds drops an atypical fund from its portfolio, the resulting level of heterogeneity in the industry goes down, even if only by a tiny margin.”

He points to hedge fund liquidation data as proof that niche funds are more susceptible to failure. Specifically, he finds that “When funds of funds revert to intermediary status, constraints flow once again and atypical funds are selected out of the market.

In other words, atypical “niche” funds are the first species to become extinct when the investment climate changes.

Ergo, the Madoff fiasco may have a lasting and fundamental impact not just on the fund of funds industry, but on the diversity of the hedge fund industry itself. A tragic bookend to LTCM? Or an opportunity for end investors to embrace the heterogeneity that makes the hedge fund industry such a dynamic one? Time will tell.

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