ADVISOR PERSPECTIVES

David Swensen Speaks Out: Are Hedge Funds of Funds a Cancer?

Robert Huebscher
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Yale endowment manager David Swensen set off alarms throughout the investment community with the following remarks, which he provided in a January 13 interview with Wall Street Journal reporter Craig Karmin:

> **WSJ:** *What about fund of funds and consultants? Can they be a solution?*
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> **Mr. Swensen:** Fund of funds are a cancer on the institutional-investor world. They facilitate the flow of ignorant capital. If an investor can't make an intelligent decision about picking managers, how can he make an intelligent decision about picking a fund-of-funds manager who will be selecting hedge funds? There's also more fees on top of existing fees. And the best managers don't want fund-of-fund money because it is unreliable. You need to be in the top 10% of hedge funds to succeed. In a fund of funds, you will likely be excluded from the best managers. [Mr.] Madoff also relied enormously on these intermediaries. He wouldn't have had nearly as much resources were it not for fund of funds.
>
> Consultants make money by giving advice to as many people as possible. But you outperform by finding inefficiencies most of the market has not yet uncovered. So consultants ultimately end up doing a disservice to investors.

We believe Swensen's arguments are misplaced. The data show hedge funds of funds performed extremely well during the challenging environment of 2008:

	2008 Return	2008 Std Dev (1)
S&P 500	-37.0%	21.0%
MSCI World	-40.3%	23.9%
HFRI Fund of Funds: Composite Index (2)	-20.7%	9.2%
HFRI Fund of Funds: Diversified Index (3)	-20.1%	8.9%
Yale	-25.0%	??

See notes at end of article.

Those investors Swensen characterizes as ignorant not only significantly outperformed broad-based indices in 2008, they also outperformed Yale's endowment. Moreover, much of Yale's money is invested in private equity deals

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that are infamously priced (marked) in a very generous manner. Many suspect Yale is down 30-35%, not the 25% Swensen suggests.

Professional management, such as that offered by funds of funds, is worth a fee, and the "assembly charge" used to build portfolios can either be a bargain or a rip-off depending on (1) the skill of the assembler and (2) the size of the fee. Our article, Don't Pay Alpha Fees for Beta Performance, examines the key issues in the selection process – for example, whether funds are using leverage to disguise beta as alpha. The data above suggests that fund of funds managers are able to select skilled managers and reject the less skilled ones.

Taking Swensen's arguments to the extreme would lead to the conclusion that mutual funds are a cancer on the individual-investor world. Swensen would argue that, if you can't even decide which stocks to own, how can you decide which mutual fund to invest in? They are a conduit for ignorant investors...

We don't accept this view of the mutual fund industry, and see no reason to accept Swensen's view of the hedge fund of funds industry.

Finally, we provide a response written by Ken Phillips, who runs a hedge fund of funds:

> Mr. Swenson's sheltered and hubris views are, more appropriately, a "cancer on the institutional – investor world." That Yale has elected to internally develop a large and expensive investment team, rather than retain outside advisors, is testimony to the many complex issues facing investors. Rather than pay a fee to an independent, experienced, and objective consultant, Mr. Swenson has taken those same monies and formed his own proprietary team, saving little in the long run and potentially compromising his objectivity as a Fiduciary. Although this financial option may be available to the largest institutions, it is not available to everyone; suggesting that all other investors be banished to the world of passive investing is naïve and foolish. Shame on Mr. Swenson for bullying and maligning investment consultants, an industry that for more than forty years has placed the interests of investors before its own. Hopefully the future performance of the Yale Endowment will allow Mr. Swenson to differentiate his returns from those of the masses – during 2008, a great test of skill, the average fund-of-hedge-funds, with the burden of their fees and purportedly less brilliant management, has meaningfully beaten his bogey.
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> Kenneth S. Phillips
> RCG Capital Partners, LLC
> One Boulder Plaza

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1301 Canyon Blvd.
Boulder, Colorado 80302

Notes:

(1) Monthly Standard Deviation Annualized
(2) Fund of Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The Fund of Funds manager has discretion in choosing which strategies to invest in for the portfolio. A manager may allocate funds to numerous managers within a single strategy, or with numerous managers in multiple strategies. The minimum investment in a Fund of Funds may be lower than an investment in an individual hedge fund or managed account. The investor has the advantage of diversification among managers and styles with significantly less capital than investing with separate managers.
(3) Funds of funds classified as "Diversified" exhibit one or more of the following characteristics: invests in a variety of strategies among multiple managers; historical annual return and/or a standard deviation generally similar to the HFRI Fund of Fund Composite index; demonstrates generally close performance and returns distribution correlation to the HFRI Fund of Fund Composite Index. A fund in the HFRI FOF Diversified Index tends to show minimal loss in down markets while achieving superior returns in up markets.

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