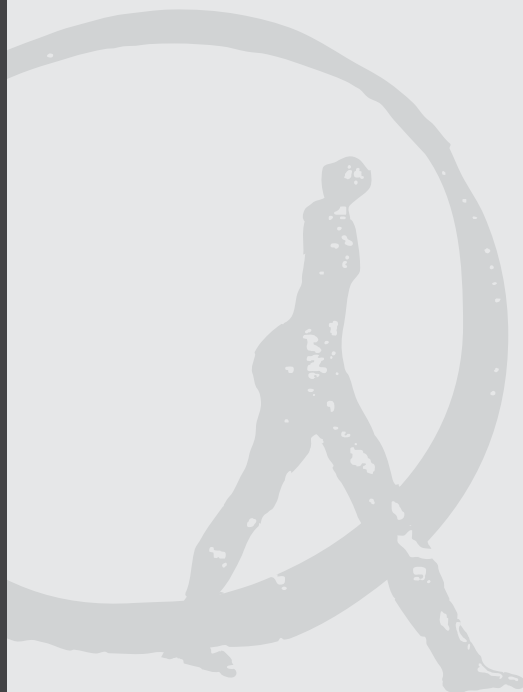


Taking a Close Look at the European Fund of Hedge Funds Industry- Comparing and Contrasting Industry Best Practices and Academic Recommendations

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EDHEC pursues an active research policy in the field of finance. EDHEC-Risk Institute carries out numerous research programmes in the areas of asset allocation and risk management in both the traditional and alternative investment universes.

Introduction

Over the last few years institutional investors' traditional portfolios have failed to meet their objectives in terms of risk and performance. Investors have thus shown growing interest in new forms of diversification, especially in investment vehicles that offer better protection during extreme market conditions. This has naturally led them to consider hedge funds as part of their investment universe. The massive arrival of institutional investors in an "industry" that up until then had been reserved to some High Net Worth Individuals or Endowments/Foundations resulted in a dramatic capital inflow and entailed a profound diversification of investors' risk profile.

This change in the alternative investment landscape obviously led to an in-depth contemplation of investment practices. With greater importance accorded to risk management, fund managers are compelled to abide by stricter transparency requirements (e.g. development of managed accounts and enhanced focus on hedge fund reporting) and tighter risk measurement and risk control procedures (e.g. development of in-house or external risk control systems, thorough due diligence, etc.).

Among the innovations that have largely contributed to fostering the growth of the alternative industry, funds of hedge funds (hereafter referred to as FoHF) increasingly stand out as the preferred investment vehicle for most institutional investors. According to Goldman Sachs & Frank Russell (2002), 89% of them were expected to invest in the hedge fund industry through a FoHF at the end of 2003, compared to 62% in 2001). A Hennessee group study (see Hennessee & Casey Quirk Acito, 2002) evaluated the global asset growth rate in the FoHF market to be 39.9% between 1999 and 2002. As a result, FoHF were estimated to represent 20-25% of global hedge fund industry assets as of December 2002 (see Goldman Sachs, 2003) and could, according to Financial Research Corporation (2002), represent up to \$1 trillion by the end of 2004.

Given the increasing importance of FoHF in the development of the hedge fund industry, in particular with respect to institutional investors, and given that multi-manager structures are often very *cost-intensive*, with a remuneration by management and performance fees levied in addition to the fees and the premiums of the single managers, questions are rising among investors on whether FoHF add value to an extent that justifies the extra layer of fees induced by their activity. To answer these questions from a European perspective, Edhec Risk and Asset Management Research Centre carried out one a survey of the best practices of European hedge fund multi-managers. This survey has focused on examining the following three dimensions that are commonly perceived as the main sources of added value by multi-managers, namely: i) fund selection; ii) asset allocation and portfolio construction; and iii) reporting and investor information. This survey is, to the best of our knowledge, one of the most comprehensive studies on the subject, with the participation of 61 European firms (investors, advisors and multi-managers) representing €136 billion euros under management (see next Section 4 for more details on the survey).

Our objective in this article is to report the results of this survey, and also to shed some light on the causes of the gap between practitioner and academic perceptions as regards to the approach followed by hedge fund multi-managers.¹ More specifically, our goal is twofold. On the one hand, we aim at presenting the best practices of the largest European multi-managers, at least as estimated from a rather representative sample, hence shedding light into what has remained so far a rather secretive industry. On the other hand, we attempt to compare and contrast these findings on what multi-managers *actually do* with academic recommendations on what multi-managers *should do*, hence capitalising on the large body of theoretical and empirical research devoted to the question of the costs and benefits of investing in hedge fund that has blossomed over the past few years.² As a result, it is our hope that this paper will be of interest to practitioners in this

1 - This article is a summary of the key findings of Edhec 'European Alternative Multi-management Practices' survey released in December 2003. This survey is a combination of permanent 'industry and academic intelligence' carried out within the Edhec Risk and Asset Management Centre and an in-depth analysis of the responses to questionnaires sent to a large number of industry representatives. The work was carried out by a team led by Noël Amenc with the support of Anne Delaunay, Jean-René Giraud, Félix Goltz, Lionel Martellini and Mathieu Vaissié. The 110 page report is freely available in PDF format on www.edhec-risk.com.

2 - Readers interested in information on academic research related to hedge funds may find it useful to visit the websites of various academic research centers devoted to the analysis of the hedge fund industry, including the European-based Edhec Risk and Asset Management Research Center (www.edhec-risk.com) or the US-based CISDM (www.cisdsm.som.umass.edu), among others.

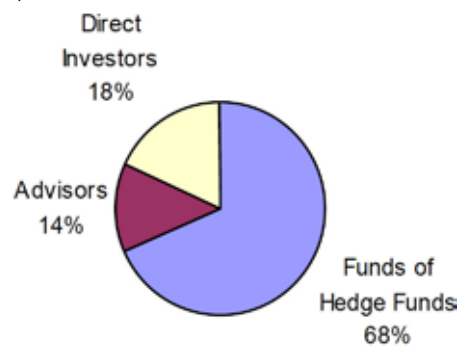
field, both from the sell-side (hedge fund managers and multi-managers, who will learn about the best practices of the largest amongst their peers) and the buy-side (investors, who will learn how these best practices contrast with academic recommendations) segments.

After a first section devoted to the presentation of the methodology, the remainder of this article is divided into three parts, corresponding to the three areas of a multi-manager's value proposition, namely asset allocation and portfolio construction, fund selection and reporting and investor information.

I. Methodology

In the summer of 2002, questionnaires for the Edhec European Alternative Multi-management Practices Survey were sent to the top 500 European asset managers, alternative multi-managers, and institutional investors. The purpose of the study was to get a better understanding of multi-management market within Europe. The study generated responses from 61 European alternative multi-management companies, representing a total volume of €136 billion of alternative assets under management at 31/07/02. It is important to note that our sample covers a wide variety of actors that are not usually included within surveys on multi-management practices, such as Funds of Hedge Funds (FoHF) managers who are actually marketing FoHF products, advisors to direct investors in hedge funds, and direct investors in hedge funds who have similar preoccupations to FoHF managers (see Exhibit 1 for the distribution of respondents by category).

Exhibit 1: distribution of respondents by category



The breakdown by country in the sample corresponds fairly well to the breakdown of the firms that compose the alternative multi-management landscape, notably as far as the dominance of the U.K. and Switzerland is concerned (see Exhibit 2). We do, however, note that answers from French asset managers are over represented in comparison to their weight among the leading firms. This can be explained by higher return rates to our questionnaires, as it was issued by a French institution.

Exhibit 2: Distribution of respondents by country

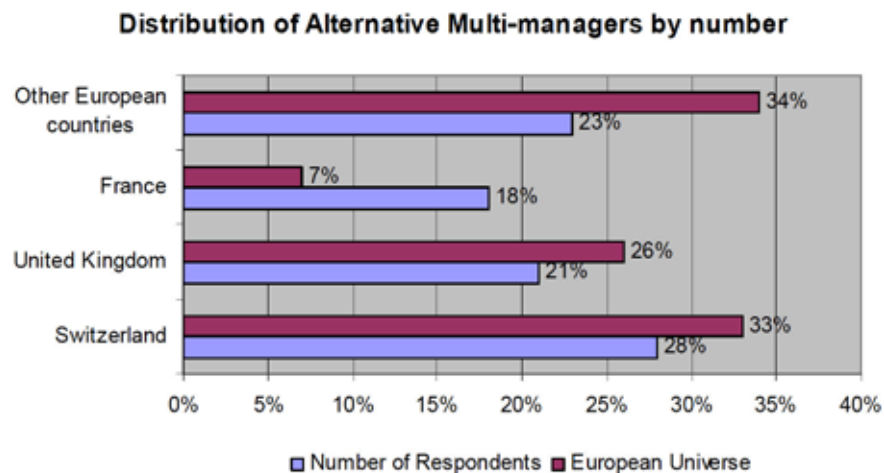
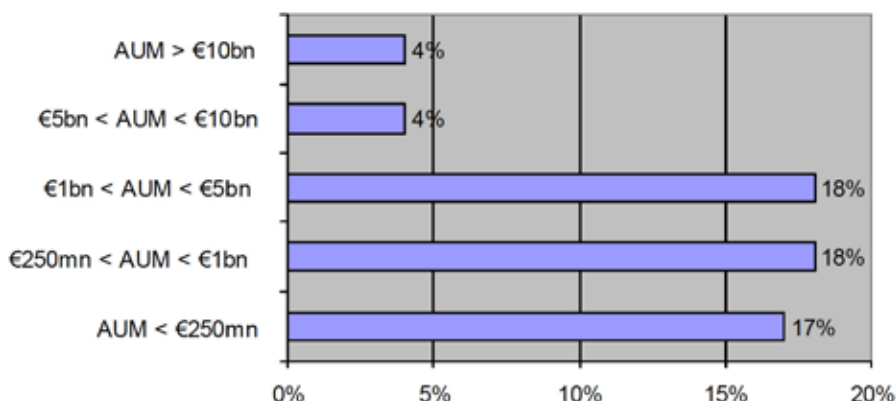


Exhibit 3 represents the breakdown of our respondents with regard to their average assets under management. We can note that 26 respondents (42% of the sample) manage more than €1 billion, which is not inconsistent with the fact that the 50 largest FoHF manage 90% of global assets. Our sample does not therefore suffer from any size bias.

Exhibit 3: distribution of respondents by size



Our results, however, should not be taken without caveats. A survey is indeed always subject to biases as a consequence of the questions that are posed. The content of a survey cannot claim to adhere to objectivity as the goals of the study, and the knowledge of the team who conduct the research, influence the orientation of the survey contents. Non-responses were considered to provide interesting information and were therefore documented when they clearly applied to a question. However, when a respondent did not cover a theme, the non-responses were not accounted for. Due to the number of responses, we are able to interpret the results on a pan-European level. On a country level, however, or when looking for differences between countries, we cannot derive any conclusions that would be representative. If we report the results for individual countries, this is done for illustrative purposes. The main conclusions we draw from the survey results are related to the entire sample rather than particular countries.

II. Fund Selection: Costly Value-Added

A significant gap between academic and practitioner approaches to fund selection

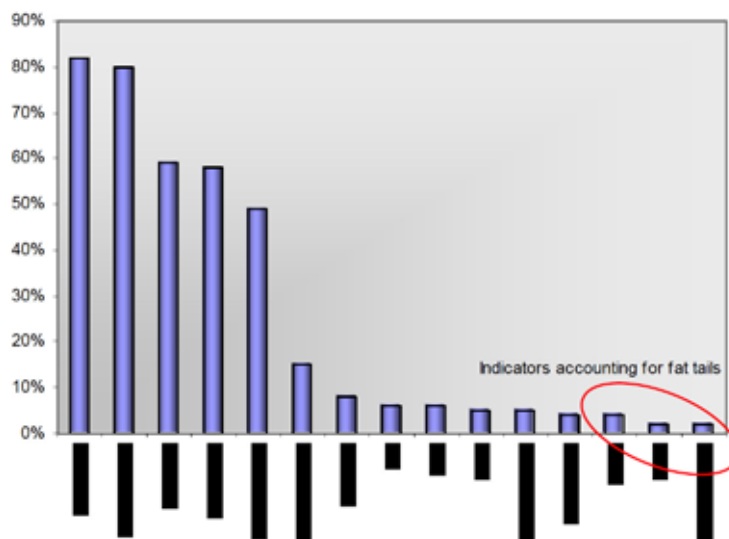
Identifying the most promising funds in an investment universe estimated by TASS at around 6,700 funds as of December 2003 is an extremely ambitious task, especially when information on individual funds is scarce. This is, however, what all FoHF have to do in the end. To shed some light on European multi-managers' practices we will put them in perspective with important issues such as the challenges raised by the specific risk profile of hedge funds, the problems posed by the quality of data in the qualitative analysis and the difficulty in quantifying operational risks.

Hedge funds gained dramatically in popularity during the last bear market, drawing many managers from the traditional world in their wake. Alternative investment strategies, however, present some specific features and as a consequence cannot be assessed in the same way as traditional investment vehicles. The problem is that those specific characteristics clearly appear to be largely ignored by European multi-managers, as can be seen from Exhibit 4. While it is widely recognised that hedge funds' returns are not normally distributed (Lo (2001), Brooks and Kat (2002), etc.), only 2% of European multi-managers pay attention to the 3rd and 4th order moments (i.e. skewness and kurtosis) of the return distribution. Indeed, most of them continue to prefer the traditional mean/variance framework to monitor manager performance, which is confirmed by the high percentage of investors, namely 82%, who consider the Sharpe ratio to be an important indicator. On the other hand, comparing the performance of hedge funds with the risk-free rate is obviously not consistent with the fact that alternative investment strategies

are exposed to a wide variety of risk factors (see Amenc *et al.*, 2003). In the same vein, only 6% of European multi-managers appear to pay attention to betas and none of them check the consistency of the investment style through style analysis. This is all the more annoying in that performance evaluation and exposure to risk factors are two sides of the same coin.

Note that 58% of European multi-managers declare that they use the Sortino ratio, which shows that the majority of them are concerned by the asymmetry of the return distribution function. Nevertheless, they turn out to be impregnated to a considerable degree by traditional world practices. While 80% of European multi-managers consider the drawdown ratio to be important to very important, only 2% compute Beyond VaR, which would be much more suited to accounting for hedge funds' outliers. In the same vein, only 4% of them compute the Omega ratio, whereas it has been evidenced in the literature that this indicator is more appropriate than the famous Sharpe ratio (see for example Keating, 2004). This reluctance to implement a new breed of indicators is all the more problematical in that Amenc *et al.* (2003) recently showed that investors who only take 1st and 2nd order moments into account greatly underestimate the extreme risk to which they are exposed.

Exhibit 4: Answer to the question "Which quantitative indicators do European multi-managers use when monitoring hedge funds' performance?"



More surprising perhaps is the importance given by 49% of European multi-managers to the information ratio. While most FoHF managers continue to market hedge funds as absolute return strategies, almost half of them pay attention to an indicator that uses the tracking error (i.e. relative risk) to adjust the performance for risk.

Hedge funds tend to be very secretive with respect to their proprietary investment strategy. As a result, investors are often provided with net of fees returns and selected microeconomic data (NAV, lock-ups, fees, minimum investment, etc.), and hardly anything else. But without any accurate information on the fund's strategy, it is difficult, if not impossible, to have an in-depth understanding of a fund's potential. Consequently, it is not feasible for investors to base their decision on a purely qualitative decision process, which is confirmed by the fact that none of the European multi-managers that took part in the survey use qualitative analysis only (see Exhibit 5). In the same way, we can note that only 7% of them use qualitative judgement from the very beginning of the fund selection process. Investors are therefore inclined to use quantitative analysis. However, this must be done with caveats. The hedge fund industry is still in its infancy and available data may not be accurate. On the one hand, as pointed out by Liang (2003), over 40% of the hedge funds contained in TASS and the U.S. Offshore Fund Directory are not effectively audited. This leaves obvious room for managers' return manipulations and questions the quality and accuracy of hedge fund data. As evidenced by Okunev and White (2002) stale or

managed prices may lead to a significant underestimation of volatility (up to 100%) and of the correlation with traditional assets. This obviously distorts the performance analysis significantly. On the other hand, Liang (2003) illustrated certain discrepancies as regards funds present in different databases (HFR, TASS, US Offshore Directory, etc.). These two points are worth noting since as many as 67% of European multi-managers use a database to select managers. Note that most of them rely on one of the well-established databases such as HFR (27%) or TASS (32%). This raises another issue. Due to their differences in construction methodologies or in management principles, the different databases are known to be diversely impacted by performance measurement biases. The choice of the database may consequently influence the results of the performance analysis. As a result, 35% of European multi-managers prefer to use proprietary databases (i.e. generally constructed by adding several commercially available databases) to diversify specific risks.

Exhibit 5: Answer to the question "How important do European multi-managers consider quantitative analysis when selecting managers?"



As shown in Exhibit 5, quantitative analysis plays a central role during the whole decision-making process for 44% of European multi-managers but only accounts for 37% in their final decision. A more conservative way to use quantitative analysis is to use it solely to screen the investment universe and set up a list of hedge funds that are subject to due diligence. In this case, the use of quantitative indicators does not impact the final decision at all. Given the fact that the quality of hedge fund data is subject to controversy and that there is absolutely no consensus about hedge fund performance persistence (see Géhin, 2003), it seems reasonable to limit the importance of the quantitative analysis with respect to fund selection. Surprisingly, only 15% of European multi-managers use quantitative analysis only for the first screening. This is not consistent with the fact that parsimonious use of quantitative analysis is all the more appropriate in that the quantitative indicators currently used to monitor manager performance are not suitable for assessing hedge funds' performance. The relative cheapness of commercially available databases and the simplicity of traditional risk-adjusted performance measures doubtless explain this phenomenon.

The complexity of ensuring appropriate due diligence

While access to investment capacity and fund selection are usually the selling points for FoHF, the complexity of managing risk may remain an issue for small to medium-sized FoHF. The risk management function encompasses a series of responsibilities prior to and after the investment decision. These cover the whole spectrum of risks, from the financial risks associated with the various investment strategies to the no less important operational risk factors resulting from the

highly complex nature of the hedge fund trading activity. It is therefore not surprising to see that 33% of European multi-managers in our sample have decided to partially or entirely sub-contract the due diligence process, which represents the most challenging task for risk managers (see Exhibit 6).

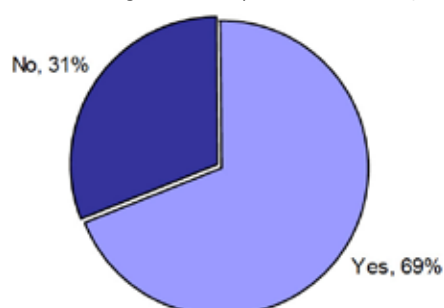
Exhibit 6: Answer to the question "How do European multi-managers select funds?"

Internally	76%
By partially sub-contracting due diligence	20%
By sub-contracting due diligence entirely	13%
No answer	5%

If selecting the funds that will perform best is a difficult goal, avoiding allocating assets to future losers cannot be considered a "no-brainer". For some FoHF, performing due diligence on a hedge fund is sometimes still synonymous with performing a background check on the manager and the company and then spending a few hours discussing the investment strategy and the supporting infrastructure with a representative of the fund.

However, this approach will not provide any sense of the reality of the investment's extreme risks, as the due diligence takes place in the middle of a sales relationship where the hedge fund is selling its capacity rather than openly discussing strengths and weaknesses. Instead, a structured process needs to be implemented that assesses a series of risk indicators, if possible in a systematic, repeatable and numerical approach in order to allow for the inclusion of the results within an allocation model.

Exhibit 7: Answer to the question "Do European multi-managers have a specialised risk analysis department?"



European multi-managers highlight detailed, qualitative analysis of fund operations in their selection and monitoring process. However, while this willingness is clear and unanimous, it does not always correspond to the reality of the means and procedures implemented. If we examine the hierarchy of criteria, it is curious to note that the quality of reporting and risk control of the underlying funds is essential in the eyes of the managers, even though they themselves do not always have tools or skills of that type, since one-third of European FoHF in our sample do not have a dedicated team for risk analysis (see Exhibit 7).

It should be noted, in the same spirit, that, for want of a capacity to genuinely reassure themselves on the transparency of the funds in which they invest, European multi-managers rely more on the reputation of their counterparty service providers (prime brokers, custodians, auditors, etc.) than on the operational analysis itself, notably for off-balance sheet operations, which is not considered important or indeed not taken into account at all by 27% of European multi-managers in our sample (see Exhibit 8). More generally, we could set out the problem of the economics of the profession of alternative multi-manager. Projecting the costs of a due diligence process cannot be sustained by FoHF with assets under management that amount to less than \$200mn. As a result, small to medium-sized funds that have not developed a sufficient internal risk capability will have to rely on a less formal assessment of risk exposure.

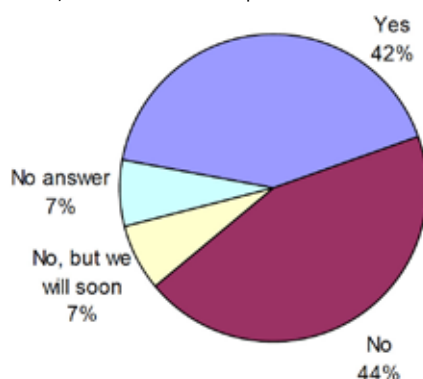
Exhibit 8: Answer to the question "Which qualitative criteria do European multi-managers apply to due diligence on hedge funds?"

	Very important	Not very important	Not considered
Coherence and quality of explanations regarding the investment strategy	96%	0%	0%
Quality of risk monitoring and reporting	95%	2%	0%
Verification of fund performance	91%	4%	0%
Legal soundness of the fund and the proposed contracts	87%	7%	2%
Competence and credibility of key service providers (prime brokers, custodians, auditors)	85%	13%	2%
Analysis of the quality and liquidity of the instruments used by the fund	84%	9%	4%
Organization and reliability of the position evaluation process	84%	11%	2%
Quality of technical infrastructure	84%	11%	2%
Financial soundness of the manager	82%	11%	4%
Quality of the decision support model or models	80%	13%	2%
Managers' financial investment in the fund	71%	9%	9%
Analysis of off balance sheet operations	60%	18%	9%
"Market place" opinion on the fund	47%	29%	20%
Quality of other subscribers	42%	35%	18%
Transparency of the manager	4%	0%	0%
Size	4%	0%	0%
Reputational check	4%	0%	0%
Consistency of investment process	4%	0%	0%

III. Asset Allocation and Portfolios Construction: A Necessary Clarification of the Means and Practices

A significant gap between academic and practitioner approaches to portfolio construction. While diversification is the leading motive for investing in hedge funds, it seems that European FoHF do not wholly take into consideration the diversification potential of the different hedge fund strategies in their portfolio construction strategy. Exhibit 9 shows that 42% of the respondents offer funds with specific diversification objectives defined in relation to other asset classes. While, for example, 80% of British alternative multi-managers offer FoHF by strategy, only 40% propose funds that satisfy precise diversification criteria. Multi-managers' lack of attention to the diversification properties of hedge funds is probably linked to the confusion that exists between the fund selection tasks, which constitute the original value-added of the FoHF, and those relating to allocation or diversification by style.

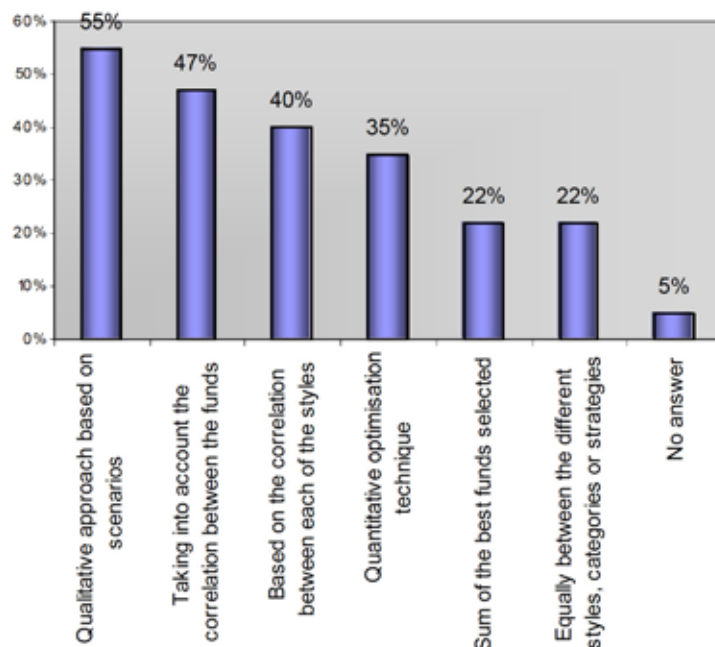
Exhibit 9: Answer to the question "Do you offer FoHF with specific behaviour or diversification objectives in relation to other asset classes?"



While a significant majority of European FoHF (75%) have a team dedicated to portfolio construction and/or return forecasts for hedge fund styles, one cannot help but observe that numerous European multi-managers continue to confuse portfolio allocation with the choice of the best managers (22%). Only 13% combine a quantitative approach with a qualitative portfolio construction approach, even though it is the only method that allows scenarios on extreme market conditions to be taken into account while at the same time disciplining and formalising the manager's intuitions.

65% of European multi-managers do not use a quantitative approach in the area of strategic portfolio allocation, despite the benefits of such approaches being highlighted by academic research. Only 47% of the professionals questioned take the correlation between funds into account to organise the diversification of their portfolio (see Exhibit 10). More worryingly perhaps, in spite of the crises in 1998, only 13% of European multi-managers have integrated an extreme risk measure and scenarios on extreme market conditions into their portfolio construction process.

Exhibit 10: Answer to the question "How do European multi-managers construct their portfolios for multi-strategy or multi-style funds?"



Once the strategic allocation has been decided on there is still one practical issue to address before picking the best funds: How many funds should be included in the portfolio? As evidenced by Amin and Kat (2003) or by Davies *et al.* (2004), increasing the number of funds may have adverse effects. First, since the different alternative investment strategies are diversely exposed to risk factors (market, volatility, liquidity, credit risk, etc.), the inclusion of numerous funds following different strategies tends to diversify away specific risks but at the same time it partly dilutes their specific betas. In other words, including too many funds or strategies in a FoHF tends to enhance the exposure to market risk since most alternative investment strategies share this source of risk. As a result, correlation with traditional asset classes increases. This diversification overkill effect is also accompanied by alpha dilution, as well as additional costs. More funds effectively imply more due diligence (in order to maintain the fund picking ability) and require an improved risk monitoring system (in order to maintain the optimal risk allocation).

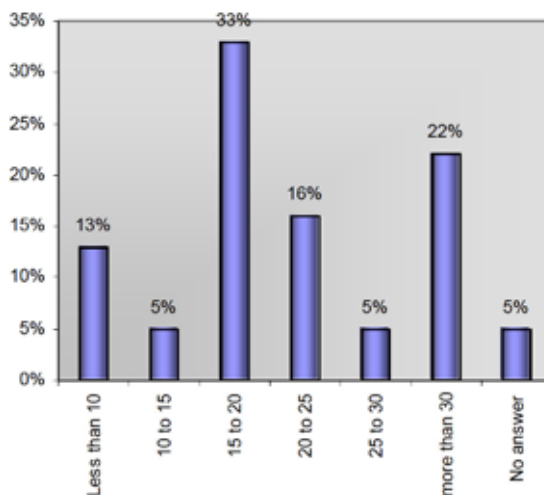
Amin and Kat (2003) provide evidence that when the number of funds increases, the skewness of the portfolio tends to decrease while its kurtosis increases. The probability of extreme events is thus increased (the magnitude of this phenomenon depends on the strategy). On the other hand, when the number of funds is too small, investors are overexposed to the volatility of single funds. That is why funds with high operational risks or other flaws in their organisation or investment process must imperatively be eliminated to mitigate this risk. Due diligence plays a central role at this stage.

As a result, an optimal trade-off must be found between too many funds (i.e. diversification overkill effects) and too few funds (i.e. overexposure to the specific risks of a single fund). Amin and Kat (2002) argue that the optimal number of funds lies between 1 and 15. In the same vein, Learned and Lhabitant (2002) find that most of the diversification effect is obtained with a basket of 5 to 10 funds, depending on the strategy.³ Only some rare studies, such as Alexander

3 - Cf. Henker (1998), Park and Staum (1998), Farrell and Gregoriou (2000) or Wintner (2001)

and Dimitriu (2004), find that most of the diversification benefits are obtained with around 30 funds in portfolio. In this respect it is interesting to note that only 18% of respondents effectively hold FoHFs that include fewer than 15 funds (see Exhibit 11). On the other hand, 27% of the respondents still invest with more than 25 funds.

Exhibit 11: Answer to the question "How many funds on average make up European FoHF?"



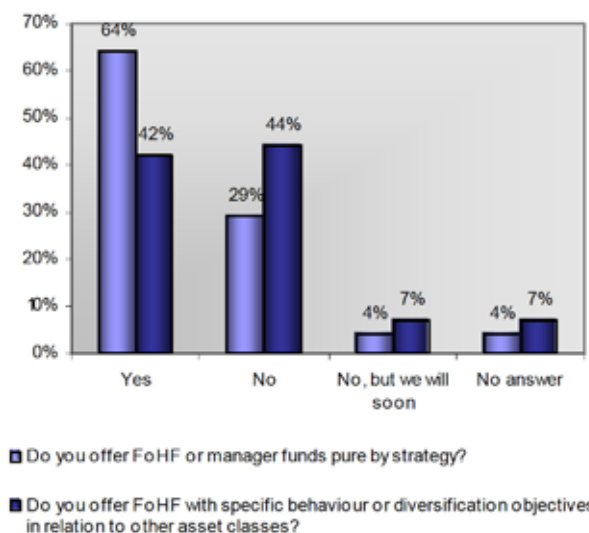
A significant gap between investors' demands and European multi-managers' offers

While the low level of knowledge transfer observed between the academic and professional worlds with regard to allocation techniques is surprising, it is even more striking to see the extent to which European multi-managers fail to respond to investors' demands and so to tap huge business potential.

Investors have different strategic allocations. As a result, even if they all share the same goal when investing in hedge funds, namely diversification, they all have specific needs and must thus be provided with customised solutions. But multi-managers continue to market simple diversified/low volatility FoHF. While diversified FoHF offer greater diversification when evaluated on a standalone basis, one must not forget that FoHF are bound to be included in investors' global allocation.

Despite the obvious business potential, only 64% of European multi-managers chose to market pure strategy FoHF and only 42% offer FoHF with specific diversification objectives in relation to other asset classes (see Exhibit 12). This is all the more confusing in that European multi-managers already dispose of the necessary "elementary constituents" to construct such investment vehicles (strategy FoHF or investable hedge fund style indices), so it does not require more expertise than that required to manage a typical FoHF.

Exhibit 12: European multi-managers' product range



IV. Reporting: Progress to be Made

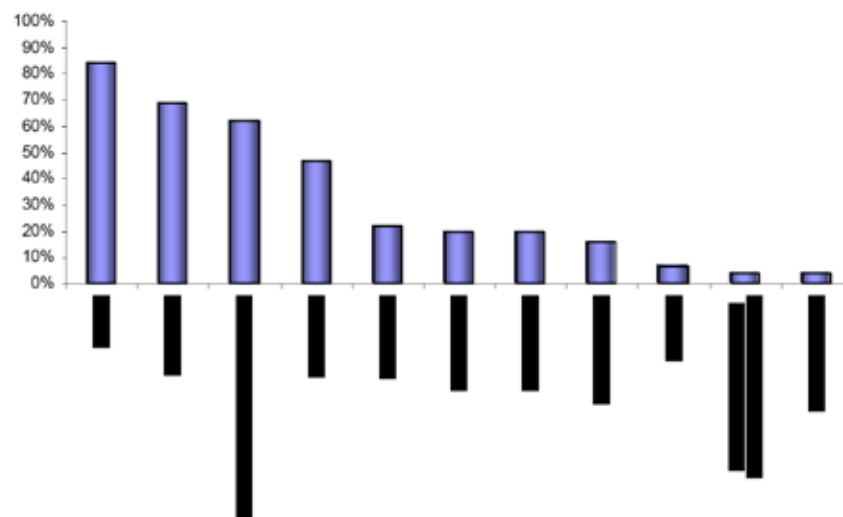
A significant gap between the needs of investors and the content of European FoHF reporting
As mentioned in the previous sections, the performance characteristics of hedge funds present some original features. Returns are not normally distributed, they tend to be biased and exposures to factors are multiple, non-linear and dynamic. As a result, information addressed to investors must take all those specific features into account to provide investors with a "true and fair" view of the fund's behaviour. As evidenced in the literature,⁴ this is a challenging task.

Given the limited liquidity of alternative investment vehicles, investors must pay particular attention to the screening of funds. It is all the more important to avoid the worst performers in that capital redemption is restricted by lock-up periods and advance notice constraints. Losses would thus rapidly be compounded. Nonetheless, once invested with a promising fund, investors still have to concentrate on monitoring manager performance and controlling risk. One has to bear in mind that investing in hedge funds cannot be regarded as a simple buy-and-hold strategy. Hedge funds are generally poorly regulated, which leaves much room for potential drift. Since hedge funds also set redemption constraints it is crucial to identify them as soon as possible.

Is the fund still doing well? The first objective of hedge fund performance reporting is precisely to inform investors about the fund performance. In this respect the Sharpe ratio is reported by 69% of European multi-managers in our sample (see Exhibit 13) and it is well ahead of the VaR (20%) or the Sortino ratio (22%) among the indicators that are favoured in the performance reporting of European FoHF. Again, one should be cautious when using this indicator. As evidenced in Lo (2002) stale prices alone may lead to an overestimation of the Sharpe ratio of up to 65%. This suggests that investors are generally provided with inaccurate performance indicators.

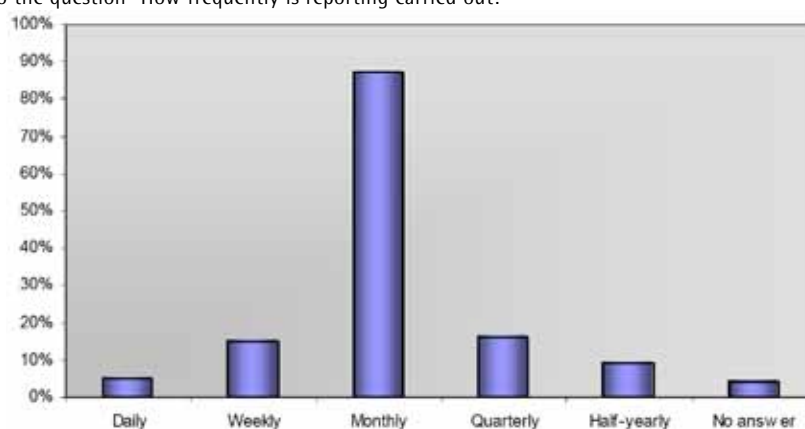
Interestingly, 84% of European multi-managers surveyed seem to consider that volatility is of major concern to their clients. This tends to imply that investors are looking for diversified baskets of hedge funds. This, in turn, suggests that alternative investment strategies are still considered as a separate class. This, however, is not the case anymore. As mentioned earlier, the arrival of institutional investors has brought about a paradigm shift. Alternative investment strategies are viewed as a means of diversification and must in consequence be part of the whole investment management process. Rather than the volatility of FoHF, investors need to assess the effect of the FoHF on the diversification of their global portfolio. Unfortunately European multi-managers do not include factor analysis in their reporting to emphasise their FoHF's diversification properties.

Exhibit 13: Answer to the question "Which indicators and information do European multi-managers use for reporting to their clients?"



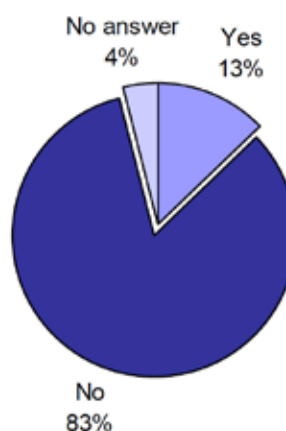
Knowing the performance of a fund is one thing. Understanding it is another. The second objective of the reporting is to help investors improve their understanding of the fund. As mentioned earlier, investing with a fund not only amounts to buying a manager's ability to generate alpha, it also involves buying betas, i.e. exposure to a variety of risk factors. Is the manager doing well because he is very good at implementing the strategy he claims to follow, or because he drifted from his original strategy to take advantage of new opportunities? Conversely, is the manager performing badly because his strategy is suffering from bad momentum or because he is trying to implement strategies that he is not good at? When FoHFs are used as diversification vehicles it is obviously important to be able to answer these questions, but this is not always the case. While 62% of European multi-managers include a comparison of their performance with a benchmark to indicate how well they performed against their peers, only 47% of them disclose a style analysis to show that they stuck to their strategy. Such information must obviously be released as frequently as possible. A monthly periodicity seems technically and commercially acceptable for FoHF. This opinion is shared by 87% of European multi-managers in our sample (see Exhibit 14).

Exhibit 14: Answer to the question "How frequently is reporting carried out?"



Finally, while studies on the failures of hedge funds have shown that certification of their performance significantly reduced the failure rate (for example Liang, 2003 shows that the proportion of unaudited funds is significantly higher among "defunct" funds than operating funds), it should be noted that only 13% of the respondents have implemented certification by an independent third party (see Exhibit 15).

Exhibit 15: Answer to the question "Is the reporting of European multi-managers certified by an independent third party?"



Source: EDHEC (2003)

Conclusion

The dramatic growth of the FoHF market over the last few years has had some consequences for the characteristics of the market. The first is the increasing heterogeneity between FoHFs. Ineichen (2002) pointed out the wide dispersion of FoHF returns, primarily on the downside,

with a widening gap between talented and less talented FoHF managers. On the other hand, the increasing importance of institutional investors in the FoHF market sharply modifies the investment process of European multi-managers. The pressures they exercise on European FoHF pushes them to modify their investment process by developing solid infrastructure, sophisticated analytical abilities and due diligence techniques. In the same spirit, FoHF are compelled to produce reporting on a regularly basis, and to clearly present their investment process and the means used for the process, to respect the transparency requirements of institutional investors. As a consequence, this industrialisation process tends to dramatically reduce the aforementioned spurious and natural limitations.

What is clear from this study is that the current institutionalisation of hedge funds, and the move from absolute performance to diversification benefits, cannot simply be understood as a change in scale and client objectives, but merely as a profound modification of investor's requirements, impacting several dimensions of the industry:

- The need for the industry to adapt tools and methods usually developed to serve the needs of long-only investors to support the specific risks hedge funds are exposed to;
- The impact on the economics of the entire value model with the confirmation of funds of hedge funds as a main provider of liquidity to investors;
- The likely specialisation of actors focusing on clearly designated areas of added-value such as fund selection or asset allocation; and
- The need to take into consideration the constraints and minimum requirements for risk management infrastructure and superior due-diligence processes that are required to satisfy institutional investors' desires.

These challenges are hitting the alternative multi-management industry as never before and will probably result in a radically different landscape over the coming years.

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