

# Assessment of Innovative Funds Strategies

## Institutional fund of funds portfolio considerations

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Investors in alternative investment strategies can benefit from a soaring number of financial innovations in new markets, regions, and strategies. These novel areas of hedge fund investing offer attractive benefits complementing the established set of alternative investments. Difficulties for the investor lie in assessing whether a new area offers sustainable attractive return potential, suitable liquidity and adequate capacity to keep up with a larger influx of capital.

The notion 'hedge fund' often falls short of capturing all these innovative themes. Areas such as insurance-linked securities, the variety of finance and lending strategies, as well as other structured finance solutions, carbon emission, weather and freight derivatives are being offered by investment management firms structuring them as hedge fund vehicles.

Generally, innovation can be found when markets become increasingly segmented and strategies become specialised (eg. insurance-linked securities), or, when new tradable instruments in established markets offer new trading opportunities (eg. real estate futures), or also when more sophisticated hedge fund strategies in matured and traditional markets are developed and evolving (eg. volatility strategies). New markets also emerge as barriers disappear; these barriers can include shorting and currency restrictions, lack of instruments and exchanges, low liquidity, limited transparency, or weak legal and regulatory framework. Additionally, a certain degree of innovation can be found if traditional hedge fund strategies are applied in new and emerging geographic markets (eg. convertible-bond arbitrage in India).

### Investors face new challenges

Faced with this plethora of new and emerging hedge fund strategies, investors are challenged with how to cope. Besides the rather conservative option of fully standing aside and ignoring any new and upcoming markets, a sophisticated investor can try to mingle them with the more traditional strategies, hence adding additional non-correlated strategies to a traditional hedge funds portfolio. Alternatively, investors can test the waters first by investing in innovative new strategies on a stand-alone basis. A fund of funds approach diversified over different innovation themes is a suitable way of gaining desired exposure and know-how in a variety of new strategies.

There are many innovative areas where an investment can make sense from a return and diversification perspective.

There is enough depth and breadth in the underlying markets, sufficient professional players offering institutionalised money management, and adequate liquidity to cope with the traditional redemption schedules expected from a portfolio of hedge funds.

On the other hand, there are areas that might not yet offer the ideal characteristics for an investment by an institutional provider of hedge fund portfolios. Whereas the return potential of an investment in a set of violins from Stradivari or Guarneri might be very attractive given their limited number (the value of Stradivari and Guarneri violins has tripled since 1990), it might not be a suitable investment in a fund of funds context given the required lock-up, inaccurate ('dirty') hedging and capacity of the field (apparently less than 700 Stradivari instruments exist). Wealthy individuals or their private bankers, however, might deem a direct investment suitable in a given portfolio context.

The matrix in the Figure 1 clusters the areas of innovation along the axis old/new hedge fund strategies and instruments and the axis old/new markets and regions. Within each cluster are areas or themes that can be deemed suitable in a fund of funds context (red) and which can be deemed as not (yet) suitable (grey).

In most cases, new hedge fund investment themes are being brought to investors through money managers looking for assets to deploy in their new strategy. A new market opportunity is rarely discovered by an investor through pure research. As such, the analysis of new investment themes is an iterative process driven by allocator and investment provider of the new theme.

The assessment of each new innovation theme requires an in-depth analysis of the underlying market before even a single fund can be looked at. An investor should understand the market's mechanics and drivers, size, capacity, participants, and level of integration/harmonisation. To assess investability, the legal and regulatory framework, transparency, price efficiency, and liquidity have to be analysed, as well as the financial instruments traded, transaction cost and execution.

### It's all in the research

There are many ways to gather market intelligence. The hedge fund that actively raises funds in a new field often helps with gathering first insights into a new market. Industry associations, non-financial participants, exchanges, advisors,

suppliers, and theme-specific conferences are also good sources. In the end, though, extensive desk research needs to be done.

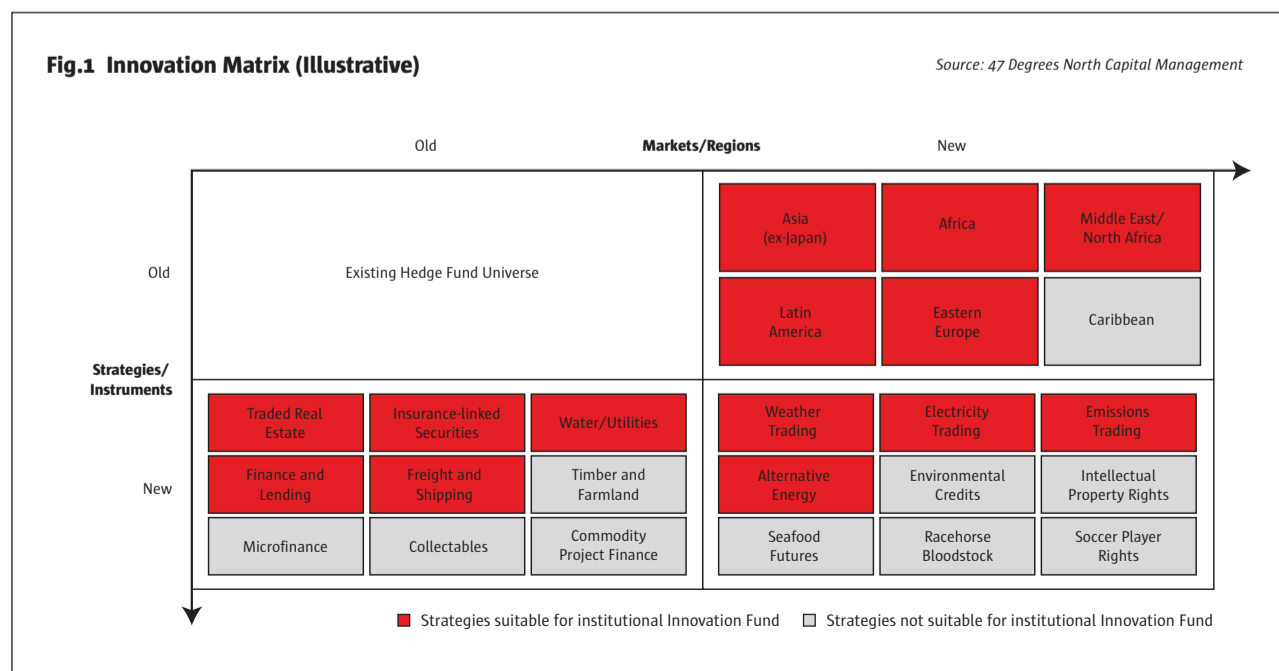
New markets undergo a transition from initiation to establishment driven by the progress of technical, social, regulatory or economic factors. Markets usually start with non-financial participants (natural buyers and sellers). Financial participants enter the field after a degree of establishment (regulatory framework, securitisation, financial instruments) with both more financial and non-financial players. Hereby, the emergence of hedge funds is a sign of inefficiencies in a market that then becomes more institutionalised and increasingly liquid as asset are deployed.

Upon analysis of a new market, its individual participants and their position within the market need closer attention. Here, the traditional process of individual manager due diligence is applied. The relatively young strategy characteristics and track record of most fund managers in a specific field only allow for a limited application of quantitative analysis. Still, investors might want to get comfortable with the level of returns that can be expected in a new investment area. A new theme might look structurally attractive, but does not provide for the returns that justify the investment in a lesser known investment area.

### Be open and opportunistic

Over time, new strategies lose their innovative character and become a mainstream investment theme or might even disappear. Whereas an investment in commodity hedge funds was a novelty 5 years ago, it has become an integral part of portfolio allocation nowadays. Therefore, in order to maintain the innovative character of a portfolio, an open and opportunistic portfolio approach is necessary as it gives an allocator the flexibility in adding and replacing strategies.

There are currently a handful of fund of hedge funds providers that offer products around innovative hedge fund investment themes. For instance - given the current political 'theme du jour' - focused clean tech and environmental investments are offered. Analysis shows that a portfolio consisting of a broader variety of several different innovation strategies as mapped out on the right side of the matrix, not only offers very low correlation among these themes, but also combines it to a portfolio with a very attractive risk/return profile with low correlation to other traditional and alternative investment products. **THFJ**



### Biography

#### RICHARD C MUELLER

Richard C Mueller is a Partner of 47 Degrees North Capital Management Ltd and Head of Business Development. Prior to 47°N, he was an investment and transaction manager within the Hedge Fund Ventures team of RMF Investment Management. Prior to this, he worked with Bain & Company in Zurich as a strategy consultant in financial services. He received a MSc in Finance from London Business School (LBS) and a PhD in Law from the University of St Gallen (HSG).

### About 47°N

47 Degrees North is a premier alternative investment firm offering sophisticated institutional investors a unique line-up of specialised fund of hedge funds products.