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Resource

Sector in Brief:

Multi-Strategy Hedge Funds

Contents

bfinance is an award-winning specialist consultant that provides investment implementation advice to pension funds and other institutional investors around the globe. Founded in 1999, the London-headquartered firm has conducted engagements for more than 500 clients in 43 countries and has 10 offices globally. Services include manager search and selection, fee analysis, performance monitoring, risk analytics and other portfolio solutions. With customised processes tailored to each individual client, the firm seeks to empower investors with the resources and information to take key decisions. The team is drawn from portfolio management, research, consultancy and academia, combining deep sector-specific expertise with global perspective.

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What's new?

There is no doubt that multi-strategy hedge funds are currently 'in vogue', particularly following the recent outstanding performance of certain high-profile names.

According to eVestment, multi-strategy and managed futures were the only two hedge fund strategies to attract inflows in 2022: the former drew USD$5.8 billion, even with significant redemptions in December that were likely driven by rebalancing. The Goldman Sachs Prime Insights 2023 Hedge Fund Industry Outlook placed multi-strategy funds second only to credit funds in terms of demand in 2022.

For investors, these strategies offer diversified hedge fund exposures without the resource burden involved in single manager allocations or the visible dual layer of fees associated with fund of hedge funds. More importantly, perhaps, they provide a highly dynamic approach to asset allocation or risk capital exposures, helping to improve flexibility and reactivity in times of market stress.

For talented portfolio managers (PMs), a multi-strategy shop can offer an environment where top performers can obtain a degree of autonomy and stability, focusing on their core investment work without the distractions of fundraising and firm management.

Yet one should not underestimate the challenges associated with this space. Popularity brings its own set of problems: investors encounter high costs, difficulty accessing capacity-constrained strategies, low transparency and high staff turnover as firms battle each other in the war for talent. It can be difficult to navigate the roster of strategies: more than 1000 providers self-define as 'multi-strategy hedge funds' in industry databases, since all that is required by such databases is that more than one hedge fund strategy be included in a given product. It can be difficult to gain conviction in manager selection, since the very dynamic nature of strategies means that track records are technically unrepresentative.

This brief research note is designed as an introductory briefing to the sector, helping investors to understand the parameters of the strategy universe and key issues involved when implementing allocations. For further information, please contact the bfinance team.

Facts & figures

> **Over 1000** managers self-classifying as 'multi-strategy' in a leading commercial manager database.

> **US$5.8bn** of inflows to multi-strategy products in 2022, according to eVestment, following US$23bn in 2021.

> **21.7%** of Hedge Fund AuM in Multi-Strategy Hedge Funds, according to WithIntelligence, up from 20.8% in 2020, making it the second largest hedge fund category after Equity Long/Short.

> **8.3%:** annualised return of Eurekahedge Multi-Strategy Hedge Fund Index, 2000-2022 (329 constituents).

The case for

> **Historically strong return generation** on a risk-adjusted and absolute basis.

> **Quicker risk-capital/tactical asset allocation decisions** versus single strategy allocations or fund of hedge funds; may be particularly beneficial in uncertain market environments (rising rates, central bank divergence, geopolitical tension) or downturns.

> **Strong risk management controls** to ensure individual strategies do not consume the risk budget and dominate returns.

> **Multiple drivers of return** in one product may be particularly beneficial in environment of weak equity market returns. Typically low sensitivity to equity markets.

> **Capital efficiency**: multi-strategy funds often benefit from internal leverage and other margin-based efficiency gains versus allocations to multiple external managers.

> **Top talent** is being attracted to multi-strategy hedge funds.

The case against

> **Expensive**: management and performance fees are relatively high, and we see growing use of 'pass-through' fees, which are not investor friendly.

> **Often poor transparency** into PM names/strategy/positions, partly driven by fears around 'war for talent'.

> **Track records are less representative** due to highly dynamic approach; investor is buying a return stream (and a disciplined risk management process), not a strategy.

> **Capacity constraints** for a number of successful managers, making it harder to access, and negotiate competitive terms.

> **War for talent** means that there is a high degree of turnover in underlying PM base.

About multi-strategy hedge funds

There are a variety of ways to develop a diversified hedge fund portfolio that spans multiple strategies: we can, broadly, consider these as sitting in three groups (illustrated in the table below). Firstly, the most obvious—and most resource-intensive—route is simply to build the portfolio oneself, with an internal team selecting and monitoring at least 10 (and often many, many more) hedge funds. Secondly, an investor can essentially appoint an intermediary for that process: a fund of hedge funds that will be able to access a variety of external (and sometimes internal) hedge funds, some of which the investor may not have been able to access directly. The third approach involves using an external manager that has the various underlying strategies 'in-house': a multi-strategy hedge fund.

These multi-strategy funds can be bifurcated into two main categories: 'pod shop' platforms, in which the various underlying portfolio managers essentially function independently and share little or no information with each other, can be contrasted against 'one-book' strategies with a single profit and loss (PnL) and more collaboration. In both cases, a 'lead' portfolio manager or an Investment Committee tactically allocate risk to the underlying strategies. Multi-strategy funds are characterised by adhering to very strong risk management frameworks—more so, perhaps, than any other hedge fund strategy.

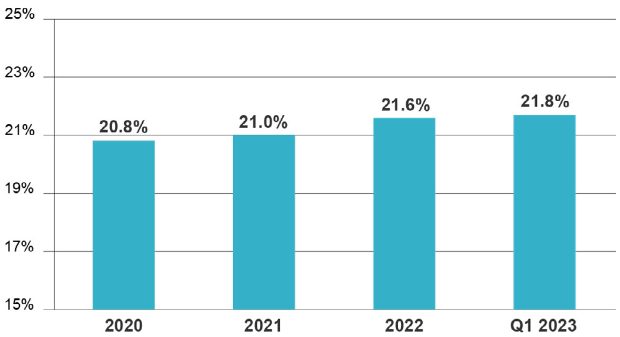
THREE WAYS TO GAIN 'MULTI-STRATEGY' HEDGE FUND EXPOSURE:

Family	Type	About	Pros	Cons
Direct allocations (Mulltiple funds)	Varying approaches, 10-50 managers	Build a multi-strategy hedge fund portfolio directly, using multiple hedge fund strategies	Highly bespoke to investor's needs, large manager universe	Burden on resources and governance, long timeline to build, slow asset allocation changes, more costly
Fund of hedge funds (one fund, multiple external asset managers)	Fund of hedge funds	Traditional approach to building a multi-strategy portfolio accessed via one fund	Good for educating clients, access to high-calibre managers, specialist ODD expertise	Dual layer of fees, slower at asset allocation decisions, weaker returns vs. multi-strategy
	Customised fund of hedge funds	Tailored fund of hedge fund solution based on client requirements	As above, plus tailored to client, e.g. bias to particular return profiles	As above
	Fund of sub-advisers	Underlying external managers provide trading signals to client fund manager	Single layer of fees	Weak performance, concept has not really taken off, limited manager universe
Multi-strategy hedge fund (one fund, multiple strategies at one asset manager; 'Internal FoF')	Siloed multi-PM platform strategy ('pod-shop')	Absence of collaboration between different PM teams: they act with complete autonomy. Platform provides PMs with risk parameters	Very active TAA, robust risk management, can attract top talent	'Pass-through' fees, low transparency, less alignment of interest, little information sharing, very capacity constrained
	Single PnL approach ('one book')	Greater collaboration between different strategy PMs vs. 'pod shop'	Transparency, more nurturing culture vs. 'pod shop', cross-fertilisation of ideas	Lower returns vs 'pod shop', more measured approach to implementing strategy enhancements

Source: bfinance

The investment approaches taken by multi-strategy hedge funds can also vary. Investors have the choice between quantitative approaches, discretionary approaches or those that blend both quantitative and discretionary styles together.

MULTI-STRATEGY AUM AS % OF HEDGE FUND UNIVERSE AUM



Source: bfinance

Despite the strong performance provided in recent years, these strategies do not aim to shoot the lights out: their goal is to provide a consistent return stream that is not correlated with traditional markets. They typically operate with volatility in the mid-to-high single digits and aim for a Sharpe ratio of 1 or above. The sub-strategies that comprise a multi-strategy hedge fund will be selected based on the extent to which they complement every other sub-strategy, ensuring that the portfolio is also diversified within itself. This variety of elements—market-dependent and market-independent, convex and directional—is intended to support an 'all-weather' return profile.

It's worth noting that there are a large number of self-defined 'multi-strategy' products that essentially operate within a single strategy area but provide multiple expressions of that strategy. **These do not fulfil the parameters for multi-strategy investing as we describe it here** yet can play an important role for clients. Examples would include event-driven multi-strategy funds, which combine a range of hard and soft catalyst events, or equity multi-strategy funds, which might bring together fundamental and trading-oriented long-short approaches, or sector and regional specialists.

Implementation considerations

Investor requirements

Investors' specific needs and priorities are crucial to understand when navigating the extremely diverse multi-strategy manager landscape. When carrying out specific investors' tenders with clear and explicit requirements, we typically find that between 15 and 50 asset managers may potentially be appropriate candidates—and these will be quite diverse in nature. Parameters such as liquidity, preferred investment approach, length of track record, fund domicile and the need to minimise overlaps with pre-existing portfolio allocations can all play a key role in determining the potential roster of viable strategies.

Liquidity

Multi-strategy managers commonly have liquidity constraints ranging from monthly to quarterly, with notice periods typically sitting between 30 and 90 days. Yet it is not uncommon to see managers imposing longer locks and investor-level gates. This is particularly true for managers that have enjoyed strong performance in recent years.

Fees and costs

Although multi-strategy hedge funds do not give the 'dual layer of fees' associated with their fund-of-hedge-fund cousins, they are relatively expensive. Management fees are generally around 1-2% with performance fees around 10-20%, but some managers price themselves considerably higher. We also see a greater number of (the more successful) multi-strategy managers adopting pass-through fee structures. These allow the manager to pass on a variety of costs such as travel, compensation, technology and operational expenses directly to the clients. Managers argue that passing on these expenses helps them to attract the best talent and stay ahead of the competition. Yet these pass-through fees are extremely unfriendly from an investor's perspective: as well as bringing greater overall expense, the unpredictability of those additional costs is problematic for cashflow management.

Turnover

There is no doubt that multi-strategy managers are capable of attracting top talent. Pod shops, in particular, provide outstanding portfolio managers with all the autonomy that they might enjoy in their own firm, free from the stresses and distractions of fundraising and business management. Yet turnover is heated: there is a high degree of churn among the underlying portfolio management teams and it can be difficult for investors to get a transparent picture of that turnover (information will not necessarily be forthcoming!). The churn is particularly evident among platform managers ('pod shops'), which tend to have more of a 'hire and fire', 'eat what you kill' culture than their apparently more nurturing 'one book' counterparts. Indeed, we see those single PnL shops receiving an inflow of talent from platform firms. The counter argument, however, is that any given PM team departure is less detrimental to the overall platform multi-strategy funds than it would be for 'one-book' multi-strategy setups.

Transparency

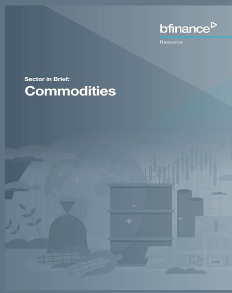
It can be challenging for investors to gain appropriate transparency on underlying PM performance when scrutinising the platform ('pod shop') approaches. 'One book' type strategies, on the other hand, do offer direct access to underlying PMs and a higher degree of transparency into individual books and positions.

Key takeaways

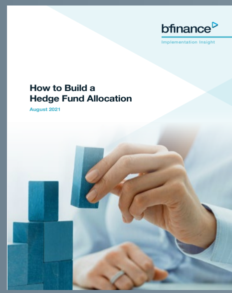
- Investors seeking to build a diversified hedge fund portfolio can consider whether to use single manager positions, fund of hedge funds or 'multi-strategy' hedge funds.
- Multi-strategy hedge funds offer highly diversified and dynamic return streams in a tightly controlled risk framework that can act as a core holding within a hedge fund portfolio.
- This is a highly diverse and poorly categorised space. Although more than a thousand managers self-classify as multi-strategy hedge funds, institutional investors seeking to select a manager will typically find between 15 and 50 potentially viable strategies that may suit their needs, depending on the precise requirements.
- Certain multi-strategy platform products are challenging for new clients to access but there are high quality offerings beyond the handful that dominate industry headlines.

Related reading:

Manager Intelligence and Market Trends
(February 2023)



Commodities Sector in Brief
(January 2023)



How to Build a Hedge Fund Allocation
(August 2021)

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