



Cambridge Associates looks for opportunities in less developed markets

As it enters its fourth decade, the Boston-based consultant focuses on emerging and younger managers for its direct investment clients

David Shukis

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rivacy has long been a hallmark of Cambridge Associates, partly because clients of the Boston-based consulting firm also tend to be publicity-shy. They include many of the top non-profit organisations in the US, including Harvard University and The Bill and Melinda Gates Foundation Trust.

Cambridge Associates has been quietly going about its business for almost 40 years, and advising clients to invest in hedge funds for nearly as long. But the firm's low profile masks a rapid pick-up in pace at its hedge fund practice over the past three years.

Headed by David Shukis, the practice oversees \$26 billion in hedge fund assets invested in approximately 250 underlying managers on behalf of 265 clients.

That represents an increase of about 100 clients and \$6 billion in assets since 2007. To keep up with demand, Shukis's team has grown substantially to more than 100 people as part of a concerted firm-wide effort to invest more in specialist areas of expertise.

One reason for the expansion in his practice, Shukis points out, is "client demand for intensive due diligence of funds" post-crisis. This has attracted new clients whose in-house research capabilities fall short of their revised standards, and in turn has led the practice to bolster its own due diligence resources. "With hedge funds it is important to be extremely selective," Shukis notes.

Another reason for the growth is that Cambridge Associates continues to extend its long reach outside the US. The firm's London office recently moved to

larger premises for the fourth time since opening its doors in 1994. It now commandeers an entire floor of a new glass and steel tower near Victoria Station, leasing out some of the area in readiness for the 70-strong London team's future expansion.

Seven of the London team work in the hedge fund practice, which caters in total to 130 clients in the UK, continental Europe and the Middle East. A Singapore office was opened in 2001, followed in 2007 by Sydney – the only location without hedge fund specialists, who will soon be in place.

Cambridge Associates is particularly interested in exploring under-developed markets. "We are looking for managers to exploit inefficiencies, and developed markets are obviously pretty highly efficient," Shukis says. Greg Moessing, a hedge fund consultant in the Boston office, was recently appointed research director of Asia and emerging markets to develop this side of the business.

Managers unprepared for the Cambridge Associates' treatment may get a bit of a shock. "If a manager goes into our Boston office there are quite likely to be 30 people in the room," says Edward O'Malley, a London-based managing director and hedge fund consultant. A manager visiting the London office may be confronted with up to 10 consultants and research staff, he points out.

These multiple points of view, shared via the database as well as in the hallway, are an important feature because they inform Cambridge Associates' opinion of a manager. It is this multi-faceted input that gives the firm its insights, Shukis notes. Stated more simply, he says, "We understand what makes a good fund and what can go wrong."

The reason for this full-on approach is that Shukis and his team are catering for a sophisticated bunch of clients, most of whom are long-time hedge fund investors. Their average hedge fund allocation is more than 20%, and the average size of their hedge fund portfolios is more than \$100 million. This means that the practice's client-facing consultants as well as its research team must be able to talk authoritatively to clients about the hedge funds in their portfolios as well as others in the universe.

Each client portfolio is custom-built to requirements. "The hallmark of our practice is tailoring hedge fund investments to client objectives and the rest of their portfolios," Shukis says. For some clients, Cambridge Associates has an advisory mandate solely for hedge funds, and nine clients have a discretionary relationship. However, in most cases Cambridge Associates will also be advising the hedge fund programme in the context of a client's entire investment portfolio.

Overall, the firm provides services ranging from research and peer data provision to total portfolio outsourcing to more than 800 clients. These include college and university en-



Charles Cassidy

dowments, foundations, UK charities, museums and hospitals, as well as family offices, pension funds, and sovereign wealth funds.

Endowments and foundations are by far the largest client group (72% of advisory assets in the US; 60% outside it) followed by family offices. Because there are fewer endowments and foundations outside the US, the firm has a higher proportion of family offices, pension funds, and government and agency funds among its non-US clients.

The weight of sophisticated non-profit assets behind Cambridge Associates is very attractive to managers. "We are perceived as a gateway to that group," says Charles Cassidy, who is co-director of hedge fund research. As long-term investors, the firm's clients are also valued by managers for the 'intellectual capital' that they bring to a relationship, Cassidy notes. "In 2008 our clients weren't taking money out of hedge funds; they were holding onto their allocations," O'Malley adds.

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Cambridge Associates itself has grown up along with the hedge fund industry. The firm was created in 1973 by James Bailey and Hunter Lewis to provide investment research and consulting services to a group of US university endowments, including Harvard University, which had originally asked the pair to review its investments. These core clients, which grew to include foundations and wealthy families, were among the earliest investors in hedge funds and other alternative assets. One benefit for the hedge fund practice is that it has access to the firm's real estate, private equity, and commodities teams.

By contrast, many other consultants have added alternatives expertise relatively recently over the past five to 10 years as their corporate and public pension fund clients moved into the space.

Bailey and Lewis are still majority owners of Cambridge Associates, and the 12 original clients still subscribe to the firm's research and peer data services. Two longstanding clients, Lord Rothschild and a prominent Midwestern family, are also investors in the firm, which is keen to maintain its independence and so remain free from conflicts of interest.

Most of the hedge fund practice's clients invest directly in single managers. Only those with a hedge fund allocation below \$30 million are advised to invest via a fund of funds.

This is not a new trend as clients have been shifting away from funds of funds for 10 to 15 years as they grow more comfortable with the sector. But among Cambridge Associates clients at least, the shift sped up post-crisis, after many funds of funds pulled money from liquid managers to pay back their own investors. "Our clients have benefited from managers who wanted to reduce their reliance on funds of funds," Cassidy points out.

Shukis cites three reasons that clients prefer the direct route. One is the lower costs; the second is being able to tailor hedge fund portfolios to their own objectives, and the third is 'owning' their manager relationships. "You can invest in a good fund of funds with excellent managers, but if something goes awry with the fund of funds firm, you lose all your relationships with managers," Shukis notes. "We say to clients, 'You can hire and fire us and still maintain your relationships'," he adds.

One result of the move to direct investing is a deeper level of interaction with clients. "Client education is a major reason why people want to work with us. Clients are looking to build their own expertise," O'Malley says. The firm has arranged hedge fund investment training programmes in particular for large Middle Eastern institutions, he says.

Cambridge Associates views hedge funds as having a role in most investors' portfolios. "The majority of our clients are looking at hedge funds as an equity asset; these investments can provide equity-like levels of return

consultant profile

with lower volatility,” Shukis says.

This in turn dictates the types of managers Shukis and his team are interested in. “The core strategies in the portfolio are based around deep fundamental analysis at the securities level,” Cassidy notes. They include selected arbitrage strategies, credit, traditional long/short equity and long/short sector funds. “We try to avoid strategies that are ‘black box’, including highly quantitative strategies or strategies that employ a great deal of leverage,” he says. These are often implicated in blow-ups, he notes.

Cambridge Associates is also wary of the “super low-volatility bond-type approach to hedge fund investing,” O’Malley says, partly because this approach often uses quant and leveraged strategies. Instead, the team typically aims for 5% to 8% volatility in its portfolios.

The manager selection process is rigorous. Cassidy says that prospective managers are willing to give the team time to make up its mind because it is such an important asset allocator. “We can take our time to understand managers and fully vet them before committing capital,” he says.

Shukis and his team prefer less-established managers. “We like to get to know them early. We want to find the leading promising funds of tomorrow,” he says. However, he points out that the slower pace of start-ups means that finding good emerging managers is more time consuming than it used to be.

Managers are sourced mainly from the web of relationships that Cambridge Associates has built up over the years. The ultimate goal is to identify institutional calibre managers with a sustainable competitive advantage, Shukis says.

The team fields a constant flow of proposals amounting to some 2,000 a year. In choosing which to follow up, Cassidy says he wants answers to several questions: how the manager has identified the inefficiency he aims to exploit; does the team believe the inefficiency exists; does the manager have the skill to exploit it, and does he have a viable business plan and the necessary infrastructure. “If they have that combination of factors we say, yes, this is someone we’d like to do more work on,” he says.

There follows a series of meetings, both on-site and in Cambridge Associates’ offices with client-facing consultants and research analysts. “It can be slightly daunting to managers in terms of multiple points of contact,” O’Malley says.

Managers may fall down at any number of hurdles, including ‘hard’ decisions on the amount of leverage they use to exploit an inefficiency, or ‘softer’ qualitative decisions about process, people, and the manager’s level of skill and integrity, Cassidy says.

The practice’s separate operational due diligence team will then take a close look at the manager’s trading infrastructure and external relationships, with a particular focus on as-



Greg Moessing

sessing counterparty risk.

The whole process can take many months. Even then, Cambridge Associates insists on giving prospective managers a trial run for a couple of quarters. The purpose of this exercise is “to evaluate how a manager interacts with us, how transparent they are, and how forthright about disclosing performance,” Cassidy says. “They may say they are happy to talk about performance and attribution on an ongoing basis, and we find they are not as forthcoming as they said,” he points out.

As a logical next step in building the team’s knowledge base, Moessing is currently tracking Africa funds, although no money is yet allocated to dedicated funds in the region

Managers can be dropped even at this late stage. “We are willing to walk away if we find that the things we think are important are things they are not willing to deliver on,” he adds.

In the wake of the financial crisis, Cambridge Associates’ clients have not made fundamental changes to their asset allocations, Shukis says, but they have wanted other concerns addressed.

The main one is liquidity. “There is much more emphasis from the client in understanding the liquidity profile of an investment and making sure it is a good fit for their overall liquidity requirement,” he notes. According to O’Malley, Cambridge Associates has been involved in several pre-launch discussions with managers about new share classes with lower fees in return for longer lock-ups.

Clients have also focused on due diligence and transparency. As well as adding staff on the operational due diligence side, a year ago Cambridge Associates expanded its relationship with independent intermediary Measurisk, giving the firm and its clients more consistent details about managers’ underlying holdings.

Going forward, allocations to alternatives look set to grow further, as institutions increasingly think of asset allocation in terms of growth drivers, diversifiers, and inflation or deflation hedges rather than from the traditional perspective of equities, bonds and alternatives, O’Malley says. Clients are also focusing on value for money. “People are thinking about where should they be spending fees on active management,” he notes.

Meanwhile, Cambridge Associates continues to build up its non-US research coverage. “The drive to look at hedge funds globally is based on a number of factors,” says Asia and emerging markets head Moessing. One is the greater inefficiencies in less developed markets; the second is that as these markets grow broader and deeper they can provide “a nice tailwind”. Lastly, he says, “hedge funds outside the US give a portfolio some diversification in which to invest.”

As a logical next step in building the team’s knowledge base, Moessing is currently tracking Africa funds, although no money is yet allocated to dedicated funds in the region. As with Asia funds in the early days, he says the big issue is whether the portfolio managers really ‘get’ risk management.

Other challenges are emerging for consultants in the way that the hedge fund industry is evolving post-crisis. The strength of renewed flows into large established funds presents problems of analysis, Shukis notes. “Some firms manage growth well and others don’t. Distinguishing the asset gatherers from the alpha generators will be a challenge,” he says.

Changes in ownership and succession issues may also pose problems, as the leaders of some hedge fund firms prepare to hand over to a second generation. “We always evaluate the process. Sometimes it goes well and sometimes it goes less well,” Cassidy says. As for smaller hedge funds, regulation is a concern. “Will there be opportunities for smaller managers to develop and grow, given the demands for regulatory compliance?” he asks.

For Cambridge Associates itself, there is the prospect of increased competition from big funds of hedge funds looking to expand their consulting and bespoke portfolio services for clients.

But given the firm’s established client base and the depth of resources that the hedge fund practice can draw on within it, Shukis dismisses this as a present threat. “Our business is sufficiently differentiated by our ability to look at hedge funds in the context of our clients’ total portfolios despite the increased competition,” he says.