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# Multi-Manager Funds: A Toolkit for Evaluation

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Institutional investors considering an allocation to a hedge fund are typically reasonably equipped to evaluate its suitability. However, traditional yardsticks are inadequate for evaluating multi-manager (MM) hedge funds, due to the uniqueness of their organizational structure and fund terms. The intention of this report is to equip investors with a better toolkit for analyzing the often unusual yet ultimately explainable behavior of most MM funds.

We define an MM firm as one that allocates capital to investment teams based on their anticipated performance, largely irrespective of the merit of other portfolio investments. While this part of their process may not appear dissimilar from how traditional multi-strategy (MS) firms allocate capital, consider that each MM investment team is usually run by a trader who operates autonomously with full investment discretion, though typically within agreed-upon limits and guidelines. MM firms tailor their compensation, incentives, and fees to suit this distinct structure.[1]

While a number of characteristics of MM hedge funds distinguish them from more traditional MS funds, it is often difficult to clearly differentiate between them. Because some MM funds exhibit characteristics of both approaches, they are less distinguishable from their traditional MS peers. We included a few such funds in our analysis to reduce selection bias and to equip readers to discern the differences.

After a discussion of the rise of multi-managers and their recent success attracting investment talent, this report compares the performance of MM funds with traditional MS funds. We then outline the key questions investors conducting due diligence on an MM fund should ask and, using our experience with a small set of funds, show how various MM funds compare to each other and to traditional MS funds. Our examination does not lead us to make a blanket endorsement of one type over the other. Rather, our discoveries provide insight into the significant ways the funds within the MM group differ not only from MS funds, but also from each other.

By no means all-inclusive, this report is based on CA interactions with what we deem to be the largest MM funds and our analysis of that subset. In time, additional data points from existing and new manager relationships will inevitably reshape some of the observations we present here.[2]

## The Rise of Multi-Managers

MM funds have grown their assets under management (AUM) at a faster rate since the 2008 financial crisis than traditional MS funds. The ten largest funds in each category serve as an imperfect, albeit broadly representative, proxy to illustrate this AUM growth—the best proxy available given the lack of comprehensive asset and performance data.

Other contributors to this report include Molly Goodman and Tom McDonald.

[1] For an in-depth discussion of discretionary global macro firms, which are one example of multi-manager hedge funds, please see our 2011 report *Global Macro: The Largest Canvas in the Industry*.

[2] Investors should be mindful of the limitations of our analysis, not the least of which is its small sample size of 19 MM funds. In some cases funds did not provide the necessary data to be included in an analysis, further shrinking the universe. The criteria we identify for evaluating MM firms were somewhat arbitrarily chosen, rely heavily on aggregated data, and are subject to inconsistencies surrounding the quality of manager-supplied data. Our analysis is also entirely backward-looking, and does not spend much time on the qualitative aspects of a manager that are important for evaluation purposes.

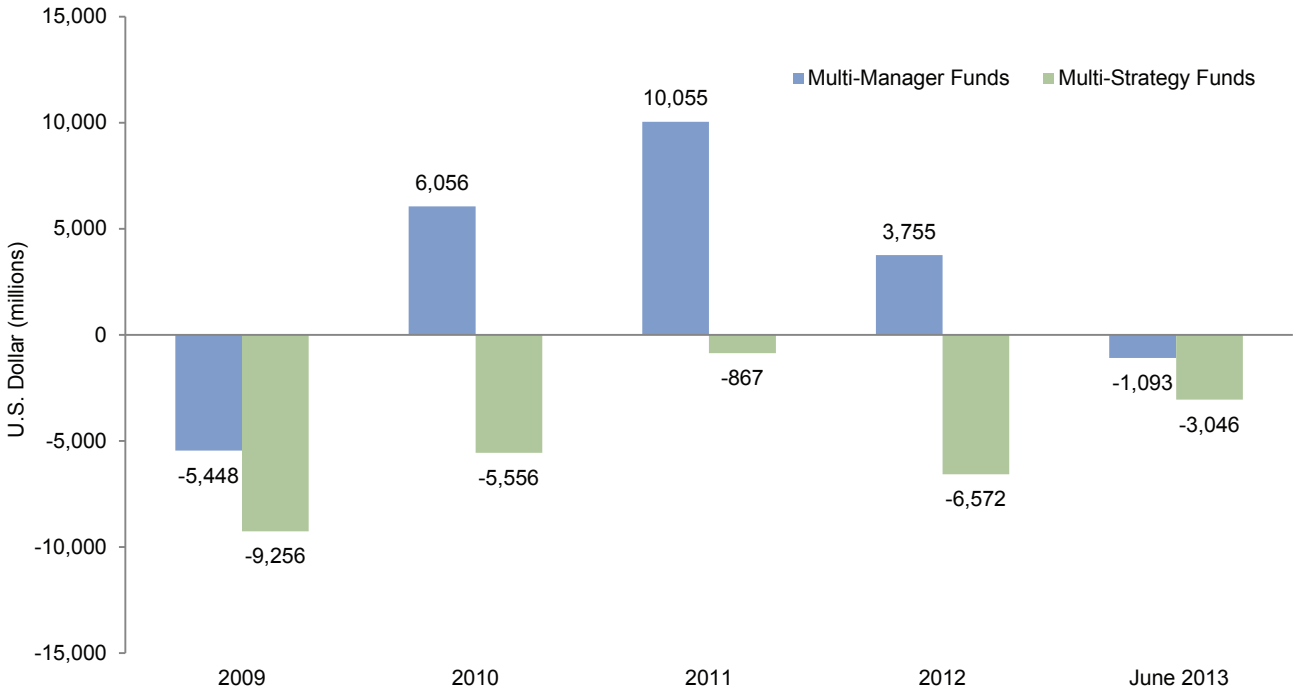
As shown in Figure 1, large MM funds attracted a disproportionate, net positive share of the asset flows in the hedge fund industry.

Of the approximately $100 billion in assets the largest ten MM funds collectively managed as of June 30, 2013, roughly 15% is attributable to net inflows from January 2009 through that date. In comparison, over the same period net outflows reduced the assets collectively managed by the ten largest traditional MS funds by roughly 20%, bringing their collective AUM to about $140 billion.

## Less Style Drift

Part of this divergence can be attributed to industry-wide factors that revealed a flaw in the management of some traditional MS funds—they became increasingly exposed to strategies that fell outside the managers' core areas of expertise, specifically, by investing in highly illiquid securities. Such securities exacerbated drawdowns during tumultuous periods like 2008 and hindered the managers' ability to recover their high-water marks or return capital to investors. In late 2008 traditional MS funds experienced deterioration in their Sharpe ratios, due in large part to losses originating from illiquid securities combined with an increase in their overall return volatility. In contrast, because MM firms tend to have limited appetite for strategies that cannot stand on their own, they generally avoid illiquid securities altogether. As a result, the late 2008 market environment did not have as much of a negative impact on their risk-adjusted returns.

**Figure 1. Net Asset Flows Comparison**
U.S. Dollar (millions)




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Comparison includes the ten largest funds in each category.

## Talent Magnet

Some high-profile investing talent has moved to MM funds over the past few years, though it is unclear how representative or meaningful these talent shifts are. A few contributing factors include:

- **Proprietary desk exodus.** Talented traders have been encouraged to leave or have chosen to leave investment banks' proprietary trading desks to comply with the Volcker rule and other Dodd-Frank related requirements. Investment banks have directed their departing proprietary traders to MM firms to help support the commission dollars typically associated with their active trading practices.
- **Attractive, individual performance–linked compensation.** In general, traditional MS firms compensate their employees with a disproportionately large weight assigned to senior management's subjective judgment or the performance of the overall fund. The firms that adopt this structure find it more difficult to retain talented traders when the fund underperforms, especially when the trader's book has been profitable. The larger the number of traders at a firm with this compensation structure, the higher the likelihood that the basis for an individual trader's compensation will diverge from the performance of the trader's book. MM firms, on the other hand, tend to tie trader compensation more strictly with the performance of each trader's individual book.
- **High hedge fund start-up costs.** Regulatory and investor requirements have increased as a result of the perceived risks posed by insufficient controls around leverage and compliance. For traders seeking to launch their own hedge fund firms, this shift has increased the up-front costs and inherent financial risks associated with establishing sufficient infrastructure to support the necessary legal, operations, and risk management standards. This higher barrier makes the option of joining an MM firm with a sizable infrastructure and a large back-office staff more attractive. And many talented traders prefer the opportunity to focus solely on investing.

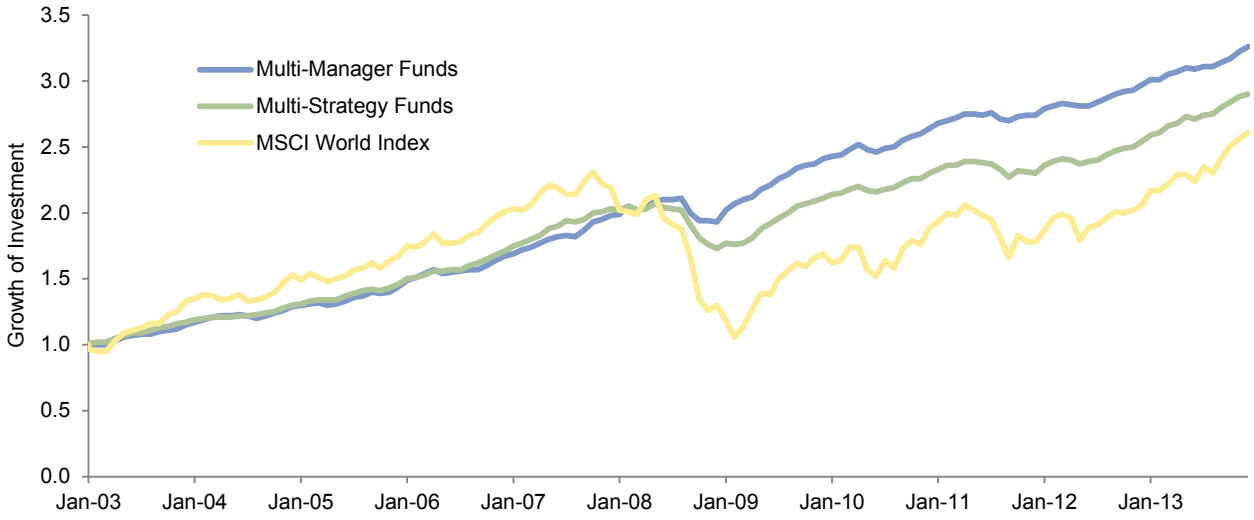
## Multi-Manager Performance

Several performance-related characteristics differentiate MM funds from their traditional MS peers. MM funds' cumulative performance compares favorably to traditional MS funds over long periods of time (Figure 2). This cumulative MM outperformance for the period is in large part due to the shorter and less severe drawdowns the MM funds' had during tumultuous market periods (Figure 3). As a result, MM funds have exhibited lower beta to the MSCI World Index over the past few years (Figure 4).[3] We have considered numerous additional performance-related indicators to compare MM funds with traditional MS funds and have included some of them in the Appendix.

[3] In Figures 2–4, the data for MM funds and traditional MS funds represent an equal-weighted portfolio of the same ten funds for each group used in the net asset flows illustration.

### Figure 2. Cumulative Multi-Manager Fund and Multi-Strategy Fund Performance

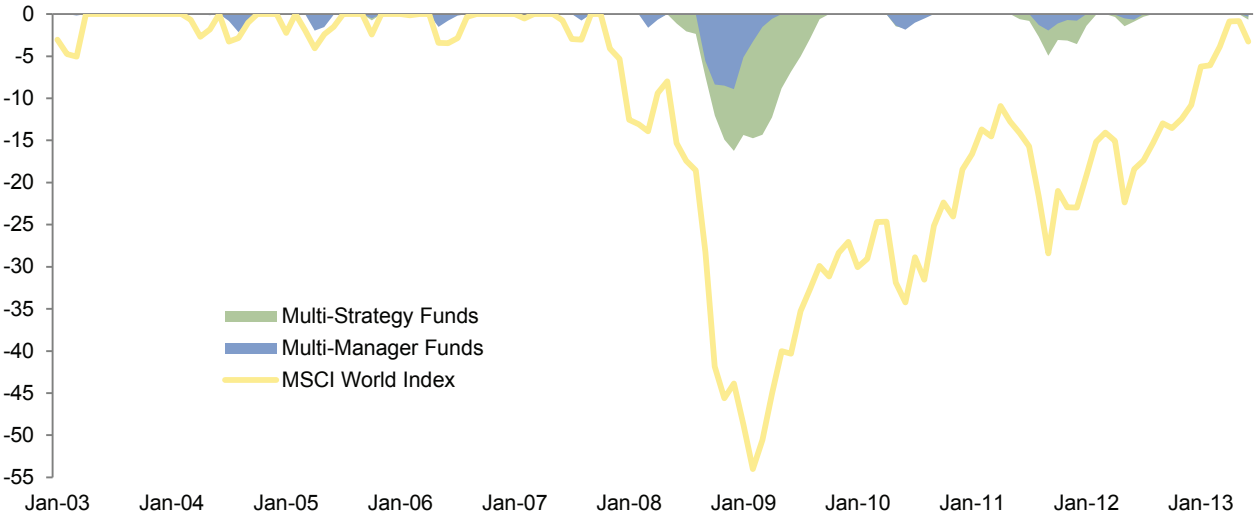
January 1, 2003 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All statistics are computed from monthly returns in the original reported currency of each series.

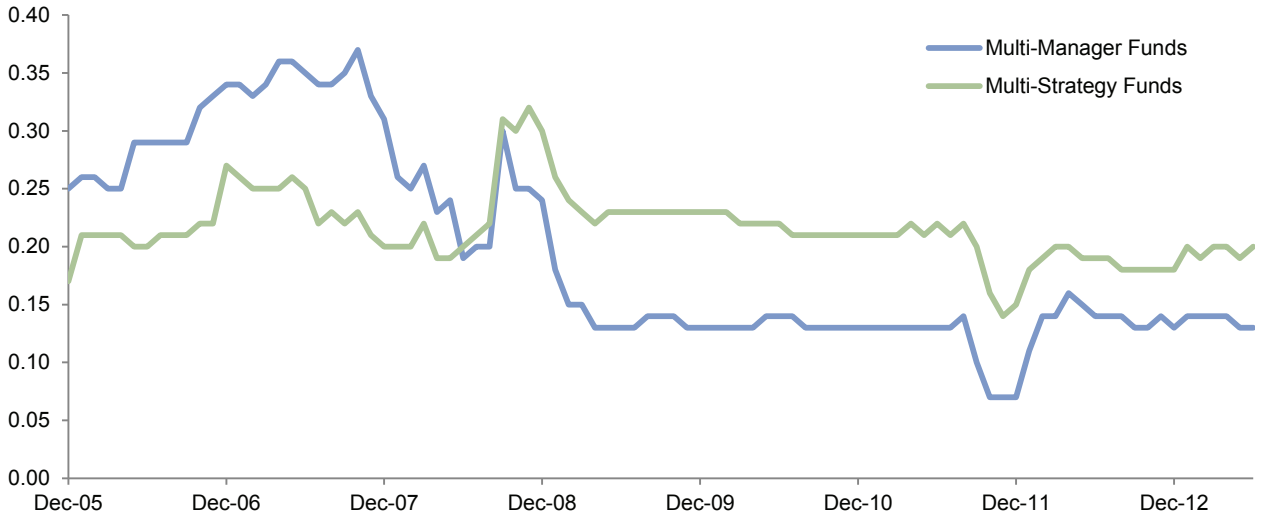
### Figure 3. Time Below Previous Peak: Multi-Manager and Multi-Strategy Funds

January 1, 2003 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All statistics are computed from monthly returns in the original reported currency of each series.

**Figure 4. Multi-Manager and Multi-Strategy Fund Beta Versus MSCI World Index: Rolling 36 Months**
January 1, 2006 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All statistics are computed from monthly returns in the original reported currency of each series.

## Criteria for Evaluating Multi-Manager Firms

When evaluating a prospective MM allocation, investors should tailor some of the questions they would ask regarding any hedge fund allocation and in some cases should ask altogether different questions. This section explores some of these questions; the key questions are:

- **Who manages overall risk?** Investors may not be privy to organizational changes within the firm because few MM firms make the underlying traders visible.
- **How involved are the firm's founders in managing its products?** In addition to the inherent challenge of isolating and evaluating return drivers in a highly diversified portfolio, the existence of "center books" can make it more difficult to pinpoint who is managing the fund's capital.
- **What is the rate of employee turnover?** For an MM firm, there is a technical reason for the existence of an opportunity cost when a trader departs.
- **What is the amount of insider capital?** Insider investors sometimes get slightly better terms.
- **Are the firm's interests closely aligned with investor interests?** MM funds have underlying nuances that may cause investors to question the degree to which the team has its own skin in the game.
- **How has the fund performed?** Higher risk does not necessarily translate into higher return.
- **Is a mechanism in place to regulate drawdowns?** The behavior of different MM funds cannot be explained by the amount of leverage they use—it depends instead on what investments they make and how they make them.

- **How does the firm manage equity exposures?** MM funds mandate various guidelines on their equity teams, which has consequences for how the equity portfolio drives fund returns.
- **Are withdrawal terms appropriate for the portfolio?** Fundamental mismatches can potentially occur between portfolios, which tend to be dynamic, and withdrawal terms, which tend to be static.
- **What's the true cost to investors?** The variation in expenses between different MM funds is wider than it may appear.

In the process of evaluating MM firm, we found that no two are alike—each structures its organization and investment process differently. So although we do not discuss particular firms in detail in this paper, we do compare and contrast some key differences between firms in the examples that follow.

## Who Manages Overall Risk?

A highly diversified portfolio with many decision makers renders it difficult to identify and evaluate drivers of returns. MM firms tend to be quick to fire trading teams when they underperform. While this practice may help to subdue losses in the fund, the turnover also means that it is particularly difficult to anticipate the future sources of fund returns. Investors may not be privy to organizational changes within the firm because few MM firms make the underlying traders visible or provide investors access to them.

## How Involved Are the Firms' Founders in Managing Its Products?

Senior management plays a critical role in maintaining a common culture at their firm, mandating appropriate trading limits for each trader, and allocating capital among them. In some cases their responsibilities are confined to these roles, and traders have most of the day-to-day investing responsibilities. In such circumstances investors' confidence in an MM firm's senior management is a function of their ability to source and select talented traders.

However, senior management involvement can meaningfully vary. At other firms, they actually trade directly and are intimately involved in day-to-day investing activities. In such cases, it is common for senior management to maintain a "center book" designed to upsize investments in the best ideas from the underlying traders' books. Center books make it more difficult to discern who is managing the fund's capital at any given time because the fund's largest holding may not represent the highest-conviction idea of the trader who originated and underwrote the position. In such circumstances investors' confidence in senior management is a function of their ability to trade their individual books profitably and to enlarge best ideas from other traders.

In either of these cases, MM firms typically do not make this analysis easier, because their transparency reports aggregate the exposure information for all underlying traders.

## What Is the Rate of Employee Turnover?

Many MM firms do not make their underlying traders visible or provide investors access to them. As a result, investors may not be privy to organizational changes within the firm. MM firms' explanations typically cite their policy of quickly firing trading teams when they underperform to help subdue losses in the fund. However, there is an opportunity cost when such a trader departs before bringing the portfolio back to its high-water mark. Because the fund would not be required to pay incentive fees to the trader until the trader completely

made up for the previous losses, the opportunity to grow the AUM at a lower cost is lost. Thus, somewhat counterintuitively, increasing the pace at which unprofitable traders are replaced may hurt investors in the short run. Some of this downside is addressed by putting the realization of incentive payments on a vesting schedule, as described in the alignment of interests discussion on the next page.

## What Is the Amount of Insider Capital?

Insider capital is an area where investors will likely find unusual disparities between MM firms. Insider capital is sometimes invested in separate vehicles governed by slightly different redemption terms from those offered to external LPs. For example, one manager's insider capital is invested through a separate legal entity that invests in ancillary strategies, employs different leverage levels, and is subject to undisclosed liquidity terms at senior management's discretion. Another manager's insider capital is invested through a separate internal-only vehicle that allows employees monthly access to their capital, as compared to external LPs' quarterly access. In some other cases, senior management applies leverage to enhance the returns on insider capital, which may introduce instability due to the covenants that typically accompany external financing.

## Are the Firm's Interests Closely Aligned with Investor Interests?

Hedge fund firms need to strike a balance between generating sufficient profit on reasonable terms to attract investor capital and maintaining a sufficiently appealing compensation structure with stable capital to attract talented traders. In this regard, MM firms are no different from any other hedge fund organization. That said, MM firms have certain distinguishing characteristics.

Specifically, MM firms tend to (a) attract and retain traders with compensation structures based on their own individual performance, and (b) maintain fee and withdrawal terms that allow them the flexibility to do so. MM firms have cited the specialization of the equity markets as justification for this approach, reasoning that employing traders to focus on distinct areas of the market is necessary given the intensity of competition from rival investors. By compensating traders based purely on the success or failure of their individual efforts, MM firms appeal to traders who are seeking to focus on investing, not on managing a business. Investors should be aware of the terms and limitations that typically accompany such structures, the behavior they encourage, and the additional responsibility they put on firm management to monitor and regulate the traders to safeguard investors' interests.

First, MM fund employment contracts are typically tailored to each individual trader subject to the trader's track record, caliber, and sector focus. Employing autonomous traders places tremendous demands on the senior management team to maintain effective oversight over many disparate parts. The better firms will have sufficient experience and powerful enough systems to take appropriate action when individual traders fall short of expectations, when the investments they have made collectively approach their stop-loss levels, and when certain unintended risks aggregate to the portfolio level. A by-product of hiring multiple traders with overlapping sector focuses is that the practice may breed rivalry and herd behavior. These effects can undermine the benefits that arise from collaboration and sharing resources within the firm.

Second, MM firms with small asset bases tend to suffer higher organizational risk because

economies of scale play a significant role for MM firms. Even when a small firm pays its traders a meaningful profit percentage, the dollar amount of compensation is unlikely to meet traders' requirements and support each trader's expenses, such as analysts, Bloomberg terminals, and financing. However, larger MM firms can meet traders' requirements even at a lower profit sharing percentage because they are able to allocate larger amounts of capital to each trader. Additionally, larger MM funds are better able to spread fixed infrastructure costs over a larger asset base.

Regarding term structure, MM firms commonly offer numerous underlying share classes, and potential investors should be aware of the specific details of the share classes they are considering. Redemption privileges may vary between share classes, so that some investors' ability to withdraw from the fund may be impaired in a scenario where other investors can withdraw on preferential terms. For example, one manager offers its MM fund through two flagship classes of shares, an annual share class and a quarterly class that subjects investors to a 25% investor-level gate. These two classes represent 75% of the fund's AUM. Approximately half of the remaining assets represent over a dozen legacy share classes that hold investors to quarterly redemptions subject to a gate the greater of $150 million or 17.5%. Under certain circumstances, the investors in these legacy share classes could withdraw their entire allocation from the fund at quarter-end. Meanwhile, investors in the two flagship classes are bound by more restrictive terms.

Regarding compensation, most MM firms compensate their traders formulaically and explicitly describe this methodology in traders' employment contracts. Firms that adopt this practice typically believe that not all investment talent is created equal, and thus compensation needs to be tailored for each trader. In general, traders' payouts range from 8% to 20% of profits. Some firms adopt a nuanced approach whereby their traders' performance bonus is calculated on a sliding scale of 0% to 30% of their trading profits; the higher the rate of return, the larger the share of profits a trader keeps. Other MM firms use combinations of discretionary and formulaic inputs to derive each trader's share of profits they generate. In addition to variations in the portion of trading profits paid to traders, MM firms differ by the terms governing how these payouts are calculated and their vesting schedules.

- **How are bonus payouts calculated?** Traders at some firms are subject to a perpetual high-water mark and do not earn a performance bonus while their returns are below the high-water mark. This approach helps avoid distorted decision making by traders, especially in anticipation of a near-term resetting of their high-water mark. Other MM firms reset their traders' high-water marks at year-end.
- **What portion of these payouts is deferred or vested over time?** A standard firmwide deferral program wherein a portion of traders' compensation is vested for a significant period of time has some associated benefits. Specifically, deferrals can help discourage departures and offset potential future losses originating from an individual trader's book. Firms that mandate deferrals typically apply them to a significant portion of compensation over a period of time, in many cases 25% deferral over a three-year vesting period. Other MM firms compensate traders entirely in cash, or do not disclose details on their deferral program altogether.

In addition, investors should determine whether other key provisions are in place to better align interests, including: (a) a key-man clause to protect investors in case of senior-level departures, (b) substantial insider capital, (c) substantially equivalent liquidity terms for insider capital and external LPs' investments, (d) a standardized deferral program or performance claw-back feature to deter departures and offset potential losses, and (e) the absence of side letters providing preferential liquidity terms to specific investors.

Our analysis suggests that few if any funds meet all five of these factors. Investors should note that these simple qualification criteria grossly oversimplify important nuances that differentiate MM firms from others. While having more of these qualities is generally better, some individual qualities may hold greater weight, and a small number of them can combine for a potent mix. A few key areas investors should examine closely include the fund's term structure, insider capital, compensation, and firm culture. Note that most MM firms have yet to make meaningful progress toward succession planning. This is especially the case at firms where GP ownership is concentrated at the top.

## Is a Mechanism in Place to Regulate Drawdowns?

Low levels of leverage do not necessarily coincide with low levels of volatility. Investors seeking a broader measure of fund performance can look to MM funds' historical susceptibility to drawdowns. To understand the wide range of historical drawdowns, investors may want to consider the drawdown limits each MM firm imposes on its traders, one of the key tools MM firms use to help enforce self-discipline. However, the effectiveness of these loss-controlling measures depends on their implementation, which in some cases is at senior management's discretion. For example, one manager mandates stop-loss limits implemented in stages: a 50% reduction in allocated capital if a PM incurs a 2.5% loss on his existing allocated capital, an additional 50% reduction of the remaining capital in the event of a cumulative 5% loss, and a full stop-out—an immediate sale of the assets in the portfolio to prevent further losses—after a cumulative 7.5% loss. However the manager expands the limits for traders having an unusual "winning streak." In most other cases MM firms lack drawdown limits, grant exceptions, or widen their limits in certain circumstances, such as for an unusually profitable or long-tenured trader.

Because most MM firms maintain soft drawdown limits or often grant exceptions to hard limits, a comprehensive list of each MM firm's limits is of little value when comparing MM funds. Instead, investors should focus their due diligence efforts on identifying the guidelines used to evaluate the traders they employ and gauging senior management's response to an unprofitable trader. Some MM firms may approach these trader management issues in different ways.

The senior management of one MM firm, for example, say they believe the evolution of traders follows an arc. Young and inexperienced traders tend to be more dynamic and energetic—over time they mature and excel, but eventually lose focus. They also say they believe the evolution of strategies is cyclical, that unprofitable strategies once shunned and dismissed by market participants will over time regain their attractiveness and get a lot more interest, leading to capital inflows that inevitably erode their profitability. Accordingly, this firm's senior management does not require its traders to be profitable at all times, but rather

they hire promising talent, initially allocate small amounts of capital to them, and eventually increase their allocations in anticipation of a favorable market environment—when they do expect the trader to be profitable. As a result this firm is in fact tolerant of trader underperformance, a characteristic it shares with some other MM firms.

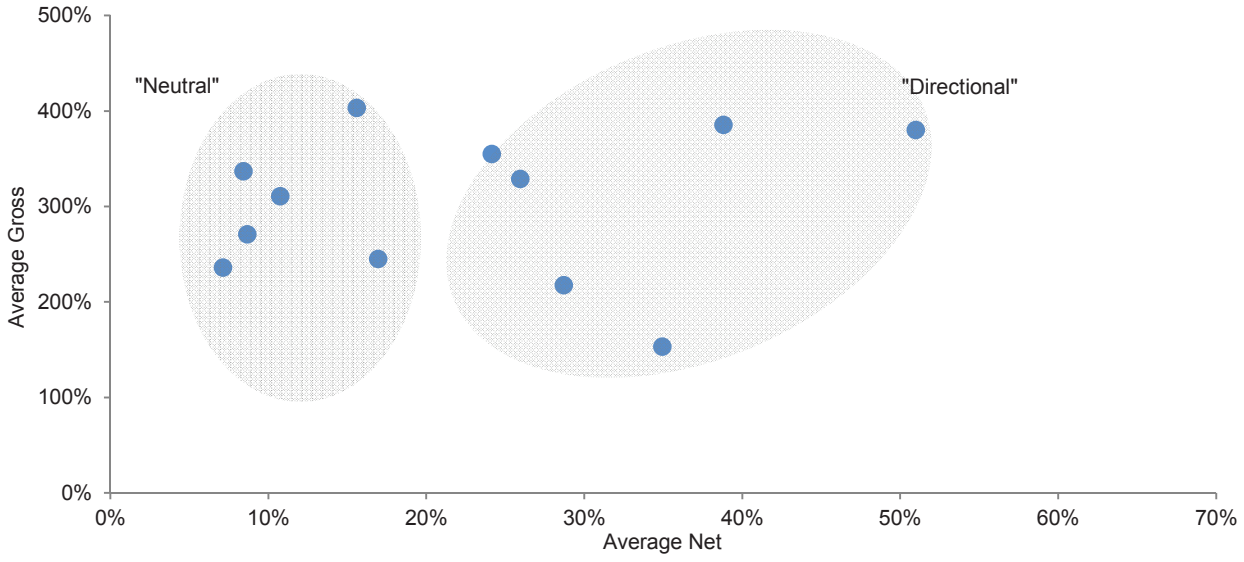
## How Does the Firm Manage Equity Exposures?

In addition to the aforementioned drawdown limits, MM firms commonly require their equity traders to abide by gross and net exposure limits, often explicitly defined in employment contracts. Firms typically respond to breaches of these limits by liquidating the trader's book and dismissing the trader from the firm. It is unclear how significant these prescribed limits are to a fund's risk profile because they vary between firms, as does the extent to which they are enforced within each firm. One manager, for example, limits its equity-focused traders' net exposure to within 15% of neutrality at all times, while other MM firms either hold their equity PMs to soft net exposure limits or lack them entirely.

Note that we hone in on equities because they tend to dominate MM funds' portfolios and they are a relatively straightforward asset class with exposures that are less subject to manipulation—at least relative to credit or fixed income.

Figure 5 groups MM funds' equity books into two categories based on two dimensions: average gross exposure (y-axis) and average net exposure (x-axis). MM funds' equity exposures tend to cluster into two broad categories:

**Figure 5. Multi-Manager Fund Equity Exposure**
January 1, 2009 – June 30, 2013




Source: Cambridge Associates LLC.
Notes: Chart uses manager-provided monthly long and short market value data from January 2009 through June 2013. This graph captures exposures originating from only the equity books in each MM's portfolio, including in fundamental, event-driven, and quantitative strategies. The denominator in calculating the figures for the chart is the capital allocated to equity strategies (not total fund NAV) to properly account for funds' different allocation sizes to equity strategies.

- **Neutral equity books** are those in which traders are typically limited to maintaining low amounts of net long bias, so traders' behavior is generally consistent with going long a company and shorting a roughly equal amount of a closely-related company. The general expectation is to quickly take profits and quickly cut losses. As a result, returns originating from these equity books tend to be steady and well balanced. Unsurprisingly, most of these books belong to MM funds that maintain strict net exposure limits as outlined above.
- **Directional equity books** are those in which traders are typically allowed to express their fundamental or event-driven views with more directionality. These traders' behavior is generally consistent with "letting profits run" on idiosyncratic situations as market perception catches up with fundamental reality. Accordingly, net exposure limits are typically much wider and profits are more volatile, consistent with the aforementioned MM funds that maintain soft exposure limits or lack them entirely.

While different MM funds' equity books perform in different ways, in general those that fall into the directional category derive a much larger portion of their equity profits from beta relative to those in the neutral category. This difference is illustrated in Figure 6, which decomposes equity returns into those attributable to leverage (gross exposure), beta (net exposure), and value add (alpha) over the past five years.

Overall, not only do different firms generate different levels of equity returns, but the way they achieve them varies meaningfully depending on the fund. Interestingly, as illustrated by the two bars on the right side of Figure 6, the average MM fund is roughly equally effective at generating alpha on its equity investments as the average traditional MS fund. However, MM funds tend to derive a larger portion of their equity returns from leverage, while traditional MS funds tend to derive a larger portion of their equity returns from beta.

Note that MM funds and traditional MS funds vary in the portion of their portfolios they allocate to equities. Table 1 puts total equity returns from Figure 6 in the context of the role equity strategies play in their respective portfolios.

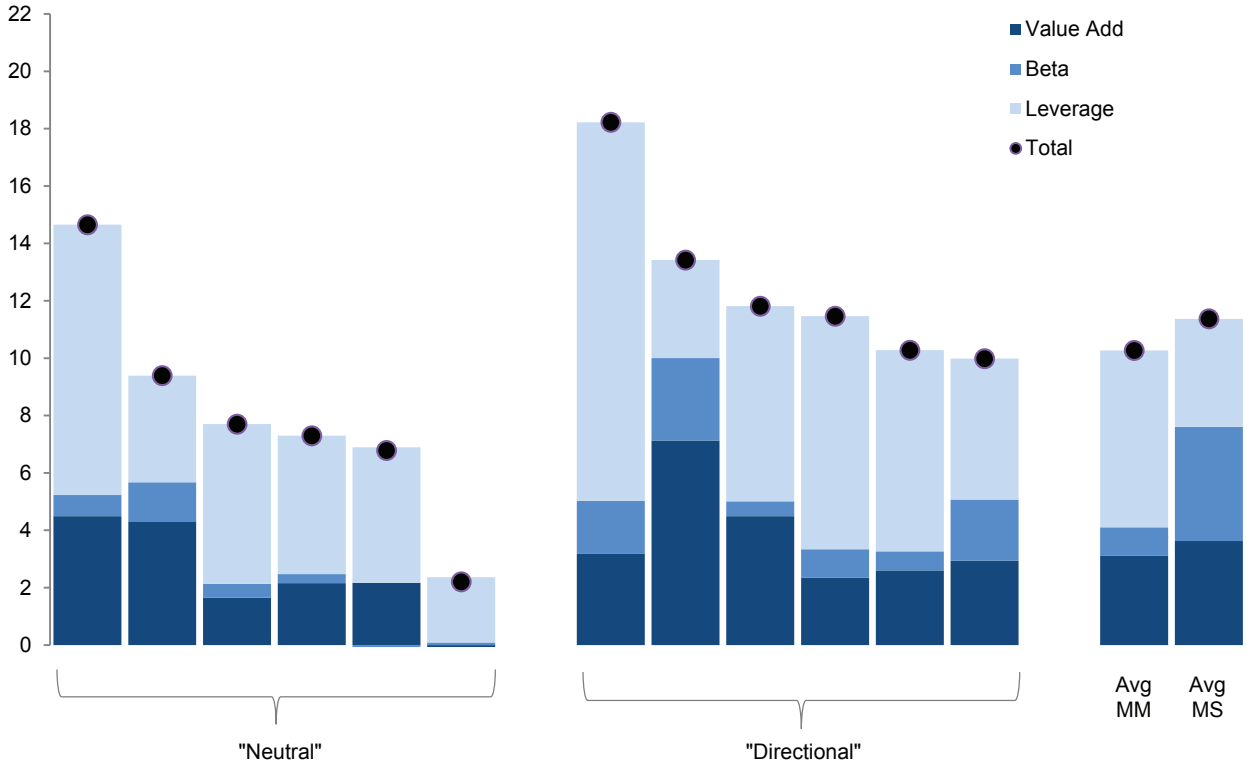
MM funds tend to derive a substantially larger portion of their overall returns from equities relative to traditional MS funds. This difference may be explained by traditional MS funds being more active in other asset classes. As we illustrate later, these other asset classes have generally been less liquid.

**Table 1. The Role of Equity Strategies**

| Multi-Manager Type | Equity Return as % of Total Fund Returns |
|---|---|
| Neutral | 63% |
| Directional | 58% |
| **MM Average** | **60%** |
| **Traditional MS Average** | **39%** |

Source: Cambridge Associates LLC.
Notes: Based on monthly data from January 2008 to June 2013. Traditional MS represents the average of traditional multi-strategy funds.

**Figure 6. Multi-Manager Fund Equity Return Decomposition**
January 1, 2000 – June 30, 2013 • Annual (%)




Source: Cambridge Associates LLC.
Notes: Figures are based on monthly long and short market value and profit contribution data from January 2009 through June 2013. Avg MS = average for traditional multi-strategy funds. Ranges for traditional multi-strategy funds are as follows: value add (min=-3.3%, max=8.9%), beta (min=1.6%, max=11.5%), leverage (min=-6.3%, max=16.2%), and total (min=5.8%, max=20.6%).

## Are Withdrawal Terms Appropriate for the Portfolio?

MM firms may hold investors to very different withdrawal terms. It is important that investors evaluate the degree to which a fund's withdrawal terms are appropriate for the liquidity and duration of its portfolio holdings. However, investors may find it challenging to evaluate the anticipated holding periods of all underlying PMs employed at an MM firm. An alternative would be to consider the liquidity of an MM fund's portfolio in its entirety.

We cross-referenced each MM fund's withdrawal terms with the overall portfolio liquidity using FASB Topic 820 fair value measurement categories, which define level 1 assets as those valued using quoted prices in active markets for identical assets or liabilities, level 2 assets as those valued using significant other observable inputs, and level 3 assets as those valued using significant unobservable inputs.

We found that on average, as illustrated in Table 2, MM funds have substantially lower exposure to Level 3 assets than traditional MS funds.

**Table 2. MM Fund Overall Portfolio Liquidity**

| Multi-Manager Fund | % of Portfolio in | | |
|---|---|---|---|
| | Level 1 | Level 2 | Level 3 |
| MM Average | 66 | 29 | 5 |
| Trad MS Avg | 46 | 38 | 16 |

Source: Cambridge Associates LLC.
Notes: Figures based on representative fund's 2012 audited financial statement. Level 1, 2 and 3 figures are based on FASB Topic 820 (formerly FAS 157) fair value measurement categories. Ranges for MM funds are as follows: Level 1 (min=5%, max=98%), Level 2 (min=2%, max=72%), and Level 3 (min=0%, max=67%). Traditional (trad) MS = average for traditional multi-strategy funds. Ranges for traditional multi-strategy funds are as follows: Level 1 (min=14.7%, max=79.8%), Level 2 (min=16.3%, max=54.4%), and Level 3 (min=3.9%, max=37.5%). Note that Level 1, 2, and 3 categories generally correlate with liquidity, but not at all times. For example it may take many months to liquidate a large position in a small-cap company listed on a stock exchange, depending on daily trading volume. Similarly some Level 2 assets, such as corporate bonds, may benefit from deeper liquidity than some Level 1 assets.

## What's the True Cost to Investors?

Traditional MS firms typically maintain a fixed fee structure, which helps incent cost efficiency. Fee structures at most MM firms, however, permit the pass-through of investment-related expenses (including salaries and bonuses) to the fund's investors, often in addition to incentive fees. A by-product of a pass-through fee structure is netting risk, where investors may incur the cost associated with compensating profitable traders even if the overall fund is unprofitable in a given year. Investors are thus exposed not only to the risk of all traders incurring losses in a given year, but also the risk of wide performance dispersion between the most and least profitable traders.

MM funds generally have one of three types of fee structures:

- **Flat fund-level incentive fee.** Investors incur a management fee, a fixed incentive fee on the net profits of all underlying trading strategies, and non-compensation-related operating expenses. In most cases netting risk is incurred by the firms.
- **Full pass-through of expenses without a fund-level incentive fee.** Investors incur a management fee in addition to paying all salary and bonus compensation and operating expenses. Here, investors incur netting risk.
- **Full pass-through of expenses with a flat fund-level incentive fee.** Investors incur a management fee and an incentive fee on top of all salary and bonus compensation and operating expenses. Here, investors incur netting risk.

Note that each MM firm has its nuances related to fees, making direct comparisons between firms imprecise. Putting aside such idiosyncrasies, it is possible to compare the costs between different MM firms using historical audited financial statements. Table 3 approximates annual fee structures that correspond to the dollar amount of expenses that investors actually incurred over the past five years, accounting for trader compensation and operating expenses (including audit, professional, and uncategorized "other" fees) as well as incentive fee charges. More "expensive" funds are ranked lower in the table.

Investors need to be aware of the costs associated with investing in a MM fund, not all of which are immediately apparent. Effective fee structures vary drastically between MM funds, and even between years, depending on the individual and collective performance of traders employed by the firm. The differences in incentive fees between some MM funds and

**Table 3. MM Fund Annual Fee Structures**

| Tier | Multi-Manager Fund | Effective Fee Structure | Who Takes Netting Risk? |
|---|---|---|---|
| 1 | Manager A | 2% + 17% | Firm |
| | Manager B | 2% + 17% | Firm |
| | Manager C | 2% + 22% | Firm |
| | Manager D | 2% + 22% | Firm |
| | Manager E | 2% + 24% | Firm |
| | Manager F | 2% + 26% | Firm |
| | Manager G | 2% + 27% | Firm |
| | Manager H | 2% + 29% | Firm |
| 2 | Manager I | 2% + 34% | Firm |
| | Manager J | 2% + 38% | Firm |
| | Manager K | 2% + 38% | LPs |
| | Manager L | 2% + 46% | LPs |
| | Manager M | 2% + 47% | LPs |
| | Manager N | 2% + 47% | LPs |
| | Manager O | 2% + 52% | Firm |
| **MM Average** | | **2% + 33%** | **---** |
| **Traditional MS Avg** | | **2% + 13%** | **Firm** |

Source: Cambridge Associates LLC.
Notes: Based on representative feeder fund's audited financial statements. Denominator used is the average between year-beginning and year-ending net asset value, adjusted for redemptions. Note that the underlying calculations penalize smaller funds (in part due to economies of scale) and those with more modest performance. Traditional MS = average for traditional multi-strategy funds. Effective incentive fee ranges for traditional multi-strategy funds: min=1.5%, max=26.9%. Effective fee structure is management + incentive.

traditional MS funds can be staggering. They are largely attributable to MM firms being able to pass through many organizational costs that normally are paid with management fee proceeds.

Comparing performance between funds is inherently incomplete without properly accounting for the period subsequent to 2008 due to high-water mark–related incentive fee differentials. Part of the reason investors in traditional MS funds have incurred under 20% incentive fees is that the funds spent a lot of time under their high-water marks during the five years ended December 2012. Specifically, traditional MS funds spent an average of 23 months (or 41% of the last 60 months) under their respective high-water marks subsequent to their 2008 losses. In comparison, MM funds spent an average of 13 months (or 21% of those 60 months) under their respective high-water marks, roughly half as much time. Clearly, if traditional MS funds had less severe drawdowns, their effective fee structures would have been higher.

We found that "expensive" MM funds, represented by the Tier 2 category in Table 3, tend to exhibit similar annualized net returns to "inexpensive" MM fund returns, represented by the Tier 1 category. However, historical performance data suggest that the more expensive funds tend to outperform the inexpensive funds on a risk-adjusted basis. The more expensive funds tend to also exhibit lower beta to the MSCI World Index (Table 4).

Investors should also consider the significant disparity between gross and net returns to investors as a result of the vastly different fee structures. Based on our analysis, the average MM fund needs to generate 40% higher profits on its investments for the investor to benefit from the same net return as with an average

**Table 4. MM Fund Betas to MSCI World Index**

| Tier | Avg AACR | Avg Sharpe | Avg Beta |
|---|---|---|---|
| 1 | 8.5% | 1.08 | 0.18 |
| 2 | 8.6% | 1.34 | 0.08 |

Sources: Cambridge Associates LLC and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Notes: Figures based on monthly net returns from January 2008 through June 2013. Beta figures are relative to the MSCI World Index. Tiers are in reference to the average of MM funds within each tier as categorized in the previous table.

traditional MS fund (Table 5). While this is a broad generalization that ignores different uses of leverage, we find it generally consistent with MM firms' tendency to place more stringent return expectations on its traders. In turn, this disparity helps explain the existence of strict drawdown limits, tailored compensation programs, and generally higher levels of employee turnover.

## Conclusion

This report examines the characteristics of multi-manager hedge funds that sufficiently differentiate them from their traditional multi-strategy counterparts to warrant particular consideration by potential investors. Our examination does not lead us to make a blanket endorsement of one type over the other. Rather, our discoveries provide insight into the significant ways the funds within the MM group differ not only from MS funds, but also from each other. The resulting questions investors should include in their due diligence process are provided here as a resource for investors that want to avoid unexpected outcomes and build on their qualitative analysis of the firm's potential to ultimately select the fund that is the best fit for their needs. ■

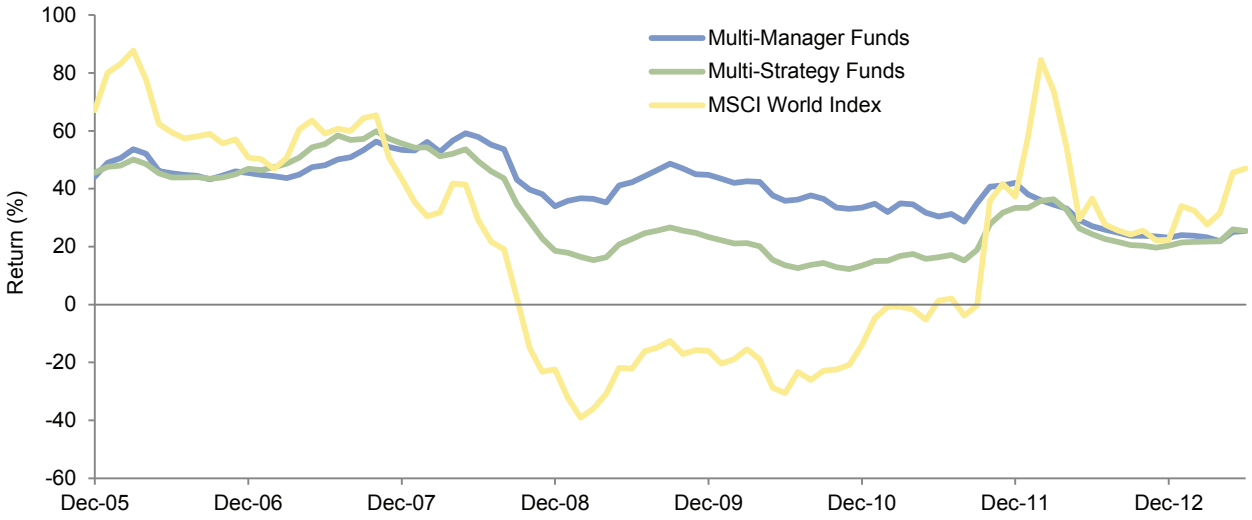
**Table 5. Gross Return Necessary for a 10% Net Return**

| Multi-Manager Fund | % Gross Return Necessary for a 10% Net Return to LPs |
|---|---|
| Manager E | 25.0% |
| Manager J | 23.6% |
| Manager O | 22.3% |
| Manager N | 22.1% |
| Manager L | 20.8% |
| Manager C | 19.5% |
| Manager K | 18.4% |
| Manager I | 18.3% |
| Manager M | 18.3% |
| Manager G | 17.8% |
| Manager D | 17.4% |
| Manager F | 16.7% |
| Manager H | 15.3% |
| Manager A | 14.2% |
| Manager B | 13.7% |
| **MM Average** | **18.9%** |
| **Trad MS Average** | **13.6%** |

Source: Cambridge Associates LLC.
Notes: Figures are on a total feeder-fund level, ignoring differences between share classes. Note that the underlying calculations penalize smaller funds (in part due to economies of scale) and those with more modest performance. Data based on 2008–2012 audited financial statements for representative feeder funds. Traditional MS = average for traditional multi-strategy funds. Ranges for traditional multi-strategy funds are as follows: min=11.5%, max=16.2%.

### Appendix Figure 1. Cumulative Rolling Performance: 36 Months

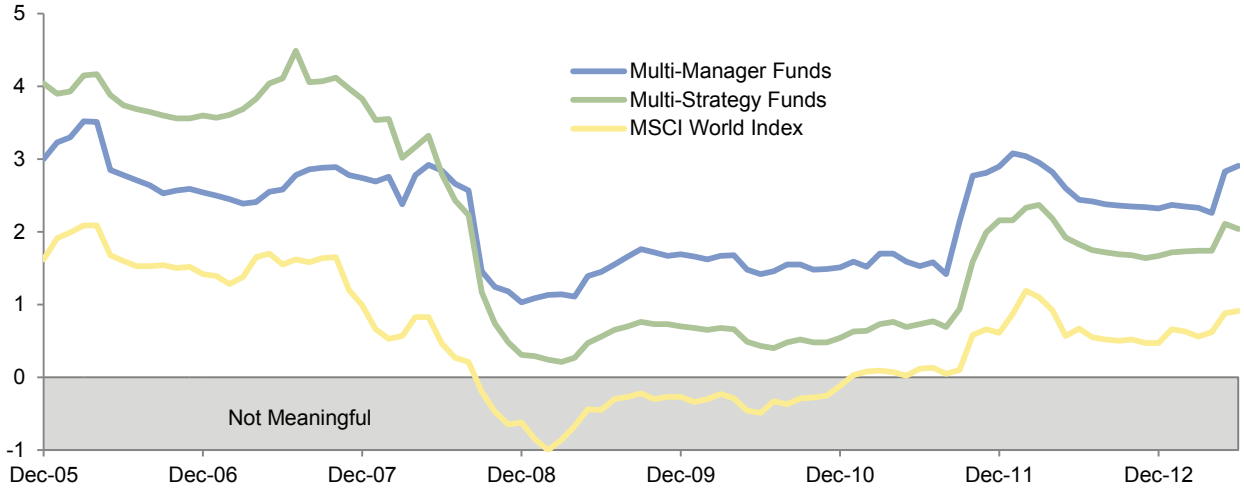
December 31, 2005 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All statistics are computed from monthly returns in the original reported currency of each series.

### Appendix Figure 2. Sharpe Ratio: Rolling 36 Months

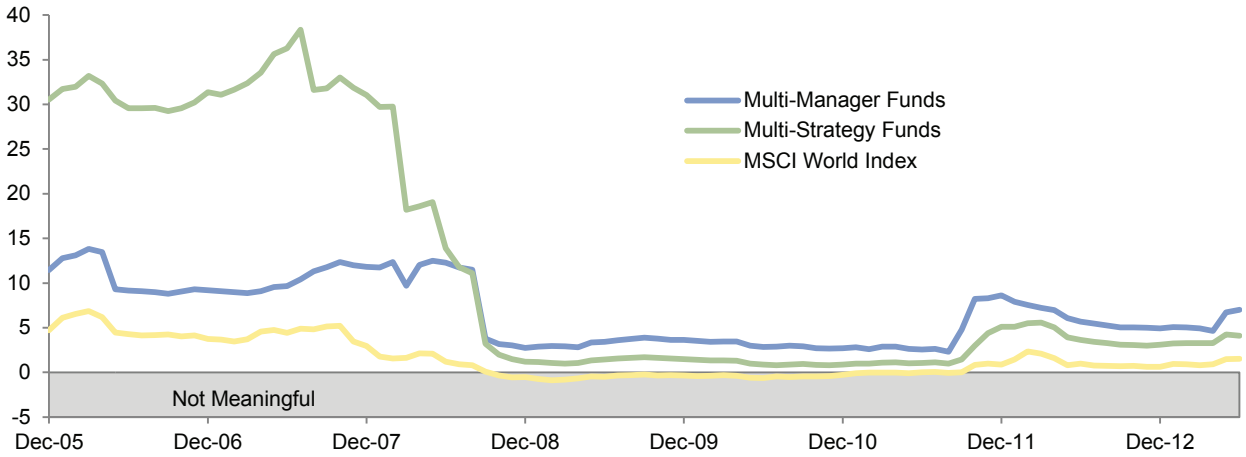
December 31, 2005 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All statistics are computed from monthly returns in the original reported currency of each series. Sharpe ratio is defined as the return in excess of the risk-free rate by standard deviation.

### Appendix Figure 3. Sortino Ratio: Rolling 36 Months

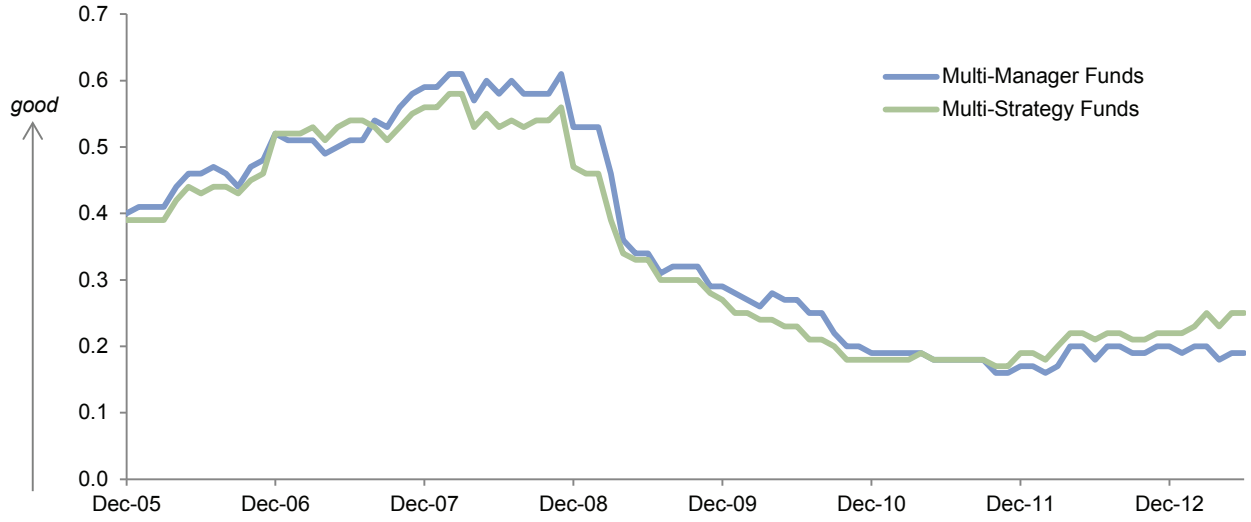
December 31, 2005 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All statistics are computed from monthly returns in the original reported currency of each series. The Sortino ratio is defined as the return in excess of the risk-free rate divided by downside deviation. It penalizes only those returns falling below the target rate of return, while the Sharpe ratio penalizes both upside and downside volatility equally.

### Appendix Figure 4. Up Capture: Rolling 36 Months

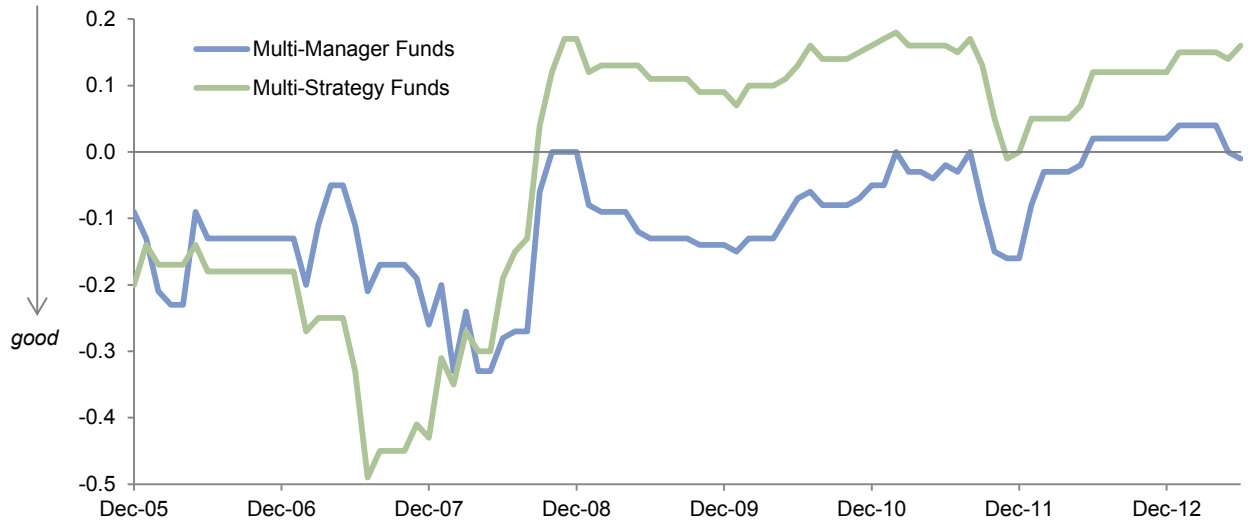
December 31, 2005 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All statistics are computed from monthly returns in the original reported currency of each series.

### Appendix Figure 5. Down Capture: Rolling 36 Months

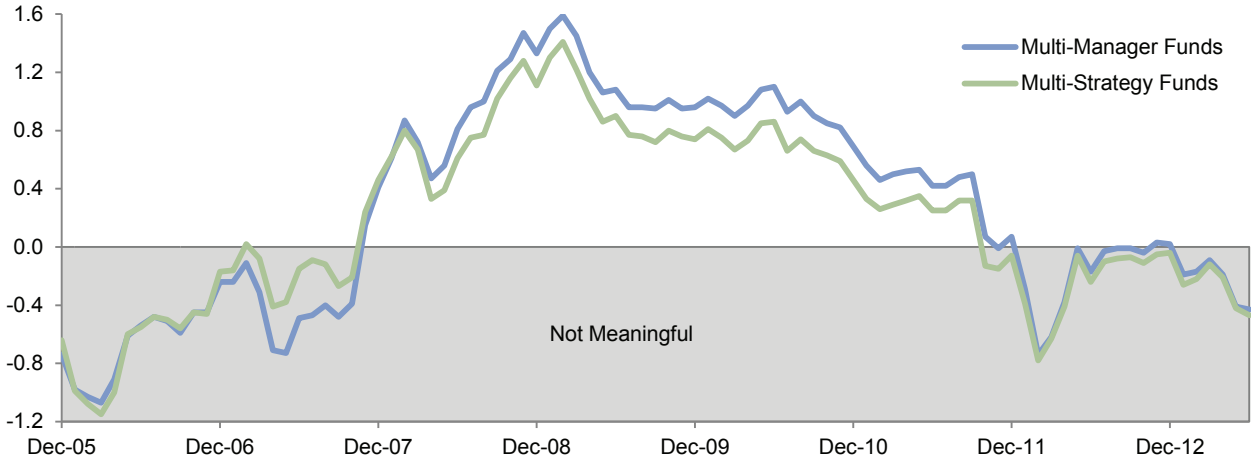
December 31, 2005 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All statistics are computed from monthly returns in the original reported currency of each series.

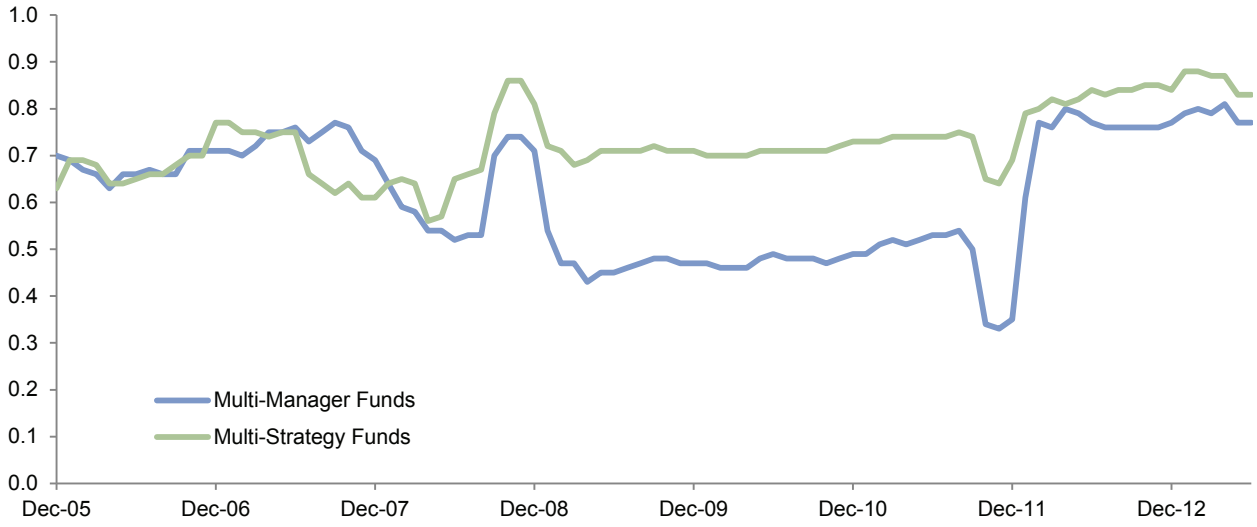
### Appendix Figure 6. Information Ratio: Rolling 36 Months

December 31, 2005 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All statistics are computed from monthly returns in the original reported currency of each series. The information ratio is defined as the expected active return (active return is the difference between the fund's return and the return of a selected benchmark index) divided by tracking error (the standard deviation of the active return).

**Appendix Figure 7. Correlation with MSCI World Index: Rolling 36 Months**
December 31, 2005 – June 30, 2013




Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All statistics are computed from monthly returns in the original reported currency of each series.