

# Reconsidering Funds of Hedge Funds

The Financial Crisis and Best Practices in UCITS,  
Tail Risk, Performance, and Due Diligence

Edited by  
**Greg N. Gregoriou**  
Foreword by **Stephen J. Brown**



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**THE FINANCIAL CRISIS AND BEST PRACTICES IN UCITS,  
TAIL RISK, PERFORMANCE, AND DUE DILIGENCE**

**Edited By**

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Academic Press is an imprint of Elsevier



Academic Press is an imprint of Elsevier  
The Boulevard, Langford Lane, Kidlington, Oxford, OX5 1GB, UK  
225 Wyman Street, Waltham, MA 02451, USA

First published 2013

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#### British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

#### Library of Congress Cataloguing in Publication Data

A catalog record for this book is available from the Library of Congress

ISBN: 978-0-12-401699-6

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Printed and bound in the United States of America

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# **Reconsidering Funds of Hedge Funds**

# Foreword

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The passage of the Uniform Prudent Investor Act of 1994 (UPIA) created an opportunity for the growth and development of Funds of Hedge Funds (FoHFs) providing institutional investors access to the high return of hedge funds by allowing them to diversify their risk exposure and to delegate their due diligence responsibilities to these FoHFs. However, the global financial crisis in 2008 was a major challenge to FoHFs. Poor returns and the flight of institutional capital during the financial crisis have led to a major reduction of assets under management by FoHFs. Recovery has been slow despite improved returns subsequent to the crisis. The economic environment remains a challenge for small FoHFs, but large FoHFs see opportunities and are attracting new capital. This book is a collection of studies that for the first time analyses in some depth the impact of the crisis on the FoHFs industry and the risks and opportunities that lie ahead.

The financial crisis in 2008 and the unfortunate coincidence of the Madoff scandal at the end of the year drew attention to the risks associated with hedge fund investing. A number of chapters in this volume address the need to develop new tools to calibrate – and control – these sources of risk.

Institutional clients demand increased attention to operational due diligence. Improved transparency and oversight are essential. This has led to the development of Undertakings for Collective Investment in Transferable Securities (UCITS) FoHFs. This institutional framework, originally created to standardize mutual fund structures in Europe, has come to be employed by FoHFs mainly in Europe but increasingly in USD accounts. Because these were originally designed for mutual funds, the improved transparency and oversight comes at the cost of severe restrictions on the strategies and instruments available to the funds. Among other things the investments are limited to relatively liquid securities. This provides operational flexibility but at the same time limits the investible universe of securities. This book examines carefully the nature of this tradeoff and the costs that it imposes, not only in terms of operational complexity but also in terms of potential reduction in returns. Since organizational frameworks of this nature can increase the comfort level of institutional clients, there may be opportunities for large FoHFs who can manage the cost and complexity of these arrangements.

The financial crisis also drew attention to the financial risks associated with hedge fund investments. It was thought that diversification alone would suffice to control and even eliminate financial risk. Indeed, this was perceived to be a major advantage of FoHFs in the period leading up to the crisis. However, the crisis revealed that many hedge funds were not immune to the economy-wide credit and liquidity risk that characterized that period. This exposure gave rise to excessive tail risk at many FoHFs. A number of chapters in this book address the need to develop new ways to measure this risk exposure and to develop performance measures that appropriately account for it. The consensus appears to be that there is good news. A variety of data sources suggests that FoHFs had favorable returns even after accounting appropriately for this risk, with evidence that large FoHFs had disproportionately higher returns.

The last section of the book addresses in some detail the legal and regulatory risks facing the FoHFs industry both in the United States and around the world. The UPIA, which applies to United States fiduciary investors, provides the clearest statement of what constitutes prudent investing in English law-based systems: a fiduciary investor must, in investing and managing fund assets, consider the purposes, terms, distribution requirements and other material circumstances of the fund. In the past FoHFs have relied on the somewhat illusory benefits of diversification. Overdiversification not only leads to diminished returns; it also increases legal risk to the extent that it renders more difficult their necessary due diligence responsibilities. At the same time there are significant opportunities for those FoHFs large enough to absorb the expenditures associated with appropriate due diligence and the increased costs of compliance that have arisen as a result of the financial crisis.

While the financial crisis had a significant and negative impact on most FoHFs, the bottom line is that the industry can meet the challenges it faces and that there are significant opportunities available for those FoHFs able and willing to take advantage of them.

**Stephen J. Brown**

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A native of Montreal, Professor Gregoriou obtained his joint PhD at the University of Quebec at Montreal in Finance which merges the resources of Montreal's four major universities UQAM, McGill, Concordia, and HEC. Professor Gregoriou has published 45 books, 60 refereed publications in peer-reviewed journals and 22 book chapters since his arrival at SUNY (Plattsburgh) in August 2003. Professor Gregoriou's books have been published by McGraw-Hill, John Wiley & Sons, Elsevier-Butterworth/Heinemann, Taylor and Francis/CRC Press, Palgrave-MacMillan and Risk Books. His articles have appeared in the *Review of Asset Pricing Studies*, *Journal of Portfolio Management*, *Journal of Futures Markets*, *European Journal of Operational Research*, *Annals of Operations Research*, *Computers and Operations Research*, etc. He has also been quoted several times in the *New York Times* and the *Financial Times* of London. Professor Gregoriou is hedge fund editor and editorial board member for the *Journal of Derivatives and Hedge Funds*, as well as editorial board member for the *Journal of Wealth Management*, the *Journal of Risk Management in Financial Institutions*, *Market Integrity*, *IEB International Journal of Finance*, *The Journal of Quantitative Methods for Social Sciences*, and the *Brazilian Business Review*. Professor Gregoriou's interests focus on hedge funds, funds of funds, and CTAs. He is EDHEC Research Associate in Nice, France, Research Associate at the Caisse de dépôt et placement du Québec (CDPQ) Chair in Portfolio Management at the University of Quebec at Montreal and is lecturer at the School of Continuing Studies at McGill University in Montreal.

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