

WINGED FISH, MULTI-STRATEGY HEDGE FUNDS, AND OTHER HIGH FLYERS

Intelligent Design; A Sub-Chapter

May 2006

If evolution of the hedge fund business is a Darwinian equation, the question arises “what of the winged fish?”

Multi-strategy hedge funds have risen to critical acclaim as the next-gen hedge fund. This thought piece tests whether a foundation in investment attributes exists for this claim, and extends the forward-looking debate on efficient design in hedge.

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Grail Partners is an advisory merchant bank specializing in the investment management business. We advise clients on strategic M&A transactions—merger, acquisition, divestiture, restructuring—and we invest firm capital to incubate and capitalize financial businesses.

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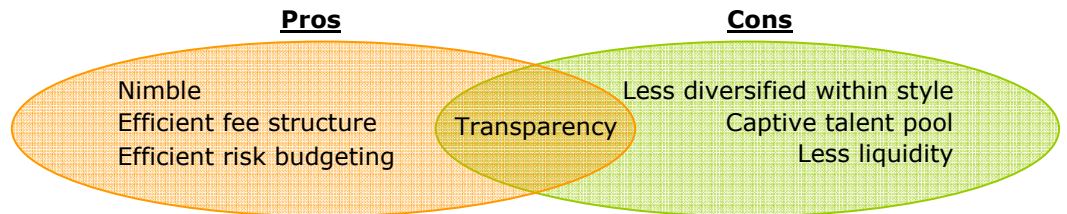
Nature and Nurture

In the long-term, the shape of fiduciary money management businesses is determined primarily by investment characteristics; hedge funds are no exception. At any given moment other considerations may be powerfully influential, but over the longer term returns and their distaff cousin – return expectations – will call the tune.

Data on investor demand suggests the decision to invest through a FoHF is akin to the choice between TV dinners and cooking: less administration required to enjoy the meal, lower risk of being burned, and, although food stamps are not accepted, most grocery stores will sell TV dinners without club membership.

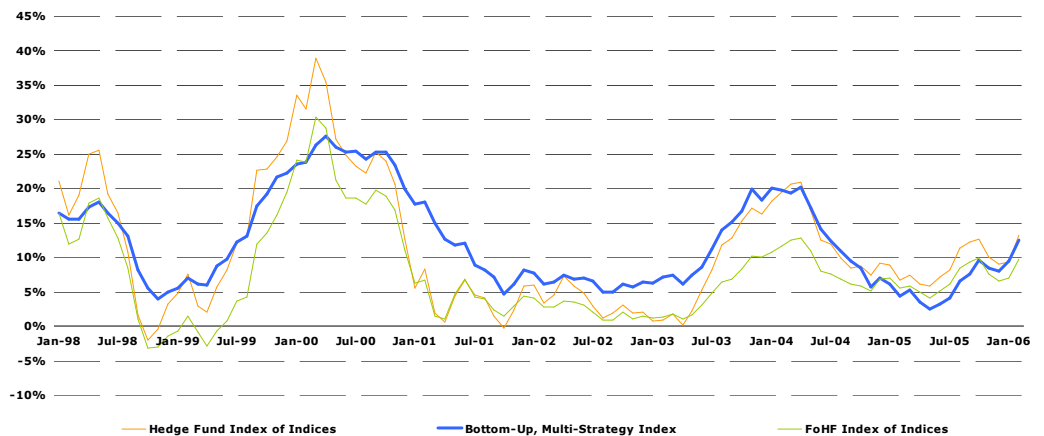
But what does one get? For the hectic and the indifferent of any age, a TV dinner, a pizza or a can of Dinty Moore does the trick – eaten over the sink, perhaps? – but as tastes mature and means allow, cooking and dining out become the norm. We assume the result is improvement in result, but is it really so, especially when cost and convenience are taken into account?

Our hypothesis is that a comparison of multi-strat to FoHFs as a *strategic choice* surfaces pro’s and con’s on both sides:



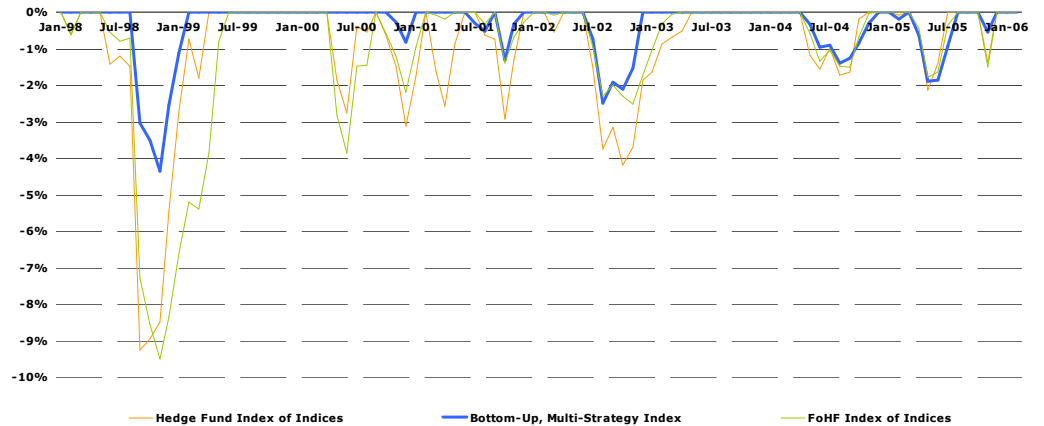
The question is, “how do these arguments weigh on results?” We commoditized the argument by comparing an Index of Hedge Fund Indices and an Index of FoHF Indices to the broadest grouping of Multi-strategy returns readily available (our “Bottom-up Multi-strategy Index”) by equal weighting the returns of 75 multi-strategy funds.

Exhibit 1: Rolling Twelve-Month Net Performance: 1998-2005



These aggregated results show a consistent advantage to Multi-Strat as measured by returns. As important for many investors, will be the advantage in terms of Drawdown. As illustrated below, our simplistic data supports the intuition that Multi-strategy funds are more nimble – drawdowns are less severe and time to recovery is shorter.

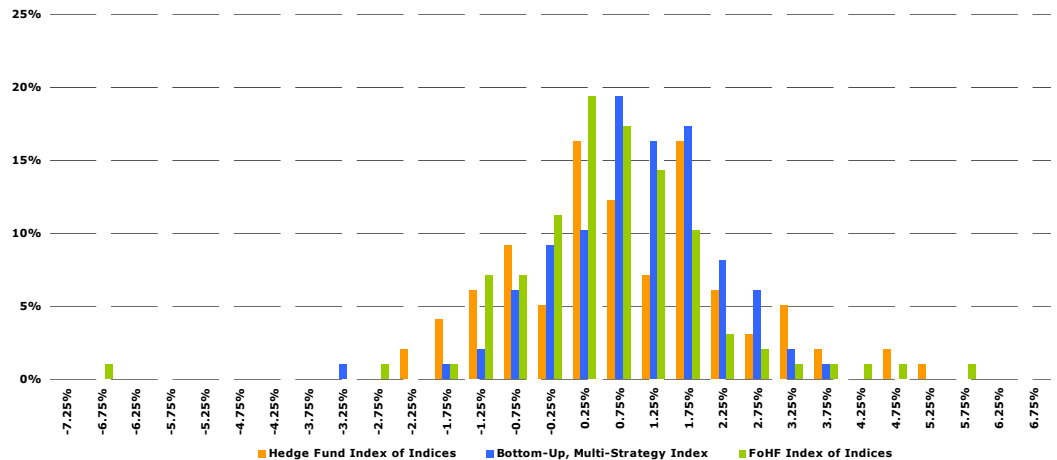
Exhibit 2: Drawdown: 1998-2005



The blue ribbon for Consistency also goes to Multi-Strat with 19% negative months relative to 27% for the FoHF IoI and the HF IoI.

Finally, in our “Spice vs. Rice” taste test the advantage seems to go to Multi-Strat, although the question of the diner’s individual palate is important. Those with a love of jalapeño-laden opportunity might willingly take the risk of a bad fat tail experience, but for many, too much fat tail risk adds excitement and indigestion in equal measure.

Exhibit 3: Distribution of Monthly Returns: 1998-2005



Recognizing the work of Liang, Kat, Wiseman, Hsieh and others in testing the validity of hedge fund analysis using database information, we would be remiss by not admitting some level of distortion to the above analysis from backfill bias, self-

selection bias, and survivorship bias. Further, the implicit strategy-bias to a Bottom-up Multi-strategy Index – heavy on relative value and light on trading strategies – likely accounts for some of the difference in performance relative to the FoHF IoI.

Our analysis also homogenizes as it oversimplifies: in the quest for alpha consumers should never – as we have in this analysis – combine the results for specialist FoHFs and generalist FoHFs. Specialists will naturally avoid the perils of over-diversification and will tend to self-select for quality against a narrower benchmark. Similarly, generalists fall into categories that are easy to recognize in practice but hard to differentiate in the data: *investors* who concentrate their bets and *incubators* who judge talent are both taking real investment risk and must manage their portfolio – they are to be sought, while *allocators* will embody the worst of the overdiversified result and deliver the structural “cons” with little investment “pro”.

As with natural selection, the success of the multi-strategy model has inspired a number of evolutionary trails. We continue to believe a disproportionate share of money will flow to multi-strategy funds.

APPENDIX

Exhibit 4: *Constituents of the Indices of Indices*

Hedge Fund Index of Indices		Fund of Hedge Fund Index of Indices	
AltVest	Credit Suisse/Tremont	AltVest	CISDM
Barclay Group	HFR Fund Weighted	Barclay Group	HFR
CISDM	Van Hedge Global		

Note: Equal weight applied to all indexes

Exhibit 5: *Constituents of the Bottom-Up, Multi-Strategy Index*

Multi-Strategy Funds Offered by the Following Firms:		
Agamas Capital	Delaware Street Capital	Onyx Capital Management
Alexandra Investment Management	Duet Asset Management	PCI Investment Management
Alternative Investment Management	Evans Capital Growth	Polar Securities
Angelo, Gordon & Co.	Everest Capital Limited	Promethean Capital Group
Argent Financial Group	Forest Investment Management	Ramius Capital Group
Asuka Asset Management Limited	Front Street Capital	Ritchie Capital
Atlantis Capital Markets	Global Investment Balanced Strategies	Sagamore
AVENDIS Capital	GRAVITAS Capital	Salida Capital
Basis Capital	Gulf International Bank	San Francisco Sentry Investment Group
Brandywine	Henderson	Stratton Street Capital
Brummer & Partners	HSBC	Systeia Capital Management
Calamos	JMG Capital Management	Tennenbaum Capital Partners
Canyon Capital Advisors	Kayne Anderson	TFS Capital
Capital Fund Management	LibertyView Capital (Neuberger Berman)	TQA Investors
Carlson Capital	Mariner	Wealth Capital Management
Clinton Group	Midas Capital Management	WG Trading Company
Concordia Advisors	Monarch Capital Management	
Deephaven Capital	Monterrey Investment Management Ltd	