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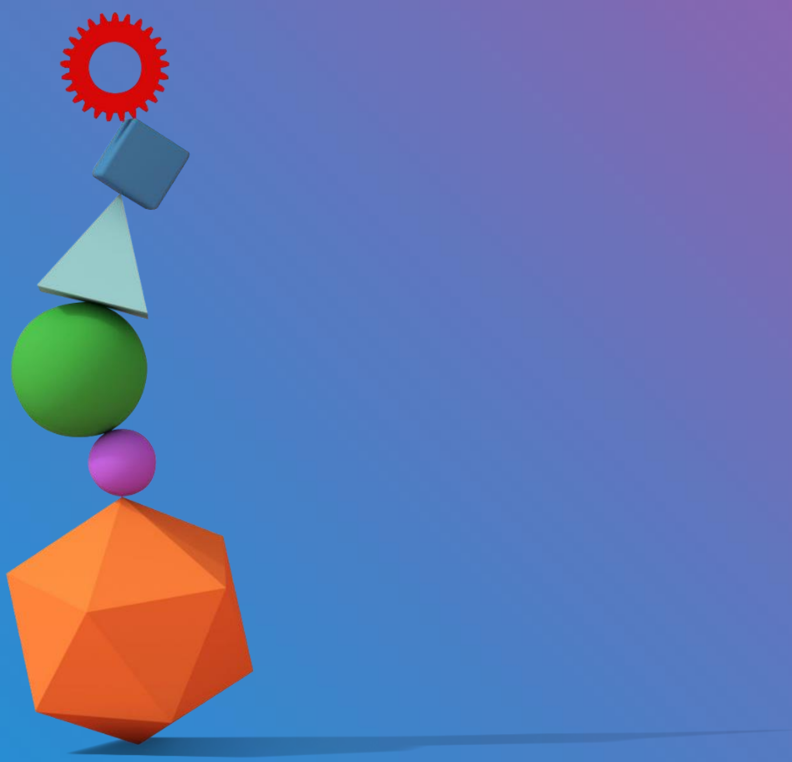
Multi-Manager Platforms: A due diligence perspective



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Introduction

There have been many headlines regarding multi-strategy hedge funds recently, most of which emphasize the attractive performance generated and the parabolic growth that typically results. Returns have indeed been impressive; not only in absolute terms but also relative to the broader hedge fund universe and even more so when compared to traditional asset classes that generally struggled in 2022.

Within the multi-strategy category, however, offerings can differ substantially. Some are referred to as "platforms" or "pod-shops", while others can be referred to as "centralized". Platforms are often associated with funds that employ dozens of portfolio managers (multi-manager multi-strategy), each of which manage their own capital allocation and operate independently from one another. Centralized offerings include multiple portfolio managers and sub-strategies, but there is typically limited overlap and a centralized risk-taking function that weighs relative risk/reward across individual opportunities. The platform model found significant traction following the GFC as many proprietary bank trading groups were shuttered or substantially constrained, and the model was further fuelled by the decline in fund of funds, which had previously served as a key source of early-stage funding for many emerging hedge funds. On the other hand, funds considered centralized often operate with fewer risk-takers who work in a relatively collaborative manner (e.g. single P&L). Importantly, we view these labels as two ends of a spectrum as opposed to two well-defined buckets. Below, we explore the attributes that contribute to these labels, with an emphasis on platforms, as well as where a fund might land on that spectrum. In tandem, we aim to shed light on key considerations as it relates to conducting due diligence on these strategies.

To provide some structure, we group attributes into three sections – Organization & Personnel, Economics & Terms, and Portfolio – however, we recognize that there is a high degree of interconnectedness between them. Towards the end of the paper, we share a table that summarizes the ideas discussed. Ultimately, we hope to provide a helpful introductory framework for understanding and evaluating hedge funds within the multi-strategy category.

Organization & Personnel

When comparing multi-strategy funds, the **number of portfolio managers (PMs)** can vary substantially, from half a dozen to more than 100. This attribute naturally influences risk-takers' ability to communicate and **collaborate**. As one might expect, there is likely to be more collaboration at firms with fewer risk-takers and less at those with more. In some cases, collaboration is actively managed – either encouraged or frowned upon. At the same time, collaboration may sometimes evolve into groupthink, potentially driven by seniority or the loudest voice in the room, and some managers may therefore employ a more insular approach.

As the number of risk-takers increases, one would expect it to become increasingly difficult to find differentiated and **additive PM-level sub-strategies** that can be incorporated at a material size. For example, a strategy with 150 underlying PMs is likely to already have exposure to most sectors, geographies, asset classes, and trading styles. Similarly, as the number of PMs increases, so does **competition for capital**. It is also worth noting that, according to a recent study from Goldman Sachs, 52% of multi-manager platform firms now allocate to external PMs. These external allocations tend to be via Separately Managed Accounts and sometimes an exclusive relationship.

Allocating externally begins to blur the line between a multi-strategy fund and a fund of funds (FoF), although differences remain. For instance, FoFs will make the majority of their investments in pooled funds, alongside multiple Limited Partners, with terms dictated by the external portfolio manager. Still, some FoFs may provide access to low-capacity managers, better transparency, better liquidity, lower fees and expenses, as well as more arms-length legal, operational, and financing risk.

In terms of collaboration and capital allocation, as the number of PMs increases, the portfolio may be more susceptible to conflicting or concentrated **underlying exposures/return drivers**, particularly those that are indirect (i.e. over-diversification and over-concentration across risk factors), and more effort will be needed to avoid such issues. As risk-takers increase (and notional exposures), risk management functions should scale accordingly. The number of P&L sleeves is particularly notable when considering the fees and expenses often associated with multi-strategy offerings, as well as the introduction of netting risk, which we will address separately. Furthermore, the trading orientation differences in timing and risk expression across PMs within the category may help mitigate this risk. Moreover, many platforms dictate a factor-neutral positioning or very tight constraints at the underlying PM level.

Two more considerations that stem from the number of risk-takers are key-person risk and compliance risk. As the number of risk-takers increases, **key-person risk** may decrease, depending on capital allocation. At the same time, from a legal perspective, the risk of **compliance** infractions likely increases with more PMs, or the cost of ensuring that infractions do not occur likely increases. This can get quite complex depending on the geographic locations of PMs, underlying strategy complexity, regulatory jurisdictions, and instruments traded. To generalize, as the number of risk-takers increases, collaboration, the ability to incorporate additive exposure profiles, and compliance efforts are likely to become more challenging, while key-person risk may decrease.

Related to the idea of incorporating additive PM-level sub-strategies, one topic often associated with multi-strategy firms is their approach to managing **investment talent**. Some firms take a more traditional, patient approach to hiring and terminating PMs, while others have relatively high turnover. For the former, PMs are hired with a long-term orientation and an effort is made to understand performance – underperformance in particular. For the latter, PMs who do not meet or exceed performance expectations can be terminated without much warning. In this sense, the management of PMs is akin to trading securities with a strategy of “cutting the losers and letting the winners run”. The level of turnover can be as high as 20-30% at times, which can present challenges for a traditional due diligence framework, though we note our comment above on reduced key-person risk. Equally though, as risk-takers increase, due diligence becomes less about understanding individual PM style/approach and more about the risk management framework and financing arrangements.

The ability of multi-strategy firms to acquire talent in such an active manner likely rests on the relative convenience provided to the PM as well as the associated economic terms. Regarding convenience, a PM can be offered the opportunity to join a multi-strategy firm, receive a sizable dollar allocation, and focus almost exclusively on investing. This is in contrast to launching their own firm which is likely to be a much more effort-intensive process with many more non-investing requirements (i.e., business management) and, potentially, lower probability of success. Also, with an increase in technological connectivity over the last few years, multi-strategy firms are opening more office locations, thus making geography less of a constraint. With a more centralized approach in which there are fewer risk takers, however, PMs may be better positioned to receive a larger capital allocation, depending on overall AUM. Firm culture can also play a critical role in recruiting and retention efforts, which is often shaped by the personalities of leadership as well as risk management protocols.

The economic arrangement can also be quite attractive for PMs at multi-strategy firms. With an insular approach in which PM payouts are based on the PM’s individual portfolio, a PM typically receives 15-25% of profits generated (aside from having many expenses paid for – more on this later). Importantly, PMs with positive performance will typically receive a performance payout even if the overall fund generates a negative return, something referred to as **netting risk**. Put differently, returns across PMs are not netted in order to calculate a PM payout, thus resulting in investors incurring incentive fees even if the fund's overall performance is negative. Firms that use a single P&L model in which payouts are calculated based on overall fund performance do not present this risk; however, an individual PM may become frustrated if their strong performance is negated by poor performance elsewhere in the portfolio.

Economics & Terms

Regarding the expenses mentioned above, it is increasingly common for multi-strategy funds, platforms in particular, to include full or partial **pass-through expenses** to underlying fund investors. Intuitively named, pass-through expenses are those incurred by the manager and then paid by the fund (i.e. Limited Partners) in addition to any management fee and fund-level performance fee. The constituents of the pass-through expense vary by manager but can include PM salary and incentive payouts, talent acquisition costs (e.g. hiring bonuses), business professionals' compensation, infrastructure costs such as technology and rent, as well as travel and entertainment.

In a recent report published by Barclays[1], which incorporated a sample of 42 managers, 40% had no pass-through, 30% had a partial pass-through, and 30% had a full pass-through. According to the same report, under a full pass-through model, investors typically pay 1-3% in fixed expenses plus an additional 3-6% in performance-related expenses. In partial pass-through models, investors typically pay between 1.75% and 4%, inclusive of all fees and expenses, the latter of which may be capped. In a no pass-through model, investors pay the headline management and incentive fees, as well as any operating expenses outlined in the PPM (e.g. trading, audit).

It is worth noting that some research has shown that funds with pass-through expenses have performed better than those without, net of fees. Nonetheless, those funds operating a full pass-through model will naturally and consistently have a higher gross return hurdle in order to generate their targeted net returns. To illustrate this, for an investor to achieve a 10% net return, a fund must generate a gross return of approximately 20% or more, assuming roughly 400 bps of fixed costs (management fee and operating expenses) and a 20% incentive fee at both the PM and GP level. These rough estimates exclude netting risk and manager-specific nuances; however, the table below seeks to conceptualize the division of economics when pass-through expenses are present.

Figure 1. Average break down of pass through expenses

Fee details	Gross return assumption				
Gross return	**5%**	**10%**	**15%**	**20%**	**25%**
Management fee (0–2%)	1.0%	1.0%	1.0%	1.0%	1.0%
Operations, talent acquisition & retention (2–4%)	3.0%	3.0%	3.0%	3.0%	3.0%
PM incentive compensation (15–25%)	0.4%	1.4%	2.4%	3.4%	4.4%
Fund-level incentive fee (15–25%)	0.1%	0.9%	1.7%	2.5%	3.3%
Total fees & expenses	4.5%	6.3%	8.1%	9.9%	11.7%
Net return	**0.5%**	**3.7%**	**6.9%**	**10.1%**	**13.3%**
Net return as % of gross return	9.6%	36.8%	45.9%	50.4%	53.1%
% of gross return consumed by GP	90.4%	63.2%	54.1%	49.6%	46.9%

Source: Mercer

[1] *Multi-Manager Hedge Fund Review, 4Q22 Update, Prime Services Capital Solutions, January 2023*

In contrast to the hedge fund universe at large, we have recently seen an increase in fees and expenses stemming from an arms race for talent and infrastructure. Aside from fees and expenses, more stringent terms (i.e. longer lock-up periods and more stringent gates) have not been uncommon over the past few years. This shift does not appear to coincide with less liquid portfolio exposures, implying that allocators are not necessarily being compensated for the decreased liquidity.

Portfolio

Another key attribute that shapes a multi-strategy fund is the approach to **risk management**. At the PM level, key differences in risk management tend to be: overall exposure ranges (i.e. long, short, gross, net), concentration, factor risk, and stop-loss implementation. Differences may also emerge depending on how customized these risk parameters can be for each PM. As one might expect, they typically differ by sub-strategy (e.g. long/short equity vs convertible arbitrage). From a more top-down perspective, the way in which capital is allocated across PMs may also differ between managers; however, it commonly stems from the perceived risk/reward profile, – however that may be derived. Also from a top-down perspective, funds may differ in how they manage risk or enhance returns, with a central trading portfolio ("center-book") sometimes used in order to enhance or hedge certain exposures. Naturally, different risk methodologies tend to influence which PMs are attracted to certain firms and, relatedly, those same risk methodologies likely impact the level of PM turnover.

The approach to risk management also imparts the need for **technology**. The need for accurate, comprehensive, real-time risk management systems can be quite onerous, especially with a large number of risk-takers. With risk management as a key tenet of most multi-strategy firms, significant resources are typically dedicated to developing and improving technological infrastructure.

On the topic of risk, **leverage** can vary substantially across funds, ranging from less than 1x to 6x under regulatory collateral requirements. However, when considering all forms of financing such as derivatives and repurchase agreements, in which collateral requirements are less, it is plausible that a fund could achieve 20-30x leverage – underscoring the absolute necessity for mistake-free risk management. When evaluating funds, it is important to consider any differences in the way a firm measures and communicates these metrics.

In order to achieve such leverage, prime brokers are of course a critical piece of the puzzle. Given the size of some multi-strategy funds, their typically lower directional exposure, tight risk management protocols, and high trading frequency, they can be high revenue-generating customers of prime brokerage groups. As such, prime brokers are often able and willing to provide large multi-strategy funds/firms with preferred financing arrangements (e.g. lower cost, 60-90 day terms) relative to funds that might be more directional or trade in less size and volume. These preferred financing arrangements likely allow multi-strategy funds to remain in a position of strength during periods of stress, particularly larger firms that are able to negotiate favorable financing terms.

In addition to the aforementioned attributes, funds within the multi-strategy category may, of course, differ materially due to their underlying strategy allocations. For example, one fund may carry a heavy allocation to equities while another might be primarily focused on credit opportunities. Similarly, some funds may be more directional and others more relative-value oriented. Some funds may shift allocations relatively quickly, while others prefer a more static approach.

Typically, managers provide ample transparency into asset-class exposure, but transparency can vary as more detail is sought. For example, transparency may be limited as it pertains to financing arrangements, underlying risk takers and their allocations, as well as industry and position-level exposure and attribution data. Based on past experience, firms with lower AUM and fewer PMs tend to be more transparent than larger firms. At smaller, centralized firms, investors are typically able to meet and speak with the underlying risk-takers. The ability to do so when working with a platform is often limited.

Categorization & Considerations

From a fund evaluation perspective, it is important to note that each attribute discussed above exists on a spectrum. Each fund lands somewhere on that particular attribute spectrum, and its placement may be fluid over time. With all of the attributes of a fund taken together, one can attempt to place the offering on the spectrum between a Centralized and Platform approach, as illustrated below. The green and red text seek to indicate which side of the spectrum is favorable or unfavorable, respectively, to an investor.

Figure 2. Spectrum of centralized and platform approach

Centralized	⟷	Platform
	Organization & personnel:	
Lower	Number of PMs	Higher
Higher	Collaboration across risk takers	Lower
Higher	Potential for additive exposure profiles	Lower
Higher	Key-person risk	Lower
Lower	Compliance risk / costs	Higher
Lower	Talent acquisition	Higher
Lower	Netting risk	Higher
	Economics & terms:	
Lower	Pass-through expenses	Higher
Higher	Liquidity terms	Lower
	Portfolio:	
Lower	Breadth of risk oversight	Higher
Lower	Financing & treasury capabilities	Higher
Higher	Transparency	Lower

Source: Mercer

Conclusion

As indicated, there are many attributes to consider when evaluating multi-strategy offerings, and each likely impacts another. Taken together, they help define a strategy and differentiate it from similar funds in the category.

In terms of use-case scenarios, despite their diversified portfolios and strong risk management capabilities, multi-strategy funds still present single line-item risk, suggesting that a single allocation is unlikely to be a prudent approach for replacing a well-constructed hedge fund portfolio.

Ultimately, we hope this framework allows investors to better understand how multi-strategy offerings may differ so that they can set appropriate expectations and choose the best path forward given their respective objectives.

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