

## Funds-of-Funds Structural Issues

### General

Funds-of-funds ("FOFs") can provide attractive investment opportunities for hedge fund investors and are often good businesses for their managers. FOFs usually target reduced risk in exchange for a somewhat reduced upside potential. FOFs don't often hit home runs, but that's not every investor's target. We see FOFs being formed by relatively conservative investment managers, "wealth management" firms, and also by "normal" money managers who want to diversify their businesses. In the last case, the more specialized the investment strategy of the money manager, the more value they might achieve from accessing and offering other investment styles via a FOF.

Managing a FOF has its challenges. One consequence of sending capital to outside managers is that there is added exposure to a fraud or a blow-up. Having more managers means a greater likelihood of eventually encountering such a problem. On the other hand, the more managers across which a FOF allocates assets, the less the consequence, so it's a tradeoff. Most FOF managers conduct extensive due diligence and monitoring plus have limits on the amount of capital they give to any one investment fund. Accordingly, FOFs generally target having from 10 to 40 managers. Fewer than 10, the consequence of fraud/blow-up risk becomes high. Greater than 40, monitoring and due diligence may become tough.

### Compensation

One principal issue with FOFs is the "fees-on-fees" aspect. FOF asset-based fees usually range between 0.75% and 1.5% and there may be incentive rates up to 10%. 1% and 10% may be justifiable, but it is difficult above that. If the average hedge fund charges 1%+20%, another 1%+10% at the FOF level makes the overall rate 2% + 28% – and that's if every manager is profitable. However, since it's likely that they won't all make money every year (and the losing funds won't give back 20% of the losses), the effective incentive rate will be higher. The bottom line is that, at those fee rates, it may be difficult to develop an appealing net track record.

### Lock-ups

APM is biased against using lock-ups in regular hedge funds because they present a marketing impediment, plus the objective of stabilizing capital is met only for each investor's first year anyway. The landscape changes a little on a FOF. If the FOF is unable to obtain side letters exempting it from lock-ups on underlying managers, there may be a significant liquidity issue in the first year. That liquidity problem may diminish, but doesn't go away, since some managers treat locks on a contribution-by-contribution basis, plus FOFs change managers - introducing a new liquidity restriction even though the FOF may not have taken in money itself.

If the FOF changes 20% of its managers on average each year (equivalent to an average manager lifespan of 5 years) and they all have lock-ups, then the FOF will have a 20% liquidity issue at all times.

APM therefore believes that a lock-up in a FOF is more saleable since there really are liquidity problems downstream that are outside of the FOF manager's control. However, keep in mind that a lock-up on contributions at the FOF level doesn't solve problems after the locks expire. FOF managers should try to secure a no-lock side letter on all managers with whom they invest.

### Notice

The notice requirement for withdrawals should comfortably exceed that of the underlying managers. The "average" hedge fund has quarterly liquidity on 30 days notice, so the FOF needs to be in advance of that. We see FOF notices of 45 (possibly a little close for comfort), 60 and 90 days. By the way, where a 90 day notice exists and the FOF starts on Jan 1, a person deciding to withdraw after the first quarterly report in early April will have a departure date of Sep 30. So, the 90 day notice will also help stabilize capital.

### Withdrawal Challenges

So, what if there are withdrawals on a date when the FOF has significant lock-ups at underlying managers? The problem is that funding a withdrawal from liquid

### Withdrawal Challenges continued

managers will shift the FOF asset allocation towards the illiquid ones. The shift may be acceptable or only partially acceptable. Some older FOFs had a provision that the withdrawing LP could be redeemed from most of the managers in the FOF but retain a residual interest in the illiquid managers. As can be imagined, that would be an accounting and reporting nightmare, so it is no longer seen.

What most FOFs do in a case like this is to simply limit the withdrawal amount to something that results in an acceptable overall FOF asset allocation and delay the balance until a future withdrawal date. Many FOF documents have language specifically describing such a percentage "gate" in advance – a limit of capital that will be permitted to withdraw at any time. FOF not using a gate may rely on document provisions that permit withdrawal delays under certain circumstances.

One additional approach is to establish a credit line to fund withdrawals. Here, instead of shifting asset allocations, the FOF simply gets more leveraged. The concern is to avoid losses while the FOF has the leverage in place. If the FOF levers up in order to fund a withdrawal and the leverage exacerbates losses, it could cause discontent with investors. A manager wouldn't want to hear the complaint that "some other limited partner decided to get out of the fund and it cost me money!"

### Capital Contributions

Managers of hedge funds may have a "grace period" policy regarding the timing of additions. Since the manager of the hedge fund can adjust the portfolio for late arriving capital, if subscription paperwork is in order, a couple days of grace may be permitted for actual money to be received. In a FOF, late portfolio adjustments are more challenging, since the opportunities to invest are determined by the underlying managers. Since the delay in investing "late" capital may be 30 days or more, grace periods are much less common in FOFs.

### Manager Allocation Changes

Credit lines are often used to take care of the cash flow timing differences when changing managers. The problem is that credit lines are usually hard to obtain for new or smaller funds. Fund managers should check the reality of this option before highlighting it in an offering document.

### Annual Report Timing

It is tempting to state in offering documents that audits and K-1s will be delivered within certain specific timeframes; however, those reports are dependent on reports from underlying managers. Accordingly, APM believes it is better to state such timing as "as soon as practicable" rather than use fixed dates.

SEC-registered investment advisors who manage FOFs are generally required to deliver their audits within 180 days of year-end. Since this depends on receipt of audits from underlying managers, prior to sending capital to a new manager, it would be prudent to make note of the date on the prior year audit reports.

Similarly, the timing of the FOF K-1s will be dependent on the timing of those reports from underlying managers. Again, it is a good idea to note the delivery date of prior year K-1s.

Many FOF offering documents attempt to preempt complaints about K-1 timing by disclosing upfront that it is likely that investors will have to extend their personal tax returns. Note that filing the FOF tax return using estimates could expose investors to possible fines. As we understand it, if the underlying fund has "reportable transactions" that the FOF tax return does not reflect, it could result in a violation of reporting requirements which may result in fines for investors of \$100,000 per occurrence. Because of that, our experience is that most tax preparers (usually the auditor in funds APM administers) will not file a fund-of-funds tax return without having received all underlying K-1s. However, in cases where a majority of underlying K-1s have been received, it is usually possible to request an estimate of taxable income that investors may use.

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