Q Going forward, how are you positioning your funds to add value?

MARK **PURDY**
Managing Director & Chief Investment Officer, Arrow Hedge Partners

Active management means using both sides of the balance sheet — the long side and the short side — say the principals of Arrow Hedge Partners, now 10 years old. But sourcing managers that are capable of doing that successfully and consistently involves extensive due diligence, according to Mark Purdy, Managing Director and Chief Investment Officer. The benefit is that a 15% to 20% exposure to hedge funds could improve investor returns, says Arrow's Director of Research Keith Tomlinson.

KEITH **TOMLINSON**
Director of Research, Arrow Hedge Partners

MARK **PURDY»** We only invest with a manager if they provide, transparency, liquidity, and employ modest leverage. We choose managers who reflect our views on markets, sectors and instruments, and then we monitor them closely. A good portfolio manager is a person who can employ whichever tool in their toolbox the market most requires and who will be able to generate decent returns and manage risk. Our principal product offering consists of four multi-manager funds. We also offer 14 stand-alone funds, which complement our principal funds by using specialized investment mandates — mostly equity long/short funds.

In respect to our current positioning and market outlook, in the short term, we think we have reached an inflection point. In 2009, our multi-manager funds were positioned more towards credit, which we considered to be the best risk/reward available in the market. We were able to invest directly in a distressed debt fund in January 2009, and that fund returned 50%. Our timing was quite good. Because we maintained a very good liquidity profile, we had the flexibility to invest in this opportunity.

Going into 2010, we were looking more at event-driven and global macro opportunities, which did very well in the first quarter of the year. Since then, the market has been much more difficult, and a nimble trading approach is proving most effective.

KEITH **TOMLINSON»** At the start of the year we saw divergent outlooks and economic opinions from various research sources. In my 20 years in the industry, I'd never seen this uncertainty before. We chose to invest with managers that use strategies that allow them to be nimble.

In the fund of funds, are those individual managers also available to investors?
TOMLINSON» We have allocated to 40 managers globally, and 14 of them are offered on our stand-alone platform. We have chosen them because they complement our principal fund of funds offering. The strategies are liquid, transparent and relatively easy to understand for investors. They provide excellent diversification on both the fixed income and equity sides of a client portfolio — an important tool for advisers to become more familiar with and educate their clients on the benefits of these absolute return products.

In the fund of funds, how do you manage the volatility?
PURDY» The volatility of our Multi-Strategy Fund has been quite low since inception in 2002, in the 3% to 4% range. Tested through two severe bear markets, our core mandate has exhibited very steady returns, taking 25% of market risk. We managed to be almost flat over the very difficult 2008–2009, period so our recovery has been much better than the majority of other investment funds that are still underwater from their peaks. We try to manage volatility by pairing funds that exhibit different correlations to each other, and therefore try to create a barbell approach to the portfolio.

When you offer stand-alone single managers to investors, what criteria do you use?
PURDY» We look for an investment mandate that will complement an investor's long-only portfolio. It also has to be positioned correctly with the advisor and the client. So we've moved towards what I would call "real hedge funds" — hedge funds that actually go short and use both sides of the balance sheet, the long side and the short side. In other words, we have upgraded the platform to provide a more "all weather" portfolio for different market environments.

How do you do your due diligence on these managers?
PURDY» We have two distinct teams engaged in the manager selection process: an investment committee and a risk committee. We look at the three main aspects of any hedge fund firm: the people, and their ability to carry out what they're saying and whether they've done it before; the process, and whether it's something we can understand; and finally the portfolio, which is something that we can measure. Is it liquid? Can we verify that? When we go out into the field, our due diligence is centred on two office visits. It's usually several members of the team, with different members each time. Each visit is followed up by a written report. Then we conduct a full operational review of the business, including people, internal controls, trading, cash management, etc. Once the manager is recommended by both committees, the investment committee will determine the size and timing of any subsequent allocations.

Our investment philosophy has never altered, even after the credit crisis. Virtually half of all the prospective managers we investigate fail to make the grade. We currently have just over 200 managers at some stage of the selection process.

Do you set leverage limits on managers?
TOMLINSON» Absolutely. We don't like leverage. Leverage combined with illiquidity explains probably 99% of the problems in our industry. And even though it's so easy to avoid, it can make the whole industry look bad. We all get painted with the same brush — and leveraged strategies are the paintbrush.

How do you know that you're getting alpha from a manager rather than beta?
TOMLINSON» We use position level transparency to determine how the managers are generating their returns: ideally, it is from both the long and short side and across multiple securities. That is how we can separate manager skill from luck and find the alpha. But the key is to focus on the particular strategy you're investing in: it may be quite different. If you're getting a reasonable rate of return for the risks, that's the space that you want to be in. Take, for example, a multi-strategy fund we have set up to generate equity-like returns with bond-like volatility: we've produced the bond-like volatility and we've beat the equity market by miles. Since we started the fund, the equity market is down, but cumulatively, we're up over 30% over the period. We consider that a successful result.

How much do you need in hedge fund investments to move the needle in a traditional long-only portfolio?
PURDY» We recommend building around the fund of funds as your core allocation and then adding stand-alone single funds that complement it. An appropriate allocation, in our opinion, would be somewhere between 15% and 20%. That's definitely a number that can move the needle. For example, if you're looking at a global ETF or a global long-only manager, you can complement that with a global long/short manager: you'd have a good pairing. And you would monitor it, in the same way you would monitor a long-only investment, making sure it's doing what you put it there for, and then rebalancing the position sizes in a disciplined way as asset prices move.