The Thinking Man's Approach

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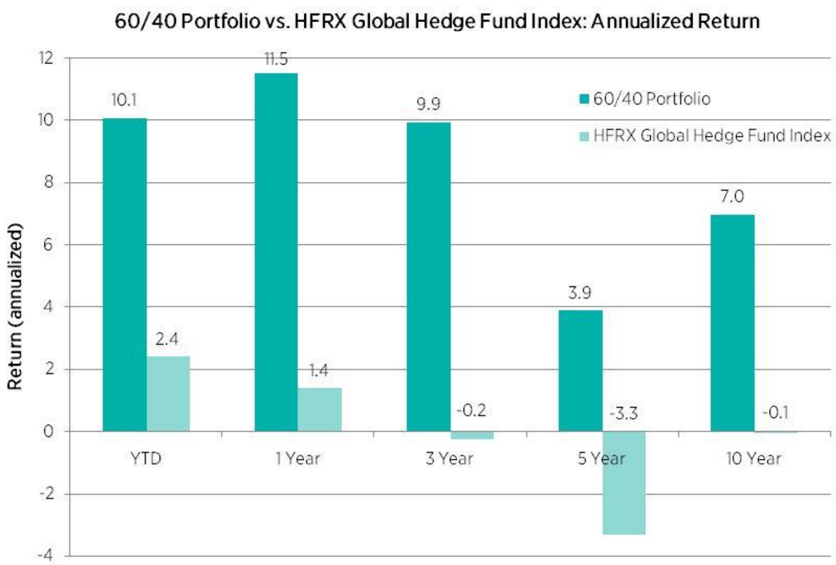
We have started a monthly series titled the "The Thinking Man's Approach" which relating to the way we serve our clients and conduct business at BigSur. This will include a wide range of subjects, some of which include: fiduciaries, wealth & succession planning, family governance, outsourcing models, and investment philosophies & approach.

BigSur's Views on Hedge Funds

We do not believe in buying hedge funds as an asset class. However, we believe that there are a few high quality funds which can help lower volatility and add some excess return for a portfolio. This requires quantitative and more important qualitative analysis. We believe there are several necessary conditions that funds need to meet in order to be considered for investment, as highlighted in this research note. For those clients that would like access to hedge funds, we believe a 10% allocation is appropriate

Industry Background

In 2012, the Hedge Fund Research Index is 2.4% year-to-date, significantly underperforming a 60/40 equity/bond portfolio (YTD up 10.1%).[1] Hedge Funds have had lower volatility, however they have consistently displayed much lower returns than balanced portfolios during the past 10 years (see chart below).



Data as of 10/24/12		YTD	1 Year	3 Year	5 Year	10 Year
Return (Annualized)	60/40 Portfolio	10.1	11.5	9.9	3.9	7.0
	HFRX Global Hedge Fund Index	2.4	1.4	-0.2	-3.3	-0.1
Standard Deviation (Annualized)	60/40 Portfolio	7.2	9.1	10.6	15.4	12.2
	HFRX Global Hedge Fund Index	2.3	0.6	3.2	4.3	1.5

Even the above performance figures overstate the hedge fund track record! One has to take into consideration that hedge fund indices have selective reporting of new hedge funds, as well as the *survivorship bias*. When hedge funds lose big money they often stop reporting and as their performance treads below their "high water-mark", they decide to close shop. Some re-open with a different legal entity. There is a broad range on the estimated degree of survivorship bias- mostly because the data and information is sketchy and inconsistent. Academics Ibbotson and Chen estimate returns are 2.7% - 5.7% lower per year than indices suggest [1]; others such as Kat and Guarov say there is a 2% over estimation. [2]

The death of hedge funds was proclaimed in 2008, when investors were shocked to find managers had been investing in securities that were tough or impossible to sell in a crisis period. Many hedge funds had illiquid positions that should have never been included in what were funds with quarterly liquidity- they were more appropriate for a structure of a private equity fund. These hedge funds ended up needing to "gate" (i.e., modify their agreed liquidity terms) and employ other creative tactics that prevented investors from redeeming their positions in the funds. The only decade where hedge funds performed well consistently (as an "asset class") was in the bull market of the mid-1990s to mid-2000s. Just as in 2008, when the bull market ended they crashed, and many managers quit. After each clear-out, the industry recovered, finding new ways to profit.

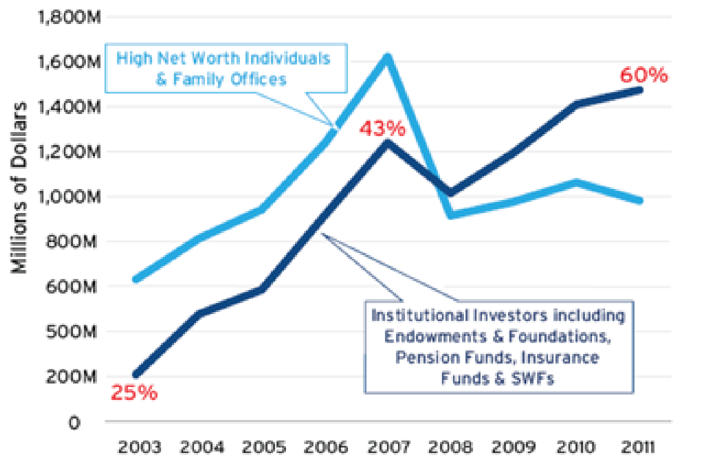
There are many different problems facing the hedge fund industry today. One problem is the amount of liquidity in the industry. Hedge funds used to significantly profit from inefficiencies in the markets, but now, with so much capital looking to exploit the same opportunities, the inefficiencies quickly disappear. Another issue is size- many hedge funds have become so large that it is extremely difficult for them to outperform as they are limited in their ability to participate in smaller investment opportunities. At the same time, the industry faces much more competition. What were once exclusively strategies used by hedge funds – short selling, quantitative analysis, high-frequency trading, global macro – are now commonplace even for retail investors. It has become much more difficult for hedge funds to gain an information edge, as technology has made data and complex analysis instantly available to all. Lastly, hedge funds have become more regulated and less exotic; they look more like the products being created by the traditional fund management industry, only with higher fees.

While the industry faces many problems, there has been some positive transformation since the 2008 crisis. The industry has consolidated since then, as many hedge funds were forced to close in the wake of the crisis. The amount of leverage used by hedge fund has decreased; funds are more conscious of aligning their liquidity profile with their underlying securities; and with new regulations facing hedge funds, the likeliness of fraud and a Madoff like situation has decreased. Institutional investors have actually increased their allocation to hedge funds: in December 2007, hedge funds were 9.2% of institutional investor's portfolios (totaling $1.2 trillion). In December 2011, hedge funds had a 10.5% allocation (totaling $1.5 trillion). While assets in hedge fund strategies have not reached

[1] Ibbotson, Roger G. and Chen, Pen, "The A,B,Cs of Hedge Funds: Alphas, Betas, and Costs"

[2] Kat, Harry M. and Amin, Guarav S. "Welcome to the Dark Side; Hedge Fund Attrition and Survivorship Bias over the period 1994-2001"

their peak ($2.8 trillion in 2007), they have been steady increasing ($2.5 trillion at the end of 2011), mostly driven by institutional investors (see chart below)[1].



Source: Citi Prime Finance analysis based on eVestment HFN data

Two Opposing Investment Approaches by Prominent Institutional Investors

While most institutions are allocating to hedge funds mainly to "meet their return objectives"[2], not all of them see the "value" of investing in hedge funds. For example, the Norway Government Pension Fund, the largest sovereign wealth fund in the world (with AUM of $656 billion, 10 year annualized return of 4.9%)[3] has an investment approach that shuns away from hedge fund land, focuses on traditional asset classes, values transparency and liquidity and utilizes passive strategies through efficient investment vehicles. On the other extreme (in terms of investment approach), other successful institutional investors, like the Yale University Endowment Fund (with AUM of $19 billion, 10 year annualized return of 10.6%)[4] have had such a great success with having hedge fund exposure. Under David Swensen's leadership, the endowment fund has built a portfolio with few traditional asset classes; the great majority of the portfolio invests in hedge funds, private equity and other alternative asset classes. Many families that tried to replicate Yale's approach have failed, only few have been successful.

BigSur's Advice on Hedge Funds

[1] Citi Prime Finance Analytics, "Institutional Investment in Hedge Funds: Evolving Investor Portfolio Construction Drives Product Convergence," 2011
[2] Crystal Capital, "Crystal Quarterly Hedge Fund Review" Q2 - 2012
[3] As of 6/30/12; NBIM, "Government Pension Fund Global Second Quarter 2012"
[4] As of 6/30/12; Yales News, "Yale Endowment" 9/27/12

Our philosophy at BigSur Partners is focused on constructing portfolios with the below characteristics:

- long-term objectives
- broadly diversified
- use of low cost vehicles and some passive strategies (like ETFs) to gain exposure to some mature asset classes
- use of active managers for those less mature and more inefficient asset classes
- high levels of transparency
- relatively high level of liquidity
- value-focused
- contrarian investment style

While our philosophy is more in line with Norway Government Pension Fund, we see the value that the exposure to select hedge funds can create, as demonstrated by the Yale Endowment's superior return.

We do not believe in hedge fund as an "asset class," on the account of poor performance, high fees, and risks associated with illiquid vehicles. We would never, for example, buy an investable index of hedge funds (like we do with equities to gain exposure to an asset class). That being said, we do believe that hedge funds can add value. There are a few select high quality institutional hedge funds which have strong track records of performance and can help reduce an overall portfolio's volatility and enhance return. These are funds which have a historic low correlation to the S&P 500, high alpha coefficients,[1] and have both excess return and lower volatility over the S&P 500. A selection of hedge funds with these criteria can help lower the volatility and slightly enhance returns of a diversified investment portfolio.

An investor with no capacity to perform a good quantitative and (especially) qualitative due diligence should not have hedge funds. Only investors that have an objective and independent advisor should consider investing up to a 10% of their overall portfolios in hedge funds. We think it's a necessary condition for the advisor to be objective and independent; but not sufficient. Because of the nature of the hedge fund industry, simply running a performance analysis to identify which managers meet the desired quantitative criteria (i.e.: low correlation, high alpha, strong track record) is not enough.

Other relevant conditions for successfully investing in hedge funds include:

- capacity of an on-going due diligence process
- open access to "books," management teams etc
- strong operational depth
- ownership of talent: owners of the firm are talent of the firm (keeps talent tied to the fund)
- transparent and effective performance measurement
- access to top tier institutional funds (with long track records through periods of up & down markets, period high redemptions etc)

[1] Alpha is a risk-adjusted performance measure which shows the "active" return on an investment

Meeting these conditions is vital for us to consider investing in a hedge fund. This is what we describe as "the problem," we will not invest in hedge funds until we know these conditions are satisfied. What is the solution? Conducting an on-going due diligence of all of these conditions requires significant resources and expertise. We believe the "solution" is to outsource this process to an independent firm with hedge fund expertise and the capacity to conduct in depth and on-going due diligence.

An important quality for a hedge fund advisory firm is that it conducts it's own due diligence (on-site visits of managers, quarterly calls, etc.) but in addition have access to the extensive quantitative and (more importantly) qualitative databases by industry leading providers. One example is Albourne, which provides quantitative data and in-depth operational analysis. Albourne's operational analysis covers a wide variety of factors including: comments on the hedge fund's trading processes; understanding valuation and pricing methodologies; and mapping out legal structures of the fund. They also focus on understanding dynamics of investment team and showing how much of the talent of the firm is also the ownership of the firm (one of our key conditions- as it ties the talent to stay at the firm).

Other crucial factors include the firm's "skin in the game," meaning the owners of the firm are investing in funds that they recommend. This is a key element for us, as it shows the firm's conviction in their recommendations. Finally, we believe it is important to have access and relationships with top tier fund managers. Some of these funds are closed to new investors, but firms with existing relationships with these managers are often granted access to the fund. Additionally, a relationship with the fund team gives us informational access, another important condition.

Implementation

We have completed the process of vetting hedge fund advisory shops which we believe would be good fits for BigSur's clients. If you are interested in learning the specifics of the BigSur Wealth Management Hedge Fund portfolio please contact your investment advisor.

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