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INVESTMENT MANAGEMENT

# How Multi-Manager Platforms Find Strength in Numbers

**AIP HEDGE FUND SOLUTIONS** | INVESTMENT INSIGHT | JULY 2023

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Multi-manager platforms are experiencing a surge in investor interest. Consider this excerpt from a Bloomberg article:

> "Investors are plowing money into funds that don't rely on the next macro genius or star stockpicker, but instead offer an army of traders who invest in an array of strategies. These behemoths secured pretty much all of the new money in the hedge fund industry last year, cementing a tectonic shift that's accelerated since the pandemic."[1]

Why are these vehicles attracting so many investors? How do they compare with traditional hedge funds? What should investors consider if they are interested in them? We tackle these and other fundamental questions about multi-manager platforms in the following FAQ.

### 1. What are multi-manager platform hedge funds?

Multi-PM hedge funds, hedge fund platforms, or Multi-Manager Platforms ("Multi-PM" or "MMPs") are investment organizations that employ many specialized hedge fund managers and strategies, collectively operating as one entity, where individual units have discrete P&L responsibilities.

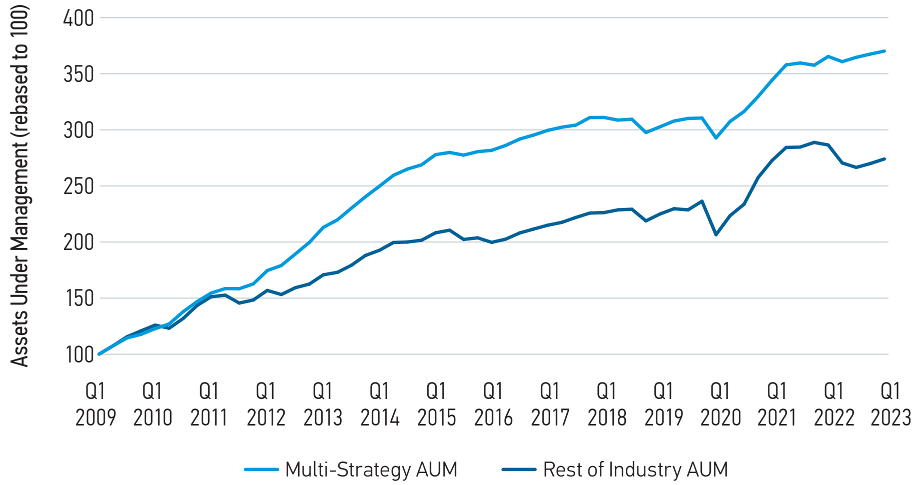
[1] Source: Bloomberg, "An Army of Faceless Suits is Taking Over the $4 Trillion Hedge Fund World," January 30, 2022, Nishant Kumar

Multi-PMs share several characteristics:

- They are investment vehicles in which the manager oversees a number of independent portfolio management and trading teams.
- Multi-PMs are responsible for integrating risks and overseeing all operational activities, even though decision-making can be centralized or decentralized, and the investment approach can be coordinated or free standing.
- Many are designed as all-weather investments, seeking to deliver absolute return and attractive risk-adjusted returns throughout almost any market environment. Some, less concerned about neutrality, seek to concentrate the best ideas into a mix of bottoms-up/top-down portfolio construction methodology. Others apply thematic tilts to the portfolio, trying to take advantage of investment trends, momentum or short-term market moves.
- Multi-PM platforms deploy capital across many multi-asset opportunities, including a wide variety of fundamental and quantitative strategies.
- They manage the risks generated by the underlying investment teams, relying on substantial investments in technology and expert teams of investment and IT professionals.

**DISPLAY 1**

**Multi-PMs Have Grown Faster than the Rest of the Industry as of Late**




Source: HFRI data. As of March 31, 2023. Note: Data rebased to 100. Hedge fund industry managed $3.8 trillion at the end of March, of which about $904 billion was in multi-strategy money pools.

### 2. Broadly speaking, what are the potential advantages for the client of a Multi-PM platform over the traditional, single-manager hedge fund?

Managers of traditional hedge funds are typically sophisticated specialists and gifted investors, employing any of almost three dozen strategies, as defined and classified by organizations such as Hedge Fund Research, Eurekahedge, or Preqin. Investors must not only select which hedge fund strategy is best for the prevailing environment, but also which manager is best positioned to execute the strategy. Consequently, single-manager funds tend to carry net exposures and trading betas associated with their particular strategy. More often they are amplified forms of the manager's investment views, leading to highly correlated ideas and holdings. In many cases, portfolio construction and risk management tend not to be as sophisticated as their core investment management expertise.

A multi-manager platform offers a range of diversified alpha sources and centralizes the risk management function. The independent managers are thus free to put their talents to their highest and best use. The platform manager devotes a comparable level of expertise to managing risk, ensuring, for example, that all unwanted exposures are hedged and that the independent investment managers are within risk budget guidelines. Simply put, many Multi-PM funds consistently deliver their investment objective and target volatility.

### 3. Broadly speaking what are the potential disadvantages?

Multi-PM platforms are operationally complex structures that demand a wide range of capabilities from the platform manager, which entails a high-level commitment of time, resources and expertise.

The platform manager must be able to attract and retain multiple talented investment teams, allocate assets, and establish and enforce risk budgets. They must hedge the overall risk exposure of the independent managers and minimize the correlation of their performance. Multi-PMs must also manage high turnover rates while sourcing specialists and developing talent.

Thus, investor due diligence of Multi-PMs must take into account skillsets and infrastructure that in many ways are markedly different from single-fund managers. The same is true when considering different Multi-PMs and assessing the likelihood of consistent alpha generation. Moreover, the due diligence task is sometimes hindered by inconsistent or obscure reporting, limited investment transparency, and fee opacity.

### 4. How many of these sophisticated specialist investors are there and how big is the universe?

There are over 8,800 hedge fund managers, according to Preqin, a leading provider of hedge fund intelligence, and in the same AIMA headcount study,[2] it was estimated in North America that there are 78,500 hedge fund employees with an average number of 19.7 employees per fund manager. Estimated employees in Europe and Asia Pacific were 21,000 and 11,700, respectively. Typically hedge funds are evenly split between investment and non-investment professionals, suggesting 55,600 in the total hedge fund talent pool. However, this broad population represents all hedge fund strategies and not the narrower set the Multi-PM platforms employ.

Focusing on just Multi-PMs, we believe there are roughly 9,500 investment professionals across more than 30 firms worldwide. Both the quantity and quality of trading talent have grown with the strategy. From 2008 to 2021, Multi-PMs expanded almost 50% faster than the industry[3] and during this period more and more investment professionals learned to hone their skills, making them attractive to this style of investing. Right now the universe of trading talent has never been larger.

### 5. What evidence is there that the Multi-PM structure has outperformed traditional single-manager hedge fund?

**A.** For the 10 years ended April 30, 2022, a Multi-PM Peer Group Composite,[4] comprised of 32 members, had an annual average return of 8.57% vs. 5.10% for traditional hedge funds, with about half the volatility (See *Display 2*). Even though this Multi-PM Peer Group Composite outperformed the HFRI Fund Weighted Composite Index by 3.47%, Multi-PMs, with their lower beta and tighter risk management, collectively generated more than 7.1% of annualized alpha when compared to the HFRI index, over the same period (See *Display 3*).

**DISPLAY 2**

**Multi-PM Platforms Have Delivered Stronger Risk-Adjusted Returns Than Hedge Funds**

*Average Annualized Returns, 10 Years Ended 3/31/23*

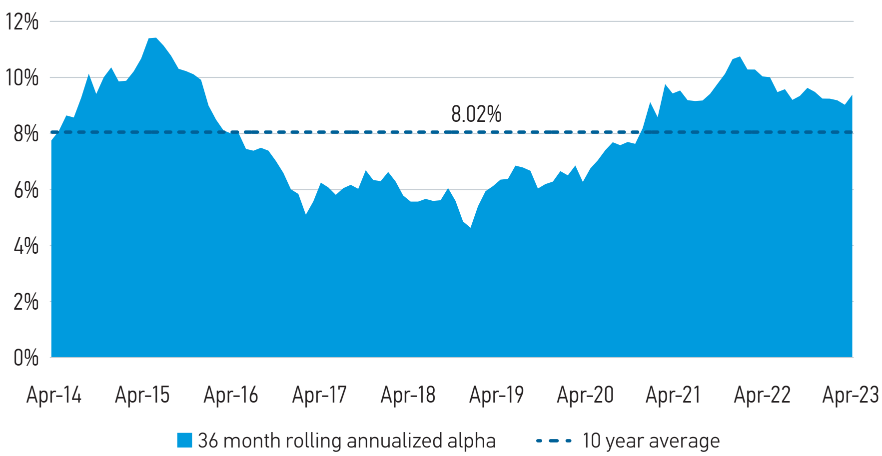
| | AVERAGE MULTI-PM HEDGE FUND | HFRI FUND WEIGHTED COMPOSITE INDEX |
|---|---|---|
| Average Annual Return | 7.97% | 4.44% |
| Annualized standard deviation | 2.99% | 6.04% |
| Sharpe Ratio | 2.59 | 0.61 |

Source: MSIM AIP Hedge Fund Solutions. As of March 31, 2023.

**DISPLAY 3**

**Multi-PMs Have Consistently Generated More Alpha than Hedge Funds**

*Excess Alpha: Multi-PM Peer Group Composite v. HFRI Fund Weighted Composite*




Source: MSIM AIP Hedge Fund Solutions. Shows difference between rolling 36 month annualized alphas and 10-year average excess alpha. As of March 31, 2023.

[2] Source: https://www.aima.org/educate/hedge-fund-industry-data.html. As of March 31, 2022.

[3] eVestment (Source: Bloomberg, "An Army of Faceless Suits Is Taking Over the $4 Trillion Hedge Fund World," January 31, 2022, Nishant Kumar)

[4] Source: MSIM AIP Hedge Fund Solutions. Performance reflects a population of 32 Multi-PM hedge funds in operation over the 10-year period, starting with fifteen as of May 2013 and ending with 35 as of March 31, 2023. This composite represents the equal weighted mean average of the monthly returns for each available Multi-PM constituent as they entered the market. Specific composite membership, methodology and additional data is available under a non-disclosure agreement and upon request.

### 6. What evidence is there that Multi-PMs are achieving a significant degree of market neutrality?

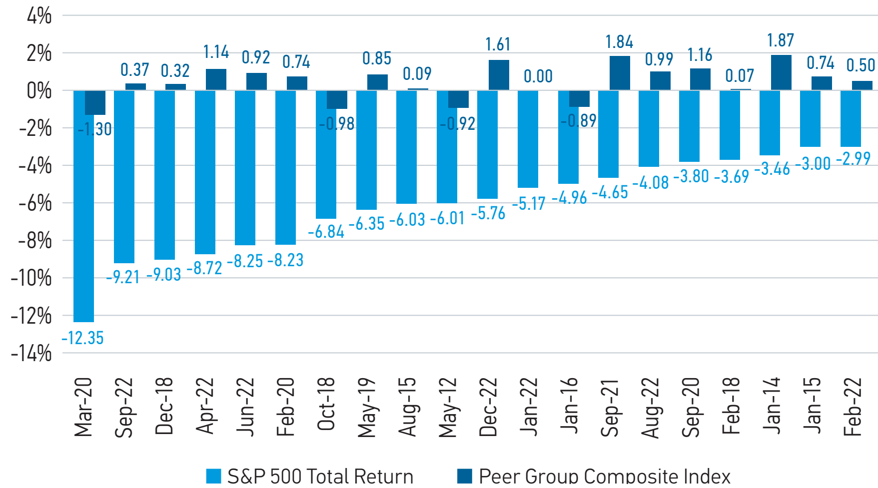
**A.** Using the same 10 years ended March, 31, 2023, the correlation of the Multi-PM Peer Group Composite to the S&P 500 Index is 0.18 vs. HFRI Fund Weighted Composite Index of 0.52. Market sensitivity, as measured in terms of beta to the S&P 500 Index, is 0.04 vs. 0.26, respectively. Alternatively, and one of the more compelling ways to show market neutrality, is to view the results during some of the worst down-market periods. Looking at the aggregate (equal weighted average) returns of the Multi-PM Peer Group Composite, one can almost see a wave of positive and negative results, oscillating around zero (See *Display 4*).

**B.** Another straightforward way to assess market risk mitigation is to look at the average result when markets are down. *Display 5* shows the average return of the Multi-PM Peer Group Composite during every period the S&P 500 index was negative. This is sometimes called "downside capture."

**DISPLAY 4**

**Multi-Manager Platforms Have Held Up Well Through S&P 500 Downturns**

*Average Returns of Multi-PM Peer Group During 20 Largest S&P 500 Monthly Declines*

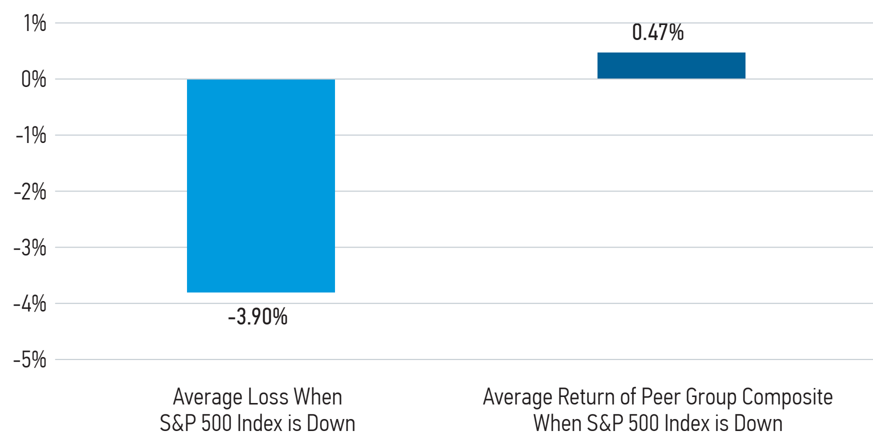



Source: MSIM AIP Hedge Fund Solutions. As of March 31, 2023.

**DISPLAY 5**

**On Average, Multi-Manager Platforms Gained During S&P 500 Downturns**

*Multi-PM Peer Group Downside Capture*



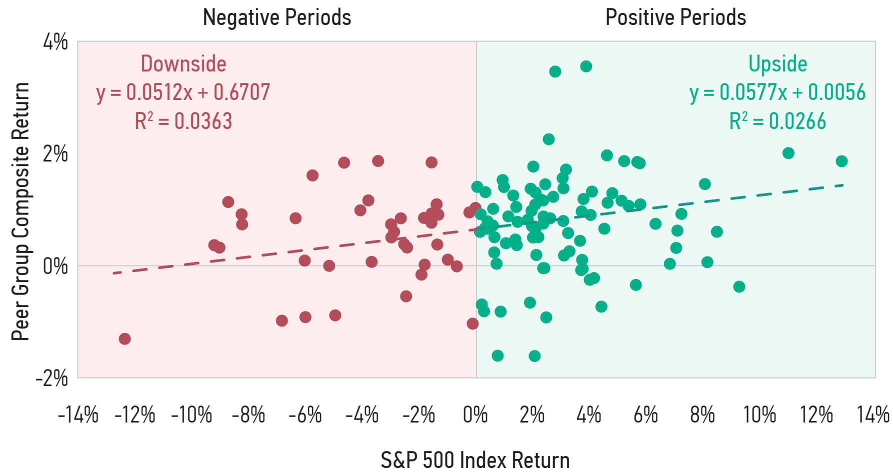

Source: MSIM AIP Hedge Fund Solutions. As of March 31, 2023.

**c.** Finally, a bit more technical, if you analyze each return of the Multi-PM Peer Group Composite relative to the market, distinguishing between up markets and down markets on the x-axis, you can see no discernible pattern. But a regression analysis reveals that during down markets (the red dots), the beta of the Multi-PM Peer Group Composite to the S&P 500 is close to zero, with a modest upward slope (0.05). Similarly, during positive markets, (the green dots), the beta follows a similar upward slope (0.06). The level of market neutrality in both down and up markets can be denoted in the R-Squared statistic.[5] In down markets the R-Squared is 3.6% and in up markets 2.7%, suggesting less than 10% of the market explains Multi-PM's returns (See *Display 6*).

**DISPLAY 6**

**Multi-PMs Have a Low R-Squared With the Market**

*The S&P 500 Index Explains Little About Multi-PM Performance*




Source: MSIM AIP Hedge Fund Solutions. As of March 31, 2023.

### 7. How is market neutrality integral to both portfolio construction and risk management?

The goals of market neutrality and generating pure alpha are two sides of the same coin: Both seek to avoid or mitigate unwanted market risk. The two goals shape every aspect of a multi-manager platform, from the selection and onboarding of investment teams to the platform manager's intricate hedging protocols. Some of the more advanced platforms seek to manage and, through controlled processes, reinforce diversification. By actively monitoring and separating overlapping risks while concurrently engineering steps to promote low correlations, portfolio construction and risk management merge. Perhaps obvious, there are tried and true approaches that ensure tight risk management and low correlations and limit market exposures.

- **CURATED DIVERSE UNIVERSES AND RISK GUIDELINES FOR PM TEAMS** — Fundamental long/short equity managers are selected for their expertise within any of the major Global Industry Classification Standard (GICS) sectors or sub-sectors. The more selective platforms can partition the PM's trading universes and establish bespoke risk guidelines, whereas others can have multiple teams in the same sector and simply employ monolithic down-and-out risk management rules. Quant strategies are diversified across time horizons, with dollar volume and VaR limits. Many factors, such as the size and philosophy of the manager, the heterogeneity of industry risk, and the number of key return drivers, as well as the sector's native levels of active risk or total trading volumes, can influence how the platform manager decides on maintaining neutrality.
- **MINIMIZATION OF INTER-MANAGER CORRELATION** — The platform manager monitors potential overlaps among country/industry/style risk factors and seeks to identify and mitigate "crowded" trades. Quant strategies, especially the ones with short horizons, tend to have low correlations to market risks and the ability to adapt quickly to rapidly changing trading environments. But surveillance without action tends to be a passive form of risk management. The more advanced platforms employ live oversight of risk budgets for the independent managers and provide real-time feedback to enhance risk management, and also reserve the right to exercise their at-the-touch liquidity, should it be needed.

[5] R-Squared is an explanatory metric that measures how much of the market's movements is responsible for the Multi-PM Peer Group Composite's variation.

- **CENTRALIZED TRADING PORTFOLIOS AND RISK LIMIT ENFORCEMENT** — Most platform managers construct a dedicated portfolio to hedge unwanted risk factors through overlays. Market and industry risks can be offset in blunt fashion with futures or sector ETFs whereas factor risk reduction can be accomplished by trading efficient baskets of stocks. For quant oversight, limits for each PM tend to be enforced based on target dollar volatility and volatility-based drawdown triggers. Limits on gross and net dollar exposure, and position concentration as a percent of trading levels, provide bright-line tests for the platform manager to enforce daily.

The bottom line is that market neutrality ensures, to the greatest extent possible, that investors are paying only for active risk, not for beta or factor exposures that are easily—and cheaply—replicated in numerous other investments.

### 8. How does a platform manager ensure that expenses are minimized and that the firm's incentives are aligned with the investors'?

Multi-PMs fees are generally higher and involve variations on the classic hedge fund 2%/20% fee structure because of the two differing levels of management involved. One level of competitive compensation is required to attract and retain the underlying trading teams akin to the 2%/20% model. Additionally, the platform manager who oversees the entire infrastructure and operation, while managing the overall risk and fund administration is compensated. Good platform managers invest heavily in the business, personnel and technology. For investors, the payoff should be reflected in the after-fee performance of the Multi-PM, and we believe this value proposition is reflected in the Multi-PM track record (See *Display 2*). The complementary skills of the platform manager and the independent managers more than compensate for the total fees, and have generated more alpha, on average, than a single-manager fund.

Platform managers can, and should, do everything possible to align incentives of their managers with investors, with some of the more innovative managers embedding performance hurdles in their fee structures. Such structures shift a portion of the fixed management fees to fees that are charged to investors only when earned by performance. We have seen newer entrants challenge the open-ended structure with some success.

### 9. What are the strengths to look for in a platform manager?

To attract the best talent in a highly competitive environment, platform managers need to stand out as the "partner of choice" for independent managers. We believe the most attractive platforms offer the independent manager's risk-taking autonomy combined with a strong franchise that has a global reach, backed by organizational stability and limited business risk.

Investors need assurance that the platform manager views them as partners, investing alongside them, with a cost infrastructure optimized to maximize their return. In this context, "franchise strength" means the willingness to negotiate competitive terms with independent managers, vendors and service providers for the benefit of investors.

Investors deserve a partner that is a fiduciary committed to the highest standards and institutional responsibilities. This includes comprehensive reporting and providing enough transparency or access to key decision makers to understand not just how alpha is being generated, but why it is likely to persist.

### 10. Why are multi-manager platforms particularly timely in today's environment?

Hedging unwanted market exposure has always been key to protecting alpha, but doing so has become more complicated and nuanced.

For example, the impact of "risk on/ risk off" episodes in the pre-pandemic world usually was effectively hedged with the S&P 500 Index, largely because factors like growth, momentum and value had reasonably consistent—and predictable—performance during such periods.

But the same has not held in today's market environment. Investors have had to rapidly adjust to, among other things, punishing inflation, the most hawkish Fed hiking cycle in decades, rapidly rising and volatile long term interest rates, geopolitical tensions and concerns over the ultimate path of economic growth.

Performance factors have undergone large shifts in direction and magnitude, and as a result, the S&P 500 Index has become too blunt a tool for hedging. Factor exposures associated with hedge funds have been behaving very differently under the surface of daily market moves.

This evolution of risk led to underperformance of many traditional hedge funds in 2021 and Q1 2022 compared with Multi-PM hedge funds, which are structurally better equipped to identify complicated changes in factor performance and keep hedging techniques up to date.

### Conclusion

Multi-manager platforms share with traditional hedge funds the potential to generate alpha and a return profile that is uncorrelated with major asset classes or performance factors. But they also add a level of diversified alpha sources and sophisticated risk management that is difficult for many hedge funds to match. If this description fits your portfolio objectives, we believe multi-manager platforms deserve your consideration.

## DEFINITIONS

**HFRI Fund Weighted Composite Index ("HFRI Fund Weighted"):** The HFRI Fund Weighted Index is a global, equal-weighted index of single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in USD and have a minimum of $50 million under management or $10 Million under management and a twelve-month track record.

**Alpha:** The excess return of an asset not explained by systemic (market) risk.

**Beta:** Represents the Fund's volatility relative to the market. A statistical measure of the tendency of a market or security to rise or fall sharply within a period of time, usually measured by standard deviation. Higher levels of volatility correspond with higher levels of risk. See also Standard Deviation.

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