Institutional Investor's alpha

Aksia's Jim Vos: "We don't simplify things"

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Aksia's reputation soared when a warning not to invest in Madoff became public last year, and the firm has taken off. The consultant talks about the next red flags, how fees are changing and how Aksia's due diligence process works.

By Anastasia Donde

Hedge fund consulting firm Aksia, founded by Credit Suisse veteran Jim Vos and five other former executives of the Swiss bank, grabbed the spotlight in December 2008 by reminding clients that the firm had recommended that they not invest in Bernard Madoff's feeder funds, given the "extensive list of red flags" its investigation of Madoff had raised. The Madoff report, which was written in mid-2007, sealed Aksia's reputation for thorough due diligence and research, and the firm has since taken off.

Founded in October of 2006, Aksia now employs 43 people and has offices in New York, London and Tokyo. Its clients are based in Europe, North America and Asia; about half are pension funds, while endowments, foundations, government-related funds and insurance companies make up the rest.

In the United States, Aksia advises the Philadelphia Public Employees Retirement System, the New York State Common Retirement Fund, the School Employees Retirement System of Ohio and both the Public Employees' Retirement Fund and the Teachers' Retirement Fund in Indiana. The firm's clients have about $21 billion invested in hedge funds.

Before going out on his own, Vos, who is chief executive and head of research at the firm, spent about 20 years at Credit Suisse, holding senior positions in New York, London and Tokyo in a variety of areas, including research, derivatives and finally as chief of its fund-of-funds unit.

Aksia's sudden success has made its employees highly sought after in the hedge fund world. In December Americas head of advisory services Jake Walthour left the firm for Citadel Investment Group, and two other advisory services staffers, Sarah Cole and Corissa Mastropieri, left to join Albourne Partners, one of Aksia's competitors. The moves prompted some clients to put the firm under review. But Aksia moved quickly to plug the gaps and has recently hired Jaeson Dubrovay from NEPC and Bruce Ruehl from Gleacher Fund Advisors. Aksia is suing Cole and Mastopieri. In a case filed in New York State Supreme Court in mid-January, Aksia alleges that the pair stole confidential and proprietary research reports, templates, investment data and methodologies and took them to a competitor.

Last month staff writer Anastasia Donde got an inside look at what makes the Aksia model tick when she spoke with Jim Vos about where the next red flags are, how fees are changing and how Aksia's operational due diligence process works.

What are you hearing from clients right now?

At the edges we are starting to see some concern about AUM growth at some really fantastic managers, particularly on AUM growth vs. reinvestment, resourcing and staffing. What we are finding is that institutions are quite comfortable with hedge funds. And the staff at institutions is fighting for larger hedge fund allocations and getting up to policy targets for allocations. We are seeing investors being constructive, realistic and mature about it. Most investors we know acknowledge that there is beta in the hedge fund industry—that it's not pure alpha, it's not zero correlation. They look at hedge fund strategies as being smart beta and lower net exposure. For the industry there is a pretty good, solid foundation of committed investors at this point in time.

Are fees and terms changing a lot?

The old 2 and 20 is now 1 1/2 and 20. There is more of that without a doubt, which is great. Also some fantastic managers that had very high fee levels (north of 2 and 20) that have more expensive business models to run are working hard to try to offer more products with 2-and-20 fee structures. Obviously, there is more investor pushback on fees. It's more of a hot-button issue, and fees have much more scrutiny now than they did before. As long as managers' fees are in an acceptable range, what we are trying to push for is alignment of interests. We want the terms of the fund to be appropriate for the assets that they are managing in the strategy and to make sure that all investors have the same terms. I think asset/liability management and risk transparency are equally as important as fees.

Obviously, everyone sees the problem now with fund-level gates, and the market is moving to no gates or investor-level gates. We are supportive of that, and we like reasonably high investor-level gates, such as 25% a quarter. The percent level has to be high for it to work, and they must apply the same number to all investors.

What do you want in a hedge fund manager?

We look for a clean business model and alignment of interests with investors. We prefer managers that have simple product structures, where our investors' economic returns are closely tied to the manager's profitability. We look for fund structures that make sense for the strategy. We look for managers that reinvest in their business as it grows. Those are probably the most important things. We look at background and not just the key person—but we are very focused on midlevel and upper midlevel investment people—so that we get a good assessment of the quality of the tier of people below the top level of fund management.

What are some red flags?

We want managers to be honest about all the ways that they benefit from managing a fund. They have management fees, performance fees, but we also want to know about soft dollars and expenses that the managers are allowed to get reimbursed for. To the extent that we find hidden fees or expenses that the manager gets, that's tough. If these are not appropriately disclosed at the outset, that would be a red flag.

Another red flag is potential conflicts of interest. We really applaud the managers that build business models and product lines that minimize the existence of potential conflicts, and we think that's the right way to do it. And number three: We call it looking at the belly button. We really care about the quality of midlevel and upper midlevel investment people at the fund. We find one-on-one time with that layer of people really tells a lot about the firm. Great managers will attract and nurture great people. We try not to place too much priority on our time with the top person at the fund. We think that's completely overweighted when people vet hedge fund managers.

Do you have a preference for hedge fund specialists?

We and most of our clients tend to have a preference for independent firms and for firms that have one area of excellence and specialization. We are slightly more cautious about firms that are offering products in many different areas.

What are your concerns going forward? What might be the next shoe to drop?

The good news is that managers get the joke, and operational standards and service provider arrangements are improving across the industry. But many steps that are being taken to improve operational standards look better on the surface than they are in reality. To the extent that someone is relying on third parties to provide more operational efficiency, you have to look at what exactly the contractual relationship is between the fund, the manager and the third party to make sure that the headline isn't better than the reality. Given the hedge fund business model and many other manager models, if there are unscrupulous people they will find ways to do unscrupulous things. These issues only concern a small minority in the industry. I don't think that ever goes away, and I think standards are getting better. I would just advise investors not to place too much reliance on high-level descriptions of operational arrangements. They really have to dig in. Most things, when they are presented to investors, are embellished a bit, and you just have to take a skeptical eye.

Describe your operational due diligence process

We use something we call mosaic theory when we look at funds. Our view is that no one due diligence tool or procedure is going to work most of the time, so what you need to do is come at it from many different perspectives. On our operational due diligence team, we have people with hedge fund operations background, audit background, forensic audit/fraud background and legal background. Different people will take a different look at the fund and its managers, back office, service providers, interdependencies, documents, looking for potential problems. We are very careful to make sure that our operational due diligence people have an active dialogue with our sector team, people who cover front-office aspects of a manager. Increasingly, what we are finding is potential issues may not be found in a straightforward manner by any one technique. But by having your operational people and your sector teams talking to each other and sitting next to each other, you are better able to spot things that may not make sense. Secondly, we always prefer funds where there is a minimization of potential conflicts, and we view these as just as important an operational consideration as the independence of the net asset value. Last thing is that we don't simplify things. It's pretty complex to go in and do operational due diligence, and we always make an effort not to simplify things but to really dig in and present our investors with a thorough picture of everything that's going on.

What do you think is the role of funds of funds in an institutional portfolio?

I think that in the long term most large investors will choose a combination of direct hedge funds and funds of funds. We prefer the more institutional firms because they have a more stable capital base. There are multistrategy funds of funds that invest across strategies, and the survivors in that segment of the market will continue to be fine because they offer instant diversification and a way to put money to work quickly. The survivors will be ones where business management and investment management are two different areas at the firm. In their portfolios they will have a mix of established blue-chip hedge funds, as well as more interesting off-the-run managers that are not widely held. I think the best multistrategy funds are the ones that have a strong CIO function and really know how to mix momentum and value investing. When we look at funds of funds, we score them according to the prior 12-month track record of each hedge fund they add and remove. We score funds based on the extent that they are consistently buying hedge funds that have been way up the past 12 months and selling hedge funds that have been way down— momentum investing. Value investing would be the opposite. We think the stronger firms do a reasonable amount of value investing.

I think niche funds of funds will continue to do okay. An example is emerging market funds of funds. That's an interesting, off-the-beaten-path area where they are playing hedge funds in China and India, where many investors do not have the time, staffing or resources to do due diligence. Funds of funds that are appropriately staffed by specialists will continue to do fine.

What do you think of the shakeout in the funds-of-funds industry?

The shakeout has happened and is still happening. But I'd argue that the top five to ten institutionally focused funds of funds are quite healthy right now and really suffered minimal redemptions. I do think it's a shakeout, but the firms that have institutional clients and know their investors are going to be fine.

We have some clients that invest both in funds-of-funds and directly in hedge funds, and we provide advisory services for them on funds of funds. We do investment and operational due diligence and monitoring and risk work on their funds of funds. Hedge funds are the majority of our work, but I enjoy the funds-of-funds research aspect as well. I think the industry got knocked a bit and people have a tendency of dancing on the grave, but there are very strong chief investment officers and very strong research people in the funds-of-funds community. I think the fund-of-funds industry is going to come back and surprise people a little.

Where is the industry talent moving?

What we are seeing, especially in Europe, is that people from the funds-of-funds industry are going to pension funds, life insurance companies or government-related funds, and that's really starting to accelerate to the degree to which European pensions are now starting to allocate directly to hedge funds. The contraction in the funds-of-funds industry sparked this, and some pretty good people moved from funds of funds to the end-user industry. I think that's fascinating and that's really going to empower European institutional moves into hedge funds directly. I never saw this coming. Every time I'm in Europe, I see it more and more. I think now people like working for an end-user institution, where they don't have to focus on marketing or product or business concerns, now they are in full-time investment roles. I don't see it happening in the United States.

Where are investment opportunities right now?

One of our current themes is taking advantage of the wide spread between liquid and less liquid assets. Since April 2009, the liquid part of the credit market has rallied very strongly, but the illiquid part has lagged. That's a really important theme for us and has been for the past four or five months. There is a lack of capital out there relative to the mass of illiquid assets. We are looking at general event-driven and credit-driven hedge funds but also at hybrid hedge fund/private equity-type structures—basically, funds that have a drawdown, a lockup and performance fees only earned as capital is returned to investors. We like funds that are offered by large, stable institutional hedge fund firms that can afford to manage them for years until they earn performance fees. That's a really great way to play a couple of areas, such as assets coming out of the FDIC and banks, rescue financing, secondary investing in distressed assets, whole loan mortgages, corporate loans and residential mortgage-backed securities.

Another theme we are focused on is Europe. The redemptions out of the European manager community, in our opinion, were quite a bit larger than the redemptions out of the North American manager community, and most managers in the equity and event-driven areas tend to be regionally focused. We are quite focused on European event-driven managers because that sector of the market has really been decimated by redemptions. We also like European equity long/short managers, although there is much more of a long bias among the European long/short manager community as opposed to the U.S. manager community, so you have to be careful to find managers who have reasonably low net long exposures and will vary their exposures and have active single-stock short books. But we like the supply-and-demand equation in Europe versus the United States.

We are also working on start-ups. You'd expect in a year like 2009 or 2010 to have a large number of new hedge funds starting up. After the difficulties in 1998 and 1999, a number of fantastic funds started in 1999 and 2000. You would expect to see that in 2009 and 2010, but there have been very few successful new launches, and you see an increasing percentage of the industry's assets going to the very large funds. So the very large funds are dominating a larger and larger portion of the industry's assets, and the next round of new managers are not getting started as much as they should be. The reason may be the absence of funds of funds that have historically been active investors in start-up hedge funds. To the extent that there are high-caliber teams launching, we think it's a good time to be involved. Because there isn't so much capital being thrown at them yet, we think there is a lot of opportunity there.

How much does a manager's history or reputation matter when it comes to start-ups?

We really focus on people's reputation within the manager community of similar managers and traders. We try to do a lot of reference checking within the community. If it's a long/short financials fund, for example, we want to know what other financials managers and research people think of the manager. We are not as focused on overall reputation as we are on the reputation within the strategy.

As a consultant, how do you mitigate liability risk?

If you are in the business of offering advice to investors for allocating to hedge funds, you'd better make sure that you are really doing everything you say you are doing. The firms that are at quite a bit of risk are the ones that perhaps market that they are doing more than they are actually doing. There is always risk in the market. Bad things will always happen. But the best risk management is transparency of process, so clients know what they are getting. If clients are surprised to find out that they weren't getting what they thought they were getting, that's where the trouble begins.

What keeps you up at night?

We have a very high resources model for large end investors, and what's most important to me is that we never want to be spread too thin. What would keep me up at night is having an inappropriate workload to staffing level, where any firm can run into trouble. We are focused on large sophisticated services for large sophisticated investors, but with a high resource level.