A Platform Mentality for Hedge Funds

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The Mutual Fund Parallel Argument

An argument can be made that among institutions and high net worth individuals, alternative investments are the “new mutual funds”—and over the next decade they will evolve along a course parallel to that of mutual funds in the 1980s and 90s. Some hedge funds are in strong competitive position to benefit from the “parallel argument.”

In the early 1980s, most mutual fund marketing focused on specific hot funds and their managers (e.g., Magellan and Peter Lynch). The next phase of evolution increased emphasis on fund management companies and their diversified “families.” However, mutual fund assets did not explode until the early 90s, when funds began to emphasize the utility of their **platforms**. Their platforms included a variety of services that made investing more **convenient** (automatic reinvestment, dollar cost averaging), **flexible** (exchanges, automatic rebalancing), and **strategic** (asset allocation models, fund-of-funds).

The modern mutual fund platform allows virtually every investor (and every investment professional) to use mutual funds to create customized investment programs. This has expanded applications, opportunities and participants while creating a snowball effect for assets. In a subsequent phase of their evolution, mutual funds failed to regulate platform manipulation (timing, day trading) to protect the vast majority of their investors.

Alternative investments are moving beyond the “fund focus” phase into the next phases that emphasize company strength and platform benefits. Although there are many reasons to believe institutions will enjoy “platform benefits” in alternatives as much as individuals have in mutual funds, few alternative investment providers yet have developed a “platform mentality.”

The platform exists to make diversified investing (among alternatives) convenient, flexible and strategic. It offers compelling reasons why institutions should consider consolidating an alternative allocation with one management company, instead of spreading it among several. These reasons can (and should) be different for alternatives than for mutual funds, designed to reward investors for working with an innovative company that understands institutional needs.

Spreading the Wealth

In the first phase of hedge fund evolution (the single-fund focus phase), the strongest funds grew into asset-gathering giants, while most of the rest fell by the wayside. In the next phases (company-focus and platform-focus), it won't be as easy to fold unsuccessful funds without losing credibility and momentum—and the strongest platforms will achieve a blend of assets across diverse fund strategies. There are several ways that a "platform approach" can help to spread the wealth more evenly among hedge funds, including existing funds that have fallen out of favor and innovative new single-strategy funds to be launched in the future:

Low-correlating pairs—The hedge fund has two funds that show a negative correlation to one another. Combining both funds on the same platform might help to increase risk-adjusted returns.

Allocation of cash flows—Many hedge fund investments are one-time sales processes and decisions. But a variety of institutional investors have committed a percentage of their total portfolios to alternatives—and they have continuing cash flows to invest. In the 1990s, a huge factor behind mutual funds' asset explosion was steady cash flows from defined contribution plans, and top alternative platforms now have similar potential. An alternative platform that can accommodate quarterly cash flows allocated and diversified among several funds could enjoy advantages, including ability to "spread the wealth" among platform funds and cross sell existing investors into other funds.

Rebalancing—A platform that enables rebalancing among funds automatically spreads the wealth, by transferring assets from top-performing funds to lower performers.

Automatic reinvestment—One way to create assets for innovative new funds could be to encourage clients to reinvest some part of gains or distributions into other portfolios. Over time, positions in out-of-favor or new portfolios could gradually be acquired, as comfort with these portfolios grows.

Client feedback—The four most important criteria in launching new single-strategy funds could be: 1) They leverage the firm's research/management strengths and insights (grow by evolution); 2) They have low correlation with existing funds on a back-test basis; 3) They meet needs expressed by existing investors for added diversification; and 4) They help the firm expand into new areas that don't depend on the same economic conditions or market climates as existing strategies (i.e., they diversify the firm's ability to attract assets and earn incentive fees across all environments).

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