



## Take 15: Risk Management in Fund-of-Funds Portfolios

Peter D.A. Stein, CFA, Managing Director, Pacific Alternative Asset Management Co.

Interviewed by Gregory Seals, CFA, Director of Fixed Income and Behavioral Finance, CFA Institute

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**GREG SEALS:** Welcome to another episode of Take 15 from CFA Institute. My name is Greg Seals. I'm director of fixed income and behavioral finance. Today, we have the pleasure of being joined by Peter Stein to talk about risk management in a fund-of-funds context. Welcome, Peter.

Now, Peter, let me introduce you a little bit further. You're a managing director at Pacific Alternative Asset Management, otherwise known as PAAMCO, in Newport Beach, California. Previously, you were the CIO

of the University of Chicago Foundation, where we're sitting today at the Financial Analysts Seminar. So, you're uniquely qualified to talk about risk management, funds of funds, and alternative investments given your background. That's what we wanted to delve into today.

To start out with, maybe we could talk a little about the endowment model and some of the issues that have come up with that through the financial crisis, maybe spending a little more time on private equity, less-liquid strategies.

**PETER STEIN:** You're asking it more politely than I've heard it before. Usually the question is, "Is the Yale model dead?" I think it's very much so.

Financial markets are cyclical, and we're certainly at a tough point in the cycle. But those tough points are what create opportunity.

We're at a point where most people don't have liquidity; most people are afraid to budget to things that take a long-term commitment and that bind them to the uncertain timing of capital calls, but that's what makes for attractive returns and things like this. Of course, that also makes it difficult for people to take advantage of it, but that's how markets work. Things are getting more attractive; things will get more attractive still, but it's difficult to extract those returns.

**SEALS:** When you don't have the flexibility?

**STEIN:** If it were easy, it would not be as attractive.

### TAKE 15 SERIES

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### ABOUT THIS EPISODE

Peter D.A. Stein, CFA, discusses the fallout from the endowment model investment approach of heavily relying on illiquid alternative investments. He also discusses his firm's investment structure for alternatives and how they approach risk management in a fund-of-funds structure.

**SEALS:** Now, switching over a little bit to the fund-of-funds world that you work in now, one of the criticisms, I suppose, has been the fees in a fund-of-funds world. Can you comment on what the justification is for those fees or how you guys have approached that question?

**STEIN:** There are two sides to that. One is we, as a fund-of-funds provider, negotiate aggressively with the underlying managers, and we actually make up a significant portion of the fees we charge by negotiating with the underlying managers as sort of a volume discount. In particular, we focus on, in our business, what we call an emerging manager: start-up or near-start-up managers. We not only provide early capital, but we also tend to be a preferred investor because of the fact that we've done this a lot and that we provide them a sounding board and we help them get themselves set up. We frequently get significantly reduced fees. We tend to almost pay for ourselves.

But that aside, we provide an oversight structure and fiduciary responsibility (as well as having 130 people now in total in the selection of the portfolio from the universe of thousands of hedge fund managers) in the continual oversight, due diligence, portfolio construction, risk monitoring, and measurement.

**SEALS:** It's quite a few services you're providing.

**STEIN:** I could keep going for as long as you want me to.

**SEALS:** I think we get the idea. It's possible that, you know, obviously, there are different flavors of funds of funds out there, different ways that people are structured in terms of providing these services and the value they find. I think we're going to talk about that a little bit more.

**STEIN:** Many of our clients do direct investments as well. And we are happy to work with them. Our firm is very relationship based. We have relationships with our clients; we work with them. Again, we focus on earlier-stage managers. They don't need us to invest in the big name-brand managers and pay us a fee to do that. We will talk to them about it as they're looking at things and help them with that decision, but that's part of the relationship; that's not part of what we put in the fund in the assets that we have under management for them.

**SEALS:** Right. Well, let's talk a little bit more and drill down on the risk management process at PAAMCO, how you guys have approached it. Maybe you can talk in that context a little bit about the things that might be different now versus prior to the crisis we've been through.

**STEIN:** Risk management at PAAMCO is very comprehensive; it's central to our business. It's one of the cores. It's something that we take very seriously, to the point where we will not invest. First of all, risk has a veto on any manager hire. We won't invest unless we get position-level transparency from the manager in a format that's acceptable to us on at least a monthly basis. Our risk-data people can veto as well if the format and the data are not acceptable. We take it

very seriously. We use the risk information in the traditional sense that funds of funds have always used it, as a sort of safety net, and also as part of the portfolio construction process.

**SEALS:** In terms of aggregating the managers together?

**STEIN:** Risk is more than just the quantitative risk management. Risk comes in many ways. So, one of the things that has been a big push for us since before 2008, and we have continued to focus on it (it worked very well for us in 2008), is structure and governance. Those are part of what we refer to. This is another answer to your question about how do we add value. Those are part of what we refer to as non-investment alpha. So, we've made a big push on investment structuring.

Where we are in commingled funds, we have a big emphasis on making sure that there are true independent directors, rather than rented directors. We prefer, however, where we can, in most cases, to be in vehicles where we can have control over the assets if necessary and structures that we can set up.

**SEALS:** How common is that? Do you have some sense of how common that is in the industry?

**STEIN:** There is a lot of talk about it. There are more and more people doing it. We like to think that we are the cutting edge. It is something that we have spent a lot of time and energy on, and it worked well for us in 2008, when people were gating and suspending and that sort of thing. It is something we have continued to focus on and move forward with. That is one side of risk management. The other thing is the quantitative risk management that I mentioned. We have position-level transparency from all of our managers.

**SEALS:** So, you can look for overlaps and positions that might be too large?

**STEIN:** Not just that, but in my previous lives in, say, endowment, if I had position-level transparency from my managers, it would have been meaningless because I wouldn't have been able to do anything with it. Here, we actually have a large risk department with people who know what to do with these data, and we are all trained in how to use the reports. There is actually a lot of overlap between risk and portfolio management. So, we have copious quantitative risk reports.

One of the things we do particularly well is to integrate the quantitative and the qualitative risk reports. One of the things that anyone who knows me (and anyone who has seen me) knows that I am very fond of saying—and I say it over and over and over—is that, "Anything that can be measured with one number probably is not that interesting or that useful." So, we don't just use one report or one number. We have multiple reports, any of which could suggest something that might need further investigation. If any of those reports suggest further investigation, then we go and we talk to the manager and we discuss it and find out what is going on.

Also, every month for each manager we write a risk report, and that risk report is a combination of qualitative and quantitative—both. And something that, having seen a lot of this type of thing, I have always thought is that most places overemphasize either the quantitative or the qualitative.

**SEALS:** So, it's the blending that's important to you in looking at risk?

**STEIN:** I think that people who think they can do risk management in a purely quantitative way are fooling themselves.

**SEALS:** Right, there are tools to help you get to decisions or questions, as you said.

**STEIN:** And then, on the other hand, when I was without the quantitative tools, trying to do it all qualitatively, the more complex your portfolio gets, the harder and harder it is to do—the more you are letting go by, the more you are relying on “big picture” thoughts and rolling things up. Having this combination of quantitative and qualitative and using it iteratively back and forth to understand what is going on is, I think, the approach that has to be taken to do it well once you get into a moderately complex portfolio.

**SEALS:** Certainly, hedge funds are complex, and we really appreciate you sharing your insights and thoughts about approaching the risk management problem. So, thanks, Peter.

**STEIN:** Thank you.

**SEALS:** And thank you for joining us for another episode of Take 15 at CFA Institute.

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