Jonathan Miles, managing director and head of hedge fund advisory at Wilshire Consulting, talks to Sasha Jensen, CEO of Context Jensen Partners, about his firm's approach to manager due diligence and how hedge funds can play a role in client portfolios

Q How would you describe the hedge fund outlook of Wilshire Consulting and its clients at the moment?

A Our outlook is that hedge funds broadly haven't lost the ability to play an important role in client portfolios. We recommend clients expand the discussion beyond just hedge funds (given these are just fund structures) to include other unconstrained alternative strategies such as risk premia and liquid alternatives, and make strategy and manager selections aligned and optimised to a plan's investment objectives and other investments. Marketable alternatives become a broad-based toolkit with every investment having a role and purpose.

Q How has that outlook changed as a result of the election and the current geopolitical environment?

A Uncertainty has increased, but it's premature to predict any direct impact to the alternatives market and specific strategies. Clients should continue with established plans and be prepared to adapt if warranted.

Jonathan Miles
Head of hedge fund advisory, Wilshire Consulting

Sasha Jensen
CEO, Context Jensen Partners

Q What are the characteristics Wilshire Consulting looks for in hedge fund managers?

A There are a few different qualities you could use to describe what we think is a good manager. One is humility – "I know what I know, and I know what I don't know." It's important that managers don't think that they're better than the market, because they're usually not. Another is the idea that they understand they're in a competition with other investors, which means they understand what asset allocators are going through. We need to find managers who are truly unique and doing something that is differentiated and worth investing in. Managers who can articulate what they do differently and why will stand out.

Q How does Wilshire Consulting evaluate managers on these characteristics?

A We look for managers who have a commitment to self-improvement. A component of our process is called attribution, which looks into what managers attribute their successes or failures to, and what they do to address those failures. There's a quantitative and qualitative element to the process. The quant side is focused on performance attribution – where are returns coming from, where are managers making and losing money, and how does that relate to a manager's advantage? We need to have transparency into the sorts of decisions a manager makes and how they allocate capital.

Qualitatively, we look for managers without hubris. We hate it when managers blame the market for losing money, and then take credit for all their winners. Managers should be honest and own their losses as much as they own their gains. A lot of people only look at where they lost money, but they should also focus on where they made money and how, because obviously we want them to emphasise what works and change what doesn't.

Q In what aspects, if any, is Wilshire Consulting flexible? Are there any areas where Wilshire has stricter parameters?

A No compromise will be made on transparency, regarding the portfolio, people, process or firm. A robust operational infrastructure is also a must. For the remainder, a mosaic approach is used where every aspect of a manager is evaluated on a relative basis. The ideal manager generally only exists on paper so everything is an assessment of risk/reward to this ideal.

Q Are there any particular hedge fund strategies that Wilshire Consulting / its clients are interested in or staying away from at the moment? Why?

A All else equal, clients are encouraged to prioritise hedge fund investments as diversifiers versus traditional investments. Priority is given to strategies that exhibit low correlations to equity and credit markets supported by a qualitative assessment of the strategy. Selection can also be influenced by a strategy/manager's ability to harvest illiquidity premiums, identifying structural inefficiencies and actively influencing outcomes. We don't think investors should pay higher fees for beta-driven results or for strategies where it is difficult for managers to differentiate themselves other than through performance.

Q What are your expectations around fees – will they come down?

A Without a doubt fees will continue to decline on average, but they are also likely to be more barbelled. Managers with strong investor demand have little incentive to lower fees, but if returns do not improve with rising rates the pressure should increase.

Q How does Wilshire Consulting address client concerns around liquidity?

A Many institutional investors do not have immediate liquidity needs and should use this to their advantage when negotiating fee breaks for longer commitments or investing in strategies with longer time frames that aren't classified as private equity.

That being said, the demand for liquidity can be a key driver of jumps in correlations as the average investor reduces risk. Investors with longer investment horizons can use this to their advantage and earn economic rents by providing this liquidity. We believe that longer-term economic fundamentals will drive valuations.

Q What can hedge fund managers and their IR staff do better during the due diligence process?

A Transparency in all areas is critical. The portfolio is a manifestation of a process, and understanding how this process is structured and how decisions are made is integral to due diligence. Provide detailed performance and exposure attribution, in Excel, since inception. All investors should be treated equally and transparency provided around when investors are offered preferential terms.

Be proactive in providing information: a comprehensive due diligence packet is a great start. This may include the most recent presentation, research/commentary over the last 12 to 24 months, a list of all documents available for review (identifying those requiring non-disclosure agreements), a standard DDQ (Aima version preferred), ADV Parts 1 and 2, and performance and exposure attribution in Excel. Be transparent about known issues or concerns – leaving it up to us to find something that is easily found is not the right way to start a relationship based on transparency and trust.

Q What are the main investment challenges facing Wilshire's clients at the moment, and how can hedge funds help address these?

A Meeting performance targets without over-concentrating risk exposures. Hedge funds offer a toolkit that can be instrumental by providing access to strategies unavailable via traditional funds, strategies that generate returns regardless of market direction, and that can actually offset drawdowns in risk assets. This investment flexibility can improve an investor's ability to reach performance targets besides simply taking long-only exposure to illiquid assets, the segment of the market that has the highest expected returns over the next 10 years.

Q Hedge fund performance has suffered in the context of broader market headwinds such as central bank intervention. What should IR staff at hedge funds focus on in such an environment when communicating with existing clients?

> "Managers who can articulate what they do differently and why will stand out"

A Take responsibility for poor performance rather than blaming exogenous events. Focus on the facts and educating investors when a strategy should do well or poorly. Investors are more likely to redeem when they don't understand what is driving performance or if managers aren't being forthcoming about what isn't working. ▪