The Interview – Robert Ferguson, Benchmark Plus: "Allocating assets to managers according to some market view or forecast is an inexact process at best"

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Benchmark Plus chief executive Robert Ferguson says the USD1.7bn fund of hedge funds manager says the firm's unique investment process analyses alpha streams rather than returns, allowing for an equal comparison of all strategies and enabling the firm to allocate to funds and managers that have demonstrated skill at exploiting specific market inefficiencies and generating returns in excess of their portfolios' specific risk exposures.

GFM: What is the history and background of your company, principals and funds?

RF: Headquartered in Tacoma, Washington with an office in Freehold, New Jersey, Benchmark Plus is a fund of hedge funds manager with a unique approach to creating alpha-producing beta-neutral funds.

In 1995, after 10 years of involvement with alternative investment strategies at a major West Coast investment consulting firm and a Fortune 500 corporate pension plan, the founders launched the predecessor firm to what is now Benchmark Plus Management.

Today, Benchmark Plus manages approximately USD1.7bn in hedge fund assets across three principal strategies with varying degrees of risk/reward: Benchmark Partners Fund, Benchmark Institutional Partners Fund and Benchmark Long Short Partners Fund.

GFM: What is the structure of your funds?

RF: Benchmark Plus is an SEC-registered investment advisor and is completely employee-owned. The original Benchmark Partners Fund is a 3c1 fund, while the Institutional and Long Short Partners funds are both 3c7 funds.

Each Benchmark Plus fund maintains an onshore and offshore structure in a reverse master-feeder structure intended to provide the fund and its investors with the benefit of US legal jurisdiction and US GAAP-compliant audits. It also enables us to utilise the onshore version of our underlying hedge fund managers' portfolios.

GFM: Who are your main service providers?

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RF: Our fund administrator is ABN Amro Fund Services (Cayman), our auditor is Deloitte & Touche in Seattle, and our legal advisor is Drinker Biddle & Reath in Chicago. Our custodians are ABN Amro Fund Services (Cayman) and Société Générale in Los Angeles. Our prime broker is JP Morgan Chase – Futures Trading in New York.

GFM: What is your distribution strategy and targeted client base?

RF: We are one of the 15 largest US-domiciled fund of hedge funds managers of pension assets in the world. More than 95 per cent of our assets are from institutional investors including public, corporate, Taft-Hartley, endowment and foundation clients, with the balance from employees, high net worth individuals and family offices. We also have significant assets from non-US clients and are continuing to explore ways better to access the non-US marketplace.

GFM: What impact has the recent global financial crisis and economic downturn had on your business?

RF: The 2007-08 period created many dislocations in the markets that ultimately presented significant alpha opportunities for investors. As our investment process is structured actively to neutralise imbedded beta exposures, we viewed this crisis as an exceptional alpha opportunity and were able to stay fully invested at the most opportune time.

Our bottom-up, alpha-focused investment process also identified and allowed us to capture many of the outstanding alpha opportunities during 2009. Our exceptional results in 2009, capturing significant alpha with essentially zero beta, clearly validated our investment beliefs and process.

GFM: Please describe your investment process.

RF: We believe that pockets of inefficiencies exist within the markets that can be exploited by highly skilled and disciplined managers. We believe that properly benchmarking hedge fund managers through our Real Alpha process – both qualitatively and quantitatively – is the only effective, efficient and reliable way to identify exceptional hedge fund managers.

We seek as many different sources of alpha as possible to limit our dependence on any one alpha source, and attempt to manage the systematic risk exposures of each underlying manager dynamically and actively. The goal for our funds is to maintain, depending on the particular fund, a measured beta to equity or bond markets at 0 per cent (Real Alpha Funds), 40 per cent (Real Equity Fund), or 100 per cent (Enhanced Index Funds).

In contrast, nearly all other funds of hedge funds allocate assets to managers according to some market view or forecast. This is an inexact process at best. Our process analyses alpha streams rather than returns, allowing for an equal comparison of all strategies. We then allocate to those funds and managers that have demonstrated skill at exploiting specific market inefficiencies and generating real alpha – returns in excess of their portfolios' specific risk exposures.

GFM: What is your approach to managing risk?

RF: Risk for us is not volatility – upside volatility is actually good. Rather, we focus on risks that might cause a permanent loss of capital and actively control such risks in several ways.

We design a custom benchmark for each manager, reflecting their respective systematic risks – that is, their exposure to the broad financial markets. We create an offset position to neutralise each manager's residual systematic risk exposure. Each manager is now essentially beta-neutral.

We ensure a diverse group of alpha streams to further diversify the fund and account for factor exposures, which are diversified through our optimisation process. Finally, we maintain dedicated allocations to long volatility strategies that should perform best when market volatility increases or major market dislocations occur.

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GFM: How many funds and strategies are in your portfolio?

RF: As a bottom-up allocator, we do not use a pie-chart approach to strategy allocation. Rather, we seek unique managers capturing alpha from diverse sources and combine them into an optimal portfolio. As such, our funds will have from seven to 10 different alpha sources and will be allocated across between 15 and 30 different hedge fund managers.

GFM: What are your criteria for including a manager or strategy in your portfolio?

RF: We include new managers that have demonstrated consistent alpha with appropriate risk management, infrastructure and control procedures and will be additive to our fund either through bringing increased diversification or incremental alpha.

GFM: What are your criteria for removing managers from the funds, and do you aim to replace them immediately?

RF: Except for operational or business issues, which could require an immediate termination, we will remove managers primarily for a degradation of their alpha.

GFM: What developments do you expect to see in your investment sector or industry field in the coming year?

RF: Our institutional investor base continues to increase their use of alternatives but with varied rationales and expectations. Additionally, this wave of new capital may ultimately put pressure on alpha. Counterbalancing this trend, proprietary trading desks are being disbanded, reducing the amount of competition for alpha opportunities.

Along with this, the propensity of investors has been to gravitate toward larger funds, leading to increasingly crowded trades and overlap among portfolios. This herd behaviour also has the potential for significant disappointment. The logical, but perhaps not easiest, solution is for investors to pursue more innovative and unique investment approaches that offer clearly-defined risk and return parameters and an identifiable value proposition.

GFM: How will these developments affect your firm and the performance of your funds?

RF: Rather than having results driven by market conditions or direction, our approach is focused on the skill element of managers capitalising on specific inefficiencies in pricing or valuation at the security level. Over time, this has proven to be a more repeatable and sustainable method for generating uncorrelated returns.

Our philosophy and strategy have always favoured those sectors of the market with the greatest inefficiencies, often found at the periphery of the capital markets, where the largest sources of alpha are likely to exist. These more discrete investment strategies, in combination with our risk management protocols, tend to produce returns that are truly diversifying and non-correlated with both the market at large and other hedge funds.

As investors grow increasingly aware of the composition of their hedge funds' performance, we anticipate they will focus more upon the impact that market-driven returns have on their portfolio and the interplay among their managers. Consequently, the ability to manage aggregate hedge fund risk and access unique alpha sources will take on greater importance. These skills are clearly in Benchmark Plus' sweet spot.

GFM: What do investors currently expect from managers, and how do you deal with those expectations?

RF: Most investors are seeking uncorrelated returns with low volatility along with high nominal and absolute returns at all times. But definitions are ambiguous, behaviour is not always consistent with the stated objectives, and investors are disappointed when their results don't keep pace with the broad markets' gains.

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At Benchmark Plus, we have long understood that there are two distinct components of the risk/return equation – systematic (beta) and idiosyncratic (alpha) exposure – and each has markedly different attributes. Our goal is to help investors comprehend the characteristics of both components and effectively manage the risk of each.

Our preference has been to have a clear definition of alpha, an objective metric by which to measure it and a process to mitigate the influences of beta, which can readily overwhelm alpha, especially in down markets. Markets always fall much faster than they rise!

GFM: What differentiates you from other managers in your sector?

RF: Virtually all aspects of our process are different from other managers, most clearly illustrated by the firm's name. At Benchmark Plus, we have a defined process for benchmarking each manager and objectively identifying those managers producing the 'plus' (i.e. alpha).

GFM: How do you view the environment for fundraising over the coming 12 months?

RF: Our efforts are focused on investors who appreciate our strengths, which encompass our objective metrics for evaluating and selecting managers, our focus on managers exploiting clearly-defined market inefficiencies and our active risk management process. Our goal is not to have the most clients or assets under management, but to generate the greatest level of alpha possible for those investors that see the merit in our approach.

GFM: How do you expect your business to be affected by current and proposed regulatory changes?

RF: We do not see any significant impact on our business from the many proposed regulatory changes. We see these as a cost of doing business, not a hindrance.

GFM: Do you have any firm plans for further product launches?

RF: We recently created a new series within our six-year-old Long Short Partners Fund called Real Equity. This addition was created as a long-only substitute and is designed to exhibit specific return and risk attributes over time relative to the S&P 500. It seeks to achieve these results by delivering a stable and consistent equity beta exposure, augmented with non-correlated alpha.

The goal is to provide strong equity-like returns with significantly lower levels of equity exposure and volatility. These attributes allow investors to control their equity market exposures more precisely than traditional long/short offerings, which are characterised by variable and uncertain betas and a reliance on market timing.

- Fund of Hedge Funds

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