

Multi-Manager Hedge Fund Programs: Implementation Considerations

Hedge fund allocations within diversified investment portfolios demonstrated downside protection relative to many other risk assets through the recent credit crisis, and the asset class as a whole has exhibited attractive risk-adjusted returns over the long-term. Given their potential diversification benefits, it is no surprise that hedge fund industry assets are approaching an all-time high and that investors continue to build and evolve the hedge fund investment programs within their portfolios. It is generally understood, however, that there are many risks and costs, both explicit and implicit, associated with investing in hedge funds.

At the highest level, selecting a portfolio of hedge funds is analogous to selecting a portfolio of stocks. The opportunity set of existing hedge funds approximates 7,100 funds, while the number of publicly traded companies trading on the world's various exchanges approximates 10,000 companies. Furthermore, these respective opportunity sets continually change as companies are created or go public, evolve, merge, go out of business, etc., and new hedge funds are formed or existing hedge funds are closed. While there are many similarities, there are also meaningful substantive differences. The universe of stocks is readily identifiable through public sources. To the contrary, privately offered hedge funds are restricted in their use of advertising and many of the most successful hedge fund managers specifically seek to remain out of the public eye. Further, for most publicly traded companies, financial information is readily available in a relatively standard format, whereas hedge fund manager information is not universally aggregated in a single location and the limited information available is characterized by heterogeneity.

The myriad challenges associated with successfully executing a multi-manager investment program have impelled many institutional investors to employ investment consultants, fund of fund managers (acting in either a discretionary or advisory capacity) or specialist advisors to assist with the implementation and maintenance of this portion of their portfolios. The purpose of this document is to identify and describe several important considerations and related evaluation criteria that investors in this position should take into account when seeking an advisor for their multi-manager hedge fund investment programs. The views expressed in this document reflect the current judgment of BlackRock Alternative Advisors. *There can be no assurance that a multi-manager approach will be successful even if the selection of managers is based upon the criteria provided herein, or that the individual or collective performance of underlying hedge fund investments will be profitable.*

Advisor Considerations

Evaluation Criteria

Organization

An ideal organization should demonstrate a fiduciary-oriented culture and long-term adherence to its core philosophy. Investment performance and the quality of product delivered to clients should be a top priority, which may be apparent through a lengthy and proven track record of selecting top tier managers, significant principal investments and other incentives that align the advisor's interests with those of the client.

Features of a strong organization include a stable and diverse client base and a global presence with access to broad capital markets insight. The latter may provide broader investment sourcing and insight.

An organization should demonstrate a long-term focus on operational excellence by reinvesting in its personnel, technology and broader infrastructure.

- How much capital is invested by employees in the products that they recommend or manage? What percentage of net worth does this represent? How has this investment level changed over time?
- What is the business plan for the organization and how does this align with client interests?
- What is the governance structure for the organization?
- What are the primary systems used by investment professionals? Were they developed in-house or purchased off-the-shelf?
- How does the organization invest in its infrastructure and functional support areas (e.g., operations, legal, reporting and technology)?
- What is the organization's relationship with "The Street" and does it provide meaningful capital markets insight and other benefits to investors (e.g., investment sourcing and reference checking)?
- Does the organization have a clearly definable track record attributable to specific decisions and actions? If so, how does the track record compare to peers with a similar investment philosophy and strategy focus? If not, what basis would they propose for evaluating their advice?

Team

It is important that the organization has a diverse and knowledgeable team of professionals across distinct investment research, risk management and operational due diligence teams. The independence of these teams encourages checks and balances and sufficient diligence in each step of the investment process.

Senior team members should have experience across multiple market cycles with limited turnover of senior investment personnel. Low levels of senior investment professional turnover suggest a greater likelihood that past performance is attributable to current team members.

The majority of investment professionals' time and energy should be focused on investment-related activities. Marketing and administrative duties should not be a primary focus.

- What are the investment team's experience and areas of expertise?
- What has been the historical turnover among key investment professionals?
- How are particular roles and responsibilities divided among specific individuals?
- How are the investment decision-making functions integrated? What is the nature and frequency of interaction and collaboration among the risk, research and operational due diligence teams and how is information disseminated among them?
- How are staff evaluated and retained?
- If the firm has multiple offices, how is communication and coordination among various locations maintained?

Manager Sourcing

An ideal organization should have a multi-faceted manager sourcing capability. A robust, independent sourcing network of high quality market practitioners is preferable to reliance upon traditional sourcing channels (e.g., capital introductions and published indices), as it may foster more unique idea generation.

Early identification of managers should be emphasized, as it can foster greater potential to negotiate favorable terms that may otherwise be unavailable to later investors.

- What are the primary sources of manager identification?
- What percent of "approved" managers was initially sourced directly by the organization versus through capital introductions?
- What percentage of investments was made on day one, or within the first six months following launch?
- How has the organization enhanced its sourcing capabilities over time? What is the evidence for these enhancements?
- How many new managers does the organization evaluate and recommend per year?

Investment Due Diligence

The investment process should be driven by in-depth and independent fundamental research. Reliance upon historical track records or superficial due diligence may result in investments that are not well understood or may place investors at increased risk of fraud or other adverse outcomes.

An organization's investment due diligence should be underpinned by a robust and repeatable process focused on evidencing the claims made by managers under evaluation and confirming that their investment processes are supported by sustainable points of differentiation. This should include bottom-up assessment of investment portfolios, on-site verification of managers' research, systems and infrastructure, as well as qualitative assessment of individuals at various levels within organizations under evaluation. This evaluation should be supplemented by a wide range of reference checks encompassing character, reputation and investment skill.

It is important that the due diligence process incorporate a diverse set of opinions to avoid overreliance on the opinions of a limited number of people, and an organization should be able to demonstrate that it has updated its research and reevaluated its thesis related to underlying managers periodically over time.

- How is the organization's philosophy reflected in its approach to due diligence?
- What specific procedures are performed in connection with initial and ongoing due diligence to help verify manager claims?
- How many underlying managers are reviewed each year?
- How frequently is on-site due diligence performed?
- How is the manager reference checking process conducted? How many references are typically sought for a given manager?
- What type of analysis is performed on a manager's portfolio? Is the portfolio evaluated on at the position level and, if so, is actual position-level detail compared to the stated investment thesis?
- What type of comparative analysis is performed across managers and strategies? How is this incorporated into the due diligence and manager selection process?
- How is capital markets research incorporated into due diligence?
- How many investment organizations are covered per professional?
- How is information stored and shared across the investment team?

Operational Due Diligence

An ideal organization should have a dedicated and experienced operational due diligence (ODD) team, as operational issues have historically been an element of numerous hedge fund failures. The ODD team should have a strong understanding of industry best practices with respect to operational infrastructure, such as counterparty arrangements, cash movement controls, valuation policies and procedures, use of key service providers and regulatory and compliance practices.

Periodic on-site reviews of underlying managers' procedures and systems should be conducted, and the due diligence framework should encompass key service providers. Background checks of an underlying manager's organization and key personnel should be a focus of the ODD team. Ideally, the organization would perform this function in-house to better control the quality, scope and frequency of checks versus what may typically be provided by an outside provider. The organization should have a centralized system to capture and communicate its due diligence findings and to monitor underlying manager information across multiple areas.

The ODD team should have a strong voice in the overall investment decision making process, including potential veto power over manager selection.

- What are the experience and areas of expertise of the ODD team?
- Has the organization been exposed to any "blow-ups" due to fraud over its history?
- What is the scope and frequency for on-site operational due diligence manager visits? What areas are covered? What level of system review and testing is conducted?
- Is due diligence conducted on key service providers, counterparties and fund directors?
- Is the background checking function performed in-house? What is the nature of the checks, which individuals at an underlying manager are evaluated and how often are checks updated?
- How is operational due diligence incorporated into the investment decision making framework?
- At what point is ODD typically engaged within the overall investment evaluation process?
- Are there examples of when ODD led to a decision not to fund or to redeem from an underlying manager?
- Are there examples of when ODD observations and feedback influenced a manager's process?

Legal Due Diligence

Given the changing regulatory environment and increasing complexity of hedge fund documentation and other legal matters, it is important that the organization have an in-house team of experienced lawyers able to address issues on a real time basis.

The team should understand the legal nuances across various jurisdictions, have regular interaction with regulators and have meaningful experience structuring funds and evaluating tax matters. Legal due diligence should be a core element of the review and structuring processes and should be taken into close consideration by the investment research team.

- What are the in-house legal team's composition and experience?
- What is the process for evaluating underlying manager legal documents and subsequent legal issues, such as proxy votes?
- How are legal reviews documented and concerns escalated?
- How is legal due diligence incorporated into the investment decision making framework?
- Are there examples of when legal due diligence led to a decision not to fund, to redeem from or to create a custom structure with an underlying fund?
- How does the organization keep up with the changing regulatory framework, and does it seek to influence regulatory changes?

Investment Structuring

An ideal organization should demonstrate an ability to negotiate, and experience in structuring, investment terms and conditions with underlying managers. This can provide meaningful value to investors, potentially including fee concessions, enhanced governance rights, investment guidelines and risk parameters, and risk transparency. Further, the expertise to structure custom investment vehicles can provide the means to pursue niche and off-the-run strategies on an opportunistic basis.

- What level of fee concessions has been negotiated?
- What percentage of the organization's manager relationships are accessed through a custom fund?
- How has the organization improved liquidity, governance and reporting terms for its clients?
- Is the group able to take control of a portfolio and wind it down if necessary?

Portfolio Construction and Recommendations

A balanced portfolio construction process often reflects a blending of qualitative and quantitative information, and both bottom-up and top-down perspectives.

Thoughtful input to portfolio construction is important to enhance the potential risk/reward profile of a client's portfolio. This should include a decomposition of both market risk factors as well as secondary risk factors (e.g., sensitivity to market volatility, credit spreads, etc.), in addition to stress scenarios that may negatively impact a portfolio.

Analyses should seek to incorporate a forward-looking view on how each underlying manager may be anticipated to perform under different scenarios.

- Does the organization make recommendations for position sizes? If so, how are these determined?
- Are portfolio recommendations based on bottom-up or top-down analysis and views, and how frequently are they updated?
- Does the organization have a formal process to obtain and synthesize capital market inputs and other data to inform views?
- Has the organization demonstrated a history of capitalizing upon market opportunities and avoiding pitfalls?
- How robust is the group's system for understanding portfolio risks? Are stress testing and scenario analyses performed? What steps are taken to proactively adjust allocations to underlying managers based on the perspective gleaned from risk analysis?
- What is the historical turnover level of the recommended portfolio?
- How diverse or concentrated is the recommended portfolio?

Risk Management

A dedicated and active risk management function is critical to the management of investment exposures. Ideally, the risk management team should have detailed knowledge of underlying managers' portfolios to enable regular calibration of observed risks relative to expectations.

An ideal organization should have the ability to conduct analysis on underlying manager portfolios based on both risk factor exposures as well as position-level information. Position level analysis can be used to check for unintended overlap across various manager investments and to assess drivers of risk and performance, including where managers may be generating alpha.

An ideal organization should be involved in regular risk-focused qualitative discussions, collecting qualitative risk-related information from the underlying manager's risk personnel and portfolio managers. This may enable proactive identification of significant risk themes that may not be captured by traditional quantitative methodologies (e.g., VaR, backward-looking stress tests).

The risk personnel should have detailed knowledge of the capital markets so they can develop forward looking scenarios and measure portfolio risk.

The spectrum of risk analytics and insight should represent a critical input in the portfolio construction process and ongoing underlying manager evaluations.

- How many dedicated risk management professionals does the organization employ, and what is the ratio of personnel to approved underlying managers?
- Does the risk management team regularly and effectively discuss the detailed composition of the underlying managers' portfolios and the prevalent risks therein?
- How, and with what frequency, are the portfolio exposures across managers and for individual underlying managers reviewed?
- With what frequency are risk exposures discussed with risk personnel and/or portfolio managers at each underlying manager?
- Does the risk management team review the individual investments of underlying managers? If so, what form does this review take?
- For those underlying managers where position-level transparency is provided, what capabilities does the organization have in modeling securities, trades and portfolios?
- How does the risk management team determine if identified risks should be escalated to other investment professionals? How many underlying managers have been escalated in the risk process during the last three, six and 12 months?
- Amongst the organization's approved underlying managers, what percentage provide the organization with the following levels of risk data: 1.) Position-Level Detail, 2.) Risk Exposure Detail, 3.) Very Limited/No Risk Information?
- Does the underlying organization rely upon track records for measuring risk, using historical data for statistical factor analysis?
- How are forward looking scenarios developed? How many have been developed and how often are they updated?
- How is the risk of "tail events" evaluated for underlying managers and in the context of portfolio allocation recommendations?

Service Provider Management

Well-staffed back- and middle-office team can serve to oversee and interface with third-party service providers. This can contribute to timely and accurate client reporting and administration.

Significant relationships with service providers and counterparties may enable the negotiation of fee discounts and other service concessions.

- Does the organization maintain back- and middle-office functions?
- Does the organization coordinate audit preparation and other regulatory filings?
- Has the organization negotiated fee arrangements with service providers?
- Can the organization provide net asset value replication, and timely and accurate weekly and monthly performance reporting?

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Certain Risk Factors

Past results are not necessarily indicative of future results. Historically, funds of funds and hedge funds have produced gains and losses due to changes within the equity, interest rate, credit, currency, commodity and related derivative markets. Additionally, gains and losses are impacted to varying degrees by investment acumen, market volatility, corporate activity, securities selections, regulatory oversight, trading volume and money flows. These elements and/or their rate of change may not be present in the future, and thus future performance may be impacted. Any investment in a fund involves a high degree of risk. Investments in funds of funds and hedge funds can be highly illiquid.

The performance of funds of hedge funds will depend on the performance of the underlying hedge fund investments. There can be no assurance that a multi-manager approach will be successful or diversified, or that the collective performance of underlying hedge fund investments will be profitable. Hedge fund managers may be subject to limited regulation (or may not be registered with any regulatory body), may experience potential conflicts of interest with respect to their management of allocated fund assets and from time to time, vis-à-vis other underlying hedge fund managers, may take opposing positions with respect to particular securities or investments. Funds of hedge funds will rely on information provided to them by the underlying hedge fund managers and there may be limited ability to confirm or verify such information.

Hedge fund managers may implement a variety of investment strategies and techniques, including short selling, leverage, hedging (such as derivatives, swaps, forwards, futures and options) and securities lending. Hedge fund managers may invest in a wide array of investments, including non-US investments, non-US currencies, distressed assets, illiquid investments (such as those subject to legal or regulatory restrictions on transfer), and commodities and futures, each of which may have diverse associated risks, including counterparty risk, credit risk and liquidity risk.

The secondary market for investments in hedge funds is a recent development and as such may exhibit illiquidity, wide or non-existent bid-offer spreads, and brokerage charges. In addition, there may be restrictions on transferring fund investments. A fund may be leveraged, which may increase the risk of investment loss, and its performance may be volatile. Funds of funds and hedge funds may involve complex tax structures; therefore, there may be delays in distributing important tax information. Funds of funds and hedge funds are not subject to the same regulatory requirements as SEC registered funds or mutual funds and are not required to provide periodic pricing or valuation information to investors. Funds of funds and hedge funds may have significant fees and expenses that would reduce returns.

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