

Collateralized Fund Obligations: The Value of Investing in the Equity Tranche

Missinhoun, Jean; Chacowry, Leena . Missinhoun, Jean; Chacowry, Leena.

[ProQuest document link](#)

ABSTRACT

Collateralized fund obligations (CFOs) are structured finance products linked to the performance of the underlying fund of hedge funds. This innovative alternative investment product provides customized risk-and-return benefits with low correlations to traditional asset classes, thereby allowing investors to diversify their portfolios through exposure to hedge fund investments. Although several fund-of-hedge-fund managers have been considering CFO deals, they are still struggling to raise money from equity investors who agree to absorb the first losses. This article demonstrates through statistical performance analyses and simulations that investing in a CFO equity tranche does provide real value to investors, as it outperforms funds of hedge funds in 80% of our observations.

FULL TEXT

The hedge fund industry has grown at a ferocious pace in the last decade, from as few as 300 funds in 1990 to more than 7,000 today. Assets under management have ballooned from \$20 billion in 1990 to an estimated \$1.16 trillion today. According to several market researchers, hedge funds will quadruple by 2010, with the growth driven by funds of hedge funds. Funds of hedge funds, which have seen their assets grow by 1,605% since January 1997 from \$21 billion to \$358 billion' in 2004, now control one third of the hedge fund market. To date, only three public deals have been brought to market-Man Glenwood Alternative Strategies I, Diversified Strategies CFO S.A., and Man Glenwood Alternative Strategies II. Collateralized fund obligations (CFOs) are structured finance products linked to the performance of the underlying fund of hedge funds. This innovative alternative investment product provides customized risk-and-return benefits with low correlations to traditional asset classes, thereby allowing investors to diversify their portfolios through exposure to hedge fund investments.

Although several fund-of-hedge-fund managers have been considering CFO deals, they are still struggling to raise money from equity investors who agree to absorb the first losses. We demonstrate through statistical performance analyses and simulations that investing in a CFO equity tranche does provide real value to investors, as it outperforms funds of hedge funds in 80% of our observations.

A SHIFT IN THE HEDGE FUND MARKET

Low volatility and non-correlation to the broader markets have attracted an increasing number of high-net-worth investors who for a long time have been the primary source of capital for hedge fund managers. However, the hedge fund industry is riding a major trend. In an attempt to seek capital preservation and diversify their portfolios while generating absolute returns with a correlation to the broader market, institutional investors (i.e., insurance companies, pension funds, and banking institutions) have recently been increasing their allocations to this investment class. Various estimates cite that more than 50% of hedge fund investing today is institutional, an increase from 12 years ago, when more than 80% of hedge fund investment came from high-networth individuals.² Nevertheless, many institutional investors still lack the investment mandate to gain exposure to alternative assets and below-investment-grade fixed income securities. Beyond legal restrictions (i.e., ERISA), they demand liquidity and transparency in their investments based on their fiduciary duty to act in accordance with the prudent investor rule by which most institutional managers are governed. Although hedge funds provide precisely what institutional investment managers' portfolio objectives demand-capital preservation, higher alphas,

and lower correlations-they customarily lack liquidity, based on their lock-up periods, and transparency, based on their proprietary investment strategies.

Liquidity is a problem for investors partly because of the investment styles of hedge funds. For instance, a spread arbitrage would fail if investors withdrew funds prior to the contraction and during a margin call. Likewise, distressed debt investments require substantial time for returns to materialize, given the slow nature of the bankruptcy process.

Conversely, the same bankruptcy process also creates inefficiencies in the market and subsequent premiums for investors. Liquidity could easily be resolved through creation of a secondary OTC market for tradable hedge fund securities.

Transparency is another issue hindering institutional investors from allocating more capital to alternative investments.

However, it is very important to understand what investors need in terms of transparency. Although hedge funds may not want to divulge their positions and trading strategies, investors are concerned only with having access to information to understand, evaluate, and verify the risk-adjusted performance of their investments. This is essential and an underlying principle of the prudent investor rule. Having knowledge of the positions and trades is meaningless without substantial analysis. A comprehensive analysis of the fund's positions and trades by an independent and credible third party-more precisely rating agencies such as Moody's, Fitch, and S&P-will ultimately result in a matrix of risk-return parameters. The investors only need verification that the hedge fund is performing within its investment mandate, such as leverage ratio, Sortino/Sharpe/Treynor ratio, net asset value (NAV), number of positions and concentration (diversification), beta, alpha, tracking error, industry exposures, long-short ratio, VaR, volatility, skewness, and kurtosis. If this information was accumulated and reported by a credible and objective third party, the asymmetric information chasm between institutional investors and hedge funds would be reduced.

In order to increase capital flows from institutional investors to hedge funds, more financial infrastructure needs to be developed to increase transparency and liquidity and to offer more appealing risk-return trade-offs to investors. Financial engineering can create the necessary market infrastructure to reduce the inefficiencies in the market, thus creating a more complete and efficient financial market. Allocating scarce resources efficiently among capital providers creates value in the financial markets. Disintermediation parses the total risk-return properties of a security into individual components that fulfill individual investors' risk-return preferences, thus creating a more complete financial market. Although certain risk-return profiles may be achieved through various combinations of financial derivatives, there may still be differences that can create value within an overall asset allocation strategy. For instance, if the hedge fund industry could create similar risk-return securities as other asset classes, value would be created within a diversified portfolio through the low correlation of hedge-fund securities. Taking this concept one step further, how can a hedge fund create value through financial innovations that not only give better risk-return trade-offs with a lower correlation to other asset classes, but also increase transparency and liquidity for investors?

FINANCIAL INFRASTRUCTURE INNOVATIONS

Funds of Funds

A fund of funds is a fund that holds a mix of many successful uncorrelated hedge funds and other pooled investment vehicles and spreads these investments among many different funds or investment vehicles. A fund of funds simplifies the process of selecting hedge funds by blending together different funds to meet a range of investor risk-return preferences while spreading the risks among a variety of funds. As a result, a fund of funds typically delivers a more consistent return than individual funds.

Exhibit 1 shows the five largest funds of funds in order of asset size.

Investors have different investment objectives. Funds of funds recognize this difference by structuring funds based on an investor's age, investment horizon, and tolerance for risk. No two funds or managers are exactly the same. Each will apply different amounts of hedging to a portfolio and employ different amounts of leverage. Therefore, returns, risks, and volatility can be controlled by the mix of underlying funds. Volatility depends on the mix and ratio of strategies employed. Understanding the risk-return characteristics of a fund strategy allows the manager to blend funds that are often able to produce fairly predictable returns.

By investing in funds of funds, investors can potentially mitigate the unique risk associated with investing in a single strategy or manager. Funds of funds provide several advantages for investors. Access to individual funds typically requires

an investment of \$1 million or more. Funds of funds pool investor contributions and buy partnership interests in other hedge funds, allowing investors to access funds that may otherwise be unaffordable. Investing in a fund of funds also allows investors to invest in hedge funds with one of the industry's stars that may not be accepting new clients. Funds of funds typically have moderate to low correlations with equity markets, which provides investors with risk protection against equity market downturns. Funds of funds also eliminate the need for time-consuming due diligence otherwise required for making hedge fund investment decisions.

Collateralized Fund Obligations

Collateralized fund obligations (CFOs) are structured finance products linked to the performance of underlying funds of hedge funds. Among the more recent innovations in the capital market, CFOs are the product of years of advances in structured finance and the increasing popularity of alternative investment classes. This innovative alternative investment product provides customized risk and return benefits with low correlations to the traditional asset classes, thereby allowing high-networth and institutional investors to diversify their portfolios through exposure to hedge fund investments. For hedge fund managers, CFOs provide a conduit to raise capital from institutional investors who might otherwise have refrained from direct hedge fund investments because of their lack of transparency and liquidity.

The capital structure of the CFO is such that fund assets are repackaged into a special purpose entity (SPE) that then issues debt and equity securities with different risk/return trade-offs. These structured products, offering unique exposure to hedge funds, appeal to a more diversified set of investors, including institutional investors, who otherwise would not be interested in the original asset.

The debt of a CFO structure offers investors predictable income and principal cash flows similar to other fixed income products, but with underlying cash flows dependent on performances of the funds of funds. Furthermore, CFO debt investors benefit from the embedded credit protection in these securities. A custodian monitors performance and the health of the CFO structure, and will require managers to cure situations that no longer meet market-value and minimum-net-worth constraints. The resulting trading restrictions, liquidation, and even early redemption are procedures designed to safeguard cash flows for debt investors. Debt holders in a CFO typically do not have early-redemption options. Instead they have call options, implying that equity holders and collateral managers control early redemption. The most likely source of liquidity for debt holders requiring early redemption will be in the secondary market.

As with CFO debt securities, there are many motivations for investing in CFO equity. First, investors gain access to a diversified pool of hedge funds with a nominal investment. For example, in a structure with 4:1 leverage, a \$25 million investment in CFO equity will result in a \$100 million underlying fund-of-funds investment. A nominal investment of \$25 million may not be enough to create a diversified fund of funds on a stand-alone basis, but with leverage provided by debt holders, total proceeds of \$100 million may be sufficient. Moreover, from a return-on-investment perspective, CFO equity can benefit from a levered investment in a fund of funds. As we will demonstrate in Exhibit 4, CFO equity (or hedge fund CDO equity investors) CFO equity investors benefit from low break-even rates compared to the underlying collateral, helping equity holders when fund-of-funds managers are able to outperform the performance hurdles set by rated-note investors. The terms of the leveraged investment can be attractive as well, given the CFO structure's ability to offer term funding to equity holders. Term funding gives equity holders a much more stable funding source than alternatives that involve borrowing against collateral from banks and securities dealers, making CFO equity possibly a less volatile investment vehicle for hedge funds.

VALUE IN INVESTING IN CFO EQUITY

We performed 10,000 Monte Carlo simulations of the HFR, Fund-of-Funds Index over a seven-year period using HFR returns from January 1990 to September 2004 with monthly liquidity. The CFO equity distribution is based on a 30% equity tranche. The results are shown in Exhibit 2. Those returns are compared with other indexes in Exhibit 3.

In Exhibit 4, we show the projected IRR of the HFR FoF index and a CFO under the assumptions for the underlying collateral ranging from 0% to 18%. We now make some observations on these projected IRRs. First, for the HFR FoF index and CFO equity, the break-even IRR is about 8%, implying that a collateral performance above this level will result in an outperformance of the HFR FoF index and CFO equity relative to the underlying collateral portfolio. In other words, there is a minimum return level required on the underlying assets to make the costs of leverage outweigh funding and other costs

of investing in the HFR. FoF index and CFO equity.

The 0% IRR level varies for the two products. The CFO will realize a 0% equity IRR at underlying asset-return levels between 8% and 9%. Underlying asset returns below these levels will result in negative equity IRR. Above the break-even point between 8.24% and 8.3% for the underlying collateral, equity in the CFO comfortably outperforms the underlying collateral. However, it should be noted that the underlying asset returns should be adjusted for management fees.

While the scenarios illustrated in Exhibit 4 are hypothetical, they do provide some insight into the possible range of assumptions in underlying funds' returns and the resulting wide range of projected CFO equity returns. It is too early in the development of this market to assert whether one set of assumptions is likely to be more common than others.

CONCLUSION

CFO equity is the most subordinated class of interest in funds of funds and is the most exposed to the risk of loss. Though much smaller than the debt portion in terms of size, CFO equity has proven to be difficult to distribute. Investors, even those with an established history of investing in hedge funds and CDOs, have yet to show much interest in taking on the risk associated with the leverage equity tranche: in the three public CFO deals that have gone to market to date, the equity tranche was either absorbed by the issuer or privately placed with high-net-worth investors.

Notwithstanding, there are merits of investing in a CFO equity tranche. As a non-recourse term-levered alternative investment class with higher return and lower correlation to traditional asset classes, CFO equity within an overall portfolio strategy can have real value.

Editor's Note

Intangis is an alternative investment boutique.

To order reprints of this article, please contact Ajani Malik at amalik@iijournals.com or 212-224-3205.

Footnote

ENDNOTES

- 1 Quantitative Research 2004, Treniont Capital Management, Inc.
- 2 2004 Annual Hennessee Hedge Fund Manager Survey.

AuthorAffiliation

JEAN MISSINHOUN is a senior partner at Intangis in New York City.
jmissinhoun@intangis.com

LEENA CHACOWRY is a partner at Intangis.
leena.s.chacowry@rcgholding.com

DETAILS

Subject:	Studies; Investment advisors; Bankruptcy; Infrastructure; Institutional investments; Investment policy; Hedge funds; Securities markets; Volatility; Chief financial officers; Collateralized bond obligations; Asset allocation; Special purpose entities; Equity; Portfolio management; Innovations; Access to information; Investors; Liquidity
Business indexing term:	Subject: Investment advisors Bankruptcy Infrastructure Institutional investments Investment policy Hedge funds Securities markets Volatility Chief financial officers Collateralized bond obligations Asset allocation Special purpose entities Equity Portfolio management Liquidity; Industry: 52394 : Portfolio Management and Investment Advice
Location:	United States--US
Classification:	9130: Experimental/theoretical; 9190: United States; 3400: Investment analysis & personal finance; 2130: Executives; 52394: Portfolio Management and Investment Advice

Publication title:	Journal of Structured Finance; London
Volume:	10
Issue:	4
Pages:	32-37
Number of pages:	6
Publication year:	2005
Publication date:	Winter 2005
Publisher:	Pageant Media
Place of publication:	London
Country of publication:	United Kingdom
Publication subject:	Business And Economics--Investments
ISSN:	15519783
e-ISSN:	23741325
Source type:	Scholarly Journal
Language of publication:	English
Document type:	Feature
Document feature:	graphs; references; tables
ProQuest document ID:	221023500
Document URL:	https://www.proquest.com/scholarly-journals/collateralized-fund-obligations-value-investing/docview/221023500/se-2?accountid=11091
Copyright:	Copyright Euromoney Institutional Investor PLC Winter 2005
Last updated:	2026-08-07
Database:	ProQuest Central

LINKS

[Linking Service](#), [Linking Service](#)

Database copyright © 2026 ProQuest LLC. All rights reserved.

[Terms and Conditions](#) [Contact ProQuest](#)