Before You Invest in a Hedge Fund...

Understanding most strategies should be straightforward. If it isn't, don't invest.

BY ERIC UHLFELDER

Hedge-fund returns have lagged behind stocks for almost a decade. But as market volatility and uncertainty increases, sophisticated investors may start considering certain hedge-fund strategies that can do well in all kinds of markets, especially when prices are bouncing all over the place.

The last time the market dropped sharply, in 2008, certain hedge-fund strategies performed well. For example, diversified commodity trading advisers—which make bets on the broad direction of stock and bond indexes, interest rates, foreign exchange and commodities—gained 14%, according to the industry data tracker BarclayHedge.

And equity market-neutral funds—whose evenly balanced long or short exposure is aimed at producing more stable returns—preserved capital well in 2008, losing just 1% overall, while the S&P 500 index declined 37%.

Straightforward process

A key part of finding the right hedge-fund strategy is finding the right manager. That requires substantial due diligence. Considering that, here is a basic rule investors should keep in mind when evaluating hedge funds: While hedge-fund strategies might seem mysterious, the vetting process for these investments should be straightforward and transparent for the most part.

If it isn't, you probably should move on.

That is what Jonathan Kanterman says his firm did after taking an initial look at Bernie Madoff in 2006. At the time, Mr. Kanterman was a managing director at Stillwater Capital, helping allocate exposure at a former $1 billion fund of hedge funds, which is a fund that invests in hedge funds.

"Stillwater didn't invest" with Mr. Madoff, recalls Mr. Kanterman, "because we couldn't receive key documents to perform even basic due diligence."

The documents needed to perform due diligence, Mr. Kanterman says, include the presentation (or the fund overview), monthly performance report, due-diligence questionnaire, audited financials, Form ADV (used by investment advisers to register with both the Securities and Exchange Commission and state regulators), private-placement memorandum, investment-adviser public disclosure forms and prime brokerage statement. (See accompanying table.)

The documents won't provide investors with answers to every question, but they will highlight matters that may need further investigation.

Further, the quality of responses investors receive—in tone and substance—can help them assess the integrity and effectiveness of a manager, not just in how the manager intends to make money, but in how he or she will keep losses at bay during a sharp or protracted selloff.

Risk and transparency

There are basically two ways hedge-fund managers preserve value if prices begin to drop: Either they believe their investments can ride out volatility, or they have specific short, hedging and deleveraging strategies and stop-loss orders in place to stanch the bleeding if markets go into free fall.

A manager should be able to clearly explain a fund's risk-management strategy. But many cannot.

Jeff Willardson, managing director at **Paamco Prisma**, who runs portfolio construction at the $30 billion fund of hedge funds, says most hedge funds have an inherent bullish, or long, bias, and often when they talk about how they plan to mitigate investment risks, it isn't much more than lip service.

"If managers are unable or unwilling to identify their short positions and how they go about finding them [beyond market indexes]," says Mr. Willardson, "it suggests their research and expertise is more focused on long exposure, and [they] aren't likely prepared for challenging market conditions."

Core questions that fund documents and managers should be able to answer include:

1. What precisely do you want to accomplish, and how do you intend to do it in the current market environment?

2. Does your volatility and performance match your strategy, and how do they compare to the broad market? Long-term high volatility could suggest an inability to control risk.

3. How much leverage does the fund employ, and is there a leverage limit?

4. How much money does management have in the fund? A small amount may indicate that the interests of managers and investors aren't well-aligned.

5. What are the fund's fees, various classes and lockup terms?

6. Does liquidity of your investments match your investor redemption terms? If there is a mismatch, investors may not be able to redeem shares as expected, especially during a financial crisis.

7. Has the fund set a limit on asset capacity, and does it periodically close to new investors to ensure effective deployment of new money?

8. Does the fund use top-tier service providers (administrator, custodian, auditor, etc.)? Lesser quality entities may obscure transparency and affect reporting reliability.

9. Do you provide investor references to potential investors? A reluctance to do so could mean that current investors wouldn't enthusiastically endorse the fund.

10. Have you ever gated (controlled the outflow of) or suspended redemptions?

11. Is your board of directors independent of management?

A telling gauge

Another especially revealing metric is maximum drawdown—the amount a fund's value has fallen from a peak to trough before rising above that previous high. Since the Great Depression, that number for the S&P 500 index is minus 55%, reached during the 2008 financial crisis.

Most hedge funds have an inherent bullish bias.

The broad market will directly affect the drawdown of virtually all strategies. But the degree of drawdown will depend on a hedge fund's focus. For example, over time, an equity long-bias fund (whose exposure is predominantly long) is likely to experience greater volatility and drawdown than a global macro fund, which should be more hedged against negative events.

But the degree to which a fund loses money also reflects a number of specific fund characteristics and risks, including quality of research and management, asset exposure, leverage, valuation and risk controls.

In addition to thoroughly understanding a fund's portfolio and performance, Panayiotis Lambropoulos, hedge-fund portfolio manager at the $29 billion Employees Retirement System of Texas, also reviews operational matters, including the degree to which investors are committed to the fund, counterparty risk (the quality of the companies involved with the execution of trades) and regulatory compliance.

Further, he emphasizes the need to visit a fund's office to help make sure the reality matches what the documents, marketers and managers are saying.

The most important takeaway to identifying a good manager, says Paamco Prisma's Mr. Willardson, is finding one "who can explain and demonstrate a clear, articulate and repeatable investment process, which helps distinguish performance generated by luck versus skill."

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Where to Start

Documents that a potential hedge-fund investor should review as part of his or her initial research, or due diligence.

DOCUMENTS	KEY POINTS
Presentation	Overview of the fund: history, strategy, performance, key management, service providers and basic portfolio metrics.
Monthly Report	Performance note providing insight on what happened to the fund and the market in the most-recent reporting period; also may include service providers and key portfolio metrics.
Form ADV	Required filing for all hedge-fund managers with at least $150 million in assets; includes descriptions of the firm and managers' background along with important disclosures and identification of any related businesses owned by the fund's principals.
Due Diligence Questionnaire (DDQ)	Explains a fund's structure, strategy, risk controls, managers and operations.
Audited Financial Statements	Reveals matters of performance, valuation, leverage, expenses and taxes.
Private Placement Memorandum (PPM)	In essence, a prospectus that defines the structure, intent and limitations of the fund. Legally, this is the most important document the manager disseminates.
SEC.gov/Independent Adviser Public Disclosure (IAPD)	Regulatory information about fund and management, including disciplinary actions and Form ADV.
Prime Brokerage Statement	Portfolio holdings, prices, number of shares and total value of each position. Managers may not readily wish to share it with prospective investors.