No Short Cuts

Hedge funds can bring compelling exposure to a portfolio, but carefully vet the manager and the fund. Here's a checklist. By Eric Uhlfelder

Because their operations are private and top managers enjoy celebrity-like status, hedge funds retain mysterious appeal to investors looking for an edge.

Why?

Traditional money managers and mutual funds are largely index-centric with little chance of delivering substantial outperformance, while hedge fund managers are perceived as Peter Lynch unleashed. That's simply not true.

Relative to the market, most hedge funds have not been good investments. According to BarclayHedge, a major industry tracker, the average hedge fund has underperformed the S&P 500 six out of the last 10 years, including the past four calendar years.

Through the first half of this year, every hedge fund strategy substantially trailed the market, which was up nearly 14% through June. Even long equity bias funds underperformed the index by about 5%.

Throw in persistent reports of malfeasance, most recently headlined by longtime master of the universe Steve Cohen having his fund charged with insider trading, and most advisors may decide the waters are just too shark-infested to dive in. However, the biggest problem afflicting the industry is that there are simply too many managers, more than 8,000 at last count. Collectively, they have mired the value and perception of this independent form of asset management.

Potential Value

The case for hedge funds is that they can provide unique access to compelling, actively managed investment strategies such as distressed, event-driven, arbitrage, global macro and long-short debt and equity. And yes, there are seasoned managers who have shown they can consistently deliver gains without taking you on a roller coaster ride or needing to hide from the Justice Department.

For advisors who want to gain such exposure, the trick then is knowing how to

FIGURE 1

Hedge Fund Due Diligence: 20 Key Issues And The Sources That Provide Answers

PRIMARY ISSUES	KEY POINTS	DOCUMENT SOURCES
PORTFOLIO		
Portfolio Composition	Look at concentration and diversification by position, sector and asset class to determine exposure and potential volatility and risk.	Presentation, Prime Brokerage Statement
Strategy Consistency	One needs to be able to understand a fund's strategy and its execution, along with the potential for investment deviation and style drift.	Presentation, DDQ, PPM, Prime Brokerage Statements, Audited Financials
AUM And Leverage	Identify the size of the fund, and the degree, stability of source, cost and duration of leverage to help distinguish AUM from notional [regulatory] value.	DDQ, PPM, Audited Financials
Performance, Volatility And Fees	Monitor quality and consistency of returns through analysis of monthly performance, confirming relevancy of benchmark and then assessing consistency and source of outperformance; determine worst drawdown and duration of recovery; identify and understand how management and performance fees affect returns; and distinguish between early performance that may have been boosted by low initial fees versus performance net of current fees.	Presentation, Monthly Report
Hedging Strategy	A key indicator of whether downside risk is capped is when primary positions are hedged through exposure to opposing positions; substantial reliance on unhedged single-directional trades may generate greater upside but comes with more potential volatility and risk.	Presentation, DDQ, Prime Brokerage Statement
MANAGEMENT		
Manager Background, Tenure And Size Of Team	Learn a bit about the manager, distinguishing between manager versus fund performance, and know how many key people are around to run the fund.	Presentation, DDQ, ADV, SEC—IAPD
Management's Financial Exposure To The Fund	Management and investor interests should be aligned.	Audited Financials, DDQ
Conflicts Of Interest	Watch for trading through an affiliated broker-dealer; no independent directors; investments in positions owned by management; manager's time divided across other businesses.	DDQ, ADV
Past Malfeasance/Bankruptcy	Background checks are essential to know if key managers have gotten into trouble and if they are telling the truth about myriad things.	ADV, SEC—IAPD
Service Providers	Suggests the level of quality of operational execution and oversight.	Presentation, Monthly Report, DDQ

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RISK CONTROL		
Investment Oversight	How are decisions made—individually or via consensus?	Presentation, DDQ
Valuation Of Assets	Essential in assessing integrity of performance and liquidity.	DDQ, PPM
Operational Risk	These include risks associated with counterparties, trade oversight and custody.	DDQ
Strategy Risk	Assess limitations and vulnerabilities of individual strategies.	Presentation, DDQ
Limiting Losses	Understand how a fund may limit losses on individual positions and/or at the portfolio level.	Presentation, DDQ
TRANSPARENCY		
Quality Of Fund Documents	Key to assessing a fund's transparency, its ability to communicate and management's understanding of its own operations.	Presentation, DDQ, ADV, SEC—IAPD
Current Investment Positions	Identify recent changes and why they have been made.	Monthly Report, Prime Brokerage Statement, Recent Presentation, Recent Audited Financials
Investor Base	Review number, types and geographical distribution of investors and ownership stake of significant investors.	DDQ, ADV
Restrictions On Investor Redemption	Gates, suspension and sidepockets are means in which a fund can hold onto capital when an investor requests redemption.	PPM, DDQ
Investor Liquidity	Consider liquidity of investments versus terms of redemptions—how well the two are matched is a key to assessing redemption risk.	Presentation, DDQ, PPM

first vet the hedge fund universe and then individual funds and managers to reduce the chance of getting clipped by a negative surprise and to increase the odds of boosting client returns.

Figure 1 will help you get started. It's a primer of essential operational and investment issues you need to understand before committing a penny to a fund.

This review looks at four key categories: portfolio, management, risk control and transparency. The figure then identifies the underlying points each issue raises and the specific documents prepared by hedge funds that provide the answers. If they don't, then avoid the fund. It's that simple.

Start the search process by considering funds with at least $100 million in assets. Make sure this is investor assets or net asset value, not notional value, which includes leverage that could bump up the valuation several times. (Leverage exaggerates volatility. Advisors new to hedge funds should limit this multiple to three times NAV.)

According to Jonathan Kanterman, a hedge fund consultant, when a fund's NAV is at least $100 million, it likely ensures use of quality service providers, hiring of dedicated risk managers and chief financial officers, and near-term sustainability.

Kent Clark, who oversees $20 billion as chief investment officer of hedge fund strategies at Goldman Sachs Asset Management, searches for compelling investment theses when considering strategies and sectors. "We had raised cash during

FIGURE 2

Documents

PRIMARY ISSUES	KEY POINTS
Presentation	Overview of the fund: history, strategy, performance, key management personnel, service providers and basic portfolio metrics.
Monthly Report	Performance note providing insight on what happened to the fund and related marketplace during 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 firm, manager, fund, assets, investor composition, managers' background, along with important disclosures and identification of any related businesses that might be 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, expenses and taxes.
Private Placement Memorandum (PPM)	In essence a prospectus - a legal testament defining the structure, intent and limitations of the fund, making it the most important document that the manager disseminates; includes management biographies and detailed description of the fund, and fund objectives and risks.
SEC.gov/Independent Advisor Public Disclosure (IAPD)	Myriad regulatory information about fund and management, including past and pending 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 with prospective investors.

the crisis," recalls Clark, "and re-risked the portfolio post-crisis into, among other things, credit. Since then, we've moved away from directional credit into more trading and long-short credit strategies."

To find the right managers, Clark reviews a very extensive list of characteristics, including "the investment team's experience and expertise, alignment of investor and manager interests, thoughtful portfolio management, independent risk management with genuine input in the investment process, and clear evidence of qualified people, processes and systems."

Red Flags

Knowing key red flags saves time, because when they are seen, it puts an immediate end to a fund review. Listed in Figure 3 are 10 such markers, ranging from management reluctance to clearly describe what they are doing, annual financials that are not audited and the inability to speak to one or two current investors.

One important red flag not mentioned is maximum drawdown: the percentage that a fund has fallen from a peak before fully recovering anytime in its history. There is no one standard level of drawdown because it can vary significantly by strategy and the age of the fund. But for conservative advisors, that limit should be no more than 25%, and recovery should not exceed six to nine months.

In addition, very small worst drawdowns are suspect, especially during times when you know the entire market has been slammed. If a number appears too good to be true, it probably is, reflecting suspect valuations or other financial engineering.

Many funds collapsed through this figure in 2008 because of illiquidity and forced selling (not necessarily loss of quality), which sent certain asset valuations plummeting. Some investors didn't necessarily blame managers because of the universal meltdown going on at the time. And many who stayed on were rewarded as prices surged the following year.

Others, however, were not as fortunate when they saw their funds shut down. All funds will tell you they actively manage risk and will discuss metrics like VaR (value at risk) and speak about decisive daily management meetings to control the downside.

If wealth preservation is your main concern, then it's advisable to find managers who—at a certain point—have shown to be willing to throttle back exposure and/or leverage to stop the bleed-

FIGURE 3

10 Key Red Flags

PRIMARY ISSUES	KEY POINTS
Management's Reluctance To Speak To Investors	Potential for fiduciary failure.
Unknown Service Providers	Potential for obscuring transparency and negatively impacting operational integrity and performance.
Unaudited Financials	Uncertainty about key financial metrics.
Material Conflicts Of Interest	Raises issues of integrity.
Unclear And Incomplete Investor Communications	Selective response to questions may suggest operational and investment deficiencies, potentially involving portfolio holdings, and a gap between manager vision and reality.
Lack Of Access To Existing Investors For Reference	Less than a compelling endorsement of the fund.
Long-Term High Volatility	Suggests an inability to control risk and issues with overall investment approach.
Frequent Turnover Of Key Personnel	Problems with the fund structure and internal relationships.
Lack Of Manager Assets In The Fund	Failure to link manager and investor interests.
Liquidity Mismatch Between Redemption Terms And Assets	Investors may not be able to redeem shares as per agreement, especially during a financial crisis.

NOTE: Jonathan Kanterman significantly contributed to the development of these figures.

ing. And those who claim they can do this will be able to explain the specific process and examples thereof.

In a recent study of 22 hedge fund failures, prepared by the nonprofit research and educational organization Greenwich Roundtable, the three most frequent causes (evident in half the cases) were excess leverage, liquidity problems and inadequate risk management. About a third of the time, key problems also involved inadequate transparency, unreasonable volatility and service providers.

One of the easiest ways to help avoid problematic funds is to visit management before investing. During such trips, Jonathan Kanterman has discovered gaps between what he reads in fund documents and what he sees involving staffing, technology, investment process and management spending time running other businesses. An on-site visit reveals something else that can't be known from afar: If you aren't treated like Warren Buffett, don't invest.

Coda

Due diligence doesn't stop once the investment is made. It's only the beginning. Every year you should review key issues and remain satisfied with the answers. Flag deviations, and if they aren't resolved, then seriously question your investment.

Goldman Sachs' Clark says that when he sees "volatility larger than expected, it may suggest the manager is taking on more or different risk than we were told he would. And when we observe lower risk than expected, that may indicate inclusion of illiquidity and unmarked securities, or a manager deciding to focus on collecting management fees rather than trying to generate returns from performance fees."

For Clark, investors should never feel complacent. He believes "over the medium to long term, we don't expect managers to consistently deliver strong returns and that fund rotation is an important part of achieving consistent long-term performance."

Advisors can pass off due diligence by investing through institutional hedge fund platforms or funds of funds, with both approaches bringing added fiduciary protection. But this process will add another level of expense that may lead one to question whether the endeavor is worth it in the first place, because regardless of what industry pundits may say, hedge funds are not an essential part of any high-net-worth or institutional portfolio. Good managers are. And until you find one, don't invest. FA