A Crash Course on Hedge Fund Due Diligence for RIAs

Removing some mystery from a $4 trillion asset class.

Eric Uhlfelder
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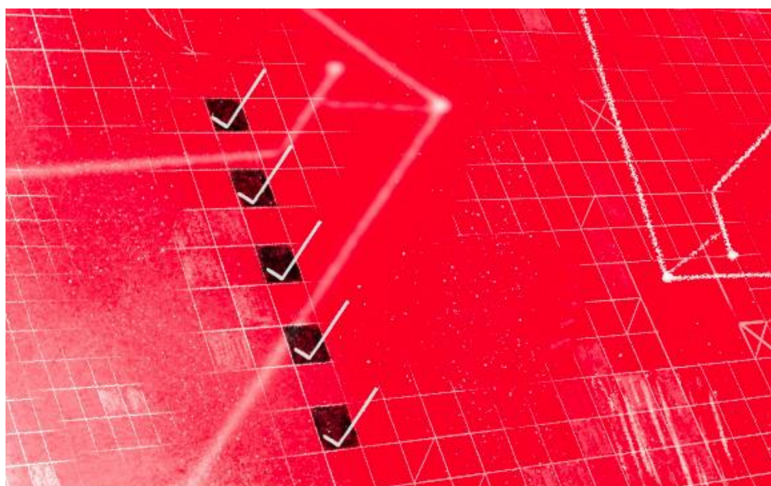
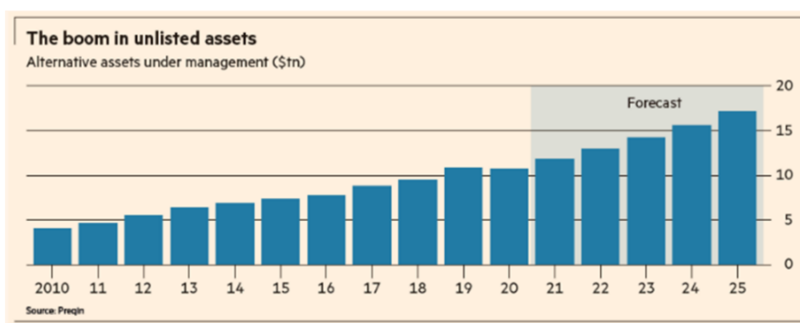


Illustration by RIA Intel

By the end of last year, surging Covid-19 infections collided with record stock and bond prices--along with rising inflation--triggering volatility and increasing concerns about economic recovery. These trends are enhancing the argument for portfolio exposure beyond long books of traditional securities.

Investors have been pouring money into various alternative assets, such as private equity, real estate, private credit, and crypto currencies. This trend is expected to continue, according to the alternative investments data and research firm Preqin. But the long directionality of most alternative investments won't likely counter the hazards that show up when momentum reverses.



With this in mind, many advisors have been turning to liquid '40 Act alternative funds to provide clients more diversified and hedged exposure in a more transparent and less expensive wrapper than offered by traditional hedge funds.

These alt funds offer access to the some of the same strategies hedge funds provide. But a drawback of these '40 Act funds is they are trying to be something they can't be. Having to hold largely liquid assets with limits on shorts and leverage alters the alchemy that's behind successful hedge fund management.

HISTORIC AVERAGE ANNUALIZED RETURNS: '40 Act Alternative Funds vs Hedge Funds

A look at 6 Strategies

	Equity Long Short (%)	Equity Market Neutral (%)	Credity Long Short (%)	Event Driven (%)	Managed Futures (%)	Multistrategy (%)
Hedge Funds	8.1	4.2	5.3	6.5	4.0	3.6
40 Act Alternative Funds	3.4	0.8	1.5	2.6	0.0	1.6

Note: Return distributions include annualized returns for funds that were alive at any point during the 15 years from July 2003 through June 2018 and had at least 36 months of return history.
Sources: Vanguard calculations based on data from Morningstar Inc. and HFR.
Originally reported in: "The Wrapper Matters: Comparing Liquid Alternatives and Hedge Funds," Vanguard Research, 2019

Hedge funds can excel because they aren't time constrained. They can invest longer term in a wider variety of assets and can deploy greater leverage to exploit opportunities. These and other factors have fueled the industry's expansion past the $4 trillion mark in 2021.

The trick for advisors is finding the few fund managers who can do those things consistently while containing risk. Even some of the best known and largest hedge fund managers can't make this claim.

So what should a wealth advisor be looking for and how does one begin a search for the right hedge fund? Here's a start.

First, it's essential to understand that proven hedge funds often do things differently than other asset managers. Many target temporary distortions and mispricing in equity, debt and other assets, often focusing on under researched companies, industries, and assets that are out of favor. To do that, they can't be constrained by time or low exposure limits.

Barnegat Fund, a New Jersey-based hedge fund, featured last year in these pages, has provided a number of compelling investment examples. One involved the collapse of Lehman Brothers. This forced the selloff of Treasury Inflation-Protected Securities, or TIPS, which the brokerage used as collateral. This flooded the TIPS market, causing their prices to plummet and yields to soar to 6 percent — more than twice the yield of nominal Treasurys. (Inflation was hovering around 1.6 percent around that time). It set up a compelling relative value trade for Barnegat, which anticipated the gap between TIPS and Treasury yields would normalize. Propelled by leverage, the trade paid off in spades.

Investments like that involve making capital commitments, both on the short and long side, which take time to play out. Many funds will add to positions if prices continue to break further against them. But this is just one way some of the more proficient managers generate significant returns uncorrelated to the market. They can't do this if they need to meet significant short-term redemption liability.

Anthony Novara, research director of global hedge fund strategies and capital markets at the $250 billion Chicago-based advisory Fiducient, has seen private clients and external RIAs they assist become more open to hedge funds since the start of 2021. With market values at record highs, he believes some advisors are seeking to balance market exposure with sources of more steady and less volatile returns.

Fiducient has overseen the allocation of more than $3 billion into such managers, focusing on multistrategy and event-driven funds, with the latter driven by equity, distressed, and credit exposure.

Novara cautions investors, and especially those new to the space, not to be pulled excessively toward investment narratives at the expense of not looking rigorously at a fund's operational story. This is where he believes less obvious risks reside. "Before we make an allocation, we want to know the firm's operational risk — from front through back office, to counterparty risk and across all service providers," Novara told RIA Intel.

His team also studies a manager's pedigree and experience along with discerning a fund's opportunity set and stated asset capacity.

"We're not looking to match the market's torrid pace of appreciation that we've seen over the past decade," says Novara, "but searching for more modest and steadier uncorrelated returns." The reason: Fiducient expects more muted market returns and higher volatility going in 2022 and beyond.

Where Hedge Fund Evaluations Should Begin

Before diving into the details of a hedge fund's strategy, investors should start with some basics, according to Kent Clark, the former co-chief investment officer of alternative investments and manager selection at Goldman Sachs.

Advisors need to understand "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," Clark said.

This kind of review will then quickly lead to the study of a fund's strategy: hedged equity, credit, global macro, relative value, and distressed — to name a few. There are roughly 20 primary strategies with some increasing their focus on new plays, including crypto currencies and SPACs.

If you don't understand the strategy, or how the manager is executing it, stay away. Some proven fund managers (typically, but not limited to, quants) won't reveal their secret sauce to preserve their investment edge. But if a wealth manager can't figure out what a fund is doing, it's impossible to gauge when a manager is staying with or deviating from its stated strategy and investment process.

With these concerns in mind, Loic LeMener, whose Dallas-based Opus Wealth Management has allocated 7.5 percent of his firm's $250 million assets under advisory into hedge funds since the beginning of 2021. With the bull market on a record run, he thinks it makes sense to balance his clients' market exposure with uncorrelated and idiosyncratic investments that have performed well regardless of market volatility.

His first foray was into Dan Zwirn's Arena Special Opportunities fund, which invests in under-researched, sub-investment grade real estate, corporate, commercial and industrial debt. Since its launch, Arena has been generating steady annualized gains of around 8 percent with low volatility since its launch six years ago. The fund was featured in Global Investment Report's 2021 annual hedge fund survey.

Before he made his first investment in Arena, LeMener said he spent more time looking into the fund than he ever did for any other investment. He reviewed key documents, examined a series of sample loans the fund made to industries he was familiar with, and interviewed the investment team and several investors who are in the fund.

"I cautiously entered into hedge funds to diversify my clients' portfolio beyond the market and I'm pleased with the Arena's transparency and focus on a clear repeatable strategy with a priority of achieving consistent returns," he said.

LeMener has since added three additional hedge funds to various portfolios with clients being the limited partner in each fund. He believes the asset class can be a valuable hedge to clients' portfolios, especially as stocks continue their record-setting run.

Choosing Hedge Fund Strategies

Given the market's current frothiness at the end of 2021, let's assume an RIA is seeking consistent, long-term performance — no swinging-for-the-fences kind of returns — along with a proven ability to offer downside control.

Allocators often learn about funds through colleagues, industry contacts, consultants, prime brokers, and trusted research reports. Those kinds of personal recommendations are a good start.

While more clinical, the most objective approach to finding potential investments is using a broad database that lets you screen by strategies, assets, returns, and risk you deem desirable. This is also a good hands-on learning experience.

To get started, set minimums for the age of a fund with the same manager (at least five years), assets ($300 million), and average annualized returns (8%+), along with limits on standard deviation and drawdowns. Searching a database, such as BarclayHedge, can clear a path through thousands of funds to reveal a handful of managers that meet these standards.

After studying these numbers, one can quickly discern connections between strategy, returns, and volatility. Equity long-bias managers may be the largest winners over time but can also be the most volatile. Fixed-income relative and global macro funds tend to be tamer on both ends. But there are always plenty of outliers in every strategy, and it's in this space that you'll likely find the most intriguing managers.

Three Key Qualities

A fund with a precise vision, a well-articulated investment process, and a track record showing consistency across market cycles are qualities investors should look for in hedge funds.

If a manager deviates from these qualities, it could reflect a shift in process. The fund could be taking on more risk or deviating from their established investment strategy and style. If that's that case, investors need to find out why.

"One of our hedge fund managers, who had been doing very well, was suddenly losing more money than we ever anticipated," recalled Tilo Wendorff, managing director of absolute returns at the $10 billion German alternative asset manager Prime Capital. It turned out this emerging market distressed fund manager was hit hard by the 2019 Argentina debt crisis. But the degree of

loss could only have been explained if the manager had exceeded the fund's own risk limits, thought Wendorff.

That's what Wendorff eventually learned. Even worse: it turned out this was something the manager was doing on a regular basis. "But because the outcome of taking on more risk was masked by positive returns," Wendorff said, "we didn't have data behind this outperformance. So, we did not discover this excessive risk taking until later."

Reading Material

A presentation document explains a hedge fund's history, investment team, strategy, track record, and risk management — ideally in a compelling narrative.

It should clearly explain how ideas for trades are generated. Greenwich Alternative Investments, a leading industry research and advisory, wants to know "what type of research is utilized, how the strategy is implemented, how positions are monitored, and how the manager formulates an exit strategy."

When a presentation is simplistic (which is often the case), that's the first sign the fund isn't being particularly transparent with investors. Some managers aren't very descriptive or articulate. But such opacity is where investor risk starts, requiring more due diligence.

Keep in mind what Morgan Stanley's Michael Mauboussin said in our recent interview — the most compelling writing is when an author treats the reader like a peer.

Monthly investor letters should explain the link between strategy and performance; why it's succeeding, why it isn't. But many letters don't bother doing this. This doesn't automatically disqualify a fund from a deeper look. Most funds will have personnel that can provide more color. However, explanations that aren't published are less compelling.

Due Diligence Questionnaires (DDQs) follow different templates. However, the Alternative Investment Management Association (AIMA) has prepared a clear, standardized form. A firm using this form can be a good sign.

At first glance, a DDQ may seem tedious. But it can reveal a wealth of essential information, including identification of key people, their past affiliations, discussion of potential conflicts of interest, largest positions, turnover, performance, leverage, risk management, and a record of regulatory sanctions against any individuals associated with the fund.

Google search a fund and all its key personnel and scan several pages of results. It's worth the small investment of time in case something off-putting comes up. Investors may discover certain key people have jumped from job to job, or have been involved in unseemly affairs, or had been part of a fund that failed.

Best to consider only hedge funds that hire top-tier service providers: administrators, prime brokers, custodial services, accountants, and lawyers. The most reliable service providers tend to be the most expensive, which means they are affordable to funds that have been around for a while, running at least several hundred million dollars. And to sustain their high billing rates, preserving their well-earned reputation is what should motivate them to do right for investors.

But service providers aren't regulators. Reliance on "best in class" players is one of the most effective ways to help ensure a fund is doing what it claims. Investors should call each service provider to ensure it has indeed been retained by a fund.

For those used to mutual fund transparency, one problem with hedge funds is they offer limited portfolio visibility. Hedged equity funds usually reveal only their top 10 positions. Sometimes, that's substantial; other times, not so much. Industry and sector weightings should be spelled out, along with a breakdown of country exposure for managers that venture abroad. Positions and weightings need to be in line with the stated strategy and investment approach.

Investors can receive line-by-line accounting after making an allocation through a separately managed account. But not all funds offer SMAs. They cost more and might only be worthwhile if a large enough investment is being made.

Additional investment documents worth perusing include a firm's Form ADV Parts I and II (which are filed with regulators), its private placement memorandum (PPM), and audited financials, which can illuminate a fund's workings and character.

Between the Ideal and Reality

Reviewing all this information will lead to follow-up questions. Speak to key personnel, up to and including the chief investment officer, chief risk management officer, and the portfolio manager to help fill in the gaps. If you can't reach one member of the upper echelon, then walk away.

As Fiducient's Anthony Novara emphasized, it's essential to understand a fund's operational soundness, i.e., who does what and how well are they doing it, and which responsibilities are done in house and which are outsourced.

Investment due diligence involves understanding how a fund identifies an investment and then allocates capital, tracks positions, and harvest gains. Potential investors will want to scan the fund's performance grid that lays out month-to-month returns across every year of a fund's existence. This is akin to an EKG for the fund, a visual pulse revealing consistency and volatility. Make sure the narrative you're being told matches this number story.

The fund's worst drawdown will be revealed by a string of negative months. Make sure the manager clearly explains the decline and if these losses jive with what the strategy experienced. And if the drawdown was greater than what the fund's risk management process claims it could limit, find out why.

Some managers will be happy to regale you about their most successful investments. But ask them about a few bets that went south. These answers are the most telling. They reveal when the investment process broke down — why it happened, how long it took the team to recognize the problem, and what they learned from the experience.

Besides trying to get a clearer understanding of how a fund works, the ulterior motive of pressing management on sensitive issues is to gauge character. One can learn a great deal by the way people react to pointed questions through the kind of answers they give.

A good example: When questioned about why his fund lost nearly half its value in 2008 in spite of explicit risk management tools supposedly in place, a Connecticut-based fund manager flippantly responded, "You might've heard about the Financial Crisis." That comment ended the conversation.

There are few better cases of how a fund should behave when it stumbles than the Spanish-based EQMC. Co-fund managers Jacobo Llanza and Francisco de Juan had been delivering 20 percent annualized returns since they started their European small- and mid-cap benign activist fund in 2010. In 2018, the fund took a hit when its concentrated book saw two seed investments in British companies blew up within one month of one another.

“We take our missteps very personally,” explains Llanza. “Investors must be assured this failure was not due to a change in our investment style or process.” Toward that end, the managers visited major investors across Europe and the US to personally explain what had happened, why it happened, and additional measures put in place to help minimize the chance of such an event ever occurring again. The result: the fund largely sustained its investor base and its performance has since recovered.

Caution Signs

Investing in hedge funds can be a tempestuous ride, especially when a wealth manager doesn’t fully understand their risks. Here are a few things you should ask about to limit surprises.

Hedge funds often use leverage, sometimes lots of it. This is evident in the multiple difference between assets under management and notional exposure reported in audited financial statements. That factor should match what a fund says it’s going to do and be comparable for the type of strategy being run. One simple rule: the higher the leverage, the greater the need to keep unencumbered cash on hand to meet margin calls.

Seeing management holding a significant stake in its fund means they are eating their own cooking. That’s a good sign. Not having any management money in the fund, not so much.

Asset liquidity and fund redemption terms should be aligned. Learn about a fund’s ability to restrict (gate) redemptions or suspend redemptions and if it had ever done so.
The Financial Crisis caused a number of funds to close because their exposure to illiquid investments prevented them from meeting redemptions.

Funds typically have a notion of how much money they can manage without compromising investment strategy and performance. Accordingly, some managers might not accept new investors, or soft close, if they don’t see sufficient opportunities. And when the number of compelling positions contracts, they may even return capital to investors. Those are clear examples of managers aligning their interests with investors. Funds that continue to raise capacity limits should raise concerns.

And last, but certainly not least, investing in hedge funds is expensive. Management and performance fees have been coming down from 2 percent and 20 percent, respectively, toward 1.5 percent and 15 percent. Several big-name funds take as much as 30 percent of the profits. So when studying hedge fund performance, make sure to compare gross returns versus those net of fees.

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