



Hedge Fund Due Diligence; A Must Before You or Your Adviser Invests Your Money

by James J. Eccleston, Esq.

Hedge fund investments are popular, but also can be dangerous. One study suggests that nearly one-half of all hedge fund failures are caused by such issues as misrepresentation of fund investments, misappropriation of funds, or unauthorized trading.

The list of hedge fund frauds is lengthy and growing. Recent hedge fund frauds include the Bayou Funds, as well as Wood River Partners. But investors may remember some of these "oldie but goodies":

- Lipper & Company: securities fraud guilty pleas followed the managers' 40% inflation of the fund's \$4.9 billion portfolio
- Beacon Hill Asset Management: principals banned or suspended from securities industry but not before misappropriating \$300 million
- Tradewinds International: tearful DVD confession didn't cure as much as a \$22 million shortfall, in part due to the manager's spending investors' money on himself
- Manahatten Investment Fund: Michael Berger earned his place on the FBI's Most Wanted List for blowing \$400 million

All of this means that investors, and their advisers, must be cautious and diligent in considering such hedge fund investments, as well as hedge funds of funds investments.

Securities regulators have provided some guidance. For example, the SEC has published "Hedging Your Bets: A Heads Up on Hedge Funds and Funds of Hedge Funds," available at www.sec.gov/answers/hedge.htm. Likewise, the National Association of Securities Dealers (NASD) has published an Investor Alert entitled, "Funds of Hedge Funds - Higher Costs and Risks for Higher Potential Returns," available at www.nasd.com/investor/alerts/alert_hedgefunds.htm.

Moreover, the NASD has alerted brokerage firms (and their advisers) that they have numerous obligations associated with recommending hedge funds. These include the duty to: 1) ensure that sales promotions provide balanced disclosures of risk and return; 2) perform due diligence to determine that the hedge fund or fund of hedge funds is suitable for any customer; and 3) perform a customer-specific suitability determination.

But what exactly should investors and their advisers do to conduct due diligence? Fortunately, information and resources are available. Let's overview three of them. First, the not-for-profit Greenwich Roundtable publishes (for a fee) a series entitled Best Practice of Hedge Fund Investing. Selected excerpts suggest that the due diligence process is divided into eight parts. These parts are: (1) Strategy, Investment Process, and Market Opportunity; (2) Team and Organization; (3) Fee Structure and Terms; (4) Management Company, Fund Structure and Asset Base; (5) Quantitative Review; (6) Operations and Transparency; (7) Third Party Vendor and Business Management Evaluation; and (8) Intuition, Judgment and Experience.



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A second source for hedge fund due diligence are consultants to whom investors pay a fee. One Chicago-based consultant, Cole Partners, recently spoke to financial advisers on how they should go about selecting hedge fund managers. In a nutshell, the process involves three types of assessments of the hedge fund manager: administrative/operational, qualitative and quantitative. Those assessments then should be compared as against other hedge fund managers. For the administrative/operational assessment, investors or their advisers must verify background, business viability and the accuracy of marketing materials. For the qualitative assessment, investors or their advisers must understand the investment strategy, portfolio management, risk management, best/worst market environments and the manager's overall edge. And for the quantitative assessment, investors or their advisers must understand the manager's absolute performance across different conditions, relative performance versus peers and/or indices, and a basis for style drift.

Finally, the Investment Management Consultants Association (IMCA) publishes an excellent resource, available on its website, www.imca.org. In addition to an Investment Manager Questionnaire (helpful for any kind of adviser, whether or not he or she runs a hedge fund), IMCA publishes a Hedge Funds of Funds Manager Questionnaire. Investors or their advisers can utilize this questionnaire to probe: (1) Investment Process, Strategy and Philosophy; (2) Business Plans; (3) Manager Selection, Research and Portfolio Construction; (4) Manager Monitoring and Risk Management; (5) Performance and Fees; (6) Compliance and Client Reporting; (7) Personnel; (8) Operations and Administration; and (9) Taxes.

Investors owe it to themselves to conduct this level of due diligence before investing in hedge funds or hedge funds of funds. And investors who are paying advisers should expect them to do so in order to comply with their legal obligation -- or else face liability for their failure to do so.

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