Avoiding hedge fund woes

A few basic checks can go a long way toward uncovering potential problems

By Dan Hallett

Hedge funds are enticing because of their potential to enhance risk-adjusted performance. So, it should not be surprising that clients pressure advisors to find innovative alternative strategies. In turn, advisors press their dealers to make certain hedge funds available to their clients.

Although many dealers and most advisors are ill-equipped to perform proper due diligence on hedge funds, the following tips should guide this process to help avoid future legal nightmares.

> **If It Looks Too Good To Be True, It Probably Is.**

This is a simple rule that has always served me well. A painful reminder of its merit lies in the recent past. **Portus Alternative Asset Management Inc.** 's steady returns attracted big money in 2002, at a time when advisors were worn out from explaining to clients why their portfolios had fallen in value. Based on my conversations with advisors and wholesalers, many may simply have failed to read the offering documents and ask how smooth returns were achieved during such tough markets.

> **Back-Tested Numbers Are Like Fantasy Baseball.**

Back-tested numbers are common in quant-oriented strategies, or in cases in which a long-only manager has reinvented him- or herself as a hedge fund manager. For example, a fund was launched in Canada in mid-2006 by a well-known money manager who boasted a good record on his previous long-only funds. His marketing material for the new fund contained back-tested long/short performance that looked too good to be true.

Fast-forward to today. This manager's unconstrained hedge fund has lost more than half of its value (worse than its more constrained mutual fund sibling). This relatively new hedge fund manager's greater flexibility has so far been a negative. The previously marketed back-tested numbers are as reliable as my ability to manage the Blue Jays.

> **Transparency Rules.**

Some of the top hedge fund managers on the planet are very secretive. But any fund targeting retail investors must be prepared to pop the hood to help advisors and dealers understand its investment and business processes and procedures. Dealers should not tolerate, for example, a fund-of-funds' refusal to reveal its underlying hedge funds.

Audited financial statements are also must-haves. The more transparency, the better. On this note, dealers should consider a structure similar to a separately managed account whereby the dealers control the platform on which the hedge funds are offered. This step alone can solve many of the hedge fund headaches that have plagued so many firms.

> **Don't Overlook The Basics.**

Anyone is capable of doing basic checks to determine if more rigorous due diligence is necessary. For example, by checking the Web sites of the Ontario Securities Commission and B.C. Securities Commission, advisors would find two alarming facts about an apparently high-flying hedge fund whose assets have been frozen by the OSC and which is being investigated for alleged securities violations. The hedge fund's founder is no longer registered as an officer of the firm. And when the founder was registered, it was not as a portfolio manager. This implies that the founder may not have qualified for a portfolio management licence and that the previous registration was surrendered sometime over the past year.

If such a simple check is performed, it can trigger a number of important questions. Don't allow a compelling story or seemingly good performance to dissuade you from performing basic checks.

> **The Initial Assessment Is Just The Beginning.**

The above case also demonstrates that even when an initial assessment is favourable, it is imperative to conduct periodic reviews of all dealer-approved hedge funds. At a minimum, dealers and advisors should confirm that the information in the original due diligence review remains current.

I've barely scratched the surface of hedge fund due diligence, but these suggestions are a good starting point. **IE**

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