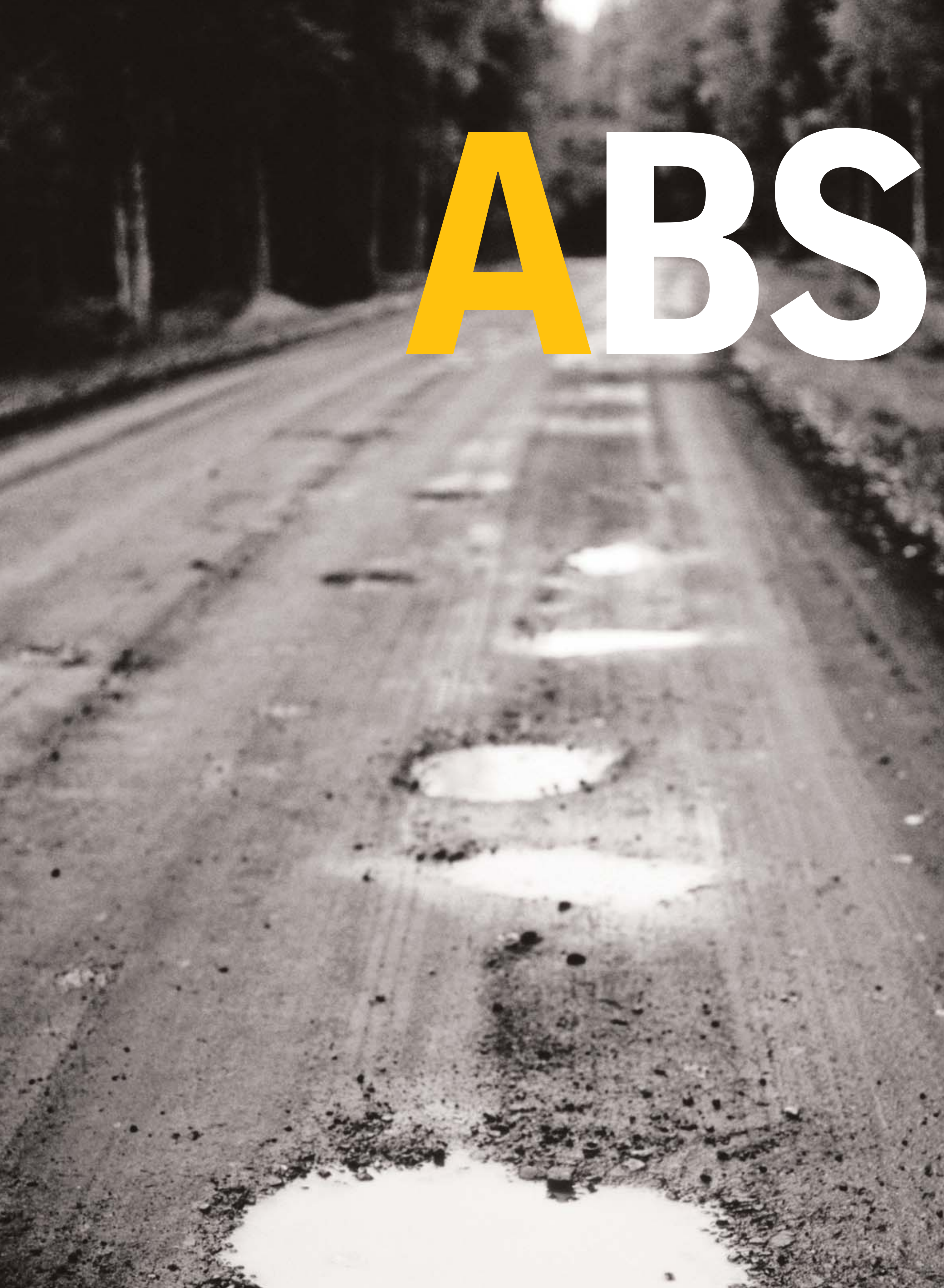
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OLUTE RISK

Navigating hedge funds requires you to dig deep and ask tough questions. By Ken Stern

Photography by Charles Mason

The recent insolvency of Bayou Management, the disappearance of hundreds of millions of dollars entrusted to it, and the attempted suicide by its CFO, highlight the risks of investing in the secretive and unregulated world of hedge funds.

Portus Alternative Asset Management still can't account for $650 million in investor assets, while Norshield and its Univest Funds are embroiled in controversy and have been recently shut down. Investors are likely to recover only a small portion of their capital. Consequently, more and more funds—both hedge and mutual—are falling under the scrutiny of regulators.

Investors and their advisors are justifiably nervous, and the latter are discovering the hard way just how critical due diligence is to the overall hedge fund selection process. If you plan to offer hedge funds to clients, there's no excuse for not delving as deeply as possible into the nitty-gritty of those funds.

Hedge funds and traditional investments differ in a number of ways. However, one of the key distinctions is the shedding of market risk in favour of manager risk. This means you have to consider what would happen if the brain behind a fund (i.e. the manager)

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were hit by a truck.

Hedge funds also carry myriad risks, some of which are common to traditional investments and others unique to the hedge fund space. Largely unregulated, governance is coming under more and more scrutiny, and it's almost certain this watchful eye will become keener in the relatively near term. However, as of today in the U.S., literally anyone can offer a hedge fund. As long as the asset level is under $25 million, and has fewer than 15 investors, no registration or other submission to public scrutiny is required. At least here in Canada the portfolio manager is required to be registered with provincial securities regulators.

The risk universe for hedge funds is substantially larger than for traditional investments. They include, but aren't limited to, the following:

- Manager risk—based on integrity and expertise.
- Liquidity risk—often hedge funds will hold illiquid or semi-liquid positions.
- Maverick risk—or rogue risk, such as when the fund manager takes off with the money, i.e. Nick Leeson and Barings Bank.
- Operational risk—can they actually keep the books straight?

Due Diligence

So given all this risk, where do you even begin? Hedge funds are subject to less regulatory scrutiny than traditional asset classes, and therefore due diligence must include extensive questioning and investigation of both the manager and the fund.

Your first step should be to read the fund's sell sheet and some of the marketing material. Be clear on the terms since this is the material you would give to your prospect. Next, it's imperative to read the offering document. Most offering documents are similar in structure and after reading a number of them you'll begin to know where to look and what to look for. Highlight any sections that cause concern so you can refer to them as necessary. Discuss your initial reactions—both positive and negative—with a fund representative. Ideally it should be the fund manager, but more often it will be a senior person such as the compliance officer or vice-president of sales.

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Once satisfied with the answers, you might think it's time to invest. Wrong! You are still in the preliminary phase. All you've accomplished so far is to allow this fund to move to the next level of the process. Remember, if you have any doubts or concerns whatsoever, you can do one of two things: Either pass on this fund or engage in more due diligence to see if you can clarify all the issues you've uncovered.

But if all looks good, you can now send your preliminary due diligence checklist to the company. Request some basic information in a useful format and add the data to a master spreadsheet for comparison with other similar hedge funds you are tracking.

The next objective is to gain an in-depth understanding of the risks you'll be accepting. This involves a series of both quantitative and qualitative checks, and the information elicited at this stage will determine whether or not you will ultimately place yours and your client's money with the fund.

Learn and understand the fund's structure. Is it long/short equity, or convertible bond arbitrage? Risk arbitrage, or distressed securities? Market neutral, or enhanced beta? Find out how investment decisions are made and ask the following questions:

- Is there a black box or a disciplined rational process?
- Can the manager override the model? Under what conditions?
- How often does this happen?
- When was the last time and why?
- What are the buy-and-sell disciplines? Do they employ stop losses?

Ask for an example of a trade that didn't work out. How was it discovered? How was it wound down? Was there much of a loss?

Quantifying Risk

There are numerous metrics used to quantify risk in the traditional investment world—each important, but when combined paint a more comprehensive picture of quantitative risk.

Two of the most common metrics are standard deviation and beta. Standard deviation can be misleading because it doesn't discriminate between the desirable upside volatility and the downside volatility, which is attractive only to short bias strategies. Beta indicates systemic risk measuring volatility relative to the

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overall market.

Look at the amount of leverage used relative to the strategy being employed and determine the peak-to-trough drawdown and the Sharpe ratio. Value at risk is also a useful tool, as it attempts to ascertain the most one can expect to lose over a specific period of time.

The Sharpe ratio is one of the easiest numbers to find, or even to calculate on your own, and most hedge funds publish this. It measures the amount of return an investment delivers relative to the amount of risk undertaken. The calculation is simple: Use the fund's return to determine the excess return over the risk-free rate, then divide your answer by the standard deviation. There's your Sharpe ratio. The problem is that standard deviation, which is the denominator in the equation, includes both upside and downside volatility. And while no one likes downside volatility, most of us welcome it on the upside.

The Sortino ratio removes upside volatility from the equation using downside standard deviation to highlight only the bad volatility. Sortino is useful but it is more difficult to calculate and not all funds provide it.

Another key risk metric you need to understand and monitor is leverage. Ascertain how leverage fits into the fund's policy and decide whether the fund's strategy calls for high or modest amounts of leverage. Find out whether the fund has ever been run without leverage; the average amount of leverage used; the highest amount of leverage used in the last 12 months and since inception; and whether leverage has ever been revoked from the fund.

An affirmative answer to the last point would be a very bad indicator. Try to find out why it happened.

Transparency

When you read the offering document you'll begin to understand how much latitude the manager has in terms of where he or she can invest. Therefore, the greater the transparency in this process, the better.

Transparency is key and you should always try to find out, and monitor, exactly what investments are held by the fund. With too much flexibility in the mandate, as outlined in the offering, the manager could literally buy tickets to a Toronto Maple Leafs game and attempt to resell them at a profit. Managers often defend limited transparency as one of their greatest advantages, arguing (with some merit) that if they had to openly report current holdings, other funds could see the opportunity and jump in. What they really mean is they don't want to disclose their short positions.

Since most managers won't provide you with the transparency you might want, you may ultimately have to make a judgment call based on the total picture provided by your due diligence process. You must also consider things such as market exposure. For instance, in a long/short equity fund that has 80% long and 40% short, the market exposure is 40% net long. The total exceeds 100% because the investment is leveraged.

Find out the fund's target range for market exposure by asking:

- What is the highest and lowest net market exposure over the past 12 months? Since inception?
- Does the fund hedge against currency risk or interest rates?
- What is the largest concentration of any one security?
- Is there a set number of positions allowed?
- What is the average number of positions held by the fund?
- How many positions are currently in the portfolio?

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Ultimately, performance is what all investors are looking for. By slicing and dicing these numbers you will add a significant amount of detail to the composite picture that defines the hedge fund you're considering.

When a hedge fund is first made more widely available to arm's-length investors (those who will invest beyond initial incubation capital and money from friends and family), pro forma returns are often used. This means historical returns are modelled using the current portfolio on a back-tested basis to show how the fund would have performed had it existed in the past. Decide whether you are comfortable using pro forma numbers. View them with a healthy dose of skepticism. When evaluating the whole process, you can't place the same weight on performance as you might have done otherwise.

Find out if the returns stated are net or gross of fees and check if there is a fairly even distribution of monthly returns or whether there are months when the returns were unusually high or low. Sometimes known as fat tails, these outlying months can tell you a lot about the fund's consistency. Ask:

- How bad were the worst months?
- How deep was the worst drawdown?
- How long did it take to recover? Weeks? Months? Years?
- Why did the recovery occur?

If the fund had a significant drawdown, you need to be extra cautious and aware of the potential consequences. Since performance fees are usually paid on net new profits and the fund is now significantly "under water," the manager might become discouraged at the prospect of an extended period of time without performance fees. In this case, one of two things might happen. The manager could close the fund and start over, or even worse, to make up the lost ground he might begin to take more risk than you signed on for.

You might set a maximum drawdown target for each fund you offer clients, with similar strategies having similar drawdown thresholds. A long/short equity fund should be given more leeway than a market neutral fund of funds, because long/short will normally have a higher standard deviation. If the fund reaches the drawdown target, consider redeeming fairly quickly, absent a mitigating factor to convince you otherwise.

> "It's time for a gut check. Your intuition can tell you a lot. If you are not totally comfortable, there's no harm in taking a pass."

Fees and Principals

A typical hedge fund can charge anywhere from a 1% management fee and a 10% performance fee to a 2% management fee and 20% performance fee, excluding the advisor's trailer fee. Anything higher should sound an alarm. If something seems too good to be true, it usually is. Understand this is an area susceptible to abuse, so thoroughly examine the fund's fee structure. An experienced advisor almost intuitively knows when the deal is too rich. That's what kept me away from Portus from the get-go. Enquire:

- How adequately are the fees disclosed?

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- How do they compare to similarly structured funds?
- Is there a hurdle rate and/or a high watermark provision?
- Do they charge fees irrespective of returns delivered to investors?
- What are the investment management fees?

A fund of funds is comprised of a number of different hedge funds, each with its own fee structure. Find out how these fees are passed through and if the advisor compensation (if embedded in the fees) is reasonable and fair.

Evaluation of people is about as qualitative as it gets. Trust is one of the most important aspects of the due diligence process. It's hard to trust someone you've never met, so wherever possible, personally meet the hedge fund manager and principals of the fund company. Keep in mind the following:

- Where did they earn their hedge fund stripes?
- Who were their mentors?
- What is their performance history?
- Is this fund their entire focus?
- Do they have any other interests that might distract them or constitute a conflict?

You also want to confirm the managers and principals have invested a substantial amount of their own money—or that they are "eating their own cooking." Ask them how much and investigate the fund's policy with respect to employees and their personal investments.

Governance

If the fund managers and/or administrators are involved in areas of governance, it's like having a fox in the hen house. Ensure that NAV calculation, custodial, and trustee services are all performed by independent, arm's-length third parties—especially the fund's auditor. Determine the methodology and frequency of these calculations and find out where the data comes from. Is every trade reconciled? Is there a formal policy related to the valuation of non-public assets held in the fund? And how are illiquid or semi-liquid positions valued? There are some funds which unequivocally state they will not invest in any securities not traded on the public markets. Every hedge fund should have an external auditor and be audited on an annual basis. In my book this is a deal breaker. No external auditor, no business. Ask:

- What is the name of the audit firm?
- Is the auditor experienced in these funds?
- How long has the auditor worked with the manager?
- Is the auditor aware of any previous audit problems?
- Were other audit firms previously involved with the fund and if so, how and why did the relationship end?
- Is the auditor aware of any other business activities the manager or other key people are involved in?
- Were any irregularities discovered? If so, get detailed information.
- Who ensures the terms of the fund's offering are being upheld?
- Who ensures fair and equal fee distribution and fair and equal liquidity constraints?
- Who monitors leverage and whether the fund stays within its stated limitations?
- Who monitors whether minimum investment provisions are being adhered to?

Decision Time

So, you've done your due diligence and the hedge fund has passed all your tests. Now it's time for the big decision. Is this a hedge fund into which you will feel comfortable placing your client's—and your own—money?

It's time for a gut check. Your intuition can tell you a lot. If you are not totally comfortable, there's no harm in taking a pass. There are enough funds out there that will pass your due diligence scrutiny.

Due diligence is not just a one-time exercise. I regularly conduct meetings with managers and/or distributors, check out my usual hedge fund Internet research sites, and read periodicals and other publications. I also keep a monthly tracking chart which, among other things, monitors returns, volatility, leverage, Sharpe ratios, standard deviation, beta and drawdown status.

If you always do your homework, the right hedge fund(s) can be an excellent addition to any investment portfolio, either as a risk reducer or a return enhancer. In addition to gaining a lot of valuable knowledge, you'll be known to both colleagues and clients as a true hedge fund professional. In the end, your clients will be happy and you will prosper. **AE**

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