For some time many consultants have stressed the diversification benefits of alternatives while appropriately pointing out important challenges to thoughtful investing in hedge funds. Since 2002 when traditional stock and bond portfolios suffered mightily, more and more clients are listening to their consultants, leading to huge allocations to hedge funds relative to just a decade ago. Transferring as little as 10 percent of a fund from stocks to hedge funds can be a major task and not everyone fully appreciates just how complicated analysis of hedge fund managers can be.

To demonstrate this point, let’s begin with an example. Assume you have been given the mandate of increasing the hedge fund portion of your portfolio from zero to 10 percent over 18 months. You have read all the studies that describe what you are looking for and the strongest guideline is that you do not want to replace your index funds (cheap beta) with hedge fund managers who are highly correlated with the stock market (expensive beta).

In reviewing hedge fund managers for possible inclusion into your portfolio you come across a multistrategy fund that has been in business for more than five years, has grown to more than $6 billion in assets under management, has a compounded annualized rate of return of more than 18 percent with very few down periods, and shows very low correlation to either the stock or bond markets. Do you:

1. Immediately request subscription documents and prepare a wire transfer?
2. Wonder how you are going to figure out the source of returns and risk, because some kind of investment process is in place that is not geared to long stocks or bonds?
3. Conclude the record is too good to be true and immediately take a pass?

Those in the first group assume that any fund that has been around for five years has its regulatory and operational act together, and that its investment record speaks for itself through both good and bad markets. The third group is cautious enough to simply not invest in anything that is not transparent and easily understood. Both groups could be making big mistakes.

The second group understands the “too good to be true” mentality but is curious enough to want to know more about the source of returns. This is where good hedge fund due diligence comes in.

The due diligence steps for long-only bond and stock funds merely scratch the surface for hedge funds. The following are several key differences:

1. Hedge funds routinely use short positions in addition to longs.
2. Leverage can dramatically change the risk profile of any strategy.
3. The range of investments in a hedge fund is limited only by the private placement memorandum (PPM), which generally is quite vague in order to protect the hedge fund.
4. Investments in illiquid, hard-to-price securities can be a major part of a hedge fund portfolio.
5. Many hedge funds are not registered as investment advisers, commodity pool operators, or any other form of regulated entity.

Good hedge fund managers are proud of their funds and the organizations they have built. They know that potential investors need to kick tires and understand their investment philosophy, process, and controls.

Let’s start with the basics. Hedge fund managers are not all alike. Good hedge fund managers are proud of their funds and the organizations they have built. They know that potential investors need to kick tires and understand their investment philosophy, process, and controls. Most will work to accommodate your due diligence needs.

But then there are some managers who simply wave their hands and explain in general terms what their investment program is all about. Often, if they are actively selling their funds, they will return to their track records as the key point of discussion, as if that is all you need to
Risk/Return Goals
The first question to be asked is, “What are the risk and return goals of the fund?” If a fund says they expect to earn 15–20 percent per year with half the volatility of the equity market, that gives you something to discuss. What will be the source of the return? If it comes from superior security selection without taking very much exposure to directional moves in either stocks or bonds, what evidence does the manager provide to suggest such outsized skill? We always should begin by assessing whether the stated goals are realistic. Be skeptical.

There are statistical tests that can help in this regard. Regressing a fund’s returns on market factors gives you an idea of what market forces have worked to produce returns in the past. If you find there is no connection between stock and bond markets and the fund’s returns, you are only half done. You have ruled out two directional factors, but there are many others to consider. In the past few years some of the most profitable hedge funds have made money on directional moves in commodities or credit spreads. In each case you need to assess whether the environment that produced the strong returns is likely to continue, or whether you are coming in at the end of the good story and are set up for a reversal.

Even the best statistics have limitations. The most significant is their backward-looking nature. Hedge funds, unlike their long-only stock and bond counterparts, can change their stripes pretty dramatically. It is sometimes this feature that makes them most attractive. The only way to evaluate the current posture of the fund is to get information about today’s portfolio. Some managers are quite transparent, giving information on their positions. Others will do this only with a lag to protect their current holdings. Others simply won’t reveal this much detail, but they may be willing to share with the investor key measures of the risks in the portfolio. Often this risk exposure data is more than sufficient to assess the current state of the portfolio.

Beware of simple statistics as a guide to risk. The Sharpe ratio has been around for years as a guide to return versus risk. It has been criticized for not being flexible enough to capture the kinds of extreme tail risks that hedge funds sometimes display. A more recent entry to the field, the Omega function, purports to solve this problem by allowing fat tails and asymmetric distributions of returns. The problem with both of these measures is that if the extreme loss event has yet to happen, neither statistic will identify its likelihood. It does the investor little good to watch the statistics change only after a massive loss has hit the portfolio.

The investor should be able to assess whether the risks taken in the portfolio are consistent with the fund’s return goals and whether they are risks the investor actually wants to take. Many hedge funds in 2005 tried to exploit the bull market in energy. Some did it through natural resource stocks. Others did it with bonds, both investment grade and distressed. Still others went directly to the oil and gas markets. You may have hired three different types of managers that year but discovered you were actually exposed to one major risk. It also is likely that risk was a major presence in your traditional portfolio as well.

Fund Valuation
The next major due diligence hurdle is determining how much confidence you can have in the valuation of the fund. Here there are two issues. The first is whether market prices are available. The second concerns liquidity around that market price. At one extreme are hedge funds that only take small positions in highly liquid, publicly traded markets. Here you can be reasonably confident that what you see is what you get in terms of returns.

At the other extreme are funds that trade in privately negotiated securities or derivatives, for which there is no listed market and perhaps very little liquidity. A fund that takes a control position in a company through privately negotiated stock poses great difficulty in this matter. Private equity and venture capital funds address this problem quite simply. They make no attempt to mark their portfolios to market every month. Investors understand and accept this, or they do not invest.

For hedge funds that are drifting toward the private equity world for their opportunities, there are many challenges. Each month they must produce a net asset value (NAV) at which investors can redeem or make new contributions. Only if these NAVs are accurately determined will the process be fair to all. Identifying
the regular pricing policies of a hedge fund is a key due diligence step designed to avoid unfair practices, or worse, fraud.

**Fund Liquidity**

Even if the pricing process is as accurate as it can be, one is left with the subjective question of liquidity. As hedge funds get bigger and bigger, it becomes harder to build or liquidate a position without having a market impact. Few worry about this when the markets are moving in your favor. It is only when the positions need to be changed under stress that the true risk of illiquidity becomes known. Each investor must ask whether the fund under review can get out of its position without severe damage to the portfolio.

Leverage is a major factor in this discussion, and it is a double-edged sword. If a hedge fund is correct in its investment theme, adding leverage gives it more return. If the fund is wrong, however, it not only increases the downside risk, it gives the manager less trading latitude. Low leverage positions might ride out a temporary storm in the market while those same views expressed with high leverage can get blown out at just the wrong time. Investors should understand beforehand what they are facing.

**Operational Due Diligence**

Turning to operational due diligence, the only serious complication that hedge funds create comes from the wide range of instruments they can trade. Because a hedge fund can trade stocks, bonds, real assets, futures, options, private securities, and all manner of derivatives, it is necessary to verify that the fund’s operational controls are up to the task. Trading, clearing, and settling all these instruments can be incredibly complicated, and this complication gives rise to the chance of error or fraud. Verify the existence of a fund’s brokers, administrators, custodians, accountants, and lawyers, and make sure they all are experienced in the area.

Finally, many, but not all, hedge funds today are registered with the Securities and Exchange Commission (SEC) as investment advisers and some are registered as commodity pool operators with the Commodity Futures Trading Commission. Many funds are not registered with any regulatory body at all. Some investors take too much comfort investing with registered entities. Regulatory bodies check only a fairly narrow range of a fund’s policies. Are the trading policies fair to investors? Are the funds properly disclosing the expenses and trading policies? While each of these questions is important, regulatory reviews are periodic and do not cover many due diligence areas that should be of concern. Some of the biggest trading blowups in history have come from regulated funds that simply took too much risk. It also should be noted that decades of close regulation by the SEC under the Investment Advisers Act of 1940 did not prevent some of the largest mutual funds in the country from engaging in late trading to the broad detriment of investors.

**Conclusion**

Hedge fund due diligence done properly is a time intensive, human-capital intensive activity. There is no magic check list that covers all the bases. If an investor lacks the necessary resources to do the job properly, there really are only two choices. The first simply is not to make the investment. The second choice is to get that expertise, either in the form of a qualified adviser who can do the appropriate due diligence or through a fund of funds that has good procedures in place. Neither activity is costless, but any expense should be framed against the resources saved by the investor and the lower chance of a real problem cropping up in the portfolio.

Returning to the first example in the article, there really was a fund out there in the spring of 2006 that showed all those characteristics. Its name was Amaranth and it was hailed as one of the great success stories in the hedge fund industry. Unfortunately many investors did not look at the real risk of the fund, or they saw it but chose to ignore it because most of the realized risk of the fund had been on the upside during its history. When the combination of too-large a position in a relatively illiquid natural gas market went against them in September, the fund lost more than $6 billion in a matter of days. This loss was not from fraud or any operational failing. It simply was a matter of trading losses accumulating quickly as they often can when a big position goes bad. Proper due diligence allowed some investors to miss Amaranth altogether as a story with way too much risk potential for the return.

Hedge funds were created as private placement vehicles to meet the needs of sophisticated investors. Make sure before you invest you demonstrate your sophistication with thorough due diligence. We never can eliminate losses from our portfolios, but we need to work hard enough to eliminate surprises, and careful due diligence is the place to start.

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