

Hedge Fund Due Diligence... More Than Just a Background Check



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Hedge Fund Due Diligence (n.) The process of understanding, investigating and reporting the full range of primary known risks of any given hedge fund strategy and structure which can lead to significant loss of investors' capital.

Summary

Performing “due diligence” has become a term widely thrown around, distorted and misconceived by both investors and investment managers in the alternative investment industry. The sad truth is that not every hedge fund investor conducts it in a comprehensive manner or believes in the merits of completing each stage using a reasonably detailed and structured approach. Both of these attitudes have led to dire consequences for investors during the market downturn, leaving them frustrated with ***illiquid holdings*** and ***losses worse than the “worst case scenario”*** than the manager had communicated.

















It is estimated that ***2,000 hedge funds have closed (~22%)*** their doors since the onset of the financial crisis and that as many as ***2,000 more*** may follow suit over the next 18 months. According to BarclayHedge, 1,500 hedge funds have closed since January 1, 2009. As investors re-think their investment processes, it is important to place comprehensive, fundamental and exhaustive due diligence at the core of any investment decision in alternative asset classes.

As hedge fund failures have led many investors astray, conducting comprehensive due diligence is necessary in order to properly assess the risks of alternative investments.

Alternative investment due diligence is a process in which ***industry professionals exhaust all analytical tools available*** to them in order to uncover red flags, warning signals and managers' shortcomings in the area of best practices with the goal of identifying as many material risk factors as possible which can potentially lead to a significant loss of capital or illiquidity.











Investment Strategy Related Due Diligence

Taking a manager’s word that he is running the type of strategy and exposures that he says is insufficient. Investment strategy due diligence goes beyond that. Despite the fact that a large amount of funds’ strategy risk may be risk compensated by long term returns, the prevalence of black-box investment strategies and the often vaguely-defined investment guidelines require investors to perform detailed investment strategy analysis as an integral part of their due diligence process. The following pages present **various sample cases** in which thorough due diligence can help identify **yellow and red flags** where intolerable, hidden risks are identified.

| Manager Representation | Due Diligence Findings | |
|---|--|---|
| DDQ: “We target a 10% maximum drawdown”. | Historical returns show drawdowns of 15%, simulations and shock analyses result in drawdowns of up to 30%. |   |
| Conference Call: “Our largest position is restricted to 5% of the NAV”. | While same is stated in DDQ, the offering memorandum does not contain position caps. Portfolio transparency onsite discloses higher position sizes. |   |
| Marketing Material: “The fund is market-neutral”. | However, gross exposures of up to 500% are run, with significant Beta tilts, sector and country exposures. The fund is only dollar-neutral. |   |
| Track record shows steady positive returns with few negative months. | The fund invests into an SPV that absorbs mark-to-market losses of the portfolio holdings, pays steady interest to the fund and hides losses on the principal amount. Close to none of the returns are effectively realized returns. |   |
| DDQ: “Our gross long exposure has been in the range of 80-130%”. | The Offering Memorandum allows up to 300%. |     |
| DDQ: “The strategy is uncorrelated to general market moves”. | However, there is a substantial event risk implied in the systematic short-strangle strategy run by the fund. |     |











Manager Related Due Diligence

Focusing on the target fund alone is missing the larger picture. Estimating the financial health of the management company can reveal critical information such as stressed resources and a subsequently limited ability of the manager to meet the fund's performance targets. Investment management companies which come under stress may risk losing key investment professionals, increase risk-taking, or re-allocate business resources to other products which can lead to large draw-downs for investors.

| Manager Representation | Due Diligence Findings | |
|--|--|---|
| DDQ: "We manage two funds, a flagship product with 1 bio AUM and a new single strategy with 50 million AUM". | AUM in the flagship fund are inflated, net client assets of 200 million with 5x leverage. Headcount of 50. Flagship fund is suspended, under water and holds illiquid assets. Massive redemptions to be expected once re-opened. Viability of investment management company at risk, new fund won't survive if flagship fund shuts down. |   |
| DDQ: Advisory is composed of a team of highly experienced, renowned industry players. | Investment manager touts the advisory board as adding significant value to the fund, however, two board members expressed minimal involvement with the fund, and only meet once per year. |   |
| DDQ: Manager does not hold any interests in related businesses or service providers. | Onsite visit reveals that manager shares his office with the fund's "independent" administrator. |   |
| Onsite visit: "We have a close relationship with our operational partners and have been working with them for many years". | Background check reveals one of the principals of the Investment Manager is a founding partner of the fund's administrator. Administrator is also a small service provider and the fund has long since grown beyond the capabilities of that administrator. |   |
| Marketing materials show standard 2/20 fee structure with high water mark. | Fund pays investment manager "sourcing fees" per trade, which can lead to increased risk-taking, and massive conflicts of interest. |   |









Fund Related & Operational Due Diligence

A manager's due diligence questionnaire gives a starting point for operational due diligence, however conducting complete operational due diligence requires significantly more patience and a detective's attitude. Despite some basic level of uniformity provided through AIMA DDQs, these 'in-sample' DDQs provided by Managers typically have multiple omissions in key areas or state half-truths and will not cover strategy-specific areas of the fund's operational risks which are not covered in the AIMA document. Altogether, the standard package of documentation provided from the manager falls far short of the information needed to complete an adequate operational analysis. Onsite visits are paramount for detecting operational risks and verifying procedures.

| Manager Representation | Due Diligence Findings |
|--|---|
| Fund Presentation, Factsheets, DDQ: "The Fund offers monthly liquidity on 45 days' notice". | Fund has gates on investor, not on the fund level.   |
| | Fund may hold 30% of redemption proceeds until auditing is finalized. Fund terms do not define time span to settle redemption proceeds.   |
| The offshore fund is an independent company and only related to the investment advisor through the investment advisory contract. | It's the board of directors that protect the interests of the investors. However, the two directors of the fund are both senior partners of the advisor, no independent person is on the board of directors.  |
| Conference Call: "We don't provide the pricing policy to non-investors". | Positions are marked to model, and when questioned, the investment manager refuses to share his "proprietary" model.  |
| Marketing Materials: "We haven't had a single down month since inception". | Historical audit review reveals that the manager has relinquished accrued performance fees to compensate for a negative month.   |
| | Through asset verification, it is discovered that fund accounts are held in the name of the investment manager not the fund.   |

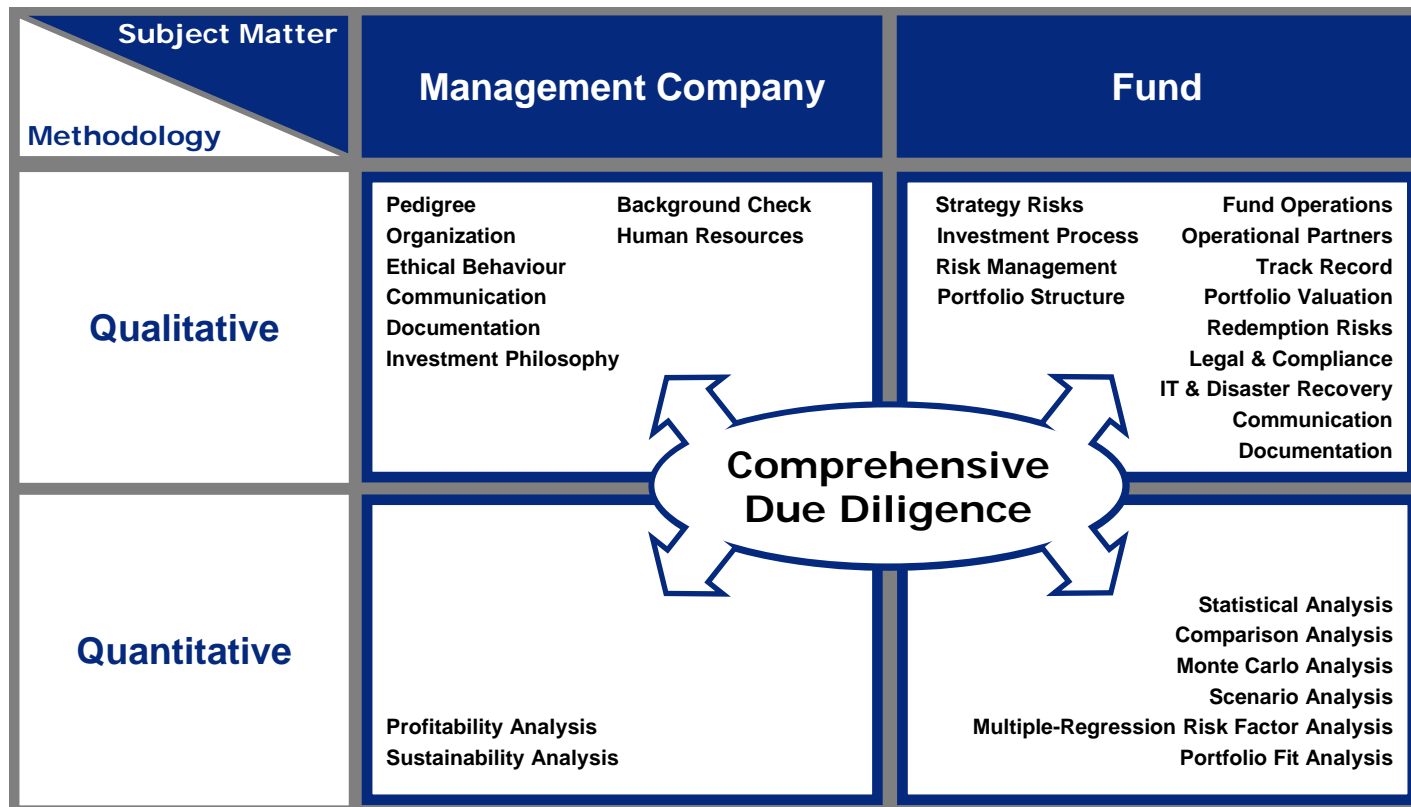
Post-Investment Monitoring

Once a fund has passed an initial due diligence process, pro-actively monitoring all risk categories can provide further insight into the fund risk profile, as well as detect shifts in the manager- and fund-related operational and strategic risks. Investors who at best passively monitor fund risks become a “last-man-out” if there is a run to liquidity by missing redemption deadlines, leaving strategic drift of the fund manager unnoticed, and becoming unknowingly exposed to key man risk through personnel changes.

| Initial Due Diligence | Ongoing Monitoring |
|---|--|
| Investment manager reports fund performance to BarclayHedge and Bloomberg on a monthly basis. | Fund’s monthly newsletters and performance estimates are now delivered 1 month later than they were historically. Fund may no longer be marketable, marking potential changes to personnel.   |
| Service providers are well-established, top names in the industry, providing independent fund valuations, timely distribution of statements, etc. | Fund changes administrator, new service agreement looks professional and independent at first look, however the administration costs are far below industry standard, signifying that the investment manager has de facto taken over his own NAV calculation.   |
| Full disclosure of historical audits performed by top 3 accounting firm, and asset verification delivered satisfactory results. | Delays in finalized NAV calculation, audit is 3 months overdue from historical delivery dates, signifying potential problems with the fund’s valuations. When questioned, manager indicates that there is a dispute with the fund’s administrator over the valuation of certain positions.   |
| Background check reveals no significant negative findings on the fund manager and principles of the investment management company. | News screen reveals that fund manager has been formally charged with driving under the influence and possession of cocaine at 4 o’clock in the morning on a Tuesday.   |

Comprehensive Due Diligence Framework

Only by integrating qualitative and quantitative factors into a professional, informed and structured process can one claim to be doing their “due diligence” in this in-transparent, competitive and unregulated market. Not completing each section of the process with a high level of confidence exposes the investor to undue and uncompensated amounts of risk.



Comprehensive Due Diligence During Industry Shakeup

There are a number of measures which investors must take in order to protect themselves during this period of contraction and the re-positioning of the alternative investment industry. The most fundamental action which can be taken by investors is to demand a standard of transparency which is acceptable in order to be able to conduct a **rigorous and comprehensive due diligence process**.

Institutional investors have acknowledged the value of conducting rigorous due diligence on funds prior to investing. By doing so, allocators can limit the amount of uncompensated risk which is taken in their alternative investment portfolios, and allow them to confidently manage their assets.

“By skipping or ignoring any of these steps... allocators may leave themselves highly exposed to risk which can be fatal for their investment.”

Comprehensive due diligence consists of much more than reading through primary fund documentation and chatting with the manager about his strategy. As the title of this paper suggests, it is certainly more than just a background check. That being said, background checks, onsite visits, full operational assessment and subsequent deskwork, including fund structure and strategic analysis must be primary components of any due diligence process. Each of these steps provides allocators further insight into the primary uncompensated and hidden risks which are inherent to alternative investments. By skipping any of these steps and failing to analyze the complete set of risk factors in a structured, comprehensive manner, allocators may leave themselves highly exposed to risk which can be fatal for their investment.

All of the following are key points that many investors have overlooked in their due diligence or simply disregarded which has led them stranded, stuck in their positions and regretting their investment decisions in their alternative investment portfolio exposures during the current downturn:

- Manager's rights to suspend or adjust liquidity terms
- Implied leverage and leverage facilities of the fund and instruments used
- Valuation policies
- Realized Gains vs. Unrealized "Returns"
- Match between investment strategy's worst-case liquidity and the liquidity terms offered to investors



Comprehensive due diligence is far cheaper than you would expect and ALWAYS pays off in the end.