Managing Hedge Fund Managers

Quantitative and Qualitative Performance Measures

EDWARD J. STAVETSKI
I want to thank my wonderful wife, Hilary, and my children, Laura and Alec, who give me strength every day. They continue my parents’ efforts to make me a better human being, husband, and father, and I am very grateful for them.
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Preface

To many investors, the hedge fund world is shrouded in secrecy and compounded by complicated structures and investment vehicles. Even some investment professionals view hedge funds as Satan here on earth. The horror stories of investors losing millions of dollars while greedy hedge fund managers collect rock star salaries make for great headlines and raw meat for governments and regulators, but do little to advance the education of the investing public.

Understanding and investing in hedge funds can be a daunting task. Not everyone will have the resources or opportunities presented to them that a Harvard or Yale endowment fund has. This does not mean that if you are a qualified investor, in the legal sense, you should avoid the hedge fund space or, even more importantly, blindly invest in a fund on the basis of a tip you received at a cocktail party. The main goal of this book is to remove some of the shroud of secrecy in the hedge fund world and provide practical tools for investing in this space. Whether you consider hedge funds an asset class or just an investment vehicle, you need to understand some of the technical aspects of structure, the comparative performance statistics, and the continual vigilance needed to successfully navigate this investment field.

In this book, the process of investing in a hedge fund proceeds from the guidelines of an Investment Policy Statement, through investing in a chosen fund, and then to the follow-up monitoring that is needed. We will break down each step of the due diligence process and focus on critical tasks, reviews, and questions. Knowledge of some financial calculations is imperative, but equally important is being able to realize that sometimes the numbers don’t add up, or notice something inconsistent in the responses and answers you get from a fund. Time and time again the book stresses that numbers and calculations do not provide answers but only questions. Investing in hedge funds is as much art as science; faith versus reason. Some of the smartest, well connected funds have gone down in flames. As an old mentor once told me, sometimes I would rather be lucky than smart. And I believe the harder you work the luckier you become.
HIGHLIGHTS OF THE BOOK

Following is a brief overview of the contents of this book:

- A comprehensive Investment Policy Statement including hedge funds (Chapter 1).
- The virtues of emerging managers versus well established ones and the risks involved in choosing either type (Chapter 2).
- Casting a wide berth to search for a new manager (Chapter 3).
- How to decipher the mind-numbing statistics that rise up around hedge fund investing (Chapter 4).
- The various concepts of risk and the real exposure you face as an investor (Chapter 5).
- Performance is important but is the hedge fund a real business? (Chapter 6).
- Researching qualitative factors that impact a hedge fund (Chapter 7).
- Portfolio construction goes beyond high performance numbers (Chapter 8).
- A review of highly detectable factors that imploded several funds (Chapter 9).
- The work is never done; the ongoing monitor is very important since real money is now at stake (Chapter 10).

I hope that the knowledge you acquire in this book will be useful in helping you to become a successful hedge fund investor. New information and methods to understand hedge funds are being discovered every day. There is no one formula or specific way to analyze every fund. But you must understand the process and be comfortable with your decision and your investment.
I would like to thank Vitaliy Katsenelson for his enthusiasm and persistence in encouraging me to take on this project. I owe a special thanks to the editors at John Wiley & Sons who provided advice, guidance, and assistance throughout this process.

Moreover, I want to voice my appreciation to the people who gave generously of their time and knowledge during my inquisitive years before I began writing this book. A mix of practitioners, including Ted Aronson of AJO Partners and Sam Kirschner of Mayer & Hoffman Capital Advisers, helped shape the practical aspects of this book, along with academics Dr. Andrew Lo and Dr. David Hsieh, who provided outstanding insights and research to complement the others. I also want to thank some old colleagues, Brain Kraus, PJ Grzywacz, and Andrew Elkin, who always made due diligence interesting.

Finally, I want to thank my family and friends, whose continued support I greatly appreciate.
INTRODUCTION

The Art and Science of Hedge Fund Investing—Are You Precisely Wrong or Approximately Correct?

Hedge funds have been around for more than 50 years, but their impact in the investment world has increased since the 1990s. Alfred Winslow Jones, trained as a sociologist and known professionally as a journalist, established a partnership in New York in 1949 that has become known as the first hedge fund. Jones wanted to protect his investments from market risk, and by shorting stocks he calculated he could sufficiently defend his portfolio against declining markets. Feeling confident that his strategy would be successful, Jones borrowed capital (leverage) to increase his long and short positions. So successful was this strategy that Jones saw his funds appreciate 670 percent between 1955 and 1965.

The interest in hedge funds remained relatively flat until the 1990s, when hedge fund managers Julian Robertson, Michael Steinhardt, and George Soros hit the news with the force of rock stars. In 1990, there were about 100 hedge funds with approximately $38.9 billion in assets under management. By 1995, there was about $185.7 billion invested in only about 170 funds. In 2005 the amount of assets under management rose to over $1.1 trillion invested in approximately 8,500 funds; however, 196 hedge funds controlled approximately $730 billion of the total.

THE EXPLOSION OF HEDGE FUNDS

There are currently over 15,400 single strategy hedge funds and over 6,100 funds of funds (FOFs), depending on the day and source you use. There
are approximately 800 to 1000 new hedge funds every year. Of the single strategy hedge funds, 36 percent are U.S. domiciled and 64 percent are domiciled offshore. Among FOFs, approximately 18 percent were domiciled onshore while 82 percent were offshore. Assets Under Management (AUM) at the end of 2006 (the most recent year for which data is available) rose to over $1.4 trillion. Prior to the bear market debacle in 2008, the hedge fund industry was expected to maintain its torrid growth. It now appears that growth will be halted as hedge funds continue to suffer from the credit squeeze. Hedge funds are imploding and gates are going up in an attempt to bring orderly redemptions to the process. It is now estimated that 20 to 30 percent of the hedge funds in existence may close over the next few quarters.

The recent activity in the hedge fund world should serve as a huge wake-up call to investors. It is not just the small out-of-the-garage type of funds that are closing. Many of the large, well-established funds have closed their doors. It is too early to do a final analysis of this downfall. The credit crisis has cut hedge funds in several ways. First, they have been subject to a swift downdraft in security prices. While many folks believe that hedge funds actually hedge the portfolio, they have been surprised at how poorly hedged many have been. Second, the credit squeeze has created a liquidity squeeze on several fronts for hedge funds. Many large funds leverage trades in order to produce any alpha. Leverage, once again, has proven to be a source of alpha in up markets and poison in down markets. As investors begin to panic, redemption notices have poured in and funds have been forced to put up gates, as due to market conditions they cannot sell portions of the portfolio without substantial damage to the NAV. This is also creating a problem with high watermarks. Steep declines in NAV will eliminate any performance bonuses managers hope to get. Keeping investment talent without the high bonus payment will cause a run on talent.

Several funds are attempting to do right by investors. They have temporarily halted redemptions and have asked for new lock-ups in order to provide orderly liquidation. In exchange for these new lock-ups, they are waiving or reducing management fees and/or performance fees until investors are righted.

The lessons to investors will be many. Safety by investing in large funds proved to be nonexistent. Investors need to pay particular attention to the short side of a manager’s book or how well the manager hedges the portfolio. Finally, character as much as pedigree is determining how managers are treating investors in this troubled time. And possibly the ultimate lessons are that excesses do eventually get worked out of the system and risk is always a major factor in the investment world.

This meteoric growth has also affected the type of funds that are now available to investors. In 1990, approximately 71 percent of the assets were invested in global macro strategies; relative value arbitrage funds ranked next
in AUM with about 10 percent. Equity long/short and equity market neutral funds combined accounted for only 7 percent of the invested assets in 1990. By the end of 2005, global macro was about 11 percent of invested funds while equity long/short funds accounted for 30 percent of the assets invested.

To further illuminate how fast the hedge fund industry has grown in recent years, 22 percent of the funds have been in existence for less than 2 years and approximately 62 percent have been in existence for less than 5 years (HFR Industry reports 2007). The explosion in assets shifting to hedge funds and the growth in the number of funds, however, do not mean the monies are being equally distributed across all funds. Less than 15 percent of the funds have more than $500 million in AUM. In fact, over 60 percent have less than $100 million in AUM (according to PerTrac Financial Solutions). There are risks, albeit quite different risks, for investors at either end of the AUM spectrum.

This growth spurt is reminiscent of the prolific growth of mutual funds in the 1980s. Investors have been jumping into the fray with a similar reckless abandon. The buzzword is performance, real or imagined. The investor’s ability to make an educated decision about a hedge fund is fully jaded by the most recent performance dot and cocktail party chatter. In recent years, many have been forced to learn painful lessons that performance can be fleeting glory. For example, top performing funds like MotherRock and Amaranth saw a huge influx of dollars to their funds based on strong short-term performance. In what seemed like an instant, more than a billion dollars in assets evaporated as oil went from around $40 per barrel to nearly $100.

Or, take the case of Eric Mindich and Eaton Park. In 1994, at the age of 27, Mindich became the youngest partner ever in the history of Goldman Sachs. In 2000 he became co-chief operating officer of the equities division, and in 2002 he became co-head of the equities division. In 2003, Mindich joined the Executive Office and became chair of the Firmwide Strategy Committee. In November 2004, he launched Eton Park, a global multi-disciplinary hedge fund. The fund essentially began and stopped taking assets in its opening week with commitments of $3.5 billion. The terms were a 2 percent management fee and 20 percent take of profits. The fund had a two-year lock-up, after which investors could redeem one-third of their assets over the next three years. The fund would allocate a portion of the assets to private equity and the majority of them to multi-strategy investments (CV arbitrage, capital structure, credit arbitrage, and long/short equity). There is no question that Mr. Mindich had what the hedge fund world calls pedigree. According to the cocktail chatter, this was a “must-have” investment. Some astute observers were rankled about the rather severe lock-up period, and some wondered aloud how folks could invest money with a manager who had, by some accounts, worked in an administrative capacity and not in an investment one for about four years. Time will be the true judge
as to who did the best due diligence on this fund. After a slow start, Eaton Park had a strong year in 2007. The long-term outcome is yet to be written.

It is no secret that the hedge fund industry has received a great deal of headline attention over the past few years. Enormous paydays for hedge fund managers coupled with, in some instances, mediocre performance have led to the typical cries for regulatory or Congressional intervention. The lack of regulation and transparency of the investments have led to much speculation about the operations, functions, and use of hedge funds. The outcry began after the tech bubble burst, when markets crashed and asset flow to hedge funds soared. The tabloid headlines in the popular press led the SEC to call for the registration of all hedge fund managers in its October 1, 2003, report. There were almost daily articles in the major national newspapers, the New York Times and the Washington Post among others, criticizing hedge funds for the crash, lack of regulation, and what was perceived as excess salaries. In fact, many likened hedge funds to a fee scheme rather than an investment option.

In an effort to protect investors from themselves, Congress sprang into action by holding post-mortem hearings, followed by the SEC requirement that hedge funds had to be registered by February 1, 2006. Phillip Goldstein of Bullfrog Investors took up the cause of the hedge funds and sued the SEC. He won his case, and the SEC has since thought better of its course of action. Subsequent to that victory, Mr. Goldstein took up another hedge fund cause that addresses transparency: He is seeking an exemption from having to file 13fs. A 13f requires an investment manager to list all equity holdings when that manager’s discretionary assets under management exceed $100 million. A victory here would add some additional wrinkles to due diligence, since the holdings transparency will be reduced. Whether Mr. Goldstein will win is unknown at this point. He is arguing that there is no legitimate government interest and his intellectual property rights are being violated.

The current cause célèbre seems to be hedge fund compensation. The same cast of characters from the press are leading the shrill chorus. Is the compensation too high? Yes! Again, we are seeing efforts to protect investors from themselves. The key point is that no one forces anyone to invest in a hedge fund. As part of their due diligence, investors need to check out the fees. Compensation is a side issue in the fee discussion. Investors need to be aware of exactly what they are paying for in the fund. The task is not always an easy one. Fee structures are not always straightforward and can include a variety of expenses that are readily discernable. The key point: If you are not comfortable with the fees, don’t invest.

The background noise continues, however, and even the regulators and legislators are aware that they must not kill the golden goose. Carefully selected hedge funds have provided higher risk-adjusted returns to pension
funds and endowments. Higher returns have allowed pension plans of corporations, states, and municipalities to return to a status of near full funding. This rise has allowed politicians to ignore issues facing an aging population and their retirement benefits, which in turn may be especially pertinent to states and municipalities confronted with underfunded pensions and raising taxes by punitive amounts in order to meet mandatory benefits.

WHAT ARE HEDGE FUNDS?

Quite simply, a hedge fund is a business structure, typically a limited partnership or private pool. It may be organized in any number of legal jurisdictions and, through what is known as a master feeder structure, could be organized simultaneously in several jurisdictions. The strategies and investments employed are wide ranging. Most funds fall into broad based strategic categories and then can be further classified into smaller subcategories by style, geography, industry, or sector. It is usually helpful to divide the hedge fund universe into the following eight broad strategies:

1. Arbitrage
2. Event-driven
3. Fixed Income
4. Long-Short
5. Macro
6. Multi-strategy (or fund of funds)
7. Sector
8. Trading

In order to gain a better understanding of some strategies the following definitions will be helpful.

Arbitrage strategies seek to capitalize on price inefficiencies between securities and markets on a nondirectional basis. Leverage is frequently used. Arbitrage (or arb, as is the common Street name) strategies include capital arbitrage, closed end fund arbitrage, convertible arbitrage, credit arbitrage, and statistical arbitrage.

*None of the firms or hedge funds mentioned in the definitions is issuing an invitation or an offer to purchase an interest in any of the listed funds. Such an offer can only be extended after an investor has received a confidential offering memorandum concerning the fund. All investors must be qualified purchasers as defined in the securities laws.*
Wolverine is an example of a fund that uses different arbitrage strategies.

**Event-Driven** strategies seek to capture gains from price movements that are the result of an anticipated or announced corporate event. These strategies include merger arb, corporate restructurings, and activist strategies. Contrarian Capital is a hedge fund that uses event-driven strategies in its portfolio.

**Fixed Income** strategies focus on the inefficiencies in fixed income securities from temporary dislocations between related types of bonds or other instruments related to troubled companies or debt issuers in some crisis. Duration Capital and Lancelot are hedge funds that implement fixed income strategies in different ways.

**Long-Short** strategies focus on the simultaneous investment stance of being long and short, typically in equity assets or derivative financial instruments. The portfolio may be net long, net short, or neutral. Braeside Capital and Oak Street Capital are two hedge funds that implement equity long/short portfolios.

**Macro** strategies may be long or short in a multitude of financial instruments globally including equities, bonds, currencies, or commodities. These funds tend to be highly leveraged and rely on rapid trading execution. Quantum and Highbridge are two large and infamous hedge funds that play the global macro hedge fund game.

**Multi-Strategies** funds employ multi-fund or multi-manager strategies that provide lower volatility though broad-based diversification. This strategy may also be organized as a fund of funds. These funds will allocate across multiple styles, strategies, and trading strategies. Halcyon, 1794 Commodore, and Guidant Capital are examples of a single hedge fund and fund of funds that utilize a multi-strategy approach.

**Sector** strategies will focus on investment activities not closely aligned to a market or investment technique, such as emerging market debt or emerging market equity that focuses on analysis of nondeveloped countries, capital flows, and economic development. Sector funds may also be employed to establish long or short positions in specific sectors such as health care/biotechnology, energy, or electronics. Sail Pacific Explorer, CCI Healthcare, and NS Utility fund are examples of different types of sector specific funds.

**Trading** strategies are dynamic trading programs that are characterized by high trading volume and high volatility. The instruments used may be currencies, managed futures, or options. John W. Henry and Renaissance Asset Management are two well known hedge funds that implement diverse trading strategies.
These brief descriptions will serve as a guide to the due diligence discussion. There are many variations of the theme; however, most hedge fund strategies can easily be placed in one of the above categories. The operations of any given fund may use one or several different methods to implement their strategy with little to no leverage or a lot of leverage. Each manager tries to implement the strategy in such a way that it provides an edge, or an ability to provide alpha.

**FINDING A COMFORT ZONE**

The understanding of what is the strategy employed is only the first step. Investors also need to be comfortable with the type of underlying instruments the fund may invest in. A general rule of thumb, used by many seasoned investment professionals, is if you don’t understand the strategy or instrument, run, don’t walk to the nearest exit. Performance, leverage, and fees are essential to understanding the underlying business sense of a hedge fund. The level of detail an investor receives from the fund with regard to fund performance, fees, and operations gives the investor confidence that the general partners share some of his interest in the success of the fund, as well as taking prudent actions to limit excessive risk on investors’ capital. An investor needs to fully examine how performance and fees are reported in order to evaluate whether or not he will earn sufficient return on capital, the sources of those returns, and whether he is ultimately getting what he paid for.

A deeper understanding of a hedge fund is not limited to its investment program. The majority of hedge fund failures have been caused by operational inadequacies. Examinations of past failures by EdHec shows that 50 percent of the failures were due to operational issues and 38 percent were due to investment issues. Additionally, some strategies are more prone to failure than others. More than with other investment vehicles, hedge fund analysis requires a quantitative and a qualitative review. Rigorous analysis can lead to uncovering shortfalls in the business or the investment process. Sometimes a simple telephone call to the named auditor or reviewing third-party vendors for an affiliation to the fund can save investors pain. This first-hand lesson was learned by investors in Bayou and Wood River, whose stories we will discuss in Chapter 10.

Despite all the academic work that is being done, analysis of hedge funds is as much an art as a science. Many of the mathematical measures that work nicely with traditional long-only investment vehicles are not effective in providing significant insights into hedge funds. As newer, statistically significant methods are being developed, reliance on qualitative measures has increased
in importance. It is instructive to note that, when examining hedge funds, quantitative analysis provides questions, not necessarily answers. Numbers viewed in isolation do not provide adequate information. For example, a manager reports a return in a high yield fund of 18 percent. Did he do well? Maybe. How did the high yield index perform? What level of leverage did he or she take? Did the fund successfully make money throughout the year? Did it make money in the long book and the short book? What was the gross and net exposure throughout the year? How does that return look in view of the prior year’s performance? All of the numbers need to be examined in context of the overall objectives and operations of the fund. This will be further discussed in Chapter 7.

A LOOK BENEATH THE (BOOK) COVERS

One of the most effective ways to analyze these shadowy beasts known as hedge funds is to divide the analysis between art and science. The science deals with the litany of Greeks (alpha, beta, and so on) that are the result of some mathematical measurement of financial activity. Quantitative number crunching is the hallmark of most due diligence processes. The qualitative view deals in the literary aspect of the fund and its terms: SEC registration, broker/dealer affiliation, pricing policies, and third-party vendors only begin the list.

Whether you use a routine screening process or are a one-off buyer, the first cut is undoubtedly alpha or Sharpe Ratio, standard deviation, and may be drawdown (a losing period in the investment record). This is typically followed by a perusal of marketing material and maybe a call to the fund itself. Taking the guided tour of a hedge fund is not a sound way to invest your dollars. The important issue that needs to be remembered is that, regardless of whether you are an institutional investor or a recreational user of hedge funds, the process by which you compare and evaluate the funds should be in-depth and consistent each and every time.

In the chapters that follow, I offer some other measures for analyzing hedge funds. The Sharpe Ratio is widely used as a measure of risk-adjusted performance. Unfortunately, the mathematical precision of this measure is better suited for investment vehicles with normally distributed returns, or traditional long-only funds. The use of standard deviation as a measure of risk will also be discussed. Standard deviation in essence gives equal weight to upside and downside risk. Investors do not. I, like others much smarter than I, have difficulty grasping a concept as upside risk. I tend to believe that an investor would take all of the upside risk he could carry. Additionally, the measure adds little value to the asymmetric returns of hedge
funds. Later we will take a closer look at downside deviation and downside capture.

In the global markets, investors are beginning to see some weakness, and those using concepts of normal distribution curves and randomness of returns will see their portfolios become quite vulnerable. The statistical 100-year events are now happening at a pace of every three to four years. The use of well structured hedge funds will allow investors to garner higher risk-adjusted returns and ride through what is beginning to be an interesting period in the financial markets. By their very nature, picking appropriate hedge funds is more complex than picking long-only funds, and the analysis is deeper and more complex.

Analyzing past performance is the science part of the process. Investors should be cautioned, however, that past performance is indicative of nothing. It does provide insight and a bit of direction on how a hedge fund manager may have allocated his or her capital under different conditions; however, it will tell you little if anything about the future. More importantly, investors need to pay particular attention to operational and business due diligence. The majority of funds that default or close do so because of operational issues. Uncovering these defects requires more leg work and understanding of the business itself. This is the art part of the equation.

In the upcoming chapters, the discussion will flow from the Investment Policy Statement (IPS), where investor guidelines and expectations are set, to the quantitative measures, qualitative rankings, and monitoring your managers. I have found over the years that quantitative numbers have generally raised more questions than they have answered. In the quantitative section, there will be some discussion on whether investors should focus on what appears to be high risk emerging funds, or gravitate to the perceived safer, more established larger funds. Regardless of the precision of the mathematics, investors will learn more about the fund itself from a close-up look at the people in the fund and how they manage the business. This matrix of art and science opens a picture into the soul of a hedge fund operation. It is imperative that investors use a consistent roadmap to due diligence and do not get consumed with an arrogance that will surely lead to missing an opportunity, or worse, to a downfall. The hedge fund business is full of intelligent people. You do not need to be the sharpest knife in the drawer, just the most diligent.

AS YOU BEGIN

The process of beginning a hedge fund search must start with an investor's Investment Policy Statement, or IPS. The comfort offered by past returns
should be only of passing interest. How the funds are currently investing, operating, and dealing with the markets and investors should be of paramount concern to you. The past is not always prelude to the future, and with a certain stick-to-itiveness and unconventional views, you can help improve your portfolio returns and avoid some common landmines that often plague hedge fund investors.

MADOFF

I would like to add one final note. Subsequent to this book being written, the investment world has been shaken once again with the discovery of the largest Ponzi scheme in history allegedly perpetrated by Bernard Madoff, the former chairman of NASDAQ. What is most surprising is that many sophisticated investors and hedge funds were taken in by Mr. Madoff. The truly unfortunate part of this tragedy is that many folks are financially ruined as a result of this scheme.

As future hedge fund investors, it will be invaluable to follow the Madoff scandal. Many of the red flags of problem investments were waving long before the end arrived. Investors violated tenets of diversification by placing all or substantially all of their assets with the fund. Conflicts of interest arose from trading and brokerage, audited statements provided by a storefront entity, manual confirms from a makeshift back-office, and returns that defied reason, probability, and belief. Add this to an unbelievable stealth atmosphere of the fund and bells should have been ringing even for the tone deaf.

As with all examples, the purpose is to learn and not make light of the tragic losses people have suffered. It is important as you read the following chapters that a healthy skepticism along with hard work may keep you out of a similar situation.
CHAPTER 1

Asset Allocation and Fiduciary Duty

Investment Policy Statement: The Roadmap

Diversification is for those investors who don’t know what they are doing.

—Warren Buffett

The Wizard of Omaha takes the approach that a savvy investor should concentrate his money in only his best ideas, but this is a difficult approach for mere mortals. Instead, it is much more advisable to develop a long-term plan that encompasses the investor’s goals and expectations and tells how best to achieve these goals. The basic building block for any investment portfolio should be the Investment Policy Statement (IPS). Whether you are a small individual investor, a foundation or endowment, or a multi-billion dollar global pension fund, the initial step before investing the first dollar should be the written guidelines of an IPS. The IPS is now part of accepted best practices.

The Investment Policy Statement serves as a roadmap for investors, consultants, and fund managers. There are four basic purposes of an IPS regardless of the size of the investor’s portfolio.

1. Identify the objectives that the investor expects from these funds. Time horizons, liquidity, and risk/return expectations will be quite important as to which investments will be most suitable. The required rate of return should drive much of the design process.
2. Define the asset allocation policy. Asset allocation may arguably be the most important part of the IPS.
3. Create guidelines for selecting investment options.
4. Establish guidelines to monitor the portfolio.

The IPS outlines the how and why of investing in alternative investments. It will provide a detailed explanation of the returns expected, the risk level, and the type of fund the investor is willing to assume. Appendix A contains a sample IPS.

**DETERMINANTS OF PORTFOLIO PERFORMANCE**

The publishing of the Brinson, Hood, and Beebower research study (1986 and 1991) on the contributions of asset allocation over the long term to investment returns has increased focus on the need for diversification of investment portfolios. Once the time horizon, risk tolerance, and asset allocation policies have been established, the selection of managers becomes a critical part of the implementation of the asset allocation policy. Much of the benefit of a sound asset allocation plan may be undermined or negated by a manager selection process that is ineffective or inefficient. If the selection leads to poorly-performing managers, asset allocation will not save the investor. The Brinson et al. study and results were reprinted in the July-August 1995 Financial Analysts Journal during the roaring bull market of the 1990s, in which concerns for diversification were lost in the rising euphoria of the tech bubble.

As a brief review, the study compiled data from 91 pension plans that had complete quarterly data for a 10-year (40-quarter) period, beginning in 1974. The study measured actual and passive returns for the portfolios, which contained allocations to stocks/bonds/cash equivalents. The results showed the average plan lost 66 basis points per year in market timing, and another 36 basis points per year from security selection. Or more succinctly, the study concluded that asset allocation explained 93.6 percent of the variation in a portfolio’s investment returns. Another interesting but little discussed result reflected the historical tendency of investors to move to the same policy mix.

Over the past 20 years, this study has been the focal point of many debates on the importance of asset allocation in portfolio management. Further analysis concluded that the actual result of the study was not total return, but volatility. The two are related but invoke an entirely different result that investors must remain aware of.