

## Does Your Manager Drive Too Fast?

### Investments & Pensions Asia – 2008 4<sup>th</sup> Quarter Edition

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***Even seemingly secure hedge fund managers can crash and burn. What are some of the tell-tale signs of trouble? Albert Chiu and Michael Langton offer some insights and suggest some key due diligence questions***

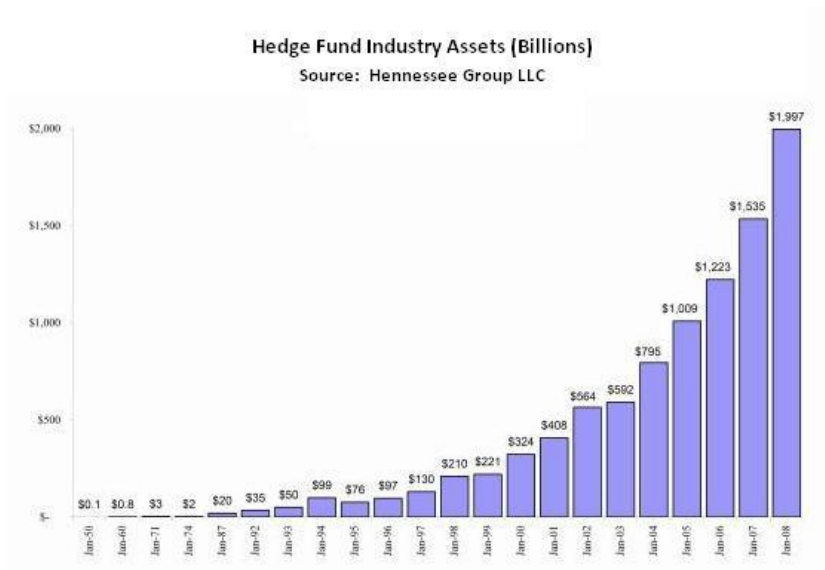
Initially, I thought it was a ridiculous question. An investor asked a hedge fund manager whether he had received a speeding ticket. If so, how many tickets did he rack up and by how much did he exceed the speed limit for each infringement? After further thought, I realized the answer to this question, assuming a truthful answer is given, could reveal a great deal about the personality of the manager. Is he an adrenaline junkie who approaches trading and other aspects of his life with the same reckless abandon? Does he impatiently speed to his destination even if it means excessive risk taking and breaking the rules of the road?

You will certainly find people like this working in the industry, perhaps for a hedge fund with a Latin name like *Indissolubilis* – meaning indestructible. Let's imagine the manager's name is Fred. Everyday Fred can be seen driving his Ferrari at 120 miles per hour, swerving in and out of traffic with nimble dexterity that allows him to get to his destination in half the normal time. Admittedly, he is a skillful driver, and not once has he been in an accident, which instills in him a great sense of invincibility.

This attitude might logically extend into his trading strategy, where he is managing ms of dollars of *other* people's money. Unbeknownst to the clients of *Indissolubilis*, in his egotistical endeavor to outperform his peers in half the time, Fred invests in some very risky ventures, leverages them to the hilt, turns a blind eye to investment restrictions and may even break the rules with the occasional insider tip. Despite some of his questionable methodologies, he clearly exhibits skill as he adeptly navigates the markets and reads its momentum like an intensely focused surfer masterfully carving up a large pipeline wave, moving in and out at the right time. But alarmingly he no longer appreciates or respects the jagged coral and other threats that lurk below the waterline.

For most of the last three years, his trading returns have been stellar, beating his competition by a wide margin. In his investor communications he claims that his performance is due to superior security picking and market timing skills, top-notch risk management and infrastructure, solid research and an adherence to stringent security selection criteria. Over conference calls he peppers his investors with performance measures such as an incredibly high Sharpe Ratio, eye-popping YTD returns, all on seemingly low volatility. He gives every impression of being the real deal.

Figure 1. Hedge fund industry assets (bns)



Some investors try to probe deeper and ask for performance attribution and risk reports, trying to understand exactly where alpha is coming from and to gain more transparency on the risk being taken. These investors are taking the right approach, but Fred calmly asserts that he does not want to reveal too much for fear of disclosing his “proprietary methods” which would then make him lose his competitive edge. Although not completely satisfied with the answer, the investors, happy with their fat returns, decide not to push him any further. In fact, they happily write out cheques for further allocations to Indissolubilis.

Truth is stranger than fiction and these characters do exist, as many of us have seen. Whether it is their larger than life egos that blind them, or they knowingly take on excessive risk, or they look to intentionally defraud their investors, these managers are out there, right now, playing with large sums of money. They can look like a surefire winner for a year or two, but the initial success masks an undetected time-bomb waiting to explode. A major adverse move in the markets that goes against Fred’s highly leveraged directional bet on, say, natural gas futures, and suddenly the fund is in trouble. The investors, if they are lucky, will get a few cents on the dollar.

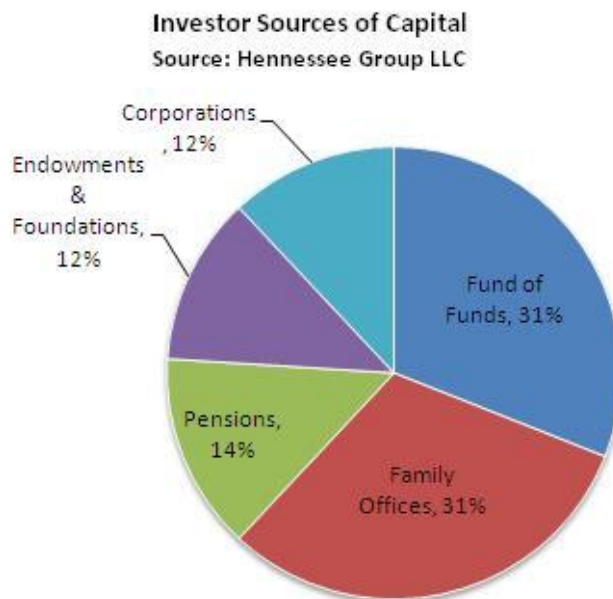
If losing all that money wasn’t enough, adding insult to injury is the fact that the fund manager, his bank account bulging from those first two years of astronomical performance fees, has just bought a multi-m dollar house in the Hamptons and is currently on vacation sipping frozen margaritas with a Jessica Simpson lookalike on a private island he just bought in the Caribbean.

Sure enough, Fred will tire of his luxury retirement and will reappear, having been handed another bn dollar portfolio. The best example of this in recent times is Brian Hunter and the infamous collapse of Amaranth. Prior to the fund’s demise, Hunter was considered a star trader and was coveted by the likes of Stephen Cohen’s SAC Capital. Even after he lost \$7bn for Amaranth, while still collecting more than \$100m in compensation, he was hired as an advisor to another hedge fund, Peak Ridge Capital.

This fund was famously up 49% in the first quarter of 2008. Prior to Amaranth, he reaped millions at first but then lost money while at Deutsche Bank and was subsequently locked out of the bank's trading system and then demoted to analyst. Just like our fictional fund manager, Hunter owns a Ferrari F430 and has had no trouble finding new job opportunities despite having lost inordinate amounts of money during previously held positions.

Hedge funds used to be the sole domain for the super-rich, so when a hedge fund went bankrupt it was usually individuals with enough personal capital to absorb the losses. Nowadays, institutional investors managing pensions and endowments are looking to enhance their returns through absolute return strategies.

Figure2. Investor sources of capital



As such, institutional investors, especially fund of funds, are aware of the importance of conducting a formal due diligence process in an effort to avoid fund managers like Fred and hedge funds like *Indissolubilis*. As new funds are launched every day, institutional investors should be expending considerable time and resources on a thorough operational review. However, I do not believe this is the case at the moment.

Typically, when an investor visits a hedge fund for the initial due diligence, an interview is conducted with the fund manager on the trading strategy which will last for an hour or so. This is often followed by a lengthy questionnaire being sent to the manager, addresses areas including historical returns, investment approach, risk management, system infrastructure, staff backgrounds, service providers, business continuity planning and other inquiries regarding the operations of the fund. This generally concludes the due diligence process. An investment decision will be made after a few months of tracking the manager and analyzing returns.

The above process bears much resemblance to a job interview which generally begins with face-to-face meetings followed by reference checks. But how much will the interviewer know about the candidate's

true performance and ethics through this process? Not much, I venture, and if that's the case, how can an investor be comfortable with the above due diligence process performed by a fund of funds or other investor advisors, particularly when there is a lock-up period for their investment?

Instead of only interviewing with the fund manager, what investors should be seeing is the entire office - which includes risk management and back office personnel. As these are the people performing the daily control functions, the checks and balances. Investors will then get a better understanding of the existing internal control procedures and the level of operational risk embedded. Many venture capitalists have now adopted the practice of speaking directly to mid-level management and support staff believing that these people have not been coached to provide the "preferred" answers and can actually provide valuable insights.

As most fund managers are managing other people's money, they may not have a problem paying for benefits that they can receive either personally or for their firm -- from broker dealers or other service providers anxious to obtain their business. Therefore, investors should conduct an "independent operational review" by obtaining data not from the fund manager, but directly from the fund's service providers as well. Some of the items to include in this in-depth review can be:

- Risk limit policy and monitoring procedures;
- Valuation and pricing policies;
- Review of portfolios for adherence to stated limits;
- Review of information systems and technology;
- Review of contract marketer agreements;
- Inquiries into wire transfer reports to ensure no funneling to unusual bank accounts;
- Examination of any extraordinary charges being expensed in the fund.

For it to be effective, due diligence should certainly be a continuous process throughout the life of the investment. In addition, the level of hedge fund transparency should increase in order for investors to gather the necessary information. Perhaps it's time for hedge fund investors to demand more participation and review.

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