Millennium Wave Investments

The following is a draft chapter from John Mauldin's new book, Absolute Returns. It deals with the due diligence process. Please note that it is a work in progress, and that the final edited version may differ significantly from this draft.

Evaluating Hedge Funds

The Due Diligence Process

1. **Why Does a Fund Make Money?**
2. **How Does A Fund Make Money?**
3. **How Much does a Fund make for the risk it takes?**
4. **Who are the Managers?**
5. **Show Me the Money**

Chapter 9- DRAFT COPY

The Due Diligence Process

By: John Mauldin

It's not what we know that will cause problems for our investments. It's what we don't know that always causes the disasters.

It's called due diligence. It's the process of investigating a fund or investment opportunity before you invest. It is the most important element of the investment process, and for many investors the one most ignored.

It is helpful to think of a hedge fund as a business. Investors would not invest in a business without asking a lot of questions, learning about the management and trying to decide if the potential returns were worth the risk.

Thinking through the questions in this chapter will make you are better investor, whether it is stocks or funds. Essentially, all due diligence boils down to these three basic questions:

1. Is Management honest?
2. Is Management competent?
3. Does the investment strategy have the potential to do well in the future?

All three questions are critical. Let me briefly touch on the third. We have all read the sentence "Past performance is not indicative of future results." It should not be read as boilerplate language. It is the single most critical aspect of successfully investing in a fund or business.

Every fund management style will have periods of good performance. Many are very dependent upon market externals. By that, I mean if the conditions are not right, they will not make money, and may even lose a great deal. As we have seen in earlier chapters, simply investing by the numbers may not produce good results. It often – quite often - produces very poor results.

You cannot determine the above by reading the offering memorandum or fund marketing materials. What fund offering material says, "We are liars" or "We don't know what the hell we are doing"?

Every hedge fund, mutual fund and public stock manager will tell you "now is the best time to invest." So do most of the professional analysts.

It is important to read the offering memorandums to get a basic understanding of the fund or business structure. But that is the beginning, not the end, of the process. You will seldom get the information you need to adequately determine whether or not you should invest in a fund in offering documents, or even adequately determine the real risks to your investment.

Let's be perfectly blunt. That long offering memorandum and subscription agreement you sign is not to protect you. The disclosure documents sent to you by mutual funds AFTER you have given them your money will not help you understand what market risks you are really taking. It is to protect the fund in case something goes wrong. Attorneys are paid large sums to think of every possible risk imaginable and then include them in the offering document, getting you to acknowledge you understand the risk. If a creative attorney thinks of some new risk or disclosure and puts it in a new offering document, that paragraph will soon start to appear in every other new document.

Offering memorandums are VERY important. Read them. Jot down questions as you do. Just remember they do not answer the most important questions.

Up to now, this book has been about helping you understand the investment climate we are in today, and what we might be able to expect in the future. Far more of your investment success will come from picking the right investment strategies (by this I mean broad asset classes) than by picking the right fund or stock. That being said, it would be very sad if you pick the right strategy but still fail because you do not do your homework on the fund or stock in which you invest.

So let's see if we can help you become a better investor.

It's 10 PM. Do You Know Where Your Investment Is?

"Hedge fund investors don't always understand what they're investing in. According to a study by Prince & Associates, three-fourths of the 384 affluent hedge fund investors surveyed didn't know their hedge fund's investment style or if they used leverage. And according to the study, those who didn't know, didn't want to know. But it makes for good cocktail chatter. Just pass the shrimp, please."[1]

I read that paragraph, and have to admit I was shocked. I wonder who they surveyed? Certainly not my clients! I hope those investors have good consultants looking after them.

In almost every case of hedge fund fraud, the investors simply did not do their homework. If investors went through a due diligence process like the one I describe in this chapter, it is highly unlikely they will end up in a fraud. (Just to set the record straight, investor losses from hedge fund frauds are a tiny (less than 1%) fraction of the frauds just recently discovered on Wall Street.)

The far larger risk to your money is not fraud, but incompetence or poor management. Investing in hedge funds without proper due diligence is like throwing the dice. Maybe you get lucky, but more likely you will end up unhappy, at the very least.

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[1] Rich Peebles from www.prudentbear.com
http://www.prudentbear.com/archive_comm_article.asp?category=Market+Summary&content_idx=12111

If you go through the process, it is much more likely you will end up with a fund that is a match for your goals, and fits into your investment philosophy. You won't be having to jump from fund to fund, chasing last year's earnings. You will know what to expect, and won't get nervous when the occasional drawdown occurs. You will also have an idea of what situations – and not your emotions -- will cause you to exit the fund.

Finding a good hedge fund is not easy. There is no Morningstar of hedge funds like there is for mutual funds. It is not that there are not a lot of hedge funds, but that there is no central source for listing funds. Industry sources tell us there are at least 6,000 hedge funds and private pools by the latest estimates, and some knowledgeable industry analysts now put that number closer to 7,000. My guess is that less than a third are in the public databases. (A third of the hedge funds in my fund of funds do not list themselves in the public databases.)

I recently saw a study which analyzed two public hedge fund databases of over funds, but there was only 30% overlap between the two databases. Their was only a combined 2,000 unique funds in both databases. This all goes to say that finding a good fund is hard work.

There are a variety of styles among hedge funds. Finding the style that is right for your investment needs is critical. Some hedge funds managers are good and some are just lucky. You do NOT want to invest in the lucky one, as luck always runs out, typically just after you invest. There are any numbers of ways that managers can hide problems in their management styles. It is important to uncover them before you invest. Hedge funds are businesses. The business side of the fund is just as important as the investment side. Are the managers good businessmen as well as smart investors?

The Due Diligence Process

Institutional investors, family offices and hedge fund analysts like myself usually have a lengthy list of questions we ask to prospective hedge funds. These questions are designed to give us the information we need to evaluate the fund. Further, they help us decide between funds which are similar in style and performance. There are hundreds of market neutral and long-short equity hedge funds. Choosing between one or another can be difficult.

As an example, I might want a 15-20% exposure to convertible arbitrage in my fund. There are scores of such funds, and a number of them may make it through the initial screening rounds. On the surface, the funds may look alike. They may even have similar trading styles. What would make me choose one fund over another? Which fund has the best "edge"? In many cases, it comes down to comfort levels. How much confidence do I have that my money (and that of my clients!) is being managed well and is safe?

In the process of writing this chapter, I sent an email to a number of my friends in the hedge fund community, and asked them to send me their due diligence questionnaires. I also asked a number of hedge funds to send me some of the questionnaires they get which they thought were particularly good. As you might suspect, the majority of the questions were similar. But what was interesting to me were the differences.

Most of the forms had one or two sets of questions designed to ferret out a particular set of issues or problems. My deep suspicion is that these differences were brought about by the authors having experienced an unpleasant relationship, and the questions were designed to avoid that problem in the future. I must confess that my own forms were not an exception to this rule.

I began to compile and organize the questions into one due diligence document. I was amazed at the length of the document as I finished. I decided I must cut the number of questions down, as they numbered over 100, and many were multi-part.

The problem was, however, that as I reviewed the document over a few weeks, each piece of information was important, and gave further insight into the company or comfort about the safety of your money. There was not one question I wanted to delete, and again I must confess I added a few more questions as I thought through the process.

The questions are designed to give us insight into the fund on several different levels. The most important thing to understand about a fund is "Why" it makes money. If you cannot understand the "Why" of a fund, you should not be investing. This is the critical question that will help you understand what the dominant factor in performance of the fund is: skill or luck. As I stated earlier, luck always runs out, typically just after you invest. More funds are based upon luck or random chance than you might think, but I can guarantee you no fund manager will admit it, and most of them would be insulted if you said so. Genius is a rising market, and good performance has persuaded more than one manager they are geniuses. Avoiding such genius is crucial to capital preservation. Finding true investment ability (genius or not) is the secret to capital growth.

The next most important question is "How" the fund makes money. What are the strategies and systems used, and what is the risk taken?

If you can get a good feeling about those two questions, then you follow up with the more mundane but critical questions of "Who", operational issues, structure, safety of assets and, of course, performance.

I have thought long and hard about the best way to write this chapter. A dry listing of the questions is not fun reading, and yet general commentary on the questions or the process is not as instructive as I would like it to be.

What I have decided to do is to simply list the questions, and to make comments on the questions that are not basically obvious. As you read through this, think about the investments you already have. Think about the stocks you own. If you are a high net worth investor, my bet is that you are asked to invest in a lot of private start-up companies and funds. You should be asking many of these questions for every investment you make. I think going through this questionnaire will make you a much more thoughtful and better investor.

One final comment before we jump in. Having the answers to these questions is not enough to truly evaluate a fund. Whenever possible, I want to visit with the management of the fund at their offices. I want to get to know the people who will be managing my money.

I have developed a rule which I simply will not break, learned over many years, and sometimes the hard way.

I will not invest with someone I don't like or if there is some question left unresolved in my mind, even if it is only intuition. Period. No matter how good the track record looks, or how compelling the story, I simply walk away.

That doesn't mean I have to get warm and cuddly feelings. I am not expecting to be their best friend. On the contrary, it is quite possible that I will someday have to redeem my money from them and getting too close can make that process difficult. In general, it is better to keep the relationship on a positive professional basis. (That being said, most of the people I deal with are genuinely nice and a pleasure to be with.)

I am a pretty easy-going guy. Like Will Rogers, I have never met a man I didn't like. Many of the best traders and managers are not "people" persons, or they may be intensely iconoclastic, shy or introverted. But they are still nice people with good ethics and standards. I always try to give everyone the benefit of the doubt.

But sometimes after meeting a potential manager, I develop a sense that this is not a person with whom I want to do business. Something just doesn't feel right, even though I cannot always put a finger on it. While there are very few occasions when this happens, as the hedge fund world by and large attracts some very interesting and engaging personalities, when it does it is always a wise thing to "go with your gut." That is advice, by the way, which is given and followed by many professionals in my position.

Unfortunately, there is nothing like a standard due diligence form. Frankly, if you are a smaller investor, the chances of you getting a fund to answer all these questions is not good. But it is likely they have similar forms, and many of them will send you one of the forms they have filled out. If you are using a consultant or a fund of funds to do your due diligence on your behalf, it might be useful to see what form they are using.

My comments are in san-serif type, so as to distinguish them from the questions.

Due Diligence Questionnaire

A. General Information

1. Company Name:
2. Fund(s) or Program(s) Name(s):
3. Offshore/Domestic Sister Fund:
4. Manager(s):
   Address(es):
5. Primary Contact(s):
6. Phone:
7. Fax:
8. E-Mail/Web Site Address:

B. Business Structure

1. Describe the origins and history of the company. Who were the founders of the company and are they still active. Are there any new principals? If relevant, describe the important events and experiences of management which give the company its "edge."

   Every fund manager, almost without exception, will tell you they have a "proprietary system" that gives them their "edge" or ability to profitably trade. This question is the start of the process of trying to determine what their edge is. These funds are charging very high fees, and they should bring some edge, knowledge or ability to the table that will truly add to their performance. Presumably you are looking at them because their performance is good. (We seldom look at funds with bad performance.)

   You want to find a reason that their performance is good. More often than most of us would like to admit, good performance in a fund or investment has been a result of random chance and not because of good investment practice and skills. Their positive returns simply benefited from being in the right market at the right time. As an example, the literature for the Janus 20 technology mutual fund in which my wife had some of her money in the late 90's told us their performance was due to their exceptional ability to analyze companies. They were still telling us the same thing in 2001, except it began to have a hollow sound.

   Their returns had more to do with a bubble in technology stocks and a lack of diversification (which made them exceptionally risky) than any ability to pick stocks. They were in the right place at the right time. Mind you, there is nothing wrong with that. We are all trying to find the sweet spot. But they confused luck with skill, and didn't move when it became the wrong place. Many of the questions you will read below are designed to help us try to see if we are dealing with luck or skill.

2. Describe the ownership structure of the company and its affiliated companies including marketing arms (an organizational chart would be helpful). Include a description of the division of power and authority of the principals.

   This is designed to give you a feel for the organization. For instance, I generally like to see someone besides the manager doing the marketing. While I may talk with the manager at some point, if he is spending too much time marketing, he is not managing my money. I want to see staff in charge of compliance, administration and operations, generally someone who is not responsible for trading or investing. These can be time consuming activities, and if a manager is doing them all or a part of them, he is not focused on the most important thing, and that is making you money.

3. What is the length of the current business structure and have there been any changes?

4. What is the number and who are the decision makers and what is their tenure? Who is on the Investment Committee? Who and how many Research Analysts are employed?

5. What are the primary sources of investment information/resources used by the firm and how are they utilized? Are these provided by suppliers or paid for independently? Does the fund use consultants? Are they paid for by the fund or by the management firm?

   Does management create its own system, or do they rely on outside sources for trading direction? Some managers simply follow models developed by other managers, or follow trading services. How much discretion does a manager use if they employ such services? Funds of this type are not really adding value. Many brokerage firms supply costly information services in return for trading business. Later on, we will want to know at what level the fund is paying commissions.

6. Please provide biographies/resumes of the principals and key employees. (Please include current residence; past employers; colleges/universities attended; marital status/children, outside activities and organizations, etc.)

   How busy are the managers? You want to know something about their personal lives, especially in smaller organizations, because major changes in someone's life can have an impact on how they trade. Are there stabilizing factors in their lives like family or church? In conversations I like to know what they read for pleasure, what kind of activities they go to, where they spend vacations, etc. You are trying to get to know the person and see if there is a balance. For large funds with dozens of traders and staff this is not as critical, but many (if not most) funds are smaller, and the behavior of key personnel can have a major impact on the fund.

7. How many are on staff (by division) and what is their background? (Trading desks, operations/administration, etc.)

8. Have you ever lost any key personnel and if so, why?

   In smaller firms, this can be a key question. The track record may be due to someone who is no longer with the firm. One of the warning signs I look for is the departure of key personnel. I once avoided a fund, which by all appearances was doing well, because the marketing director left just as the marketing was getting easy, and no one could give me a good reason for his departure, and he was under an agreement not to speak. The fund later developed problems.

9. What plans, if any, are there if a key person was to become unavailable for an extended length of time? Are there any health problems among key personnel? How often do principals and key personnel have physicals?

10. Do all professionals in the firm have an exclusive contract with the firm? In what outside business activities are the principals and key employees engaged?

11. Summarize the turnover (by departures and new hires) of investment professionals for the past three years, by year.

12. Are the principals and staff investors in the fund (what is the approximate percentage of the principals net worth invested in the fund)?

    This is a very important question. I want to see the managers have a large portion of their personal assets in the fund. If they don't eat their own cooking, then why should I?

13. Are any of the principals or staff related? Does the firm do business with outside vendors with family connections?

    If there are family connections, then you need to ask about fees, costs, etc. Since most funds have the investors pay the administrative costs, you want to make sure these are done at arms length negotiated fees.

14. Please describe the general principles for principal/employee compensation. Who in the firm receives incentives?

15. How direct is the relationship between compensation and power?

    These 2 questions are important. Many funds use a number of traders and analysts. If key personnel are not properly rewarded, they will eventually leave for greener pastures. That is obviously not good. However, you want to make certain that traders are not given an incentive to take large risks. Good trading talent is a rare thing. It needs to be nurtured and taken care of.

16. Does the firm use outside (third-party) marketing firms? Are the terms for clients introduced by these firms different than those who come to the firm directly? Are outside marketers paid by annual flat fees or by a percentage of the income from the money they raise?

    It's all about the money. This can have important implications. Let's say you are introduced by a third-party marketer who gets 25% of the fee income. When the fund gets close to capacity, it could be very tempting for the fund managers to forcibly redeem you and take money from another person from whom they get full fees. This also let's you know if management is open to negotiation on fees. While smaller investors have little ability to negotiate, larger funds and investors might be able to find some wiggle room, especially with newer funds.

17. What is the size of assets under management? What were the assets under management at the beginning of the last five years?

1) fund assets 2) strategy assets 3) total firm assets

18. At what size will the fund/strategy stop accepting new money and why will you stop at this level.

Is the fund growing too fast? How much new money can the fund actually put to work in any one given month? Is there a discernible negative correlation between growth and earnings? Growing too fast can seriously dilute earnings for some hedge fund strategies. Other strategies can only be effective at certain levels. When the funds grow beyond that level, they begin to dilute earnings. While this may allow the manager to make more money, it does not help the investor. Interestingly, if a manager has a large part of his own money in the fund, diluting earnings can cost him money, which is why you want to know how much they have the fund.

19. What is the current client mix?

a) Approximate number of clients?
b) What is the mix between institutional, fund of funds and individual accounts?
c) What is the mix between managed accounts and fund investments?
d) What is the percentage of assets controlled by your 5 biggest investors (or consultants, should they control/influence more than one investor)?
e) What percentage of your investors are onshore vs. offshore?
f) What is the turnover of your investors?

Different investors may have different priorities. If one class dominates a fund, the temptation might be to skew the fund management to please those clients. If the fund is dominated by several large investors, how reliable and stable are they? Are they “hot money”? If a fund is susceptible to losing several large investors, it could seriously change the income structure of the fund manager. Having to let go employees and cut back on services could impair the fund severely. While this may not be an issue, if there is a large concentration among a few investors, you will want to closely watch assets under management on a monthly basis.

20. What are the current and next priorities for the firm (asset growth, increase/improvement in staffing, implementation of new trading strategies/programs, etc.)? How do you intend to make them happen and who is responsible for implementation?

A hedge fund is a business. Every well-managed business has goals and priorities. Are the ones of the fund reasonable? Will they help the fund become more profitable?

21. Is the fund particularly advantageous or disadvantageous for tax exempt investors or tax paying investors?

C. Strategy Information

This section is quite critical. This is where we try to find out if the managers are gunslingers who have just been lucky or have a reproducible trading system. We are trying to find out if the track record was the result of a favorable trading climate, which will always change, or if the managers have a strategy for all seasons. If you want to keep from chasing the latest hot track record, only to find that the managers cool off when you get in the fund, this is where you must begin.

You can't know until you "look under the hood" if a strategy is right for your portfolio. Simply knowing that a fund is a convertible arbitrage or a fixed income fund is not enough. There are many ways to trade fixed income or convertible bonds. For instance, some fixed income funds are designed to make money when credit spreads are narrow and others prefer widening credit spreads. While the track records may even look similar, the underlying strategy can be as different as night and day. If you are putting together a portfolio of funds and want exposure to more than one fixed income fund, you will look for funds that have different trading strategies. Putting two funds in a portfolio that use the same strategy is not true diversification.

This section also let's me keep one of the basic rules for fund investing: never invest in a fund if you can't understand what they are doing, or if they won't explain what they do. Some investors are comfortable with "black boxes." I am not. Maybe it is the anecdotal evidence I have picked up over the years, but it seems like the funds which have the most problems are the ones with "black box" strategies.

Now I must confess that there are some strategies I simply cannot understand. While I can grasp the concepts generally, the details are simply out of my experience level. If everything else checks out, then I bring in an outside consultant or a friend who is experienced in that market and have them meet with the manager. I frequently find that the "third party" can explain the concepts to me.

1. Describe the trading approach or strategies used. If there is more than one approach used for the fund under review, please specify the differences between the various systems and upon what basis capital is allocated to each approach.

Some funds are one-trick ponies. For certain styles, that is good, and you want to make sure they stick to their knitting. Other types of funds need multiple trading strategies for different investment climates. An equity based hedge fund which never changes its strategy to conform to the volatility of the market is going to disappoint you in the future.

2. What trading/investment instruments are used?

3. What drives the performance?

   Not knowing the correct answer to this question can cost you money. For instance, one of the steadiest, high performing hedge funds in the 90's was a market timing fund. But after October, 2001, their fund performance went flat.

   They were very good throughout the years at avoiding large losses, and still are, but their particular system appears to need a bull market to actually make a profit. If your view is that we are a long way from the next bull market, then funds like this should be avoided. The difficulty is in spotting that trend (the need for a bull market) prior to its development.

   If the performance is tied to certain types of economic environments or market volatility, then you have to ask yourself, how likely is it that that climate will continue in the future? Does the fund manager have a plan to adapt to new environments other than waiting for things to change? Does he have the demonstrated skill sets needed to function in a different type of investment climate, or will he be educating himself on your money?

4. Have there been any material changes to the investment approach used for the fund during the performance record period (reduced/increased leverage, new parameters, new markets)?

   Many hedge fund managers are constantly tinkering with their trading systems. If there have been changes, you want to know why and for how long has the new, improved version been in place. You also want to know how the manager determined to make a change. Some changes, based upon back-tested data, can produce wonderful theoretical results, only to have the climate change resulting in large losses. If changes, such as the use of leverage, are the result of a manager's discretion or "feel" for risk, you want to know what criteria is used to make that change, and how comfortable you are with the decision-making process.

5. How is money made or lost?

6. What is your firm's edge or expertise? What makes your strategy unique?

7. What percentage of trading does each strategy represent and give ranges if applicable?

8. What percentage of trading is in non-listed instruments?

9. What percentage of trading would you deem to be "illiquid" instruments?

You want to make sure the liquidity of the fund's assets and their redemption policy are compatible. If investor's start to exit a fund with a large portion of illiquid assets, you probably don't want to be left holding the bag.

10. What is the best market environment for your trading?

11. What conditions cause "normal" losses for you? Unusually "large" losses?

12. What would you consider to be an abnormal loss and what would cause this to occur?

13. What efforts are made to limit the losses mentioned in questions #11 and #12? Is it automatic or discretionary?

14. How large of a loss can a position sustain before it will be closed out? Is there a risk control element in place at all times (i.e. a constant hedge of some amount)?

15. How many positions are typically in the portfolio?

16. How much capital can be allocated per position (to the best ideas)? What is the highest percentage of the capital that can/will be devoted to a single position?

17. What is the methodology to invest new assets relative to existing positions and over what time frame do new assets get invested?

18. What process is employed for a withdrawal, redemption or cut back in equity?

19. Is leverage used, how much, and if so how do you define/calculate leverage?

20. Will leverage be used to increase the position size of only certain positions or is it allocated to all positions?

21. Please provide the maximum historical leverage; minimum historical leverage; maximum authorized leverage; and typical leverage employed. If leverage fluctuates, who determines the level of leverage at any one time and upon what basis?

22. If applicable, please give the Option Adjusted Spread, Option Adjusted Duration, and Option Adjusted Convexity of the portfolio, along with their target ranges?

23. How long would it take, with normal conditions, to liquidate the fund's entire portfolio and what would be the effect on NAV?

24. Who are your primary lenders/sources of financing? Are you trading in the name of the fund with your source of financing?

25. Does the leverage create income subject to UBIT(Unrelated Business Income Tax)?

This applies to pension funds and IRAs. These investors will need to use an offshore vehicle if they want to get into a fund which uses leverage.

26. Where do most of the trading/investment ideas come from?

27. Give a life process of a trade both profitable and unprofitable.

28. How long is the track record and what is the historical monthly performance?

29. When does the record begin?

    a) Is any of it pro-forma? If so, give details as to how and upon what basis the numbers were produced.

    b) Is all of it audited?

    c) Is it net of all fees?

30. Questions concerning volatility: Was an annual return generated by large gains in one or two months? Or was the annual gain spread across the period? Examine the peak to valley drawdowns. How long did it take you to recover? How volatile is the fund relative to its peers? If more volatile, please validate the excess risk. Why did a recovery occur? Did you change your strategy? Or did market conditions improve?

31. Questions concerning breadth: Did you turn an even profit in all issues or has there been a concentration that accounted for the majority of the gains of the fund at any one time? What is the average number of investments in the portfolio? What is the breakdown in terms of long and short?

32. Questions concerning repetition: Is the fund's investment process easily repeatable or did an isolated incident cause the fund to report good performance? What has to happen for the performance to be able to repeat (good analysis, availability of certain investment instruments, opportunities, etc.)?

33. What benchmark do you feel is most appropriate against which to measure performance? Why?

34. If a trading model or strategy is used, under what conditions do you override the model?

35. Please discuss the circumstances of the largest three drawdowns and were there any changes in the overall strategy as a result of it?

36. Have there been changes in your trading strategy which would render a portion of your track record less meaningful to a current evaluation?

37. Who is responsible for executing the trades (provide name and experience) and do they have any discretion over the assets in the strategy?

38. Do you perform stress tests on the portfolio?

Risk Analysis (Please answer all applicable and/or relevant questions)

This is important, and not just for the obvious point that controlling risk is a key to good investing. Sometimes, when building a portfolio, you can take funds or managers who approach a particular investment market and have such uniquely different approaches that the combination of the two reduces risk. You can't determine this by just doing correlation analysis on a fancy piece of analysis software. You have to acquire a basic understanding of how a fund creates risk, and how they control it.

Secondly, by understanding the nature of the risk, you can see how that risk corresponds to other types of risk in your portfolio. Different funds, with seemingly different investment strategies, may all have risk from a specific event, such as a widening credit spread or a rise in interest rates. It is only as you know the specific event risks of each fund in your portfolio that you can see if you are over-exposed in your total portfolio,

As you ask these questions, you also want to find out how a manager deals with risk on a personal level. Is the manager a Cool Hand Luke or is he simply indifferent, trusting his models and analysis? If a manager does not have active risk controls in place, which he can clearly explain to you, avoid the fund like the plague.

1. How do you identify/ quantify risk?

2. How do you control or manage risk?

3. Please describe the maximum, average range, and value as of (current date) for the Portfolio Gross Long Position (% of portfolio assets).

4. Please describe the maximum, average range, and value as of (current date) for the Portfolio Gross Short Position (% of portfolio assets).

5. Please describe the maximum, average range, and value as of (current date) for the Portfolio Net Position (% of portfolio assets).

Why the three questions? Because some funds could generate their returns on the long positions, but have more risk in their short positions. Depending upon what they trade, if the market climate changed, you could be taking more risk with less opportunity for reward.

6. Please describe the maximum, average range, and value as of (current date) for the Portfolio Beta.

   Beta is important, especially if we are in a long term secular bear market. Beta is the statistic used to denote market correlation. Beta numbers range from 1 to -1. A beta of 1 means the fund performs exactly as the index against which they are measured. A beta of -1 means they perform in the exact opposite manner. A beta of 0 means there is no correlation between the fund and the index. In general, most investors want a low beta in a hedge fund. If you were looking for a high beta, you could probably find that in a mutual fund, with far lower fees.

   You have to be careful with beta. I remember reading somewhere that a management group did an analysis of hundreds of varying economic indicators, looking for a reliable predictor of the markets. Supposedly, the most statistically reliable factor was the price of butter in Bangladesh. Beta is useful, but you need to determine why a low beta exists and that it is not just a random factor.

7. Please describe the maximum, average range, and value as of (current date) for the largest single position concentration (% of portfolio assets).

8. Please describe the maximum, average range, and value as of (current date) for the country concentration (% of portfolio assets).

9. Please describe the maximum, average range, and value as of (current date) for the sector net exposure (% of portfolio assets).

10. Please describe the maximum, average range, and value as of (current date) for the number of long positions in the portfolio.

11. Please describe the maximum, average range, and value as of (current date) for the number of short positions in the portfolio.

12. Please describe the maximum, average range, and value as of (current date) for the annual portfolio turnover.

13. Please describe the maximum, average range, and value as of (current date) for the portfolio accounting leverage (total long and total short/contributed capital).

14. How do these levels compare over the past 12 months to the fund’s historical exposure?

D. Product Characteristics

This is mostly about basics, but what you are looking for is the existence of something that is unusual. Is the auditor a small local CPA firm? Why a particular law firm? After a while, you start to see the same names, and that makes you comfortable.

In fact, I would rather see an audit from a firm like Arthur Bell or Rothstein, Kass than from a Big 4. The large firms often change lead partners, or send a different accountant every few years. I like to see boutique specialist firms who know what to look for when they audit a fund, and don't have a large personnel turnover.

When you call the lawyers, CPAs, administrators and custodians, try and get the actual staff who work on the account. You might be surprised what you can find out about a fund and its history, how well they handle their paperwork and so on, just from talking with the people they hire. If you get a funny feeling in your conversation, it should raise a big red flag. If the fund has changed auditors or administrators recently, you want to know why, and you want to call the old firm.

1. Structure (LP, LLC, LTD, master feeder, C.3.1, C.3.7, etc.)

2. Fees (management, incentive, hurdle rates, high water mark, other).

3. Subscription policy: minimums, timing, fees charged? Do you have specific terms or arrangements for fund of funds? Family offices? Large investors? Are all investors in the fund charged the same fees?

   In a study done by InfoVest, 31% of hedge funds said they were negotiable on fees and 43.7% of fund of funds said they were negotiable on fees.

   Mostly, the negotiated fees are for larger investors. But you want to ask.

4. Redemption policy: What would be the timing of repayment and would there be any fees charged? Describe lock-up period, notice periods, terms of pay-out, etc.

5. Does the lock-up period match the liquidity of the investments in the fund?

6. Are there any other fee structures, or business arrangements between the firm and/or the principals and employees and any other party, either directly or indirectly, involving rebates, etc.?

7. A) Accepted Investors

		Yes	No
A) Accepted Investors	U.S. Citizen	___	___
	U.S. Tax Exempt Entity	___	___
	ERISA Accounts	___	___
	Foreign Entities	___	___

B) Suitability Requirements: Accredited ___ ___
Qualified Purchaser ___ ___
Super Qualified ___ ___

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8. Auditor:
   Contact:
   Address:
   Phone:

9. Legal Counsel:
   Contact:
   Address:
   Phone:

10. Prime Broker & Clearing;
    Contact:
    Address:
    Phone:

11. Custodian; (if different than above)
    Contact:
    Address:
    Phone:

12. Offshore Administrator:
    Contact:
    Address:
    Phone:

13. Explain your process for choosing your custodian, administrators and prime brokers. Are there any soft-dollar arrangements? How long have you known and worked with them? Were there previous relationships with any of them?

14. What are the fees for the various parties listed above?

15. Explain your process for choosing your auditors. How long have you known and worked with them? Were there previous relationships with any of them? Does the same person perform the audit each year? Have there ever been any problems with the audits? Have you changed auditors? What are the fees?

16. How does the auditor track the fund's assets during an audit? (Follow the cash; reconciling each trade; confirmation of asset levels; verbal/written confirmation with custodian)

E. Operations/Trading

A brilliant manager who can’t follow through on the paperwork is a disaster in the making. As noted elsewhere, you want to know who is making the decision on how to value the funds’ assets, and what methodology they use. What kind of conflicts of interest are there? And, of course, what disaster preparations and back-up procedures are in place?

1. With what custodian/prime brokers are the assets of the fund maintained? Are all assets, including cash, held in custody with a third party? Explain how fund assets may be moved and invested. What are your policies and procedures to safeguard fund assets (third party signatures, multiple signatures, etc.)

2. How do you assure that all accounts are traded pari passu (on an equal basis)?

3. Does the firm or any principal trade for its/their own account?

4. Will daily or weekly NAV estimates be provided upon request? Discuss accounting and reporting procedures. Does the administrator calculate the NAV? From whom does the administrators get the data (direct feed from the prime broker, multiple direct feeds, the manager, the prime broker confirmed by the manager, or other?)

5. Who prices your portfolio and how is the valuation/pricing done (marked-to-market, independent valuation, pricing service, bid list)?

6. Is there subjective pricing (i.e., illiquid or thinly traded securities)? If so, who is responsible for establishing pricing? Describe the process.

7. For the purposes of providing estimates, how is valuation/pricing done (marked-to-market, independent valuation, pricing service, bid list)?

8. How soon after the end of the reporting period is the “final” month-end NAV provided?

9. List and provide samples of all reports and regular correspondence sent to your investors and the frequency with which they were sent.

10. How often are audits conducted?

    a) Were there any factors in the past that caused a variance?

11. When do K1’s come out?

12. What transparency is available?

    a) Open position reports
    b) Summary information
    c) Dialogue only
    d) Other/ describe
    e) None

13. Explain what internal records (investor records, accounting records, etc.) are kept and in what form they are maintained. What security procedures are in place for these records?

14. How will "emergency" situations be handled? Do you have written emergency policies? Detail back-up procedures.

    a) Loss of principal(s) or key personnel?

    b) Natural "disasters" such as power outages, destruction of offices, etc?

    c) Is there an off-sight facility for record storage and trading capability?

F. Daily Order Entry (if applicable)

1. Who determines what and when orders are placed? If unavailable, then who supervises order placement?

2. Who receives telephone confirmation on fills?

3. Are lines taped?

4. What is your procedure for handling execution errors?

5. Are written confirms received and reviewed? By whom?

6. Are term sheets for OTC/structured deals reviewed prior to entering the trade? If yes, by whom?

7. What information is received from brokers on a daily basis?

8. Are monthly brokerage statements received and reviewed? Are broker reconcilements prepared?

9. Describe all procedures (including timing), for processing a trade settlement and check out.

    a) What controls are in place to protect against settlement risk?

    b) What procedures are in place to monitor unsettled trades?

10. What types of orders are placed to initiate positions? (market, limit orders, stops, etc.)

a) How are split price fills allocated across accounts?

b) In the event of a partial fill, how would the allocations to multiple accounts be handled?

c) How do you evaluate your methods for allocating positions and rotating split price fills to determine that no account is favored by such procedure?

G. Compliance Section

1. Who handles compliance issues? Do you have an internal compliance officer?

2. Are registrations with any agencies required? If yes, which ones and are you properly registered?

3. Do you trade futures contracts? If yes what percentage? Are you registered with the CFTC/NFA? If not, please attach a copy of exemption request letter from CFTC/NFA.

4. Is there an independent monitor or an internal monitor to insure that the terms of the fund's offering are being upheld, in terms of fair and equal fee distribution, fair and equal liquidity constraints, maintenance of the minimum investment, and maintenance of reporting timeliness?

5. What is the firm's policy and procedures regarding the trading of employee's personal and family related accounts as well as the policy against "front-running"?

6. Have there ever been any, or are there any, pending complaints, proceedings, disciplinary actions or litigation against the firm, its advisor, its principals, associated persons, employees, or any firm managed by the advisor or its principals?

7. Explain circumstances surrounding any pending or threatened litigation or unresolved customer complaint of any nature against the firm or any of its principals.

8. What relationships do you have which could be conceived as having the potential for a conflict of interest (brokers, accounting, auditors, sales reps, clients, AIS, or others)?

H. References and Legal Documents

References are key. Many analysts use the professional references given by the fund as a starting point. They ask the given references for other references they might think useful. On more than one occasion, I have found the second level reference to be far more informative than the given references.

Not all funds will provide a list of other investors. They have to get permission to do so, and many investors simply do not want their name given out.

1. Could you please provide us with the name, address and contact numbers of two persons who are currently invested in your fund?

2. Could you please provide us with at least three references for each of the principals, both personal and professional?

3. Could you please provide us with the following legal documents:

a) Memorandum of Association, prospectus and subscription documents of the fund
b) Certificate of Good Standing for the fund
c) Latest audited financial statements for the fund
d) Article of Incorporation of your company

Summary:

Simply getting all of the above information will not insure that an investment in any given fund will be a success.

But this information will help you understand the investments you are making. With the right answers, it greatly increases your chance of avoiding frauds or incompetence. The latter is a much larger problem than the former, although incompetence rarely makes headlines, while fraud always does.

It is much more likely that you will pick funds that are suited to you both quantitatively (risk to reward) and qualitatively (suitability to your personal investing approach). Because you understand the investment, you won’t make the mistakes most mutual fund investors make: buying after a run-up based purely on performance, selling based upon emotions and not understanding the realistic prospects for return and thus getting impatient.