Hedge Funds in Today's Investment Environment

By Gene C. Sulzberger

Hedge funds are private, actively managed investment funds that complement traditional assets and offer true portfolio diversification. With $2.5 trillion in assets currently under management, hedge funds typically lower overall portfolio volatility and can protect capital in times of stressful markets.

Given their investment flexibility, hedge funds vary greatly in investment style, use of financial instruments, concentration of holdings, use of leverage, manager talent, and whether they are directional versus non-directional. In this column, I will answer some important questions about investing in hedge funds, as well as trends affecting their performance and governance.

Q: What were some important lessons that emerged since 2008 regarding hedge funds?

A: Some of the issues involved delays in investors being able to redeem their investment; managers taking positions outside of their investment mandates; high minimums for entry; delayed K-1s for filing tax returns; and some states seeking state income tax returns from owners of hedge funds because a manager was based in that state even though the investor was not.

Q: What are managed account platforms and how have they addressed these issues?

A: Historically, many fund of hedge funds managers would invest directly with thirty or forty managers for certain investment disciplines. By doing so, the fund of hedge funds would become a limited partner in the underlying hedge funds. As a limited partner, the fund of hedge funds was subject to the rules of the hedge fund's offering memorandum, which often gave the hedge fund broad authority to delay redemptions and alter their investment mandates.

In a managed account platform, the fund of hedge funds hires managers to manage a sub-account controlled by the fund of hedge funds. This gives the fund of hedge funds manager direct access to the activity in the fund, increasing control and transparency because the overall manager can see what each sub-manager is doing. This reduces surprises occurring outside the sub-managers given mandates. In addition, the records for the transactions within the larger fund are at the manager's fingertips and K-1 returns could be prepared on time.

The managed account platform also solves the issue of taxation in individual states. If a Florida fund of hedge funds manager opens up all of the sub-accounts in Florida, then the states that do collect state income tax can't collect income on the sub-managers activity.

Q: How important is the due diligence process?

A: Due diligence is vital because there has been large growth in the number of hedge funds being offered to investors. There are relatively low barriers to entry into the hedge fund market. Access to information is often limited and manager skill difficult to verify. Also, past performance is not indicative of future returns.

The research process should focus on diving deep into the investment strategy of the hedge fund manager and the risk management process. Portfolio managers, key analysts, risk managers and business managers must be able to identify and defend their competitive advantages. They should create expectations for returns and volatility in their funds. There also must be an understanding of the investment risks and weaknesses and a consideration for the worst-case scenario.

Also, it is important to determine if investor is qualified to own the hedge fund because there are certain regulations that require an investor to have a certain minimum net worth.

Q: What operational issues should be evaluated?

A: Operational issues account for most of the hedge fund failures according to industry studies. It's important to conduct the following:

- Analyze the legal structure of the hedge fund and the management company
- Investigate the rights of investors
- Identify conflicts of interest
- Assess cash controls and examine the valuation process
- Evaluate compliance and review litigation and doing background checks

Q: What are some questions investors should ask on a continuing basis?

A: The following are key matters that should be constantly reviewed:

- Changes to the business structure, ownership, staffing or the board of directors
- Strategy drifts by the fund
- Is this a hedge fund with a competitive edge or is it an asset gathering firm?
- Is the space crowded?
- Has the alpha opportunity disappeared?
- Modifications to the fund documentation, shareholder rights, risk disclosures, and conflicts of interest
- Access to senior staff, risk managers and business management

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