Is That Hedge Fund Safe? By Mark Myers

Hedge funds are supposed to protect your investment portfolio against the risk of market downturns. But given the secretive nature of these lightly regulated private investment partnerships and the recent spate of hedge-fund failures, your biggest risk may actually be the hedge fund managers themselves.

Consider this: About one in three new hedge funds are likely to go belly up within three years of opening for business because their managers lack the skills and stamina necessary to attract and manage assets. Even seasoned hedge-fund managers can jeopardize shareholder assets by cutting corners or going too far out on a limb to achieve and sustain higher returns. And then there's Bayou Management and Wood River Capital Management, whose fund managers were recently accused by the government of fraud and misleading investors.

To avoid being burned, more individual investors are hiring special hedge-fund investigators to verify and monitor the backgrounds, skills, and performance of hedge-fund managers.

Skeletons in the closet

Most affluent investors choose hedge funds based on the say-so of wealth advisors, colleagues or friends. But such recommendations can be dangerous since most of these fund advocates have conflicts of interest and the field is largely unregulated by government agencies. Some investors try to research hedge funds on their own, but most lack the forensic training to drill down far enough or identify the biggest problems.

Hiring a team of hedge-fund investigators can make this task easier and more productive. An investigative team is usually made up of a fraud investigator who performs in-depth background checks, a manager analyst who assesses the outlook for the hedge fund's strategy, a lawyer who specializes in hedge-fund offering documents, and an accountant who has conducted hedge-fund audits.

The fee for a team investigation is relatively low, ranging from $5,000 to $10,000, depending on the assignment. Results are commonly available within weeks, and many investors retain investigators to monitor their hedge funds on an ongoing basis.

Skills that fall short

In addition to personal background checks, investigators evaluate the skill sets of hedge-fund managers. "Clients need to know whether a manager is professionally qualified to handle the sophisticated strategies promoted in the marketing

materials," says Chris Cutler, president of Manager Analysis Services, a New York firm that evaluates manager abilities and fund operations.

Last year 35% of the funds that MAS investigated were run by managers who lacked sufficient training for the investment strategies they were using. Other funds scored low operational marks for charging excessive fees, imposing unfavorable lockup provisions, and failing to cooperate with MAS on valuation issues. Of the funds reviewed, 15% ranked as strong investment candidates.

To assess a hedge fund's operations, MAS looks at its trading strategy, how much risk the manager assumes to achieve returns and key aspects of the fund's infrastructure. These factors include the quality of third-party valuations, audited fund statements, and whether administrators check to see that all expenses paid are permitted and that there are no hidden fees within the fund structure.

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