

## Due Diligence Primer

*“Unless you enter the tiger’s lair, you cannot get hold of the tiger’s cubs.”*

- Pan Ch’ao, *The Art of War*

I’m a control freak, and letting someone else manage any part of my portfolio is an idea that I approach with caution. And yet I allow this for a portion of my assets because there are certain strategies, asset classes, or managers that I want access to.

So I take due diligence very seriously.

My first rule of due diligence is that I don’t invest a dollar with a firm until I perform an on-site visit. To some of you, this might seem like an obvious place to start. But you would be surprised at how many times managers have told me that they rarely get individual investors coming out to see them.

I know you can’t judge a book by its cover, but it’s a start. I recall my first visit to a hedge fund of funds (HFOF) shop. While being escorted back to the conference room, my immediate observation was that there were no televisions running financial news, no flickering computers, no ticker tapes. It was like walking through a library. That said to me that these folks knew their job — which was to find the best hedge fund managers in the world, allocate

capital to these stars, and let them address the day-to-day movements in the markets.

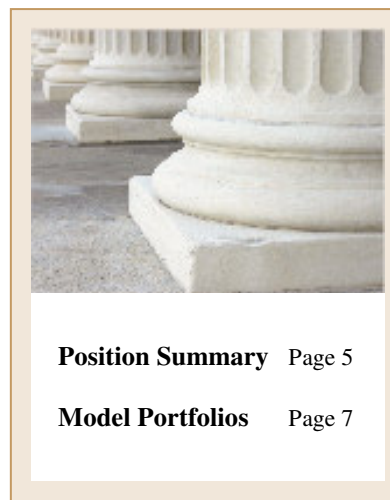
It also said to me that this group had little ability or inclination to react to the events of the day. That was a little disconcerting.

In the end, my conclusion was that the absence of “noise” reflected a confidence in their ability to identify the right people, to run not only client money but also much of their own.

Since visiting other fund of funds shops over the years, I have found that to be more the rule than the exception. Nevertheless, it’s that kind of detail that can be ascertained only in person.

It’s the same as looking into someone’s eyes or shaking their hand. Yes, it’s a digital world, but when it comes to money, there’s no substitute for doing business the old-fashioned way. Jump on a plane if you have to and get to know who you’re investing with.

Let’s take a look at some of the other items to think about when conducting due diligence. Most of my comments will apply to private investment partnerships in general. But throughout this piece, I may specifically refer to hedge funds or HFOFs since they’re what we have been discussing lately.



### Materials to review

**Private Placement Memorandum (PPM) and Partnership Agreement** — These are tediously long documents that discuss the offering and the obligations of the investor and the general partner. Getting involved in a hedge fund takes some work, and conferring with an attorney and an accountant who have a firm grasp of these documents is a prudent idea.

**Audited financial statements** — I like to see a well-recognized accounting firm or one that has a reputation for working in the hedge fund industry as the auditor. One recent hedge fund fraud involved the creation of a fictitious accounting firm, so just a little work should have sent up a red flag. There are no guarantees, of course, that a big-time auditor is an all-clear signal —

Continued on next page

## Due Diligence Primer (continued from p. 1)

Enron's auditors were Arthur Anderson. It's just one piece to the puzzle.

**Past quarterly letters** — I especially like to review past letters during particularly difficult and prosperous periods. And then question the abnormal drawdowns (losses of capital) or profits. I'm typically looking for a smooth ride.

**K-1** — Classification of income will be important to taxable investors. The same fund can have tax exposures that vary widely from year to year, but it's worth a look. Long-term gains and qualified dividends receive the friendliest tax treatment — a plus for funds held in taxable accounts.

I have found that most fund operators do not provide the second, third, and fourth items unless specifically asked for.

### Key third-party vendors

This information is typically provided in the PPM, but contact information is usually not provided unless asked for. Contacting these vendors and confirming information is a prudent idea.

- Auditor
- Law firm
- Custodian of assets
- Fund administrator
- Prime broker (for hedge funds; typically not for fund of funds)

### Portfolio questions

**Strategies of the underlying manager** — Be sure to understand

each strategy used in the fund. We discussed several strategy examples in the June 2006 newsletter issue, but there are many more. I recently read about one hedge fund fraud where the language used to describe the investment strategy was incredibly convoluted. So much so that it became obvious that the intent was to mask a strategy that made absolutely no sense.

One simple question I would expect a rather direct answer to is, "How do you control risk?"

**Amount of leverage** — How much leverage does the underlying funds use? How much, if any, does the HFOF use? Remember, the use of leverage does not necessarily equate to higher risk. All things being equal, a fund that is 100% long with no leverage can be riskier than a fund that is 150% long and 80% short.

**Manager turnover** — What are the turnover rates? High manager turnover rates may indicate that not enough effort or research has been put into selecting the underlying manager on the front end.

**Number of managers** — Typically, HFOFs engage 10 to 50 managers in a fund.

**Names of managers** — This is called transparency. I like to ask the HFOF for a list of underlying managers. Since this is the secret sauce of the firm, it is not uncommon for such a request to be refused. Even with the most secretive firms, though, larger fund positions can often be found in the audited financial statements. Some HFOFs will verbally provide the manager names to existing clients. Still others provide excellent transparency; sharing each manager name quarterly in a written report along

with some insights from the underlying manager.

**Trading by HFOF** — Does the HFOF rely exclusively on its managers, or does it take any positions itself? While not typical, I actually like seeing an HFOF trying to add value. Especially if it is being done to mitigate risk. An example might be buying index put options to provide an additional layer of protection against a market dislocation.

**Attribution of returns** — Where and how are returns being generated? We're looking for a repeatable process, not for one-time lucky strikes.

**Performance numbers** — I want to see the monthly numbers for the entire life of the fund and focus on:

- **Number of up months versus down months** — For market neutral funds, I like seeing at least 80% up to down month ratio. For HFOFs that are more directional in nature, I can deal with something in the 70% range as long as the drawdowns are small.

- **Largest drawdown** — I am really sensitive to drawdowns. Anything over 3% in market-neutral strategies starts to get me pretty uptight. Over 7% in directional strategies isn't very good for my nervous system either. As a reference point, the S&P had a 40% drawdown from 2000 to 2002.

- **Compounded annual returns and consistency of returns** — This is all a function of how much action you want. Just remember, any hedge fund that is capable of 50% returns in a quarter is also capable of 50%+ losses just as quickly. There are no free lunches. Personally, that game is not for me.

**Statistical measures** — My favorites to look at are alpha, beta, standard deviation, and Sharpe ratio.

"All things being equal, a fund that is 100% long with no leverage can be riskier than a fund that is 150% long and 80% short."

For a refresher on the definitions, usefulness, and shortcomings of the measures, please review the July 2006 newsletter issue. The best way to bring meaning to these measures is to compare, compare, compare. Compare funds with different strategies; compare funds with similar strategies run by different firms.

**Pro-forma numbers** — These are basically worthless. A new fund will assemble a collection of managers. Then, using the historical returns of each manager, they will develop a chart showing the monthly pro-forma returns for the fund going back in time some period of years. I understand that a fund of funds has to start somewhere; I just don't put any value on pro-forma numbers. It's really just data mining.

## Terms and conditions

Each PPM has its own set of rules, so these are by no means firm definitions. But they're a start to get a feel for some of the terms one will come across.

**Management and incentive fees** — As mentioned in the past, focusing on net returns after fees is the most important issue. But I would say that 1.5% to 1.75% in total fees is about average.

**Placement fee** — This is the equivalent of a "load" or a fee just for the joy of making the investment. What gall! To even ask for a third layer of fees just irritates me beyond words. The fee typically runs between 1% and 3% of invested capital. It is usually negotiable and can be waived completely. If they will not waive it, we can always walk away and take our money with us. I also find that it is more commonly found at brokerage firms than when doing business directly with a boutique HFOF.

**Minimum investments** — These are usually negotiable too. I'm really not thrilled about having more than 8% of assets in any one HFOF or more than 2% or 3% in any one hedge fund.

**Gate** — A gate limits the amount of money that can be redeemed or withdrawn at one time by an investor. A full redemption could theoretically take years. The presence of a gate will be typical in funds that pursue strategies that hold illiquid investments. Illiquid investments might include the debt or equity of private companies or real estate.

**Side pockets** — Side pockets provide a way to segregate less liquid investments from the more liquid ones. Liquid securities might be priced daily. Illiquid ones might be carried at cost until sold for a profit or loss. Side pocket investments may prevent a limited partner's ability to fully redeem from the fund until such time as those investments are disposed of. It's not necessarily a negative, just pretty much a fact of life if a fund is going to hold less liquid investments.

Side pockets can be abused. For example, an investment that has depreciated can be thrown into the side pocket, carried at cost, and not have an adverse effect on reported returns or incentive fees collected.

**Lockup period** — This period is the initial period one must wait before having the ability to redeem any interests. One year is typical, but some funds will have a longer lockup to match up with the strategy or commitment periods to the underlying funds.

**Redemption (withdrawal) periods** — Quarterly, semi-annually, and yearly are typical. Hedge funds are often referred to

## Background Checks

Here are a few other items to think about under the theme of getting to know your manager:

**Litigation (state and federal)** — Check pending lawsuits, judgements, tax liens, etc.

### Periodical search

- Free search: Google, Yahoo, Ask.com, clusty.com, and zoominfo.com.
- Paid search: LexisNexis — check out the AlaCarte program at [www.lexisnexis.com/alacarteinfo/](http://www.lexisnexis.com/alacarteinfo/). You pay only for each article retrieved.

**SEC/Edgar Search** ([www.sec.gov/edgar.shtml](http://www.sec.gov/edgar.shtml)) and **Freedom of Information Act requests** can be made by request.

**Educational checks** — Do they tell the truth, stretch the truth, or completely fabricate it?

**Previous employer checks** — The real information is obtained by contacting colleagues and bosses rather than the Human Resources department. HR is too scripted.

**Client references** — I like to speak with clients who have investments similar in size to my own.

as illiquid, but I really don't see it that way. In the alternative investment world, this is actually excellent liquidity. With private equity and venture capital, you're talking about a 10 to 12 year proposition.

Continued on next page

## Due Diligence Primer (continued from p. 3)

**Hurdle** — This is the minimum return that must be produced for investors before paying incentive fees to the manager. For example, a fund might have a 10% incentive fee after clearing the rate on the 90-day treasury (the risk-free rate). If the T-bill yield is 5%, and the manager produces a return of 8%, then the investor will pay the incentive fee on 3% (8%-5%).

As logical as the concept of a hurdle sounds (to investors at least), there are many funds that do not offer a hurdle clause. Thus, they can take in enormous incentive fee revenue for middling performance. Doesn't seem fair, but then again, whoever said life is fair? Investors, however, do have the last word — we can always just move-on.

**High water mark** — This is a very desirable clause for the investor. In fact, the absence of a high water mark is a deal killer for me. Very simply, the fund manager cannot charge an incentive fee unless the fund reaches a higher high. For example, an investor places \$100,000 in the fund. After the first year, the fund drops 10% to \$90,000. In the second year, the fund appreciates 11% to \$99,900. The manager is not entitled to receive an incentive fee on the 11% gain because the fund has not yet cleared the \$100,000 opening balance (or high water mark). Throughout the life of the fund, the high water mark should constantly be reset.

### Investigation firms

If you want to have a professional firm get involved in the process, here's a couple you can look into. First Advantage Corp. and Kroll (a division of Marsh & McLennan) are two publicly traded companies that perform investigative work and

background checks. I put calls into both firms; only First Advantage returned the call. So they get the mention: [www.fadv.com/Intelligence/due\\_diligence.html](http://www.fadv.com/Intelligence/due_diligence.html). As always, we never receive compensation from any firm or individual that we mention. And a mention is not an endorsement or recommendation.

I spoke with Aaron Smith, Director of Marketing for First Advantage. Randy Shain, who runs the division, was away when I first made contact, but he also reached out upon his return.

The firm claims to be the largest provider of background information into hedge fund managers as they work for nearly half of the 50 largest HFOFs.

Aaron indicated that a report on a hedge fund or HFOF and its primary principal would start at approximately \$2,000. For each additional principal, add about \$1,000. When you think about it, that amounts to 2% on a \$100K investment or 20 basis points on a \$1M investment. Not a large cost on those sums. To perform similar reports on private equity, venture capital, or real estate firms, the cost would be about double.

A final report takes roughly four weeks, but they usually have preliminary results in seven to 10 days. A report does not offer an opinion or a qualitative ranking but rather provides a summary of findings.

### Credit rating agencies

Moody's has recently begun a service where they issue a rating on the operational risk of a hedge fund. This should not be confused with a rating on the performance of the fund or its ability to repay debt. This is a report on how well or poorly the management team runs the business.

To perform such a rating requires the cooperation of the hedge fund, so my guess is that you're going to

see a bias toward the better firms going in for this sort of exercise. In addition, it might take some time before there is an expansive list of funds from which to choose.

It is, however, a step in the right direction. If this kind of service gains traction in the marketplace, we might one day get to the point where if a fund does not have a rating, that's a red flag in itself.

**Disclaimer:** When it comes to due diligence, you can do everything right and still be wrong. Last year, several very experienced and successful hedge fund of funds and consultants got burned by a very public hedge fund fraud case. Hundreds of millions of dollars were lost. No matter what you do or who you engage, there is always the opportunity to lose 100% of your capital in any investment but especially in private investment partnerships. The best defense remains diversification, diversification, and more diversification.

---

**Please remember:** Private investment funds generally involve various risk factors and liquidity constraints, a complete discussion of which is set forth in each fund's offering documents, which should be provided to each prospective investor for review and consideration. Each prospective investor should be required to complete a Subscription Agreement, pursuant to which the prospective investor shall establish that he/she/it is qualified for investment in the fund, and acknowledges and accepts the various risk factors that are associated with such an investment.

Balance of newsletter article content and Model Portfolios (Pages 5-7) provided exclusively to members. Disclosure information on the following page.

## Disclosure Information

*The Substantial Investor* is an Internet-based publication, with printed version availability (both of which shall herein be referred to as the “*Site*”) owned and published by Private Investor Research, LLC (“*Publisher*”). *Publisher* is **not** registered as an investment adviser with any federal or state regulatory agency. Rather, *Publisher* relies upon the “publisher’s exclusion” from the definition of “investment adviser” as provided under Section 202(a)(11) of the Investment Advisers Act of 1940 and corresponding state securities laws. The *Site* is a bona fide publication of general and regular circulation offering impersonalized investment-related ideas, opinions, and commentary to subscribers and/or prospective subscribers. To the extent that any aspect or portion of the *Site* or *Service* could be construed as investment-related advice, subscribers and/or prospective subscribers acknowledge that the information is impersonal in nature (e.g., not tailored to the specific investment portfolio or needs of current and/or prospective subscribers).

The *Site* is limited to the dissemination of impersonal and objective investment-related information (together with access to additional impersonal investment-related information and links). The publication of the *Site* on the Internet and the publication of any content should not be construed by any subscriber and/or prospective subscriber as *Publisher*’s (i) solicitation to effect, or attempt to effect transactions in securities over the Internet, or (ii) provision of any investment-related advice or services tailored to any particular individual’s financial situation or investment objective(s).

Subscribers **do not** receive investment advisory, investment supervisory, or investment management services, nor the initial or ongoing review or monitoring of the subscriber’s individual investment portfolio or individual particular needs. Therefore, no subscriber should assume that his/her/its subscription serves as a substitute for individual personalized advice from an investment professional of the subscriber’s choosing. **Rather**, the *Site* is designed solely to provide subscribers with a method to evaluate and obtain information on certain securities and market analysis.

The subscriber maintains absolute discretion as to whether or not to follow any portion of the *Site* content. *Publisher* does **not** offer or provide investment implementation services, **nor** does it offer or provide initial or ongoing individual personalized advice (neither in person nor via the Internet). It remains the subscriber’s exclusive responsibility to review and evaluate the content and to determine whether to accept or reject any investment idea and to correspondingly determine whether any such idea is appropriate for a subscriber’s investment portfolio or strategy (of which *Publisher* has and expresses no knowledge or opinion). *Publisher* expresses no opinion as to whether any of the ideas or thoughts contained on the *Site* are appropriate for a subscriber’s investment portfolio, strategy, financial situation, or investment objective(s).

The subscriber acknowledges that any past performance referred to on the *Site* relative to any idea or security may not be indicative of future results, and understands that any opinions contained on the *Site* reflect *Publisher*’s judgment exclusively as of that particular date. Therefore, no current or prospective subscriber should assume that the future performance of any specific investment or investment strategy (**including** the investments and/or investment strategies profiled on the *Site*) will be suitable or profitable for a subscriber’s portfolio, or equal historical or anticipated performance level(s).

**Publisher does not make any representations or warranties as to the accuracy, timeliness, suitability, completeness, or relevance of any information prepared by any unaffiliated third party, whether linked to *Publisher*’s web site or incorporated herein, and takes no responsibility therefor. All such information is provided solely for convenience purposes only, and all users thereof should be guided accordingly.**

**Each subscriber or prospective subscriber acknowledges and accepts the limitations of the *Site* and agrees, as a condition precedent to his/her/its access to the *Site*, to release and hold harmless *Publisher*, its officers, directors, owners, employees, advisors, affiliates, and agents from any and all adverse consequences resulting from his/her/its subscription.**

---

All content is provided for informational purposes only and should not be used for or considered a solicitation of an offer to sell, buy or subscribe for securities, investment partnerships or other financial instruments. Nothing contained herein should be considered individual investment, tax or legal advice or an endorsement or recommendation of any firm, financial advisor, individual, or investment. Any investment or strategy communicated herein can result in a complete loss of money. It is your money, and you are solely responsible for it. Information provided is believed to be reliable, but its accurateness and/or completeness is not guaranteed. Information is of the date referenced and *Publisher* is under no obligation (nor does it plan) to update information. Information may change without notice. *Publisher*, its affiliates, principals, and employees may have long or short positions in public or private securities or investments mentioned. Securities or investments mentioned may not be suitable for all investors. Subscribers are bound by the Terms of Use to which they agreed upon subscribing to *The Substantial Investor*. Readers who are not subscribers are responsible for reviewing the Terms of Use, which are available at [www.substantialinvestor.com](http://www.substantialinvestor.com), before implementing any of the ideas or strategies contained herein.

PUBLISHED BY PRIVATE INVESTOR RESEARCH, LLC  
373 Nesconset Hwy., #329  
Hauppauge, New York, 11788

PHONE: 631.348.2007  
FAX: 631.584.3192  
EMAIL: [service@substantialinvestor.com](mailto:service@substantialinvestor.com)

© COPYRIGHT 2006 PRIVATE INVESTOR RESEARCH, LLC. ALL RIGHTS RESERVED.

Reproducing or sharing any part of this document or granting third parties access to password-protected parts of website is strictly prohibited without written permission from publisher. Copyright infringement may be punishable by prison and/or substantial monetary fines.