LESSONS LEARNED: HOW SHOULD PLAN SPONSOR'S ADJUST THEIR POST-CRISIS DUE DILIGENCE PROCESS?

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The financial crisis has proven again old lessons. When hiring any type of investment manager, plan sponsors must subjectively link investment, business and operational risks by judging the ability and temperament of the manager. Specifically, fee structures drive the economics and incentives of the manager and therefore should be examined thoroughly. This is especially true of hedge funds.

Ongoing due diligence is critical and should take two main forms. First, position levels should be analyzed to objectively determine that the portfolio is operating within agreed risk parameters. This is both a deterrent to fraudsters and a helpful investment decision making tool. Second, routine onsite visits with managers provide the opportunity to judge subjectively whether the firm remains a well functioning business.

Hedge fund fraud is fortunately not any more pervasive than in any business though it does make for stunning headlines. According to a PBS Frontline documentary from May 12, 2009 entitled "The Madoff Affair", Bernie Madoff was able to repay investors in full in the early 1990s when US authorities shut down the various feeder arrangements for his investment management firm. Though far from conclusive, this would indicate that the Ponzi scheme took hold in later years. It is also fairly clear that intermediaries in these later years were not motivated to ask tough questions given their fee structures. And fraud is not a recent phenomenon. J. K. Galbraith's 1954 book "The Great Crash, 1929" describes how booming markets provide easy opportunity for seemingly upstanding people in fiduciary roles to defraud clients. This is normally discovered only in the bust that follows.

PROPER ONGOING DUE DILIGENCE CAN HELP DETECT FRAUD AS WELL AS POORLY RUN INVESTMENT FIRMS.

A subjective approach has two premises. The first is that a good relationship is not a valid reason to stay invested. This was a motivation for many investors in Madoff feeder funds. Second, any significant deterioration in a hedge fund manager's business must cause position reduction or elimination (Table 1). Even established hedge funds are highly dependent on key people. These firms frequently cannot survive adverse changes and almost never make back a large loss. Business risk must therefore be closely monitored and judged.

Rising business risk is the result of several "red flags" (Table 1) over a short space of time. For many investors, a 20% drawdown would result in full or partial redemption. But this was common in chaotic 2008 and redeeming would have meant giving up gains from the ensuing recovery. There is no way to automate the decision to terminate a manager. One can only look at the chronology of events and then make a judgement.

Table 1: "Red Flag" Indicators of Adverse Change

Categories	Adverse Change	"Red Flag" Indicator
People	Staff quality/quantity Key departure	Not enough support Partner leaves
Process	Trading activity/securities Style drift	Privates, short options Investment universe and/or selection change
Portfolio	Exposures Capacity	Concentration, directionality, illiquidity and leverage Materially exceeded
Business	AUM Redemptions	Too small for given payroll Liquidity mismatch
Performance	Drawdown Returns/Volatility	Distance to high water mark Poor asymmetry, trend analysis
Other Subjective	Unusual actions Service provider	Behaviour Auditor, administrator change rationale

Many institutional investors are now reviewing what they are willing to pay for a hedge fund. The current model of "2 & 20%" with a quarterly letter, once a year visit with the manager and sub-optimal liquidity is no longer acceptable to the informed investor. The turmoil in the financial markets over the past year has highlighted the need for both managers and investors to re-think the pay-for-performance model.

We recently met with a high profile manager (ex-large investment bank) who was starting their own fixed income hedge fund to take advantage of the dislocation

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PIAC CALENDAR

September 30 - October 2, 2009

Fall Conference

Fairmont Winnipeg,
Winnipeg, MB

May 5 – 7, 2010

Spring Conference

Embassy Suites
Chicago -
Downtown/Lakefront
Chicago, Illinois, USA

September 29 – October 1, 2010

Fall Conference

Delta Victoria Ocean
Pointe
Victoria, BC

People on the Move

NEW MEMBERS

Babak Abbaszadeh	CPP Investment Board
Brian Aitken	Nav Canada
Deanna Allen	TransCanada Pipelines Limited
Duncan Burrill	CBC Pension Fund
Jon Day	CPP Investment Board
Roman Kosarenko	Bank of Montreal
Vidya Krishnamachar	Ford Motor Company
Christian Leblanc	Hydro-Quebec Caisse de Retraite
Charles O'Reilly	Ontario Power Generation
Ron Otsuki	CPP Investment Board

NEW MEMBER FUNDS

Pierre Drolet	Banque Nationale du Canada
Joseph Kwan	WorkSafeBC

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in credit markets. The manager had an excellent pedigree and was able to explain the strategy very clearly and succinctly.

The manager was hoping to start with seed capital of US $50-100 million. The underlying investments were generally not well understood in the market and the withdrawal of investment banks from these markets left an opportunity for an expert to exploit less efficient pricing. The meeting went very well and we were keenly interested in doing further work on the fund until our final questions about fees and liquidity.

The terms of the fund were a 2% management and 20% annual performance fee – pretty standard where there is true skill. The lock-up on the fund was two years and thereafter quarterly liquidity with notice. The proposed liquidity of the fund was reasonable given the complexity and liquidity of the underlying instruments. You should now be asking yourself what is wrong with this model.

We asked the portfolio manager two questions: Do you deserve an annual 20% performance fee when your investors are locked up for two years? What happens if the fund goes up 40% in Year 1 and down 40% in Year 2? On US $100 million, the manager will collect $8 million in performance fees in Year 1. In Year 2 the investor is down over 30% on the original invested capital.

There is no consequence for the manager's Year 2 bad performance. The manager has a relatively free option in Year 1 and may be incented to take risk to generate high returns. To better align the interests of the manager and investors, performance fees should only be paid on successful realization events after the lock-up period.

It would behoove institutional investors not to focus on fees or liquidity in isolation but to review them in conjunction with other subjective factors throughout the due diligence process.

Well selected hedge funds offer investors attractive risk adjusted returns with limited correlation to pure long investments. Ongoing subjective and objective due diligence can effectively be used to judge investment, business and operational risks and to reduce the effects of fraudulent and / or badly run investment managers. Special attention should be given to fee structures to ensure that investor and manager interests are properly aligned.