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Hedge Funds: An investors' savior or looming disaster?

by Cynthia Harrington

Hedge funds often make front-page news. Either a fund manager is closing down a fund, or another is reporting spectacular performance returns. Money is pouring into these funds despite their lack of liquidity, inconsistent style and difficulty in benchmarking.

Hedge fund numbers ballooned from 550 in 1990 to more than 3,900 according to the July 2001 report titled, "Alternative Investments and the Semi-Affluent Investor," from Undiscovered Managers.

Assets grew from \$38 billion to \$480 billion in the same period. Hedge funds offer a solution to two problems in the investing environment. These funds are offering attractive returns in a low-return market and the returns show low correlation with other investments.

Despite all the promise, not everyone recommends these funds to clients. David Reedy, president and chief executive at GE Independent Accountants Network, Schaumburg, Ill., a broker-dealer specializing in the CPA market, avoids the popular product. "This reminds me of the early 1980s, when it was very hard to sell equity mutual funds but investors were lining up to buy the three-to-one write-off tax shelters. We had to tell them to take a number and wait their turn. But look what happened to investors in those limited partnerships."

"We wouldn't do something like this for ourselves so it's kind of hard to recommend it to clients," said James M. Luffman, CPA/PFS, partner, Chas. Smith & Associates, in Lakeland, Fla. "We wouldn't even consider these to be appropriate for anyone with less than \$15 to \$20 million in investable assets. But usually these clients don't feel they need to stretch for returns.

The term "hedge" means that the fund undertakes an opposing transaction for the securities that they purchase, which neutralizes market risk. Funds are categorized by investment approach and these are the categories that were named by Undiscovered Managers: Long/Short Equity, Equity Market Neutral, Convertible Arbitrage, Fixed Income Arbitrage, Event-Driven, Risk Arbitrage, Distressed Securities, Global Macro, Short Sellers, Emerging Markets and Long-Only.

Most hedge funds are organized as private limited partnerships or offshore corporations.

Two fund companies offer traditional mutual funds with hedge-like qualities: Invesco has the Advantage Fund; and AIM has the Small, Mid- and Large-Cap Opportunities Funds.

Reedy said that the first stumbling block is the ability to conduct adequate due diligence on hedge funds. Hedgefund.net, one of the growing number of Web sites that cater to the industry, recommends several pages of steps in the due diligence process, which goes

beyond the review of a manager of a traditional mutual fund.

It recommends that investors interview the manager on his spending habits to determine whether they are in line with the managers' earnings. They also need to ask what precautions the fund has taken in the event of death or unavailability of the primary portfolio manager.

Jeff Diercks, CPA and managing director of InTrust Advisors, Tampa, Fla., asks those and another eight pages of questions. Diercks started reviewing hedge funds seven years ago when working with a high-net-worth family. In May 2001, his firm added a multi-manager hedge fund to its other offerings - family office services and investment management. "We have five funds in the multi-manager fund and we're looking to expand to seven within the next two months."

Diercks conducts the due diligence process on managers that meet specific investment criteria. He targets managers with market-driven strategies and those who have a small niche in market. He looks for a consistent 15 percent return year after year, a high Sharpe ratio and over three years' experience.

Diercks also wants funds with no more than three-to-one leverage, but some have low or no leverage. "I don't come from a trading background, I'm a CPA. So strategies I don't understand I stay away from," he said.

The managers then undergo an extensive due diligence process with Diercks. On his checklist are questions about how they work with their prime broker, how transactions flow and who is handling the risk management for the firm. Diercks reviews their audited statements. He has several conference calls and personal meetings with managers. "But moving forward still takes a certain degree of faith," Diercks admitted. "I know I've done my homework but I'm still going on my gut feel of the ability of the manager."

Diercks has personal experiences with two of the problems inherent to hedge funds - managers absconding with the money and young firms that are unable to manage the complex back office. He had reviewed limited partnership documents but had not placed clients' money with managers who stole the clients' money. He had placed money with a manager but pulled it early because he felt that their back office was out of control.

"I read later, this manager was unable to meet withdrawal requests of other investors," he said.

Throw out many of the old criteria for choosing an asset manager when considering a hedge fund manager. Expect style drift. Expect tax inefficiency. "These funds were very tax efficient in the last couple of years," said Diercks. "But historically they've not been."

Many firms avoid hedge funds because of this lack of fit with their existing criteria for investment selection. "We stop with the fact that most have performance-based fees. This gives them the incentive to be riskier than they need to be," explained Luffman about the approach at Chas. Smith.

GE's Reedy says that his firm won't consider hedge funds for other reasons. His firm generally stays away from products with an artificial net asset value and low liquidity. Also, most hedge funds don't fit the GE Independent Accountants Network criteria of a minimum of five years of manager longevity and the requirement of financial stability of the investment firm. "We keep people focused on what works, a disciplined approach to investing and proper asset allocation," said Reedy.

Diercks takes additional steps to balance the risks in hedge funds. "It's critical to have a diversified portfolio because each one has periods of time it doesn't work," he said.

But he feels that all the extra work is worth the effort. "This is a great area. It does give you a leg up to differentiate yourself from other advisors. But you have to be careful."

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