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## Madoff fraud shifts focus to concerns about hedge funds



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In 2008, hedge funds didn't protect investors as many had expected. The CS/Tremont Hedge Fund Index, which included Bernie Madoff's fraud, was down 19.07 percent for the year.

While some of the disappointment was attributed to the financial crisis, investors' confidence also has been shaken by the depth and significance of Madoff's fraud. Although Madoff managed separate accounts, his strategies were distributed primarily by feeder funds structured as hedge-fund partnerships.

Many people have written off the hedge-fund business. However, we think otherwise, and believe that solid, risk-adjusted returns should be in store for diversified hedge fund investors.

Nonetheless, the significant weaknesses in the hedge fund industry that have been revealed in the economic meltdown must be addressed to regain investors' trust.

Due diligence on hedge funds must be performed by experienced, competent, deep and unconflicted organizations. It appears that many investors were lured to Madoff because of his alleged track record of unusually stable returns and his reputation as an industry leader. (Madoff had been NASDAQ's vice chairman.)

As a result, the classic herd mentality to Madoff strengthened, and he wound up taking in a lot of money. Investors overlooked the gigantic conflicts of interest and placed their faith in feeder funds, despite their own enormous conflicts of interest. It's estimated that Fairfield Greenwich, one of Madoff's largest investors, earned more than \$200 million by raising money for Madoff.

A crucial element of due diligence is understanding the custodial relationships used by hedge-fund managers. A large red flag with Madoff was that the custodian was a Madoff firm.

In addition, due diligence on a fund should confirm that the fund administrator is deep, experienced and familiar to the hedge-fund community. Likewise, the fund's audit should be conducted by a firm that's well-respected in the industry.

The investor must understand the hedge fund's investment strategy. Madoff claimed that his proprietary

trading strategies had limited risk. In fact, no one could come close to replicating his return stream, which should have raised significant skepticism. Hedge-fund structures allow for significantly more flexibility than a mutual fund. If a hedge fund claims a "secret sauce" that it won't disclose, investors and interested parties should head for the exits.

Excess leverage was the downfall of many hedge funds, and many investors didn't understand the downside risk accompanied with high leverage.

In fact, hedge-fund leverage increased in recent years despite expanding risks. Because most firms charge their fees on leveraged assets, they have an incentive to employ more leverage to make more money. By increasing leverage from two times to four times, hedge funds receive an immediate doubling in revenue — a giant conflict of interest.

Be very wary of funds that have significant leverage flexibility.

Hedge funds rely on bank counter parties for leverage and custody. As the problem with banks became apparent in the past 18 months, they imposed severe deleveraging requirements during a time of severe illiquidity and falling prices — a recipe for disaster for the markets and leveraged hedge funds.

There are plenty of additional weaknesses that must be addressed by the industry: hedge-fund redemptions and the incentives for investors to make a run on the fund; the misalignment of incentive fees when hedge funds price illiquid or hard-to-value assets (they should be paid like a private equity fund); and regulatory gaps.

We would welcome the requirement to make all hedge funds register with the SEC and adopt best practices. While these changes probably won't be a panacea, the regulators need to get their house in order.

Going forward, the number of players in the hedge-fund market will greatly diminish and will benefit the survivors in pursuit of higher, risk-adjusted returns. We believe that investors will have the tendency to understate expectations (just like they overestimated returns), and that hedge funds should have a high probability of surprising to the upside as many funds wash out.