Best Practice in Hedge Fund Investing: Due Diligence

This publication is the first collaboration of its kind, between investors and managers. The goal of this publication is to help demystify a topic that has been shrouded in myth and, by doing so, help improve the level of education among those who wish to better understand the community of active hedge fund investors. This is the first issue of the planned series of *Best Practices in Hedge Fund Investing.*

Inside this first issue, you will be treated to an informed examination into the art of due diligence. The scope will be confined to examining equity-oriented strategies. The universe of hedge fund strategies is enormously broad and diverse. Any single method of inquiry applied to all due diligence would become generic. Future issues will cover strategies in other areas such as managed fixtures, fixed income and asset-backed markets.

The investors who created this publication are members of our Education Committee. Their backgrounds are broad and diverse. They hail from the family office, bank proprietary capital, or fund of funds communities. They are all seasoned investors in a broad range of strategies. For two years, our purpose has been to uncover "soft" aspects of performing hedge fund due diligence. Our emphasis is on developing an interpretative discussion whenever a flag is raised. There have been many generic investor questionnaires circulated. Most were focused on collecting quantitative data. Quantitative analysis is backward looking. Qualitative analysis is more useful as a forward looking tool.

Selected Excerpts:

- *Strategy, Investment Process, and Market Opportunity*

  A critical first step in any evaluation of a hedge fund investment is the establishment of a proper context for the evaluation. Once the context for the evaluation is properly understood, it is possible to proceed with a more nuanced investigation of the investment strategy, the portfolio manager's edge, and other relevant fund particulars.

- *Team and Organization*

  The quality of a firm's human capital will contain, perhaps the strongest clues about its prospects for sustainable success. Moreover, the success of the organization requires both investment and business management acumen, skills that rarely reside in equal proportion in any single investment professional.

- *Fee Structure and Terms*

  The evaluation of a fund's fee structure and terms is essentially an exercise in understanding the value proposition of a particular hedge fund investment. Much of this will depend on the circumstances and environment in which the investment opportunity is presented. In the end, an investor must ultimately determine whether the terms and conditions for this investment are reasonable and fair.

- *Management Company, Fund Structure and Asset Base*

  An evaluation of the hedge fund's management company should be focused on the question of what kind of business it is. In the final analysis, an investor needs to understand if there is a true alignment of incentives between the prospective investor and the portfolio manager in regards to their investment objective.

- *Quantitative Review*

  Many experienced hedge fund investors appear to view quantitative analysis as a valuable complement, rather than a substitute, for more qualitatively drawn judgments. Deployed intelligently, certain quantitative disciplines can help confirm the wisdom of more qualitatively drawn judgments and assist in highlighting aspects of the investment strategy that warrant further investigation.

- *Operations and Transparency*

  There is a big difference between portfolio transparency and translucency. Transparency implies a more substantially active role on the part of the manager in identifying and clarifying key risks for investors. Translucency implies a simple commitment to provide a clear view of the portfolio holdings and may not be very helpful in informing the investor.

- *Third Parties*

  Evaluating the quality of the third-party vendors, as well as understanding the intersection of in-house and third-party business management, is critical to understanding how disciplined the hedge fund business and investment processes truly are.

- *Intuition, Judgment, and Experience*

  No amount of due diligence can completely replace the importance of experience and intuition when investing with a hedge fund manager. Finally and most importantly, would you invest your own money or your family's money with this manager?

About the Greenwich Roundtable

The Greenwich Roundtable is a not-for-profit research and educational organization for investors who allocate capital to alternative investments. The Group holds monthly symposia whose purpose is to discuss and provide current, cutting-edge education on alternative investing. Our mission is to reveal the essence of both trusted and new investing styles, and to create a code of best practices in the alternative investment industry.