How Not To Invest In Hedge Funds

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We all know what to look out for when contemplating a hedge fund investment.

- Independent administrators and independent valuation of assets and calculation of fund NAV.
- Independent prime broker, reputable auditors and legal counsel.
- Independent board of directors consisting of seasoned industry professionals
- Rigorous processes, documented and inculcated throughout the team.
- Independent risk management with a risk manager who can override the trader or portfolio manager.
- Manager must invest a substantial portion of wealth in the fund.
- Strong track record
- Reference well
- Etc
- Etc

The list of criteria is endless, sometimes controversial, and sometimes even self contradictory.

This is NOT how to invest in hedge funds. It is a particularly poor way of investing in hedge funds, or any funds, or making decisions in general. Particularly in a field as complex as alternative investments, a process driven, checklist approach to investing, leads to mediocrity.

How To Invest In Hedge Funds:

Understand the Risks.

One cannot manage in ignorance. Understanding risk involves understanding the operational , fraud , regulatory , liquidity , market , funding , political , and manager risks. It involves understanding which risks are acceptable and which are not. Risk management goes beyond having a big matrix inversion, Monte Carlo machine or VaR system spitting out numbers. That's just market risk and even then its just the surface. Risk measurement and quantification is not risk management. Risk is a multi faceted issue that needs a multi faceted approach. The operational infrastructure and processes are often intimately linked to the investment strategy. High frequency traders need different infrastructure to longer term buy and hold strategies. Multi asset strategies have different needs than predominantly single asset strategies.

In the area of operational and fraud risk, there is no substitute for being sceptical and leaning on principal agent theory. In the area of operational integrity, motive is sufficient for suspicion. An independent administrator, independent control over assets, are necessary conditions. If there is fraud, the impact is not just on capital but on reputation, on confidence, on career. The position and situation of the risk taker within their organization also impacts judgment. The type of ultimate clients or investors will impact decision making also. One is constrained not only by the enemy but by their generals and even the people they serve.

Understand the philosophy.

One cannot manage in ignorance. To understand fully the risks, one has to understand in quite a lot of detail, the investment strategy. Underlying most strategies is a philosophy. It doesn't always have to be the case, but most of the time, a good strategy is built on a good underlying principle. Understanding the underlying principles allows one to make a better judgment if the flexibility that a manager will almost surely employ should be construed as style drift or a genuine and considered foray into a new area based on existing and related experience. The underlying principles of a strategy also frame the strategy. The investor who takes the time to understand will also be able to infer strategies independently of the investment manager, providing a basis for independent triangulation on the logic and rigour of the manager’s investment strategy.

Understand the strategy.

It is simply inconceivable that anyone would invest in a strategy they didn’t understand. So the question really is, how well does one have to understand a strategy before they are happy to invest in it? This will vary from investor to investor. The key is to understand the strategy to ones’ own satisfaction, and realize how much one understands, and how much one doesn’t understand and invest with that self knowledge. Guessing is probably the worst sin against understanding because it extrapolates where there might be treacherous or worse, interesting, twists and turns. Without a proper understanding of the strategy it becomes very difficult to understand what operational support and infrastructure is needed by the strategy, what service providers are adequate, what exposures and instruments to expect, what environments are detrimental or constructive, what kind of personalities of managers are suitable. It becomes hard to understand the factors that influence the performance of the fund and makes attribution impossible. It leads to inconsistent decision making when it comes to investing or redeeming from a fund.

Understand the Manager.

When one invests in a fund, one is really hiring the investment manager for the duration of the investment. When one hires someone, what are the considerations? Character and integrity, skill and technical expertise as evidenced by prior experience and by formal training, judgment, ability to manage people as much as investments, personality, are all considerations. Character and integrity can be checked with the use of professional background investigative services, court searches, regulatory registers, etc.

The value of reference checking is over estimated in hedge fund due diligence. All one gets is an opinion on whether someone is liked or disliked by the referee. References provided by the manager should carry little or no weight. In fact, the noise that that information brings can be so confusing one could argue that it should not even be sought. The analogous situation is a portfolio that is marked by the manager. If one will not accept that, don't take a reference supplied by the manager. The exception is references sought to corroborate and collect factual information. But this is a mechanical exercise that can be outsourced or delegated.

This implies that all the information and impression regarding the manager or hire as the case may be, has to be from primary sources. Is it practical? Yes, but only at the expense of scale and cost efficiency. The personality of the manager is paramount. Manager's fail when they fail emotionally. What does a manager do on a winning streak? Is the manager a psychotic risk taker? Are they ego maniacs? What does a manager do on a losing streak? What do they do when they hit a big loss in a short time? Or a long drawn run of small losses? Are they patient? Does patience help their strategy? Are they self aware? What is their built in risk appetite? What is the investment process, the one written in their heads, not on the Powerpoint presentations? How does one go about compiling these impressions?

Talking, to their friends, counterparties, colleagues, ex colleagues, bosses, hires, employees, peers, competitors, etc etc. But the lines of questioning must not take the form of the usual reference checking format, for then the answers will be to the wrong questions.

Another way is to talk about the trading history, examples of interesting trades, difficult periods, great periods. Track record is a useful starting point as context for discussing in more detail the actions and tactics that generated the returns. Talking about prospective trades is also useful, especially if you are proposing trades to the manager. Their responses and assessments of your trade proposals give invaluable clues to how they manage. One should of course propose as many poor trades as good ones as a control to the experiment. The risk with discussing only good trades is that it can be gamed by the manager attempting to build relationship for future exploitation. The ability to accept criticism on one's own part is crucial in the effectiveness of this strategy. It is useful to realize that one's assessment of one's own prospective trades may be biased and poor.

Team dynamics are also important. A fund is often managed by a team. Is there a top dog? Is this a good thing? Is there groupthink? Is decision making by consensus? Is this a good thing? Its all strategy and situation dependent. It depends on the personalities of the individuals in the team. The compensation and ownership has to work with the personalities of the individuals. It gets complicated.

Understand Yourself.

Investing is as much art as science. The science is the easy bit. The art is all about being inconsistent, inspired, qualitative, arbitrary, and still coming up with good judgment. The path to good judgment is experience. The source of experience is of course bad judgment. Too much faith in one's own judgment is a bad thing. Too little is also a bad thing. In understanding the risks, the philosophy, the strategy and the manager, very often, one will reach a point where there is no checklist of criteria to qualify or disqualify a manager, a point where judgment has to be exercised. Judgment consists of the accumulated biases and prejudices of one's own experiences.

An example: I am a mathematician by training. I have built CTAs to aid my own discretionary trading, although I have never traded mechanically on their signals. To date, I have not invested in any CTA's or systematic macro funds. Why? I demand more transparency than any manager is willing to give. Basically, because of my experience in this strategy, I am too pig headed and egotistical and think I'm too smart. There are a number of things I can do. I can carry on thinking I am God's gift to CTA investing and invest that way, and will probably pay for my over confidence and inflexibility of mind. I can avoid the area altogether realizing that my experience will colour my judgment. Or, I can outsource or delegate the activity to someone else. There is no right way as long as all avenues have been considered and all the consequences and rewards are understood.

What Not To Do:

Don't rely on track record. It is history and is the confluence of skill and luck and the attribution is very often unclear.

Don't believe too much in reference checks. Use references to establish facts, not opinions. People are rarely objective about people they like or hate so the only objective opinion you are likely to get is from someone who doesn't know the subject well enough to like or dislike them.

Don't try to time strategies. You can talk about the opportunity set for a strategy but often in hedge fund investing the opportunity for profit is also the opportunity for loss.

Don't try to be smarter than the manager. They do it for a living. You allocate to them for a living. Don't confuse the two.

If you have a boss or investor or trustee who doesn't understand what you are doing or doesn't understand what the underlying strategies and risks are about, you are up the creek without a paddle. If they will not learn, you should decline the mandate.

Don’t be in a hurry. If a fund wants to close and you’re not going to be able to complete your due diligence, there are other funds.

Don’t procrastinate. It takes time to do due diligence and it is prudent to follow a fund for a few months, 6 to 12 is a good ballpark, to see how they do before you invest. Start early. Plan ahead.

Don’t listen to other investors. Use them to establish facts, not opinions. They are not going to underwrite your losses.

Don’t have any preconceptions. Examples are: shorting through indices is a bad thing, short volatility is a bad thing, nepotism is a bad thing, a history of gating is a bad thing… Everything is relevant in context.

Don’t like or dislike. Especially in the first few interviews. Its not time to like or dislike. Its still time to discover and understand.

The Luxury of the Right Structure:

Few professional investors will have the time to operate along the principles recommended above. Most of the time we are rushed, influenced by others, are too cowardly to demonstrate our ignorance, have not the right sophistication of end investor, don’t have the appropriate stability of capital, have inadequate scale, are either too big or too small, or are too emotional. Perhaps the answer is not to go after the best funds or managers. Perhaps there is no best. Or the cost of attempting to find the best is too high, in making mistakes, in becoming hostage to our own weaknesses. Perhaps the answer is to find what is suitable, to find what is necessary for the objective. Perhaps there is no best, or perhaps best is sometimes just not good enough and perhaps just good is better.