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**Hedge Funds Misrepresent Facts? Of course they do...**

**...and it's our job to distinguish fact from fiction**

## Introduction

Recent work has shown that 1 in 5 hedge fund managers misrepresent facts during due diligence meetings (Brown, Goetzmann, Liang and Schwarz, 2009). Investors in alternative investment funds have come across this fact all too often. In this paper, we take a closer look at misrepresentations, including some examples we have experienced in our work.

Regardless of how well you think you know about a fund, managers know themselves and their business better than anyone. They also recognize that investors have certain “show-stoppers” when considering an investment in their funds. There are generally 3 choices that a manager has when confronted with hard-hitting questions. These are:

- 1 - **Tell the truth**
- 2 - **Omit some information**
- 3 - **Blatantly misrepresent facts**

To the untrained eye, it can be nearly impossible to distinguish between these three general types of information.

## Misrepresentations and Omissions

***There is a fine line that managers often walk between an omission and a misrepresentation when it comes to material operational risks. Some information which managers may withhold, citing its “proprietary” nature, may indeed be omissions and, perhaps, misrepresentations in turn.***

As a part of SwissAnalytics' ***Do Diligence*** approach, we avoid relying upon assumptions or the manager's own selling points at all costs. If we can't get comfortable with or independently verify risk factors, we highlight that in our analysis.

Our entire process is designed to get managers off of their marketing pitch and produce evidence that their business is a stable, sustainable foundation for their funds' long-term success. As we have discussed in our previous papers, the onsite visit is a key portion of the operational due diligence process which, when conducted properly, can provide analysts with crucial information to properly assess operational risks.

Typically, if the manager has omitted or misrepresented information, it is in relation to factors that they believe investors will tag as red flags or will take serious enough to step away from the investment.

## Misrepresentations and Omissions

In this paper, we shall take a closer look at misrepresentations and omissions by presenting several examples in key areas that we have seen managers mislead analysts through the operational due diligence process.

Two of the authors of the paper noted in the introduction have famously proclaimed: "...the most interesting feature of hedge funds is that they are thought of as nearly 'pure bets' on manager skill" (Brown, Goetzmann and Ibbotson, 1999).

One could go further in saying that ***a naive hedge fund investment without properly detailed due diligence is also a "pure bet" on a manager's integrity and honesty.*** Only through due diligence can one turn this bet into a calculated risk.

### ***Misrepresentation***

"The statement made by a party to a contract, that a thing relating to it is in fact in a particular way, when he knows it is not so"

### ***Omission***

"Inadvertently leaving out a word, phrase or other language from a contract, deed, judgment or other document"

## Omissions

### Example 1

#### SwissAnalytics DDQ:

**Please list the identity and performance of all funds previously managed by your management company and its principles.**

#### Manager:

See our due diligence questionnaire.

#### Manager DDQ:

Currently manage 3 funds, 1 special situations fund, 1 merger arbitrage fund, and 1 global macro fund. Closed one credit fund in 2007 due to market conditions.

#### Due Diligence Findings:

All partners were once teamed up at a predecessor firm where they were founding partners and managed 2 global macro funds. ***Funds were liquidated after 2 years***, after significantly underperforming Global Macro Indices and are neither disclosed in the firm's documentation nor in our signed DDQ.

## Omissions

### Example 2

**Manager DDQ:**

4 partners have a significant amount of their net worth invested in the funds.

**SwissAnalytics DDQ:**

**In which of the IM's funds are the partners invested?  
Please provide proof of the entire invested amount.**

**Manager Response:**

This is private.

### Due Diligence Findings:

Erring on the side of caution, the investment manager may not reveal the size of their investment because analysts can cross-check this against their net worth and verify their attestations or statements. This is fundamental to ascertaining the alignment of manager and investor interests, and ***should never be too private*** to a manager asking for allocations.

## Omissions

### Example 3

**Manager DDQ:**

Section on lawsuits completely omitted from the standard AIMA DDQ.

**SwissAnalytics DDQ:**

**Manager refuses to complete and sign SwissAnalytics Investment Manager DDQ.**

### Due Diligence Findings:

***\$750 Million lawsuit has been filed*** against the investment management company in the state of New York.

## Misrepresentations

### Example 1

**SwissAnalytics DDQ:**

**Has there ever been a suspension of redemptions or NAV calculation in any fund managed by IA. If yes, explain in detail.**

**Manager:**

No.

**Due Diligence Findings:**

Through further investigation, it is revealed that the investment management company formerly managed a credit fund, which sidepocketed approximately 50% of the fund's portfolio in 2007. Investor interests in the sidepocket were paid out over a 2 year period, far beyond the liquidity terms of quarterly redemptions on 90 days notice, 90% of which is to be paid out within 30 days of the redemption date according to the fund's PPM. This is a ***de facto suspension*** of a fund managed by the IA.

## Misrepresentations

### Example 2

**Manager DDQ:** AuM of the fund - \$73 Million.

**Due Diligence Findings:** Of the \$73 Million purported, consolidated prime brokerage statements provided only add up to \$60 Million at said date, and ***less than \$40 Million of those funds are held in the name of the fund.***

### Example 3

**SwissAnalytics DDQ:** Please provide us the % of AuM accounted for by the largest 3 clients.

**Manager:** Largest 3 investors account for 10%, 7%, and 5% of fund AuM, respectively.

**Due Diligence Findings:** SwissAnalytics contacts 2 funds of funds we know are invested in the fund, each of which ***disclose investments in the fund amounting to approximately 30% of AuM.***

## Misrepresentations

### Example 4

#### SwissAnalytics DDQ:

Outside of management or performance fees, does the fund or do the principles receive any additional compensation from their investment activities for the fund.

#### Manager:

No

#### Due Diligence Findings:

By searching SEC documents, it is discovered that the manager has registered warrants in the name of principles which are delivered as a part of PIPE transactions of the fund. These warrants have historically amounted to more than **\$10 Million of excess income** for the managers, rather than being credited to the fund.

## Misrepresentations

### Example 5

**SwissAnalytics DDQ:**

Does the IA, IM, subsidiaries or affiliate, directors, principles act as agent or principal for any other entities or persons?

**Manager:**

No

**Due Diligence Findings:**

The fund's audit makes reference to a second asset management company, which through further investigation, is revealed to be ***owned by 2 principals*** of the IA.

## Conclusion - Caveat Emptor!

***Doing Diligence*** means checking, cross-checking and verifying information based upon the reasonable assumption that managers tend to withhold or distort information that will prevent them from receiving an allocation. Taking what begins largely as a “pure bet” on the manager’s honesty and integrity and transforming that into an educated and calculated risk is the task assigned to due diligence professionals. ***If qualitative ascertains made by the manager are not fully and carefully scrutinized, investors don’t even get to the point of making a “pure bet” on the manager’s skill.***

Industry professionals are aware that this is central to risk mitigation for investors in investment funds. However, developing processes and having the experience to distinguish good apples from the bad takes years of training and a diverse set of skills which can not be learned in any text book.

### Works Cited:

Brown, Goetzmann and Ibbotson (1999). *Offshore Hedge Funds: Survival and Performance, 1989-95*. Journal of Business 1999, Vol 72 Issue 1. pp.91-117.

Brown, Goetzmann, Liang and Schwarz (2009) *Trust and Delegation*. Working paper. Available through: <http://ssrn.com/abstract=1456414>

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**SwissAnalytics Due Diligence Services...**

**Support in distinguishing opportunities from eventual regrets.**