Funds of hedge funds: Ethics of this black box strategy

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Abstract This paper deals with the opaqueness and the ethics of reporting practices of funds of hedge funds (FOFs) by examining this increasingly popular black box alternative investment strategy. Numerous statistical reports sent out by FOFs managers to institutional investors have been examined and it has been discovered that many FOFs (a basket of hedge funds) present very basic and elementary statistics. Furthermore, the findings suggest that hedge funds do not adhere to the ethical and reporting standards to which mutual funds are subject. Better ethical reporting standards should be established. In addition, advanced quantitative and qualitative techniques on behalf of hedge fund managers should be introduced to properly assist and educate institutional investors as well as pension fund managers in making appropriate choices on behalf of their investors.

Keywords: *funds of hedge funds; modified Sharpe ratio; due diligence; hedge fund reporting; misleading statistics; ethics; questionnaire*

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Introduction

In the past few years, due to increased market volatility, hedge funds have received a great deal of attention because of their broad range of strategies and low correlation to traditional stock and bond markets. As providers of absolute returns, hedge funds are less regulated by the Securities & Exchange Commission (SEC) than US mutual funds. Hedge funds and funds of hedge funds (FOFs) are usually accessible to institutional and individual investors who fulfil the requirements regarding wealth restrictions. A majority of hedge funds and FOFs are created as private limited partnerships, whereby the minimum investment requirement is usually \$1m or an annual income of \$200,000 or more in each of the most recent two years. High net worth individuals must understand the risks associated with hedge funds, become familiar with the nuisances and be aware, in some cases, of unexpected and dismal returns. This has been shown in Amin and Kat[1] where the authors concluded that the median survival times (50 per cent survival time or half-life) of hedge funds was 40 months during the 1993–2001 period using the TASS/Tremont database, whereas Gregoriou[2] finds 66 months during the 1990–2001 period using the Zurich Capital Markets (ZCM) database.

Hedge funds possess a great deal of flexibility and, as a result, can use derivative instruments such as short selling, futures and options, while mutual funds cannot. Hedge funds are not regulated like mutual funds or other pooled investment funds by the Investment Company Act of 1940. As illiquid private investment pools, hedge funds limit ownership to a maximum of 499 investors, or do not issue securities to persons other than 'qualified purchasers' (principally, high net worth individuals and institutional and professional investors). They have a maximum of 499 investors to avoid the provision of the Securities Exchange Act of 1934. Because hedge funds are usually jurisdictionally bifurcated with the fund being incorporated offshore while the management of the fund is located within the USA and does not offer securities to the public in the USA, they fall outside the regulation of the Securities Act of 1933. However, offshore funds are subject to the anti-fraud provisions of the federal securities laws for sales of interests made in the USA. Disclosure requirements, if any, vary from offshore jurisdiction to jurisdiction as well as any requirement for audited financial statements.

According to the ZCM hedge fund database, an estimated 52 per cent of hedge funds are domiciled in offshore jurisdictions, while the remaining 48 per cent are based in the USA. Based on the authors' investigation period the vast majority of hedge fund managers are located in New York City. Hedge funds and FOFs are outside the control of the Investment Company Act of 1940, and exempt from the SEC supervision of investment companies. They are also not required to disclose any of their positions or operations. Once onshore hedge funds reach the limit of investors, many managers form offshore funds as a mirror image of their onshore funds to attract additional investors from around the world (the SEC excludes non-US investors in determining whether a fund has complied with the limits on investors under the Investment Company Act of 1940). The SEC, in its September 2003 report on the Implications of the Growth of Hedge Funds, has stated that it is considering bringing hedge funds under the regulation of the Investment Company Act of 1940. This may also make hedge funds subject to the disclosure and corporate governance requirements of the Sarbanes-Oxley Act of 2002 that apply to registered investment companies that are considered to issue securities. Sarbanes-Oxley requires that the financial statements of issuers be audited by an independent auditor who is registered with the Public Company Accounting Oversight Board (PCAOB). If hedge funds are forced to come under regulation in the future, it is likely they will simply relocate offshore, thereby threatening an exodus of billions of dollars out of the USA and into foreign banks in tax havens.

Many organisations in the USA, such as the Association for Investment Management and Research (AIMR), the SEC and the Commodity Futures Trading Commission (CFTC), enforce the performance standards for the mutual fund industry and commodities trading advisors (CTAs). Although each organisation has its distinctions, in a recent comparison of standards between these bastions of ethical control, Anson[3] categorises the six most common characteristics as follows: performance history, relative performance, leverage, risk management, fees and disclosure. Can these be viable and possible standards for hedge funds to follow? As the AIMR requires using comparative benchmarks, it may not be appropriate for hedge funds because they offer absolute returns irrespective of benchmarks, whereas mutual funds are relative performers to traditional benchmarks. The main objective of the AIMR is to offer transparency to investors, a much-wanted and important criterion.[4] With which organisation should hedge funds then be associated?

Who invests in hedge funds? This typically includes high net worth individuals and institutional investors such as foundations, pension funds, life insurance companies, endowments and investment banks. Today, US (onshore) hedge funds are limited to accredited investors with a net worth exceeding $1m (or who have annual incomes exceeding $200,000, or a joint annual income with their spouse exceeding $300,000, in the last two years), but FOFs allow investors with less money, or lower risk tolerance, to enter this world of privately managed money. The goal of hedge fund strategies or 'styles' is to maximise absolute return in all types of market environments using differing levels of risk and return.[5]

Under the close scrutiny of the SEC, hedge funds are not allowed to advertise, distribute brochures at freewill and even solicit potential clients. The debate continues about the grey area of advertising over the internet and the use of telemarketers to force FOFs on the general public.[6] Although many offshore FOFs advertise in European newspapers, US-based FOFs are not allowed to place advertisements in American newspapers and magazines.

Existing clients may received literature about the returns of their positions and holdings. Many requirements have placed hedge funds in a binding situation, whereby they have to comply with an increased number of regulatory obstacles ranging from greater transparency to decreasing the amount of leverage used in a fund.[7] This should result in more transparency for the FOF manager which can then be passed on to the end user (investor). Many FOFs, however, do not want to reveal their recipe for a successful hedge fund manager's selection, as this may reveal their investment objectives.[8] In many cases, FOFs will only disclose their top ten holdings to potential investors and will only disclose their entire holdings to those who have invested into the FOF.

Many FOF managers argue that if the underlying hedge funds within their portfolio are revealed, the FOF will lose a great deal of its competitive advantage over other funds. This is simply an excuse, as many FOFs have been providing detailed reports to their investors for years. An institutional investor must carefully make on-site visits to the FOF manager's offices as well as interview the staff and identify the position of each employee in the firm as well as their key roles. As such, some FOF managers may not totally understand the complex trading strategies of the underlying hedge fund managers in their own fund, which in turn could result in an inaccurate assessment of the hedge fund strategies. Many FOF managers today select star hedge fund managers with billions of dollars under management for their fund. This tactic is used as a ploy to market the fund to investors — a highly unethical practice. This can be very dangerous as many FOFs use this type of marketing to push their product through the various distribution channels. Sales people use these star hedge fund managers in a FOF for the sole purpose of promoting the FOF and apply traditional marketing and selling techniques to sell the fund. Many FOF managers use their portfolios' star hedge fund managers to reassure clients; however, a recent study has demonstrated that large or small hedge funds as well as large or small FOFs perform about the same.[9]

Some FOF managers have found it difficult to attract institutional investors, due to both poor returns and inadequate presentation of meaningful statistical reports. They have resorted to changing the fund's distribution channels and its target market, as well as lowering the once high minimum purchase to a few thousand dollars to attract retail investors.

Background

FOFs can be hazardous for unsophisticated investors who believe that they are an infallible means of protection in bear markets. There are numerous risks associated with hedge funds, such as: operational risk, credit risk, liquidity risk, market risk and fiduciary risk. Some hedge funds and FOFs have initial lock-up periods of up to two years, allowing the manager to execute his strategies properly. This is done so that the FOF manager is not flooded with redemptions by its investors. There are redemption periods ranging from 30 to 60 days' advance notice, on average, to cash out. FOFs will have to open their black box approach to their underlying hedge funds, especially when many FOFs can lock away the investors' money.

Many investors argue that FOFs charge high management and performance fees (on average 1–2 per cent of the management fee and 20 per cent of capital appreciation) and wonder if they will obtain what they paid for — 'absolute returns' irrespective of market conditions. Some FOFs have high watermarks and hurdle rates conveying to the investor the confidence of the manager. In effect, this can be used as a marketing weapon as funds with high watermarks and hurdle rates have outperformed funds that do not have them.[10] This also aligns the interest of investors and FOF managers. This fee structure, coupled with the tremendous flexibility the hedge fund manager has in valuing securities in the fund portfolio, creates both an incentive and the opportunity for fraudulent behaviour. This is enhanced due to the fact that there is little or no verification of the valuations used by the manager. The SEC Staff Report reported that 'lack of independent checks on a hedge fund adviser's valuation of a hedge fund's portfolio securities is among the most serious concerns we have identified in the course of our investigation …'.[11]

The FOF industry has noted the arrival of many new funds, which have watered down their original objective of providing protection in down markets. Numerous funds contacted by the authors were simply hyped, aggressive and leveraged funds with high management and performance fees. Some FOFs had a large allocation to one or two star hedge fund managers and were not really doing justice to the fund itself, believing that star hedge fund managers would always perform well irrespective of the performance of stock markets. It was also observed that some FOF managers did not adhere to their original strategies and had changed their focus, style and reporting of statistics post 11th September, 2001. It is vital that investors understand how a FOF manager creates his guidelines in setting up his hedge fund manager allocations as well as the method used in constructing the portfolio of hedge funds.[12]

One of the most important ratios often used by FOF managers in 95 per cent of the reports was the traditional Sharpe ratio. This uses the excess reward per unit of risk as a measure of performance, with risk being measured by the standard deviation, which cannot be used for FOFs due to the non-normality of their returns. Although an important ethical problem exists here: FOF managers are aware of the more appropriate measure of risk-adjusted performance measure for non-normal returns, the modified Sharpe ratio (which simply replaces the standard deviation in the denominator by the modified value-at-risk), but prefer to use the traditional Sharpe ratio instead. They do this because the returns are overstated when using the traditional Sharpe ratio, thereby making their risk-adjusted performance look better. The detailed derivation of the formula for modified value-at-risk is beyond the scope of this paper. Readers are guided to Favre and Galeano[13] for a more detailed explanation. Because of the incentives and opportunities for fraud (discussed earlier), performance reporting should be viewed with scepticism.

Although voluntary, presentations in accordance with the AIMR Performance Presentation Standards have increased steadily in number. In addition, an increasing number of these presentations have been subjected to independent verification resulting in reports attesting to adherence with the standards. Fargher and Gramling[14] found that in circumstances where investment managers reported better than average performance, users considered the manager's reports to be more reliable when attested to by an independent third party. The study did not make any distinction between types of funds, whether hedge funds or otherwise.

FOF managers, as well as institutional investors, should exercise proper care to ensure that the manager adheres to the legal requirement to manage funds entrusted to it prudently, as enshrined in the Uniform Prudent Investor Act of 1994. The principle of prudence stated in that Act has been incorporated into the law of the majority of the American states. Longstreth[15] defines this rule as, 'Those with responsibility to invest money for others should act with prudence, discretion, intelligence, and regard for the safety of capital as well as income.' In essence, what the prudent investor rule says is that those investing the money of others will, as fiduciaries, be required to exercise reasonable care, skill and caution in selecting investments. The manager is under a legal duty when investing a client's money to ensure that the investments selected are consistent with the risk and return objectives of the client when that investment is assessed in terms of its impact on the client's portfolio.

Many institutional investors apply the mutual fund process to hedge funds when selecting managers, believing that talent is available in both areas.[16] Once the money manager or institutional investor has completed his due diligence process, the fiduciary has an ongoing liability in performing due diligence, as well as carefully monitoring the hedge fund managers in the FOF. Due diligence is considered as a very important part of the selection process.[17] In addition, adhering to a checklist will enable investors to be more informed and educated about their FOF manager (see the checklist for institutional investors below). In the USA, the ERISA Industry Committee (ERIC) is the only organisation in Washington that is completely dedicated to the employee benefits and interests of the USA's largest industrial employers.

Checklist for institutional investors

1. How does the FOF manager select hedge funds?

2. How does the FOF manager find new hedge funds?
3. Does he perform due diligence? And how often?
4. Does the FOF manager maintain bi-monthly reports of his underlying hedge fund managers?
5. How often does the FOF manager perform on-site visits to his hedge fund managers?
6. Does the FOF manager actively or passively manage the fund?
7. Does the FOF manager alter allocations of hedge fund managers when market and economic conditions change?
8. Do the underlying hedge funds maintain their strategies?
9. Are the financial statements of the hedge funds audited?
10. If audited, are the independent auditors registered with the PCAOB?
11. Does the FOF manager keep a substantial portion of his wealth in the fund?
12. How frequently are client reports issued?
13. How transparent is the fund?
14. How much leverage does the fund employ?
15. Does the manager provide a detailed risk management philosophy?
16. When does the FOF manager remove a hedge fund manager from his fund?
17. Does the fund maintain proper legal counsel and administrators, as well as accountants?
18. Does the FOF manager geographically diversify his hedge fund managers?
19. How does the FOF manager control risk?
20. Are the financial statements of the FOF audited?
21. If audited, are the independent auditors of the FOF registered with the PCAOB?
22. Has the FOF manager voluntarily adopted AIMR Performance Presentation Standards?
23. If PPS guidelines are used, are the assertions subjected to independent scrutiny for adherence to the PPS guidelines and an attestation report issued?
24. Does the FOF manager report correctly address and meet all requirements to educate investors on a monthly basis?

Methodology and findings

Thirty-five US, European and Canadian FOFs were examined and it was discovered that only basic, elementary statistics were provided in the reports. From a marketing point of view, it is normal to provide potential investors with 'good' numbers and not to disclose statistics that would have a negative impact on the marketing of the fund. In times of poor returns, 12 per cent of the funds did not return calls. Many FOFs provided statistics they wanted their investors to see, which did not really portray the reality behind the numbers. In many cases, some of the descriptive statistics varied from report to report and were used intentionally to hide bad returns. Some well-known FOFs did present appropriate statistics (51.4 per cent of sample) and maintained a consistency in their approach. These funds have understood that producing thorough and correct reports is in itself a marketing tool.

After careful examination it was found that many highly qualified statisticians (PhDs) working for many of the FOFs had reported above average returns. It was also observed that FOF boutiques with small amounts of assets under management (<$50m) had the highest death rate and the greatest difficulty selling and marketing their FOFs, confirming the results of Gregoriou.[18] On the other hand, large investment banks seem to have the correct approach in providing proper due diligence and fiduciary duty, as well as educating their client base. Moreover, calls to numerous FOFs revealed that they were reluctant to discuss and release monthly statistics, stressing that their secrecy and special recipe for hedge fund manager selection was essential. Even large bank-owned FOFs with 60–80 managers were not able to provide answers when questioned on why there was an excess number of managers in their fund. However, these large FOFs had double-digit losses in 2001 and single digit losses in 2002. Somehow investors should at least know where and in what their money is invested. So where are the ethics used by these funds? With this great number of hedge fund managers (>60), manager skill is diluted in a FOF. This is a recipe for disaster as a result of marketing myopia and ethical neglect.

What is the point of producing returns of 1–3 per cent per year and guaranteeing the capital of a FOF over a certain number of years if one can do better by investing in guaranteed instruments producing 3–5 per cent annually? Some bank-owned FOFs guarantee your capital, some will also offer an 8 per cent total return over an eight-year period, locking investors' capital during this period. The possibility of redemptions before the contract date may be disadvantageous to the investor. Why not simply purchase government coupons that can easily return 3–5 per cent fully guaranteed? This is another ploy of these funds which use unethical methods to make more money. Here, the FOFs always make money from management fees even though the investor may not. Simply using index futures, which cost a fraction of the money as opposed to buying the index, the bank will lend out the remaining chunk of investor money in the form of loans at prime or above lending rates to its customers. Even after the eight-year period, assuming the markets remain flat or decline, the bank-owned FOFs would have loaned out money to clients of the bank at prime rate or above, while the investor would receive an 8 per cent return during the entire period. In the reports examined, some FOFs with poor performance had hired students who were purported as experts in the field of statistics. Furthermore, institutional investors are advised to consult a checklist of questions when performing due diligence on a hedge fund manager or a FOF manager.

Conclusion

Investors must be doubtful about how FOF managers present their monthly performance numbers. There is an abundance of reliable FOF managers, but it must be expected that they would want to market their funds using the best approach. Many FOFs employ uncertain statistics and use misleading benchmarks to make their performance look better. Many FOFs that were examined were switching to bond indices from the Morgan Stanley Capital International World Index in difficult times as a comparative benchmark. This could be a violation of the AIMR code of ethics. Adherence with AIMR Performance Reporting Standards may result in better performance reporting, particularly if attested to by an independent third party.

Our study also found that large clients were treated better than small ones. Investors must carefully scrutinize the marketing techniques of many FOF managers. Conducting due diligence and visiting FOF managers on-site could shed some light on their practices. The institutional investor must perform due diligence properly and demand information on how the FOF manager monitors the underlying hedge funds. Does the manager continually monitor the investments in the FOFs bi-monthly by conducting interviews with the hedge fund managers or does he use a buy and hold approach? Does the FOF sell or market the star managers in the FOF rather than rely on the managers' ability in selecting good hedge funds and altering the allocation of hedge funds in times of changing market conditions? A key issue is whether the FOF manager has the ability to manage the FOF actively. More accurate and proper statistics must be presented to potential institutional investors. Managers must be able to explain to any investor, large or small, why the FOF manager has reduced certain positions with a hedge fund manager and increased others. This may, in fact, be conveying to investors that the FOF manager is keeping a watchful eye on the hedge fund managers rather than using a buy and hold approach, irrespective of changing market conditions.

Successful FOF managers provide detailed statistics to investors and downplay the push approach (or an aggressive approach in selling). The historical performance will speak for itself and will generally result in a pull effect (soft approach in selling) from investors.[6] The use of frequent changes such as wrong benchmarks and incorrect statistics may be an indication of bad marketing or a misalignment of agency theory, as well as to lack of ethics in reporting accurate information to investors.

In conclusion, the authors suggest that institutional investors, pension funds and endowments should select funds that adhere to some governing ethical organisation and to choose FOFs with stable returns, low volatility and a proven past performance record.

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