

Contents

Preface	xi
Highlights of the Book	xii
Acknowledgments	xiii
INTRODUCTION	
The Art and Science of Hedge Fund Investing—Are You Precisely Wrong or Approximately Correct?	1
The Explosion of Hedge Funds	1
What Are Hedge Funds?	5
Finding a Comfort Zone	7
A Look beneath the (Book) Covers	8
As You Begin	9
Madoff	10
CHAPTER 1	
Asset Allocation and Fiduciary Duty	11
Determinants of Portfolio Performance	12
Why Alternate Investments?	13
A Closer Look at Hedge Fund Structures	16
The Rise of Socially Responsible Investing	20
Fiduciary Responsibility	20
Where Do I Start?	24
CHAPTER 2	
Large versus Small Funds	27
Research Confirms Small Fund Advantage	29
Performance of New Small Funds	34
Attrition Rates	36
Drivers of Outperformance	37
Invested Interests	37

Aligned Interests	38
Point of Diminishing Returns	39
Master of Trend Line Analysis	40

CHAPTER 3

The Search for an Honest Man 41

Prime Brokers	43
Conferences and Industry Events	45
Industry Publications	46
Incubators and Platforms	47
Industry Web Sites and Databases	48
Building Your Own Database	53
Unconventional Sources	53
Six Steps to Kevin Bacon	54
Sizing up the Flock	56
What's in the DDQ?	57
Summary	60

CHAPTER 4

Performance Analysis 61

The First Step: Understand What Is Being Measured	63
Two Sides to Hedge Fund Performance: Long and Short	65
Performance Standards	66
Check the Entry	67
Finding a Benchmark	68
Peer Analysis	71
Confusion from the Best and the Brightest?	73
A Practitioner's View	74
Examine the Bad	77
Examine the Good	78
Expect the Improbable	79
I Surrender	79

CHAPTER 5

Risk in Hedge Funds 81

Major Risk Categories	84
Liquidity Risk	85
High Watermark Risk	87
Concentration Risk	89

Operational Risk	89
Liquidity Mismatch Risk	90
Transparency Risk	90
Risk Process	91
Leverage Risk	91
Short Selling Risk	92
Reputation Risk	93
Submerged Risk	94
Counterparty Risk	94
Market Risk	94
Credit Risk	95
Model Risk	96
Complexity Risk	98
Key Person Risk	99
Sensitivity to Assumptions Risk	99
NAV Instability Risk	99
Derivatives Risk	100
Summary	101
CHAPTER 6	
You Only Find Out Who Is Swimming Naked When the Tide Goes Out	103
Filling Out the DDQ	103
Form ADV Part II	109
Fund Brochures and Documents	110
Planning the On-Site Visit	111
Summary	112
CHAPTER 7	
Let the Games Begin	115
The Process	115
Examining the Organization	119
Preparing for the On-Site Visit	120
Preparing the Final Evaluation	126
In Conclusion	137
CHAPTER 8	
Getting Ready Is the Secret of Success	139
Top-Down Strategy Analysis	140
Bottom-Up Manager Analysis	141

Test or Model the Portfolio	142
Portfolio Optimization	147
Summary	153

CHAPTER 9

Navigating Buyers' Remorse

155

Long Term Capital Management: Poor Diversification and High Leverage Are a Dangerous Combination	156
Bayou Group, LLC: Due Diligence Is a Must	158
Wood River Capital Management: A Lack of Experience and Auditing	160
MotherRock: The Liquidity Squeeze in a Small Market Will End Badly When Volatility Increases	162
Amaranth: Liquidity and Concentrated Portfolios Can Drag a Fund Down as the Trend of Any Trade Eventually Reverses	165
Recent Events: Ospraie Fund	168
Your Final Exam	169
Applying Your Education	170
The Importance of Second Acts	171

CHAPTER 10

Monitoring Your Flock

173

Everyone's Favorite Metric: Performance	174
Portfolio Exposures	175
Performance Trends	179
Peer Group Analysis	181
Strategy Reviews	182
Fund Size and Performance Impact	183
Management and Personnel Reviews	185
Third-Party Vendors	186
Regulatory and Legal Risk	188
Business Continuity Risk	188
A Final Word on Monitoring	189

APPENDIX A

Sample Investment Policy Statement

191

I. Statement of Investment Objectives	191
II. Asset Allocation and Rebalancing	192
III. Guidelines for the Selection of Fixed-Income Securities	195

IV. Guidelines for Selection of Equity Investments	196
V. Standards of Performance	196
VI. Selection of Managers	199
VII. Responsibilities of Managers	200
APPENDIX B	
Sample ADV Part II with ADV Schedule F	203
APPENDIX C	
Hedge Fund Manager Due Diligence Questionnaire	219
I. Background	219
II. Investment Process, Strategy, and Philosophy	221
III. Business Plans	221
IV. Manager Selection and Research	222
V. Manager Monitoring and Risk Management	222
VI. Performance and Fees	222
VII. Compliance and Client Reporting	223
VIII. Personnel	223
IX. Operations and Administration	223
X. Taxes	224
XI. Performance (See Appendix 6)	224
Attachments	226
APPENDIX D	
U.S. Equity Long/Short Managers	229
A. Organization	229
B. Investment Professionals (Product Specific)	230
C. Investment Philosophy and Process	231
D. Trading Process and Systems	232
E. Performance	233
F. Composite/Product Information	244
References	248
Bibliography	249
Index	253