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Hedge Fund Due Diligence Bulletin

The due diligence's raison d'être

I came across a very interesting book written by Bruce Johnson called "The Hedge Fund Fraud Case Book". The author spent more than a decade as a hedge fund practitioner, managing and advising funds. He was CEO of Albourne America LLC, the U.S. arm of Albourne Partners, a hedge fund advisory firm based in London. As the name of the book suggests, Bruce has collected information about fraud cases involving hedge funds and bring to us 100 different cases which occurred between 1968 and 2001. The author describes in the first chapter the methodology he used to identify the cases and to collect the facts. He spent 6 years researching for this book.

Without discussing individual cases covered by the book (for this you will have to buy it), I would like to share with you some interesting ideas Bruce developed in the preface of the book about due diligence in general and fraud in particular.

The necessity for a strong due diligence process on hedge fund investment has been emphasized by the different issues which rocked the industry in 2008. On the back of this new industry-lead requirement, Bruce question himself on the "raison d'être" of the due diligence and come with the following statement :

"In the long run, due diligence takes the prize as the most dreaded advisory service because of its poor cost–benefit ratio. The certainty of high cost and the uncertainty of results entail a potential negative payoff for those who undertake it. So, why is it there? Two reasons: Due diligence alone can immunize its purchasers from being charged with negligence in the event of a fraud, and there is no better alternative."

Bruce goes on with his reflection by asking the next question: Why do hedge funds fail? The conclusion of his preliminary analysis of fund failures is that funds fail as a result of a shortage of capital. He goes on by describing a quantitative model designed to compute a hedge fund credit rating as a predictor of a fund's likelihood to fail. Bruce identifies fraud as different from the other causes of failure and the less amenable to quantitative methods. This is basically, the starting point of the book.

According to the author: "Hedge fund fraud is a conjunction of an ancient crime and a modern application. Fraud itself is a composite crime conjoining theft with deception. The earliest legal codes had clear proscriptions against theft ("thou shall not steal"), but a more ambiguous response to deception in general, focusing instead on false accusation ("thou shall not bear false witness")."

"The earliest fraud in relation to a hedge fund was in August 1968. This case accused the senior executives and salesmen of the then, Merrill Lynch, Pierce, Fenner and Smith, with providing insider information to several of its investment clients. These included five hedge funds. The hedge funds named were among the earliest hedge funds, one of which was none other than A.W. Jones & Co. (and A.W. Jones Associates), the very first hedge fund."

Another interesting statement that Bruce makes in the book is that:

"a substantial proportion of frauds and perhaps those most dangerous to investors begin as legitimate businesses."

If I want to summarize Bruce's ideas, a good due diligence process is one which will optimize the cost benefit-ratio of the process and focus on understanding the scenarios likely to trigger a failure.

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