



Hedge Fund Fraud: Is the worst really behind us?

Year 2008 will be remembered as the year that changed the world's perception about the, now "infamous", hedge fund industry. Last year, investors realized that investing in hedge funds was not only about taking an investment risk but also getting exposed to operational risks as well as fraud risk. With "Bernie" keeping his secret until December, most of 2008 has been devoted, for investors, in the assessment of their exposure to the different types of operational risks and the way to manage and mitigate them. The year 2009 will be probably be the "witch-hunt" year for hedge fund investors.

It should not come at a surprise that the industry has seen unprecedented amounts of redemptions during the year for a total of \$512 billion, according to HedgeFund.Net. The hedge funds asset under management stood at \$1.84 trillion at the end of December down from a peak of \$2.97 trillion in Q2 2008 according to the same source. The strong demand from investors to get their money back has created for many funds an asset liability mismatch where some funds had difficulties raising cash, by realizing assets, to face the strong redemption requests. For fund managers implementing strategies using instruments that suddenly became illiquid, the only solution, to avoid collapse, has been to impose different mechanisms (side pocket, redemption in kind, gate ...) to restrict investors' redemption rights.

An asset liabilities mismatch can be intentionally generated when the fund's declared assets are no longer in existence because of a fraudulent misrepresentation. This type of fraud, often called "Ponzi Scheme" consists of a fraudulent investment operation that pays returns to investors out of the money paid by subsequent investors rather than from profit. Charles Ponzi, after whom the scheme is named, has found his master last year in Bernard Madoff who reportedly lost \$50 billion of his clients' money in a similar scheme. A "Ponzi Scheme" will usually be revealed when the volume of redemption exceeds the real value of the fund's assets and inflows no longer cover for the difference. However, the scheme could keep going as long as the manager is able to manage redemption requests. According to UBP, managers handling as much as half the industry in investments have imposed some sort of withdrawal restrictions. Recent news about additional Ponzi schemes in the US suggest that more may be forthcoming as the selling pressure on hedge funds continues during the first half of 2009.

All the hedge fund industry's stakeholders will have to learn their lessons from last year events. Investors will have to put in place new processes to cope with the "newly discovered" risks involved in investing with hedge funds. Regulators will need, and have already started, to investigate the reasons of their past failures to protect investors' interests. The increased scrutiny will likely bring along some new surprises as managers practices in reporting and valuing fund's assets will be questioned.

The current "witch-hunt" is starting in a difficult environment where the financial situation of some Hedge Fund Managers has become precarious because of investors pooling their assets out of their funds and because most of them will have to rely exclusively on the management fee they charge on the remaining assets until they recoup past losses. Resource intensive strategies and funds in unusually sharp drawdown will probably be the most vulnerable. The combination of those factors may put some managers in front of the difficult choice between the risk of making small lies to save their business or returning money to investors in a depressed employment market.

The worst in dollar losses is probably behind us but the number of revealed fraud cases is likely to be unusually high in 2009 as will be the number of fund closures. The hedge fund industry will have to reinvent itself in order to restore investors' confidence. Investors will have to be committed to deeper due diligence checks and to invest in adequate resources. Investing in hedge funds is a business for professionals and the low barrier to entry that attracted so many "pseudo" experts in recent years will no longer exist. Today, the positive trend toward a safer hedge fund industry has to be concretized in real actions that will ensure that we will never get back to where we were.

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