



Disaster Recovery Plan - Strategy Driven Policy

Investors in hedge funds are doubly suffering this year. They harshly realized that losses are not only coming from wrong investment bets but can also emerge from operational risks. In most cases, investors were unaware of their exposure to these types of "hidden" risks. Recent events have brought to light the risk linked to the fund's relationship with their counterparty. If we look at the deep discount at which trade some closed-ended funds of hedge funds, it seems like investors are already pricing in additional "hidden" risks for the industry.

As remote as the collapse of a major international counterparty, this article will describe some of the appropriate setup needed to avoid another remote risk, the business disruption risk.

From terror attacks to hurricanes, events in recent years have brought the issues of disaster recovery and business continuity into sharp focus for hedge funds, regulatory bodies, institutional investors and even savvy retail investors.

In the US, the SEC, through rule 206 (4)7, now requires every investment advisor to adopt and implement written disaster recovery policies and procedures. The SEC considers it an adviser's duty to "take steps to protect the clients' interests from being placed at risk as a result of the adviser's inability to provide advisory services after, for example, a natural disaster...".

It does not take an unusually violent act or cataclysm to constitute a disaster. Broken water pipes, a waste-basket fire, electrical surges, computer viruses, office theft and vandalism are some of the everyday threats that can leave just as large of an impact on an unprepared operation.

Before an investment manager begins to evaluate technology solutions for disaster recovery, he needs to consider two key factors: (1) how quickly can the business be brought back into order and (2) the point in time in which the business must be restored.

The type of strategy implemented will be key in determining the appropriate setup. A buy-and-hold asset manager who does not trade every day will need a different type of disaster recovery plan than a short term systematic trader who executes thousands trades a day and rely on his proprietary system to generate trade ideas.

An appropriate disaster recovery plan will address the following points:

- Data Backup. The basic solution is to backup data on a tape that is taken offsite every day. Today, many service providers propose electronic backup through T1 line or using online services. The backup frequency will largely depend on the manager's trading frequency.

- System Backup. Another factor

affecting recovery time is the restoration of the system state, namely the part of the computer that contains items like the Operating System and custom settings. If the backup solution addresses only the storage of data, it will take longer to recover. For managers using proprietary software to implement their strategy this part of the plan will be critical.

- Hot site. This is an alternative location from which the manager can restore quickly the main business functions. The type of strategy will dictate the need for such location as some function can also be run from laptops through internet access.

- Written Procedure. The plan has to be formalized in a written document that describes the steps to be implemented and all the necessary information needed to restore business.

- Test. The investment manager shall test his disaster recovery plan periodically.

Don't be taken by surprise this time, check that your managers have an appropriate Disaster Recovery Plan in place

Petters Group Worldwide - Counterparty risk again

The different strategies defined as Asset Based Lending ("ABL") share the following trade characteristics:

- Privately originated loans to companies
- Loans secured by assets
- Over-collateralization is first "hedge"

The managers in those strategies have exhibited in the past very impressive returns with low volatility and, for some of them, no down month.

Inventory lending or purchase order finance is one of those strategies. Specifically, this strategy involves advancing cash to purchase excess inventory (typically at a discount) from manufacturers and sell this merchandise to big retailers in exchange of a purchase order. The short duration of those bridge loans (typically between 90 and 180 days) and the high quality of the counterparties are two reasons why the strategy is so popular.

Like with all ABL strategies, a key factor is the monitoring of the collateral that secure the loan. In the inventory lending, the investment manager has to go by himself, or use sub-contracted field examiner, to periodically check on-site that the items are physically in the warehouse. This involves opening boxes, checking serial numbers, etc...). The next step is the valuation of the assets pledged as collateral. This is usually done based on fire-sale value (after all costs) provided by one or several specialty vendors. Another necessary step for the manager is to ensure that the assets are covered by an insurance policy.

According to a specialist in the ABL space, Minneapolis-based Petters Group Worldwide was, through its affiliate PCI, one of the major inventory brokers in the US. PCI used loans from hedge funds to finance its activity. The FBI now claims that the whole thing was a scam and that Tom Petters, the founder of the

group, was using the money lent by the fund for other purposes.

The hedge funds involved in this alleged huge Ponzi scheme, like Lancelot and Palm Beach, are now left with promissory notes from PCI whose value will be determined after the liquidation of the whole Petters group. Those funds did basically all of their business with Petters affiliates.

The Petters case is another demonstration of the risk linked to the hedge funds' counterparties. However, here it is very likely that the hedge funds involved will carry their part of responsibility and will have to explain how they let it happened.

New Product

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- Full map of your hedge fund portfolio exposures by counterparty
- Analysis of the assets at risk with each counterparty
- Verification of each underlying fund's counterparty risk management

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