



Hedge Fund Due Diligence Bulletin

Greediness victory over common sense

The announcement last Friday of the fraud case orchestrated by Bernard Maddoff is not coming as a surprise to anyone. In the light of the plethora of red flags enumerated in the press, it appears that investors, all over the world, have decided for years to avoid asking the right questions. The real question, for the financial industry, today is why due diligence and prudent investor rules have been relaxed in this particular case. The only phenomenon of surprise in this story is perhaps the size of the scheme evaluated by Mr. Maddoff himself to "at least \$50bl".

A clue, that may help us understand how all this happened, is perhaps the intentional low profil of Maddoff Investment Securities LLC. The company, to our knowledge, never signed an investment management agreement with the funds it managed, but rather, like in the Fairfield Sentry case, it was acting as the trade execution and market timing agent of the funds. This setup makes it difficult to assess the real size of assets managed by Maddoff. The unusual setup and secrecy around the failed broker/dealer is probably what made him so successful to attract assets. It was really a privilege to have an account with Bernie's institution.

The other factor that made him so successful was that Maddoff was not taking any fee to manage the accounts. According to the funds' promoters, Maddoff was remunerated through the transactions costs he was charging while implementing his investment strategy. This type of remuneration was in line with the pure execution role he was supposedly assuming in the funds. The fee schedule was therefore very attractive to the funds' promoters since they were able to keep for themselves all the fees generated by their product. It was also very attractive to various intermediaries in the industry that made a living on the retrocession paid to them by those funds' promoters.

Another characteristic of the scheme was that its reputation has been growing over time. It was indeed very difficult for investors to believe that such a reputable and long standing institution was able to commit a fraud for so long without being caught. The herd effect is also to blame in this case as investors believed that a manager cannot fool a large number of reputable financial institutions. Investors took comfort that amongst all the institutions exposed to Maddoff probably someone as done his due diligence properly. Another factor of comfort was the fact that Maddoff Investment Securities LLC was a US broker/dealer regulated by the SEC.

The sophistication of the fraud is also worth mentioning. As described before, Maddoff was not the "official" investment managers of the fund but as a custodian had to provide trade tickets and financial statements to the funds administrators/auditors to support his returns. Bernie had probably in place a sophisticated process that allowed him to simulate trades, following his declared split strike conversion strategy, that were demonstrating the type of returns expected by investors. Bernard Maddoff had kept the fund returns in reasonable range probably to avoid attracting too many lights on him.

A lot of things will be learned by the different players about this sad story. For investors, the main lesson is clear: you need to have a strong due diligence process and to have a clear segregation of duty between the due diligence department and the persons taking investment decision. If you don't have that you are potentially exposed to new surprises down the line. The side effect of this case will certainly be a worsening of the already tainted reputation of hedge funds. However, investors should be very careful not to get to wrong conclusion; the willing victims are sometimes not less guilty than the fraudster as they are the one that indirectly helped him to perform his crime.

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