

Title: Opalesque Exclusive: Hedge Fund Information - How much is enough for due diligence?

As investors have realized, in the post-Madoff era, that they can no longer sit on a pile of due diligence papers without reading it, or refrain from asking difficult questions to their hedge fund managers, they have been overly keen on getting as much information as possible. But what is the quantity of information required to conduct good due diligence? Gabriel Kurland, founder of Geneva-based Hedge Fund Appraisal (a provider of due diligence services to hedge fund investors) addressed this issue in his latest newsletter:

The recent events that took place in the hedge fund industry have had a destabilizing effect on some investors' old habits. A lot of them were taken off guard by "newly discovered" risks linked to hedge fund investments. The common reaction among investors, especially for the least prepared, has been to rethink on a broad base their approach to due diligence.

The first protective step has been for investors to redeem (...) . The following step has been to rush for the information that had been overlooked for so long and which has now become mandatory.

In the pre-BM era, hedge fund investors got a lot of comfort from two due diligence habits: (1) the fat file method; and (2) the don't know don't ask method. The first method consists of asking for all the readily-available information that can be obtained from a fund, store it in an impressive big folder on the shelf and to rest on it. The second method relies on the concept that the less you ask, the fewer problems you will uncover, the less you will have to clear issues before investing and the less you will be subject to questions after bad things happen since you did not know.

In the post BM era, and for as long as the pain will last, investors and advisors have realized that they can no longer sit on a pile of papers without reading it and that they need to ask questions even if this will reduce their investable universe and their revenue from funds' fees kick-back.

The consequence has been a disorderly rush by investors to get access to as much information as possible on their hedge fund investments. The result of this quest has been an overflow of information requests sent to service providers like prime brokers that are not at all used to be involved in investors' due diligence process.

Unfortunately, the unlikely reaction has been the implementation, by service providers, of protective measures to allow them to manage this new flow of queries from investors who are not directly their clients. The information available from some service providers is therefore, for the moment, very limited.

Investors should be very careful not to fall in the other extreme and to sink into the new flow of information to be incorporated in their Due Diligence process. The hedge fund analysts' task is to find the sweet spot between too much, too less and enough information.

The quantity of information required to conduct a proper due diligence is difficult to define. A good approach for due diligence analysts is to answer to the question "Why do I

need this particular piece of information?" In this connection, if the analyst realizes that he does not need it, requesting this information from any of the involved parties is worthless because he will never use it and it will increase the burden on the service providers. Furthermore, the Due Diligence Process designer has to acknowledge that by adding too many factors into a model, he is only increasing the model capacity to explain the past relationships at the detriment of its ability to predict the future.

The necessity for a specific piece of information has also to be analyzed in context. For example, the investment manager's Disaster Recovery Plan will need more scrutiny if the manager is implementing a high frequency, highly diversified portfolio of thousand positions than if he is trading once a month, a concentrated portfolio of liquid stocks. The first manager will need to be able to get his operations up and running very quickly to ensure minimal impact on the fund's performance.

Transparency and access to information is certainly a requisite for the industry to regain lost investor confidence, but investors should be mindful that too much information may be "information overkill". Indeed, a good due diligence process will never be one that blindly asks for all the available information, but rather one that targets pertinent information, in a structured but flexible framework and in a cost controlled manner. Investors should not forget that the due diligence process is not merely mandatory but also a tool to help them to take better investment decision. Hedge Fund Appraisal's latest newsletter:

Article Source:

http://www.hedgefundappraisal.com/Articles/HFDD_%20February_2009.pdf