



THE EVALUATION OF HEDGE FUNDS

BY KENNETH J. DEGRAW CPA, CFP®, CRFA®, PARTNER
TEAM LEADER, HEDGE FUNDS AND PRIVATE EQUITY FUNDS

The capital markets of the recent past have left investors of all sizes feeling as the Great Oz did when he exclaimed, “You’re talking to a man who has laughed in the face of death, sneered at doom and chuckled at catastrophe! I was petrified.”

Managing a portfolio of substance is no easy task in “normal” times, let alone during an extended downturn. This has resulted in many clients adding hedge or alternative investment funds to their portfolios. Conceptually, a hedge fund should complement your investment strategy through the use of strategies that either hedge risks inherent in your portfolio, or provide access to markets not otherwise available. That said, as the industry has matured, a significant number of strategies have emerged which have created investment opportunities in their own right. These strategies are no longer traditional hedge funds, but more appropriately called alternative investment funds.

DO I QUALIFY?

As a result of the largely unregulated environment that the funds operate in, they are limited as to the investors that they can consider for placing an investment in their fund. Generally speaking, investors must be “qualified investors.” An investor qualifies under the criteria if he and his spouse have a combined net worth of \$1 million and individual income of \$200,000, or a joint income of \$300,000. These requirements were set in 1982 and haven’t been adjusted since. Each fund will also have a minimum investment threshold, which is typically at least \$500,000.

HOW DO I EVALUATE A POTENTIAL FUND?

A fund will have a private placement memorandum and partnership agreement which should be reviewed in detail prior to investing. Each fund has its own unique strategy; some utilize leverage, derivatives, short positions and/or foreign investments. Accordingly, in addition to reviewing the investment characteristics, a review of the potential tax implications is equally important.

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WHAT ARE THE KEY ITEMS TO FOCUS ON?

- **The Manager** - thorough knowledge of her experience and track record is critical to success, since she is in complete control of the underlying asset selections
- **The Strategy** - analysis of the underlying strategy of the fund needs to be evaluated in the context of your risk tolerance and overall portfolio and financial goals
- **Liquidity** - what are the requirements necessary to exit the fund
- **Reporting** - what information is available to investors on an on-going basis
- **Costs and fees** - there is a management fee, typically 1% and a performance fee, typically 20% of the gain
- **Historical return** - volatility and correlation
- **Risks** given the strategy and style
- **Tax ramifications**

HOW DO I GET MORE INFORMATION ON OPPORTUNITIES?

Funds are not permitted to advertise; the internet will be your best friend in undertaking research. There are a number of sites that evaluate the funds and provide a wealth of information on industry and strategy performance, including www.morningstar.com.

Understanding the key characteristics of a potential fund investment is essential to capitalizing on the investment opportunities and maximizing your return. For more information please contact your local WS+B advisor.