Checks And Balances

Hedge fund of funds are going to have to regain the trust of investors following their exposure to Madoff

BY GERELYN TERZO

The hedge fund industry has never been known for its transparency, but as long as returns were stellar investors didn't quite seem to mind. **Bernie Madoff**, the infamous mastermind behind the alleged Ponzi scheme that cost the industry an estimated $50 billion, has changed that, and the disclosure pendulum is swinging in the opposite direction. There is arguably no group that will be more affected by this demand for more disclosure than the hedge fund of funds segment of the market.

Fairfield Greenwich Group and **Tremont Group Holdings**, both hedge fund of funds, had billions of dollars invested with Madoff. Fairfield Greenwich's Fairfield Sentry Ltd. had half of the firm's $15 billion in assets under management invested with **Madoff Securities**, according to the company's Web site.

Between two divisions under the Tremont Group Holdings umbrella, Rye Investment Management and Tremont Capital Management, the firm had about $3.3 billion invested with Madoff. The remaining assets in Tremont Capital are $2.7 billion.

"We believe Tremont exercised appropriate due diligence in connection with the Madoff investments," according to a spokesman from **Montieth Illingworth**, an outside public relations firm that represents Tremont. Fairfield declined to comment.

While there are a host of investor-led lawsuits underway against the fund of funds community, no formal charges have been brought upon them by the **Securities and Exchange Commission** or the Department of Justice.

It's a difficult sell to suggest either of these hedge fund of funds did their homework on Madoff, who consistently delivered double-digit returns to investors. "My guess is they didn't know it was fraud, but suspected as such. You put your fingers in your ears and look the other way. Madoff was generating so much money for them they probably didn't want to believe it," says **Brad Balter**, managing partner of hedge fund advisory **Balter Capital Management**.

Madoff himself did not operate a hedge fund but ran a broker dealer. But he had feeder funds through which firms like Fairfield Sentry invested, and he charged no investment fees for those. Instead, he claimed to have earned his commissions by negotiating fee retrocessions with exchanges, sources say.

This was especially attractive to fund of fund managers, whose layer of fees on top of a hedge fund's standard 2% management fee and 20% performance fee made Madoff's proposition that much more appealing.

In a 2005 letter to the SEC, **Harry Markopoulos**, a former securities industry executive, raised suspicions about Madoff.

The letter points to the Madoff fraud and Markopoulos' observations were made by "listening to fund of fund investors talk about their investments in a hedge fund run by Madoff Investment Securities."

The 19-page letter goes so far as to call Madoff out on the Ponzi scheme, and Markopoulos said he was turning the information in because it was the "right thing to do." At the time the letter was written, Madoff was estimated to have had between $20 billion and $50 billion in assets under management, according to the letter.

The SEC never acted on the letter. "It is a major source of embarrassment for the SEC as to how and why this letter was ignored," says Balter.

Those who invest in hedge fund of funds are primarily after one thing, in addition to returns: risk diversification. Hedge fund of funds are supposed to provide risk diversification based on their extensive research and due diligence. Of course, there are risks associated with investing in any hedge fund,

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but the key difference is a hedge fund of funds may invest in 20 different hedge funds with separate portfolios run by as many managers.

"Going forward, investors will demand hedge fund of funds be more open about their due diligence process before making an investment. Subsequent to this, hedge fund of funds will need to regularly communicate their safety strategy (diversification) to these investors," says **Damien Park**, president of **Hedge Fund Solutions**, a company that monitors hedge fund activism.

Christopher Peel, chief executive at London-based fund of funds **BlackSquare Capital**, a firm with approximately $300 million in assets under management, says there were some obvious red

Due Diligence cont. on p.22

Hedge Funds cont. from p.4

save the viability of the brand over the long term. And for hedge fund managers who plan to stick around for the long haul, a formal restructuring could be the lifeline they need. "We are trying to create a market for a business line that never existed before," says Kaye.

Hedge funds that are facing massive redemptions are also often burdened with a task of either honoring redemption requests by facing liquidation or figuring out a way to restructure. Many hedge funds are in this predicament. To make good on all redemptions, these funds would be forced to sell virtually all of their most liquid securities. "That would leave the most loyal, long-term investors with the most illiquid securities, which often times are of the lowest quality" says Kaye. "By the same token, these funds need to be mindful of those redeeming investors who may have critical and immediate need of their capital."

Navigant is in the process of adding to its team, and Kaye continues to field resumes from "highly qualified people." In mid-December, **Robert Picard**, who formerly oversaw $6.5 billion in assets for hedge fund **Optima Fund Management**, joined Navigant as a senior advisor to the hedge fund restructuring practice. "People who made money in the industry before are saying 'it's not the right time for me to invest as a manager. I'd rather work on developing what the future of the industry is going to be,'" says Kaye.

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Women cont. from p.8

many women will simply stay on permanent maternity leave.

The good news, however, is that the investment industry has made giant strides, even if few companies are hiring these days. "Many firms are very receptive to hiring women," says **Marty Brady**, a managing director with executive search firm **The Oxbridge Group**. "But women should understand that the firm must be able to relate to you; they must also have confidence that their management teams will relate to you."

Brady's advice for women is to take care of what's in front of them. If they're doing their job and doing it well, they'll make a name for themselves. "Women also have to remember to stay the course and not get caught up in thinking about perceived inequalities that might exist," he says. "That will not help their career progression."

Bradley agrees. "Throughout my career I was often the only woman in the room, but I never focused on that. I just did my job, made sure I worked hard every day and was a productive person. This career path is very fast-paced, but rewarding."

And even if the pace slows in light of the credit downturn, standouts, male or female, will always be in demand.

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Due Diligence cont. from p.12

flags that hedge fund of fund managers should have noticed before investing in Madoff's funds. For instance, even though Madoff was not technically a hedge fund, he traded like one and generated hedge-fund-like returns. He also served as his own custodian, employed no prime broker and traded through his own broker dealer firm.

"You want to see the best of breed, blue-chip service providers for fund administration, prime brokerage, legal and auditing functions," says Peel, who had no exposure to Madoff. "That's really important." He says there will be even less tolerance for anything other than outside, best-of-breed service providers.

Madoff's trading strategy was a split strike conversion strategy. "No one could replicate it," says Peel. "I didn't think he could possibly be making those kinds of returns unless he was the best stock picker in the world."

Balter agrees, and notes that if Madoff's strategy were legitimate, a prop desk like **Goldman Sachs** would have been able to "reverse engineer" the strategy and apply several times leverage.

Ultimately, this would have lowered the potential for returns from the strategy as more market participants would have squeezed out all the inefficiencies, he says. "I think it's a sad comment on the industry where people want to give their assets to those that have shown the least amount of care for their clients," says Balter.

Indeed, there is no shortage of blame that is going around tied to the Madoff scandal. Some blame investors, others blame the SEC, and it's safe to say everyone blames Madoff himself. Like Balter, Peel says there needs to be more accountability in the hedge fund of funds market. "You have people performing due diligence and fund analysis that have not been involved in the financial markets, such as working on the trading desk or at a hedge fund. It must be very hard to understand the hedge fund industry unless you have spent 10 to 15 years working in the financial markets," says Peel. Hedge fund of funds will need to employ "more experienced personnel."

And, while hedge fund of funds will be held to a different standard by investors, so too will hedge fund managers by fund of fund managers.

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