Looking Past Returns:
9 Issues to Consider Beyond Performance

By: John T. Alfonsi,
CPA, CVA, CFE

Recent studies and articles have documented the explosion in not only the number of hedge funds but the dollars invested in them. The "retailization" of hedge funds through (i) marketing activities, (ii) the development of hedge fund-based "funds of funds", and (iii) the growing number of public and private pension funds, means that these investments are being made by persons, families and entities that are not traditional hedge fund investors.

Overview.

Hedge funds are typically structured as limited partnerships or limited liability companies. The fund managers have fewer restrictions than their counterparts at mutual funds and may use various strategies to improve performance, including short positions, leverage, and derivatives. The goal of many hedge funds is absolute return without correlation to market indices.

This unique blend of equity investment operated as a pass-through entity using various risk-management techniques means current and prospective investors need to look beyond historical performance in assessing the investment. Generally, this requires an analysis based on principles used to assess (i) a publicly traded stock, (ii) a mutual fund, (iii) a closely held business entity, and (iv) a partnership. The analysis should focus on due diligence, operations, governance issues and federal income tax concerns.

1. Taxability.

As most hedge funds are structured as partnerships for federal income tax purposes, an investor is taxed on the earnings, including realized gains and losses, of the fund when generated. This typically results in an investor having taxable income without a distribution of cash to pay the taxes on that income (see Liquidity, following). Assuming an investor understands that risk, a tax-paying investor should focus on the after-tax return of the fund rather than its gross performance. This requires the investor to know what type of income the fund generates and its character (e.g., long-term vs. short-term gains and losses, qualifying dividends vs. interest income).

2. Trader vs. Investor.

Whether a fund is considered a trader or an investor for federal income tax purposes may impact the deductibility of certain expenses. If the entity is considered a trader, the operating expenses of the fund and interest expense are generally deductible in arriving at adjusted gross income. If the entity is considered an investor, however, the allocable amount of interest expense is considered an itemized deduction. A taxpayer's allocable share of the operating expenses of the fund is a miscellaneous itemized deduction, the total of which must exceed 2% of the taxpayer's adjusted gross income and for which is completely non-deductible for alternative minimum tax purposes.

3. Unrelated Business Income Tax.

Tax-exempt entities, including IRAs, 401(k) plans, pension and profit sharing plans, and charitable remainder trusts, are subject to tax to the extent they generate unrelated business taxable income (UBTI). The use of leverage is the most common way a hedge fund generates UBTI. A tax-exempt entity should review the operating agreement of the hedge fund. Does it have a "zero-tolerance" approach to generating UBTI? Investors with a zero tolerance for UBTI should inquire if there is an offshore counterpart fund. Many hedge funds have an almost identical fund structured as a foreign corporation for tax-exempt entities that effectively acts as an UBTI "blocker" for federal income tax purposes.

4. Liquidity.

Many hedge funds have "lock up" provisions which prevent investors from requesting a distribution or a return of all or part of their capital for a specified time period. Recent SEC initiatives to regulate hedge funds would have required hedge funds to register with the SEC; in lieu of registration, the hedge fund must provide for a two-year lock up term. In addition, funds may restrict the timing and/or amount of distributions (see Taxability, prior). Investors should know what, if any, the lock up period is. In addition, they should know how often distributions can be requested as well as the amount that may be requested. In addition, the investor should be aware of the time requirements related to requesting the distribution

5. Fees.

A common industry practice is for the hedge fund to include an incentive fee or allocation whereby the fund manager is compensated, in addition to the regular management fee, based on the performance of the fund. This incentive may be based on performance above a specified "hurdle rate". The fund may also provide for a "high water mark" where the incentive compensation is based on the highest value attained in the prior year. What, if any, is the hurdle rate? Does the fund have a high water mark? Were historical returns stated after accrual of any incentive fees? Finally, investors should be aware that hedge fund-based fund of funds may have two layers of fees, including incentive fees, one at the operating hedge fund level and another at the fund of funds level.

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6. Know the Managers.

Like many investments, success may be a result of a particular person or persons rather than the efforts of an entity. In those situations, you are investing in the person, not the entity. It becomes imperative, therefore, that someone perform due diligence with respect to the entity/fund and the manager. Is the person(s) responsible for past success still in a position at the fund to continue that success? Are there restrictions on that person(s) ability to leave? Does the fund have a formalized business succession plan if the decision-maker unexpectedly leaves the firm?

7. Diversification.

The fund itself may not provide diversification. How much of your portfolio is committed to hedge funds and other alternative investments? Funds have different investment philosophies such as long only, long/short, and event driven. The fund should be assessed on its investment philosophy and how it fits into your asset allocation and diversification strategies. You may choose to use different funds with different investment philosophies to create diversification. Alternatively, a hedge fund-based fund of funds may provide the required diversification through its investment in diverse hedge funds.

8. Transparency.

Internal controls and operating procedures are on the minds of all investors. They want assurance that their money is not susceptible to asset misappropriation or other form of fraudulent activity. Further, they want assurance that the financial reports, including performance, are free of error (information integrity). If not otherwise subject to the requirements of the Sarbanes-Oxley Act, does the firm embrace the concepts of the Act to ensure a sound internal control environment? Investors should inquire as to what mechanisms and procedures are in place to provide for information integrity. Finally, does the fund management communicate regularly and openly with its investors and share this information?

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9. Monitoring.

Once an investment has been made, an investor should not switch to "auto pilot" and forget about it. The investment must be periodically and continually monitored and re-evaluated and not just from a performance perspective. An investor's monitoring activities should include periodic reviews of the other eight items listed; are the things that caused you to invest in the fund still in place? The fund management should be reviewed for key personnel changes and reassessed based on its stated investment philosophy as compared to its actual.

Many of these issues are those addressed by business CFO's in their day-to-day duties of managing the financial affairs of a business (risk management, treasury functions, tax planning, oversight of financial reporting, and internal control assessment). These same disciplines should be applied to one's personal investment and wealth management decisions, as well.