DON'T GET CAUGHT OUT THROUGH BACKGROUND CHECKS

Background investigations on hedge fund managers are seen by most allocators as a critical part of their due diligence process

BY CHRIS JOSSELYN

Torture, incest, domestic violence, hard drug abuse and fraud. This may sound like a compendium of the crimes of the FBI's Most Wanted. But in fact these are some of the more extreme examples of reasons why investors have dropped potential or existing hedge fund managers after carrying out background checks on them.

While these cases are extremely rare, allocators can nevertheless pick up crucial (though often less scandalous) indicators as to the trustworthiness of the hedge fund managers they are analysing through background checks.

"Background checks are a key ingredient in the operational due diligence process, and post-crisis they have become even more important," says Andrew Kandiew, head of operational due diligence at $10.5bn hedge fund solutions provider K2 Advisors.

"Many areas of the background check are to confirm information that we believe to know about the manager. The purpose of the check is to verify the existence and the accuracy of the credentials they have disclosed, and if there was a gap we would certainly be concerned about that."

The basic features of most of these checks include education; work experience; affiliations; and legal, regulatory, and media profiles. "These are questions you need to be able to answer about the firm and its key individuals," says Kandiew.

While many allocators carry out part of this background verification in-house through their own due diligence teams, the growth of the hedge fund industry has spawned a number of service providers that allow the outsourcing of a portion of the process. Hedge fund due diligence firm BackTrack Reports is one such provider.

"We don't tell investors what to do," says Randy Shain, founder of BackTrack Reports. "Even if a background enquiry revealed a tonne of information that might on the surface suggest that the fund was more risky, we just report the data, and let them decide.

"Most of the investor client base for us are typically operational due diligence people, so they're already very familiar with due diligence and already doing it themselves, and they're just adding our piece to what they do. It's a bit presumptuous for us to tell them how to assess risk. We're not in there looking at the numbers, at the strategy and how it fits. We're very confident that the research we have is extremely valuable in making those decisions – it's just not us who makes them."

Allocators can have differing comfort levels in terms of the kinds of events in a manager's past they are willing to put up with. "There's a scale of investor tolerance for headline risk," says Guy Simonian, founder and CEO at outsourced checking firm Check Fund Manager.

"The least tolerant are pension funds because they have a lot of exposure to their constituents and to the public at large, so they want to do everything they can to avoid embarrassment. At the other end of the scale are individual investors or family offices – they have the most tolerance to headline risk because, depending on the individuals or who they're representing, they may not have an opinion on someone's personal behaviour – they may only be concerned with performance."

He adds that FoHFs often fall somewhere in the middle of this spectrum. "Whereas they might have some tolerance

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to headline risk, they're certainly going to be concerned where there's a risk that might cause their investors to pull out, which will cause a drawdown."

Simonian recounts how one large Californian public pension fund was invested in a hedge fund whose manager it was later discovered had convictions for domestic abuse and was a known user of methamphetamines. The pension promptly unloaded the manager when this was brought to their attention. "Fortunately for them it was in a managed account, and it never became a public matter," he says. "But it would have been a big embarrassment at the time."

At the other end of the scale, one family office discovered one of their existing managers had been charged with solicitation of prostitution. However, the allocator did not deem it relevant to concern themselves with the manager's behaviour or morality, says Simonian. "They were already invested with them, and they stayed with them," he adds.

Generally a chequered legal history is not something investors want to uncover in background checks on a manager. A long/short equity manager, for example, is unlikely to have good reason to be in and out of court every week. However, for managers of certain strategies, a track record of litigation can be something of a badge of honour.

"When you look at the most famous activists, the Bill Ackmans of the world, of course he's going to be engaged in very public, bitter battles – that's what he does," says BackTrack Reports' Shain.

"It's not a reflection of his reputation or character, it doesn't indicate he's doing anything wrong – in fact quite the opposite – if you believe that type of action will yield results, and for him it seems that it really does, then you want that. If suddenly he wasn't doing that, if suddenly there were no news stories about Bill Ackman, I'd be more worried, not less."

The same applies to distressed-focused hedge fund managers. "A hedge fund that claims to be in distressed investing, not only would you expect, but you'd almost want to see legal actions naming them and a lot of news talking about it, because if you don't, it means that they're not doing what they say they're doing. That type of investing lends itself to battles that take place in news coverage and in the courts. When allocators are looking to invest in that community, that is what they're looking for," adds Shain.

IDENTIFYING FRAUD

The stories of some of the managers who are caught out as a result of background checks are sometimes almost beyond belief. Check Fund Manager displays on its website a 'wall of shame' of some of the most egregious offenders, complete with mugshots of the managers (some of whom are even pictured in their prison-issue orange jumpsuits).

One manager on the list is Raj Rajaratnam, founder of the now-defunct hedge fund Galleon Group, who was at the centre of an insider trading scandal and in May 2011 was convicted of 14 counts, including five counts of conspiracy and nine counts of securities fraud. Before his conviction, he remained free on $100m bail, the largest in US history.

"We had an inkling that Rajaratnam was being investigated before he was charged," adds Simonian. He says a FoHF they were investigating for were able to unwind their position in Galleon a year before Rajaratnam was formally charged a year later, as a result of their checks.

Most of the red flags that allocators uncover through background checks are much smaller scale and more mundane than Rajaratnam's fraud, though they can still reveal important flaws in a manager's character.

One allocator *HFMWeek* spoke to discovered a target manager didn't have the CFA qualification he purported to have. Another investor found someone under checks had lied about his MBA score. "These are people you can't trust," says the investor.

Beyond the checks on concrete areas such as criminal records and educational qualifications, softer research can reveal more subtle clues as to whether an allocator will feel comfortable committing to a manager.

"We always do our own internal checks using our network of contacts in the industry," explains Nick Morrell, chief risk officer and head of operational due diligence at $1.3bn Geneva-based FoHF advisor Fundana.

"What we're trying to do is avoid using the managers' reference lists – our goal is always to try and talk to people that we know who are not on the reference lists who have worked with them at one of their previous firms.

"The checks that we do with our own network of contacts often do come up with more useful information as to whether or not it's a manager that we want to invest with. Often you hear about someone who is not easy to work with. The question is, are they really someone who's going to be able to build a team that's going to generate good performance if they're reputedly very difficult to work with?"

ACCESS TO INFORMATION

The time it takes to complete background checks can vary. "The checks can take anywhere from two to six weeks generally, depending on the jurisdiction of the manager and assuming that things come back normally – obviously if there's a substantive issue that needs further work, that can extend the time," says K2 Advisors' Kandiew. "A background check on someone in the US might take up to two weeks, and in the UK that could easily be four weeks."

This difference is partly down to privacy laws, which can mean it takes longer to gather and collect information in some places than others. It is generally much quicker, for example, to uncover an individual's legal and educational records in the US than elsewhere.

Investigating managers in Asia can be more challenging. "In Asia, in addition to the privacy concerns, the databases are less robust, and there's a language barrier to get over, so you're normally working through a secondary party in order to get that information," he explains.

Although it can take time, allocators see it as a critical risk control measure. "There's no advantage for us in taking risks with a manager," says Fundana's Morrell. "Because we're vetting a large number of managers every year, we can afford to be picky. As a FoHF adviser with institutional clients, we would never take a risk on that side of things. But we can take a more informed and intelligent view on certain issues than other types of investor who maybe are not as specialised in hedge funds."

"A number of our investors do ask about it," adds Kandiew. "They want to know that it's done, that it's thorough, the details of what we look at, that it works properly, and that we use it as a basis of selecting." ■