Investing in hedge funds

Prudent investors will tread carefully.

News of yet another hedge fund meltdown should alert investors to the risks associated with these investments. Hedge funds offer potentially high returns that have resulted in explosive growth in the number of funds and the assets under management. The recurring news reports of periodic hedge fund failures highlight the hedge fund risks implicit in those claimed high returns.

To understand some of these hedge fund risks, *Smart Business* spoke to Dan Lampert, a business attorney recognized for representing leading companies and successful individuals in the legal aspects of investment transactions.

What is a hedge fund?

A hedge fund pools money from institutional investors and wealthy individuals for investment. Although the name connotes some form of risk hedging, today's hedge funds run the complete gamut of investment risks, from the most stable to the most volatile investment techniques.

In analyzing hedge fund risks, one must recognize that hedge funds present at least the same, and often increased, risk levels as mutual funds. In addition, hedge funds have much less oversight and regulation.

The federal courts have rejected the SEC's modest attempt at hedge fund regulation. This leaves hedge fund investors to incur the risks of these investments without the benefits and oversight of effective regulation.

Why have hedge funds become so popular?

Hedge funds have become more popular because of (a) growth of the absolute amount of investment capital in retirement funds, (b) increasing financial challenges to the retirement of the baby boom generation, (c) the American economy's status as a relatively safe haven for worldwide investment, and (d) dwindling returns offered by conventional stock and bond funds.

Hedge funds have positioned their investment offers to appeal to an ever-growing amount of investment capital with an insatiable appetite for better returns. These trends have supported the 10-fold increase over the last 15 years in capital under hedge fund management from less than $100 million to more than $1 trillion. Today, the hedge fund community includes more than 8,000 hedge funds.

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So why do hedge funds fail?

The sheer number of hedge funds offering speculative rates of return creates a near certainty of a certain number of investment failures. Hedge funds offer a wide variety of risk profiles. There is an even wider variety of skills among hedge fund managers. It's normal to have a percentage of poor investment managers and even occasional outright frauds. The unregulated nature of the hedge fund industry increases these risks by removing the supervision that might mitigate risks.

How does a prudent investor navigate through these risks?

Successful investors benefit from the guidance of trustworthy investment advisers skilled in the type of investment being considered. Professional advice and due diligence can place hedge funds appropriately into an investment portfolio. That due diligence should extend beyond a cursory reading of an offering document. In the hedge fund arena, these professionals perform thorough analysis, including background reviews, of hedge funds and their managers.

If background review comes back clean and a hedge fund investment proves appropriate for a particular investor, the investor should then engage a skilled transactional lawyer to negotiate and explain the investment agreements. Given the lack of hedge fund governmental regulation, hedge fund investor rights depend almost entirely upon these contracts. Prudent investors should thoroughly understand (and larger investors may be able to negotiate) important aspects of these investments, including (a) the time required to withdraw funds from the funds, (b) the leverage ratios the fund can sustain, (c) any limitation on the fund's investments, and (d) compensation to fund managers and other important fund features.

What final words of advice on this subject would you give to a business executive?

Many executives underestimate their exposure to hedge fund risk. Beyond any direct investments, many executives have indirect exposure through investment by pension funds and other vehicles that invest in hedge funds. As such, all executives should become familiar with the basics of hedge fund investing.

Hedge funds have become an important part of the investment landscape. Like any other investment type, the quality of your hedge fund returns will directly reflect the quality of your investments. Quality investments start with quality due diligence and investment advice, followed by careful investment negotiation and structuring, and followed up by consistent monitoring post investment.

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