

From Hedge Funds for Dummies:

Due Diligence Questions

One of the first steps in determining if a particular hedge fund makes sense for you is asking a lot of questions. The fund manager may give you an offering document that answers some of these questions - and raises others not on the list. No matter how good the document is, you'll have to sit down for an interview with the fund manager or submit a list of questions to the fund's staff. And be sure to look for ways to verify the answers with any outside sources.

This list is just a beginning. Add to it freely!

- **Investment strategy**

- What is your investment objective? How do you get alpha?
- How was the portfolio constructed? How and why is it rebalanced?
- What is your analysis and investment style? What would cause you to deviate from it?
- If you use computer models, do you ever override them? Do you change the models?
- What is the average number of positions that the fund holds? How long does it hold a typical position? What is the level of portfolio turnover?
- Do you use sub-advisors? When and why? How are they compensated?
- Do you see yourself as a trader, an investor, or an analyst?
- Why is this fund different from others with the same investment style?
- Is this fund more suitable for taxable investors or for tax-exempt ones?
- How does the fund keep enough liquidity to meet allowed withdrawals?

- **Performance**

- What have been your worst months? Your best months? Why?
- Was your performance in the past year earned evenly during the year, or were there one or two really good months? If so, what made those months so good for your strategy?
- What was the time (the peak-to-trough range) between your best month and your worst month?
- What holdings have worked out the best for you? Which one was your worst ever? Why?
- Who calculates the fund's returns? How often? Where do they get their data, from the prime broker or from the fund manager?
- How is the portfolio valued? When is it priced? How are illiquid securities handled?
- Is your performance GIPS compliant? If not, why not? Do you report your performance to Morningstar or other tracking services?

- **Risk management**

- How does the fund use leverage? What is the average leverage? What is the maximum leverage allowed? How often are you near those limits?
- Does the fund always have some leverage?
- Does the fund borrow from one bank or broker, or from several?

- What is your maximum exposure to any one security? Any one market? How often are you near those limits?
- How much of your borrowing is overnight? Short-term? Long-term? How has that changed over time?
- How do you define risk? What is your firm's attitude toward risk?
- What risks have you identified? What are your strategies for managing them?
- What happens if a trader exceeds his or her limits?
- What are your long-tail risk scenarios?
- Do you use derivatives to hedge? To speculate?
- Do you try to profit from, or hedge against, interest rate risk? Currency risk? Market risk?
- **Fund operations**
 - Who are the fund's founders? Are they still here? If they have left, why did they leave and where did they go?
 - How are your traders compensated? What is the turnover of your investment staff? Of your total staff?
 - How much do the fund principals have invested in the fund? Is this a lot of their net worth?
 - How do you keep the front and back office separated?
 - Who is the asset custodian?
 - What are your data backup and disaster recovery plans? How quickly could you get back into business if your building shut down?
 - Who takes over if the fund manager is incapacitated or dies? What is the key person risk?
 - What are your data security practices?
 - Is the fund audited annually? If not, why not? If this is a new fund, has an auditor been lined up to do an audit at the end of the year?
 - What is your accounting firm? Your law firm? Your prime broker? Your administrative services firm?
- **Compliance and transparency**
 - What are your compliance policies and procedures? May I see them?
 - Are you registered with the Securities and Exchange Commission? With the Commodity Futures Trading Commission? Why or why not?
 - How much disclosure and reporting can I expect? How much transparency should any hedge fund investor expect?

Hedge Funds for Dummies, by Ann C. Logue

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