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When dealing with money, check hedge fund's back office

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Robert Jones

Bernie Madoff knew where to hide his crimes, so that's where your due diligence on an operator should start if you want to avoid getting burned

The lure of high returns that aren't correlated to other markets has led to an explosion of global hedge fund money, to more than US$2 trillion. Unfortunately, "explosion" also describes a number of hedge funds that literally blew up over the years due to fraud or poor risk controls.

Hedge funds are typically managed offshore, outside the jurisdiction of local regulators. The funds use wide-ranging investing styles and ask for maximum flexibility from investors on the ways they can use their money. The managers of these often obscure, boutique funds move capital quickly from trade to trade, into many different accounts.

Any investor looking at a hedge fund has to ask the question - how do I know I'm not going to get ripped off?

When attempting to answer this question, most investors often focus exclusively on front-office issues such as a hedge fund's track record, investment team and strategy. They then get blindsided by mundane "back-office" issues, such as finding out the hard way there was only one person signing off on wire transfers, or that a fund didn't have a proper administrator.

The back office is the guts of the enterprise. Here operations and accounting staff manage complicated but tedious goings-on such as cash management, collateral, settlement and accounting.

It's also where most of the fraud happens. Because the operations are complex and convoluted, fraudsters can siphon off cash using false accounts, manipulated statements and fake trades, and bury everything in stacks of paperwork. Bernie Madoff did exactly that when pulling off his multibillion-dollar fraud, allegedly colluding with back-office staffers to hide his epic Ponzi scheme for more than a decade.

As was well summarised by a recent Deutsche Bank report, investors looking at a hedge fund should ask themselves, what are the backgrounds and number of back-office staff? Is the team up to the job? What kind of expenses is the fund manager charging to the fund? What is the composition and role of a fund's board of directors? Is there a segregation of duties between portfolio managers and personnel responsible for valuing, reconciling and settling their trades?

I suspect that a very low percentage of individual hedge fund investors in Hong Kong (or anywhere) actually take due diligence to this level. But it simply must be done. Otherwise, investors who do a fairly good job of selecting funds solely based on a limited review face the prospect of having their good returns entirely offset by a few bad apples that offered tasty returns and delivered fraud.

Small investors would do well to emulate large investors' due diligence in relation to the back office and put the same blood, sweat and tears to work that they put into analysing a hedge fund's front office. Without this effort it's best to either avoid investing in hedge funds or invest in a fund of hedge funds that does all of this work for you.
