

investment-grade ratings at face value, Tsujimoto says the best managers ignored the ratings and did their own fundamental research on the bonds underlying each structured-debt portfolio. "Several of them have profited hugely in the subprime area," he says. One such winner is New York-based Paulson & Co., whose \$4.5 billion Credit Opportunities Fund I and \$2.3 billion Credit Opportunities Fund II were up a respective 26.67 percent and 32 percent in August.

For hedge funds and credit traders on the wrong side of subprime, the acid test will be how their investors feel about acknowledging that they own the losers, says Judy Posnikoff, a managing director at Irvine, California-based Pacific Alternative Asset Management Co. To avoid public scrutiny, insurance companies, pension funds and other institutional investors may dump sour funds before year-end. "There is more pain to come," says Posnikoff.

— Neil O'Hara

Digging Deeper

Hedge fund managers be warned: Investors may be watching you more closely than you think. In the wake of blowups among some of the industry's highest-profile funds, and given their vivid memories of past hedge fund scandals, investors are doing more homework on potential managers than ever before.

"Background checks are becoming standard practice for institutional investors," says Guy Simonian, CEO of West Hartford, Connecticut-based CheckFund-Manager.com — an investigative firm that caters to institutional investors, capital lenders, private equity firms and funds of hedge funds. "The trend is toward recurring due diligence and annual background investigations."

According to Simonian, one out of every six investigations raises some sort of red flag, a third of which involve something serious enough to make investors walk away. These range from regulatory infractions and criminal records to the fabrication of employment or educational histories. Investigators also try to uncover managers' own financial problems, looking for bankruptcy filings, judgments or liens, pending lawsuits — or even just bad press.

New York-based First Advantage Investigative Services offers investors a hedge fund product called the Back Track Report, which combines court-record reviews with credentials checks and interviews with people who know the manager in question. Randy Shain, First Advantage's vice president, says the firm's investigations unearth significant findings roughly 15 percent of the time.

"We find some criminal activity — sexual abuse, theft, forgery — but most of the problems involve investigation subjects lying on their résumés about their education or hiding a dispute with partners," he says.

Morgan Creek Capital Management, a Chapel Hill, North Carolina-based asset management firm that invests on behalf of foundations and endowments, has turned to hedge fund investigator services on occasions when potential investments involve illiquid markets and opaque pricing. "When there aren't as many independent eyeballs looking at a market, a manager can wander off the reservation," says Michael Hennessy, a senior investment officer with Morgan Creek.

Specialty investigators charge as much as \$1,000 for the most basic background check, even as online services such as Intelius charge as little as \$75. Private investigators admit that the Internet is a good starting point, but remind investors that many courts have yet to move their records online. A thorough background investigation involves trips to the courthouses in all the jurisdictions a subject has ever lived or worked.

Scoreboard

Hedge fund returns by strategy, sorted by investment process, asset class and geographic focus, through June 30, 2007.

	Monthly return	YTD return	3-mo. return	12-mo. return	3-yr. return*	3-yr. std. dev.*
Composite, equally weighted	3.00%	7.51%	3.27%	13.82%	11.05%	3.74%
Composite, asset-weighted	0.00	7.49	2.83	14.09	10.84	3.56
Process group						
Directional trading	-0.55	4.10	2.76	8.73	8.25	4.81
Systematic trading	-1.69	2.50	2.36	6.89	7.11	6.88
Discretionary trading	0.72	5.62	3.17	10.71	9.26	3.50
Relative value	0.24	4.83	1.46	8.31	6.25	1.56
Arbitrage	0.27	4.93	1.34	8.72	5.45	1.83
Convertible arbitrage	-0.68	3.81	0.39	8.95	4.90	3.31
Fixed-income arbitrage	0.82	5.13	1.61	8.23	6.49	1.01
Mortgage-backed arbitrage	1.09	6.18	2.61	9.66	7.02	1.15
Merger arbitrage	-1.55	3.64	-0.35	8.30	7.62	2.84
Statistical arbitrage	0.74	4.45	2.38	6.00	6.55	1.79
Multiprocess	0.72	6.61	1.86	11.66	8.52	1.87
Security selection	0.81	9.91	4.51	18.34	13.96	5.11
Long bias	0.78	11.19	4.97	21.41	16.24	6.37
No bias	0.78	11.19	4.97	21.41	16.24	6.37
Variable bias	1.00	9.16	4.62	17.07	13.27	4.89
Short bias	1.38	-0.47	0.72	-8.66	-2.38	7.74
Specialist credit	-0.81	6.45	1.27	12.30	11.36	2.48
Distressed securities	0.39	9.38	2.88	17.09	16.08	3.40
Long-short credit	-1.92	3.45	-0.48	7.85	7.72	2.27
Multiprocess group	0.82	9.36	3.20	15.45	12.30	3.56
Multiprocess	1.48	9.95	3.96	15.51	11.93	3.32
Event-driven	-0.93	7.74	1.15	15.13	12.88	4.59
Asset class indexes						
Equity	0.87	9.45	4.30	16.77	12.91	4.46
Fixed income	-0.41	5.23	1.18	9.48	9.03	1.68
Diversified	-0.38	5.35	2.63	10.53	9.51	4.26
Currencies	-1.31	2.20	0.03	8.62	5.27	4.52
Geographic area						
Developed markets	-0.41	5.83	2.09	11.26	9.65	3.56
Europe	-0.62	6.06	0.77	13.50	11.80	3.96
North America	-0.47	6.18	1.81	11.82	10.01	3.73
Japan	0.58	3.96	3.29	5.29	6.85	6.16
Developed markets, diversified	-0.57	4.68	2.42	9.14	7.96	4.04
Emerging markets	2.48	13.44	7.76	24.02	18.44	5.67
Combined Asia-Pacific	2.53	14.04	8.53	22.94	14.87	4.97
Global markets	2.90	13.72	7.20	23.41	16.39	5.21

* Annualized.

Source: MSCI.

Take Stamford, Connecticut-based Bayou Management. In 2005 the hedge fund firm's top two executives were caught defrauding investors out of roughly \$450 million by withdrawing money earmarked for investment, hyping investment returns and filing misleading financial statements to hide their actions. First Advantage's Shain says a simple look at the court records of the firm's founder, Samuel Israel III, would have been enough to keep most investors away from the fund. "Sam Israel was arrested for drunk driving, and drugs were found in his car," he says. "Also, there was a \$2.6 million judgment against him in California."

Christopher Bittman, chief investment officer for Denver's University of Colorado Foundation, turns to specialty investigators whenever his \$700 million fund plans to make a significant investment. "We take the management of our endowment very seriously, and the work of our outside private investigators is an important component," he says. "I'm not suggesting we're going to pick through a manager's garbage before we invest with them — but we reserve the right to." — **William Freedman**

As Alpha Reported

It's hard to get good help these days, particularly at college and university endowments. That was Alpha's finding when we examined the topic in "Making the Grade," in our July/August 2007 issue. Still, no one expected Mohamed El-Erian to exit the revolving door of endowment CIOs so soon after his October 2005 arrival at Harvard Management Co. In his short tenure at Harvard, El-Erian spent a lot of time interviewing and hiring investment professionals to rebuild the management office after the September 2005 departure of his predecessor, Jack Meyer. Like many before him, Meyer left to launch a hedge fund — in his case, Boston-based Convexity Capital Management — taking 33 of his employees with him. El-Erian was left to contend with a \$350 million portfolio loss in July stemming from hedge fund firm Sowood Capital Management, a Meyer-era investment. Yet he still managed to generate a 23 percent return for the endowment's fiscal year, ended June 30. In January he returns to his former employer, Newport Beach, California-based Pacific Investment Management Co., where he will fill the newly created post of co-CEO/co-CIO. — **Frances Denmark**

Frank Assessment

For Massachusetts Representative Barney Frank, the lesson of the subprime mortgage crisis is simple: Financial markets need more regulation. "We have had the worst of both worlds — great innovation accompanied by deregulation," Frank told *Alpha* in an interview last month. "You get real regulatory gaps, and the time has come to think about how to close them."

Hedge fund managers have no choice but to take Frank seriously. The 14-term Democratic congressman took over as chairman of the House Financial Services Committee in January, when his party attained the majority. But how much he really threatens the lightly regulated status of alternative investments is unclear.

"I'm not after hedge funds in particular," Frank says. "This issue is the new instruments in the market — and the enormous leverage — not who is doing the trading."

Frank recognizes that hedge funds, which are designed for institutions and other sophisticated investors, require less oversight than mutual funds marketed to the general public. But given hedge funds' role as buyers and

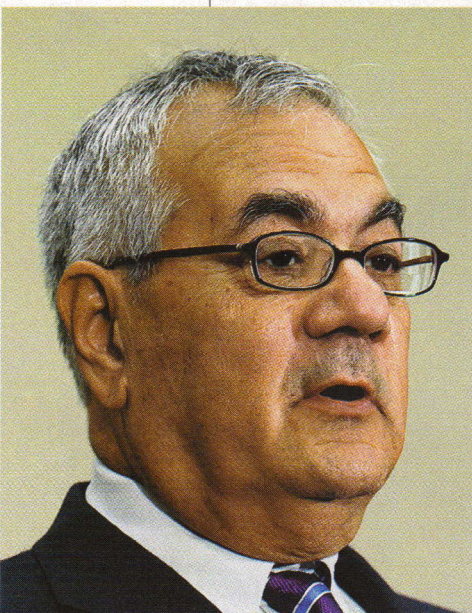
sellers of toxic subprime-backed securities, he says, "the needle has moved to where we want, at the very least more information."

Further than this the chairman will not go — for the moment — and staffers say his team has yet to thrash out details on hedge fund disclosure. A September 5 hearing Frank held on Capitol Hill to address subprime fallout proved anticlimactic, at least for fund managers. Four federal officials, led by Treasury undersecretary for domestic finance Robert Steel, were chided by committee members for their purported laxity on "liar's loans," "predatory lending" and other now-household terms. The U.S.'s broader financial architecture, including hedge funds, was not touched.

Frank struck a mild tone in his opening statement asking, "Can we come up with regulation that will diminish the harm without killing the whole operation?" His only public conclusion after the panel was to call on the Federal Reserve Board to enact a "meaningful interest rate cut" — a position with which most of Wall Street presumably would not quarrel. (On September 18 the Fed granted Frank's request by cutting the federal funds overnight lending rate 50 basis points, to 4.75 percent.)

Based in the deep-blue suburbs of Boston, Frank has a reputation as an unabashed liberal. Yet "he also has a libertarian streak," says hedge fund manager Phillip Goldstein, principal at Bulldog Investors in Pleasantville, New York, and a self-styled libertarian who won a court battle in June 2006 against a Securities and Exchange Commission regulation requiring hedge funds to register. Frank was one of the few legislators last year to oppose outlaw-

Massachusetts Representative Barney Frank: Looking at how to close the regulatory gap.



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