THINGS AREN'T ALWAYS WHAT THEY SEEM

MAURY CARTINE, ALTERNATIVE INVESTMENTS PARTNER AT **MARCUM LLP**, TALKS TO *HFMWEEK* ABOUT THE IMPORTANCE OF DUE DILIGENCE, HOW TO SPOT INVESTMENT DANGER SIGNALS AND HOW A HONDA CAN SOMETIMES OUTPERFORM THE BENTLEY

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A few years ago my big day finally arrived! My wife wanted me to have something special and she picked out the Bentley GTC. I was thrilled to own a classic automobile. However, soon after purchasing the quintessential British luxury vehicle, I learned I was in fact mistaken. The Bentley was manufactured by Volkswagen! After a little more due diligence, I discovered that my very own everyday car, the Honda Pilot, had a more advanced sound system than the Bentley. So what does all this have to do with investment managers? It is simple; our failure to exercise proper due diligence in selecting an investment manager can have severe consequences that go well beyond choosing the wrong car. As any former Madoff investor can tell you, the wrong choice can be catastrophic!

The vast majority of investment managers are hard-working individuals who take pride in what they do and act with integrity. The results of each manager will vary and the choice of managers may ultimately be the wrong choice for an investor anyway. However, nothing is worse than picking an investment manager who is dishonest from the get-go, prone to dishonesty when the going gets tough, or simply too distracted to be effective. After more than 25 years of working with start-up funds and seeing them through many years of operation, I have learned quite a few things about investment managers. Among those things are the danger signals that if ignored, can lead to a bad choice for an investor and our firm as a service provider. Let's take a look at some of the more important danger signals that investors and fund of funds managers in particular, should watch out for.

Investment managers frequently meet with us to discuss the new funds they are launching. We listen carefully to the service providers that are being selected by the investment managers. We want to see choices that make sense to us with respect to the selection of legal counsel, administrators, prime brokers and auditors. If the names of these service providers are not easily recognisable by us as having industry expertise, we make note of our first danger signal. If the competence level of the service providers is less than we think it should be, we know that mistakes in the valuation of assets and the performance of the fund can occur. We also know that less seasoned service providers may fail to recognise the danger signals that are important to them.

Many years ago a young, energetic new investment manager came to my former firm and met with us regarding audit and tax services. We were retained to provide both services. The manager retained an offshore adviser to provide consulting services and the adviser indicated that the manager could avoid paying tax on his performance and/or management fee by using a straw offshore location even though the operations would be conducted in New York. I explained the various reasons why this approach was absurd and we were summarily terminated before we even began services most probably because of my advice. I was suspicious of the "offshore adviser", and the manager's willingness to take an unreasonable tax risk was a danger signal for me! The manager's strategy was simple; the technology sector was overpriced and the bubble was about to burst so the manager shorted technology stocks in the late 1990s. He was too early and the fund incurred significant losses. Faced with the fund's likely failure, the manager invented an offsetting portfolio by creating fictitious account statements to not only hedge the losses, but to produce a positive return! The fictitious statements fooled a competent administrator, a competent auditor and even the prime broker.

What went wrong? The administrator and the auditor permitted the investment manager to provide the fictitious account statements directly to them and never confirmed the account balances directly with the broker/dealer. What else went wrong? The administrator and the auditor probably should have been suspicious of the volume of trading that was being conducted through a broker/dealer that was not recognisable as a significant service provider

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in the hedge fund industry. Since our firm's name was still prominent in the confidential memorandum (it apparently was not corrected to delete us), the SEC called me. I told them the bad news is that our firm is named in the confidential memorandum, but the good news is we were fired before we ever did any work!

What are some other important danger signals? An investment manager's style begins to drift. The manager is straying from the investment strategy he promised in the confidential memorandum. Why would this happen? Is the manager desperate to create positive performance or is he fraudulently covering up poor performance like the manager described above? Does the investment manager trade with several broker/dealers without the services of a prime broker? If the fund has sufficient assets, this should never happen. Is the administrator so small and so de-

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pendent on the investment manager's business that the manager can bully the administrator? Is the investment manager borrowing money from the fund? Incredibly this does happen and it is fair to say that most investors do not expect the fund's performance to be based in part on the interest received on loans to the manager!

Nothing is more important than the investor's initial due diligence for both new and existing investment managers. Our firm always conducts a background check on new clients. What danger signals do we look for? We are concerned when a manager has a history that includes several security law violations even if they are minor. We also take note of liens for unpaid federal taxes, pending litigation against the manager that suggests impropriety and even significant marital disputes. If the manager is feeling stress from creditors, he may be too distracted or perhaps too dependent on outstanding fund performance to suit me! I might go to dinner and a hockey game with the manager, but I won't become an investor in the fund!

Many years ago, a fund of funds manager and client referred a new investment manager to my former firm. The fund of funds manager described the investment manager as a great guy with a great reputation. Our client had invested a significant amount of capital with the manager. Our background check revealed a number of security violations. Each violation was small enough, but the number seemed to demonstrate a lack of due care or perhaps worse. More importantly, we knew the manager operated in a state that required the investment manager to register and with his record of violations, the manager would never be approved. Thus, he was technically managing the fund illegally! We chose not to take the client and because the violations were a public record, we informed our fund of funds manager of our decision. The fund of funds manager withdrew his capital and the fund did eventually blow-up.

If the securities portfolio isn't what it is purported to be and an investment manager isn't the great guy or gal he or she is supposed to be, the investor is at risk. Things aren't always what they seem. Now when I drive off in the Bentley, I don't say "Cheerio" – instead I say "Auf Wiedersehen"! ■