FINANCIAL TIMES

TUESDAY JANUARY 31 2006

FT WEALTH

Best investor practice makes (near) perfect

Greenwich Roundtable members Ted Seides of Protégé Partners (left) and Lawrence Bartimer of The Portfolio Strategy Group

By Stephen Schurr

The Greenwich Roundtable has done it again – and this time, it is going global.

Last summer, the Roundtable, a non-profit research organisation for investors in hedge funds, presented its 200 members with a report on best practices for investing in equity hedge funds. It was certainly timely, laying out the rewards and risks just before fraud was discovered at Bayou Group.

"A casual reader of our Best Practices document would have between eight and 10 points where they should have been alarmed [about investing in Bayou]," said Spencer Boggess, a US Trust executive and chairman of the Roundtable's education committee.

Following this success, the Roundtable has released "Best Practices in Hedge Fund Investing: Due Diligence for Global Macro and Managed Futures Strategies", a copy of which was given to FT Wealth. Like the equity offering, the Roundtable offers sound general advice, including: beware funds that aggressively gather assets; ensure other investors do not have special liquidity or disclosure arrangements; and conduct a thorough due diligence into the manager's background.

The 48-page report on global macro and managed futures strategies offers dozens of unique insights for investors – we chose to focus on five especially worthy ones.

But first, a brief explanation of both strategies. Global macro investing, made famous by George Soros, typically involved a top-down approach to identifying investable themes around the world in a variety of asset classes. Usually, the investments are at the discretion of the manager but sometimes quantitative models may help drive decisions.

Managed futures funds, sometimes known as commodity trading advisers, also focus on global asset classes. But they almost always trade in derivatives such as futures and options, and often the investment decisions are driven by quantitative models. The most common type of investment here is "trend following".

■ **Understand the strategy.** While the core strategy may be complex, the investor needs to have a firm understanding of what the manager sets out to do. "The core philosophy may require some elaboration but the manager should be intellectually disciplined enough to articulate it in a clear, concise and easily understandable way," the report said. For global macro, that means knowing the manager's macroeconomic outlook and how it will be implemented in the fund.

For managed futures with a quantitative strategy, the investor needs to understand "what market 'behaviour' or inefficiency are the models attempting to capture". Is it a trend follower or does it rely on mean-reversion strategies?

■ **Determine the worst-case scenarios.** Every hedge fund offers back-testing that virtually always shows smooth profits – which is nice but meaningless if it hasn't faced real-world markets.

In examining managers that have some tenure, investors should take a close look to see how the funds have done in the worst of times such as "the Russian devaluation and LTCM crisis and September 11 2001". Pay attention to what have been the best and worst environments for the funds, and ensure losses are minimised.

■ **Study the correlation among investments.** Most global macro and managed futures funds claim to offer a comforting level of diversification and low correlation among investments. But often during times of crisis "all correlations go to one" – in other words, all the positions fall at the same time. The Roundtable report notes that with global macro: "It is not necessarily important how many trades are in the book but rather how correlated these trades are."

Investors need to determine if managers are sensitive to potential correlation shifts during market disruptions and also if they are using long-term hedged positions to mitigate losses in the event of a downturn. The report quotes Ray Dalio of $20bn hedge fund Bridgewater Associates: "The key to successful investing is finding 15 good, uncorrelated return streams. Diverse return streams reduce your risk by 80 per cent."

■ **Know the leverage.** Hedge funds of all stripes employ leverage to maximise returns but inevitably leverage adds greater potential risks. Investors need to learn to what degree the fund is leveraged and what are the highest and lowest levels of leverage the fund aims to use. Pay close attention to how leverage is used in various markets, since many global markets are less liquid and highly volatile.

■ **See how risk is managed.** With many global macro funds, risk management is a separate function that is removed from the manager. Managed futures funds that rely heavily on quantitative models often embed the risk management in the models.

"With discretionary macro, an independent risk manager can sometimes mean the difference between exiting a losing position and overplaying a bad hand."

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