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House of Representatives

Best Practices in the Hedge Fund Industry

HON. CHRISTOPHER SHAYS
OF CONNECTICUT
IN THE HOUSE OF REPRESENTATIVES
Thursday, July 28, 2005

MR SHAYS: Mr. Speaker, the hedge fund industry plays a critical and special role in our capital markets and is enormously important to helping institutional investors diversify their investment portfolios and meet their future funding needs.

While the numbers fluctuate some, there are believed to be close to 8,000 hedge funds that manage approximately \$1 trillion in assets. Connecticut's Fourth Congressional District, which I'm very proud to represent, is the home to several hundred of the most successful hedge funds.

Over the past few years, the industry has received increasing attention from the media, Congress and the Securities and Exchange Commission (SEC). I happen to believe that strong oversight of our financial markets is critical to our nation's economic well-being, but recognize that with sophisticated and knowledgeable investors, hedge funds do not require the same level of scrutiny as is paid to the mutual fund industry. Nevertheless, it seems to me that more transparency and better government and regulator understanding of the industry will ultimately benefit investors and managers alike.

The Greenwich Roundtable is a not-for-profit organization, based in Greenwich, Connecticut with a mission to promote education in alternative investments. This thoroughly professional and thoughtful institution has produced a report entitled, "Best Practices in Hedge Fund Investing: Due Diligence for Equity Strategies," that I hope will serve as an important reference for this body, for investors and for others

interested in our capital markets. The goal of the publication is to "help demystify a topic that has been shrouded in myth and, by doing so, help improve the level of education among those who wish to better understand the community of active hedge fund investors." It seems to me this is a very important document and would recommend it to any of my colleagues with an interest or concern about the industry to review it.

An abstract of this report is below, and I again would like to express my appreciation to the Greenwich Roundtable for this important and timely publication.

Best Practice in Hedge Fund Investing: Due Diligence

This publication is the first collaboration of its kind, between investors and managers. The goal of this publication is to help demystify a topic that has been shrouded in myth and, by doing so, help improve the level of education among those who wish to better understand the community of active hedge fund investors. This is the first issue of the planned series of Best Practices in Hedge Fund Investing.

Inside this first issue, you will be treated to an informed examination into the art of due diligence. The scope will be confined to examining equity-oriented strategies. The universe of hedge fund strategies is enormously broad and diverse. Any single method of inquiry applied to all due diligence would become generic. Future issues will cover strategies in other areas such as managed fixtures, fixed income and asset-backed markets.

The investors who created this publication are members of our Education Committee. Their backgrounds are broad and diverse. They hail from the family office, bank proprietary capital, or fund of funds communities. They are all seasoned investors in a broad range of strategies. For two years, our purpose has been to uncover "soft" aspects of performing

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hedge fund due diligence. Our emphasis is on developing an interpretative discussion whenever a flag is raised. There have been many generic investor questionnaires circulated. Most were focused on collecting quantitative data. Quantitative analysis is backward looking. Qualitative analysis is more useful as a forward looking tool.

Selected Excerpts:

Strategy, Investment Process, and Market Opportunity

A critical first step in any evaluation of a hedge fund investment is the establishment of a proper context for the evaluation. Once the context for the evaluation is properly understood, it is possible to proceed with a more nuanced investigation of the investment strategy, the portfolio manager's edge, and other relevant fund particulars.

Team and Organization

The quality of a firm's human capital will contain, perhaps the strongest clues about its prospects for sustainable success. Moreover, the success of the organization requires both investment and business management acumen, skills that rarely reside in equal proportion in any single investment professional.

Fee Structure and Terms

The evaluation of a fund's fee structure and terms is essentially an exercise in understanding the value proposition of a particular hedge fund investment. Much of this will depend on the circumstances and environment in which the investment opportunity is presented. In the end, an investor must ultimately determine whether the terms and conditions for this investment are reasonable and fair.

Management Company, Fund Structure and Asset Base

An evaluation of the hedge fund's management company should be focused on the question of what kind of business it is. In the final analysis, an investor needs to understand if there is a true alignment of incentives between the prospective investor and the portfolio manager in regards to their investment objective.

Quantitative Review

Many experienced hedge fund investors appear to view quantitative analysis as a valuable complement, rather than a substitute, for more qualitatively drawn judgments. Deployed intelligently, certain quantitative disciplines can help confirm the wisdom of more qualitatively drawn judgments and assist in highlighting aspects of the investment strategy that warrant further investigation.

Operations and Transparency

There is a big difference between portfolio transparency and translucency. Transparency implies a more substantially active role on the part of the manager in identifying and clarifying key risks for investors. Translucency implies a simple commitment to provide a clear view of the portfolio holdings and may not be very helpful in informing the investor.

Third Parties

Evaluating the quality of the third-party vendors, as well as understanding the intersection of in-house and third-party business management, is critical to understanding how disciplined the hedge fund business and investment processes truly are.

Intuition, Judgment, and Experience

No amount of due diligence can completely replace the importance of experience and intuition when investing with a hedge fund manager. Finally and most importantly, would you invest your own money or your family's money with this manager?

