Is the proof in the pudding? Detecting fraud and operational risks through hedge fund performance and reporting

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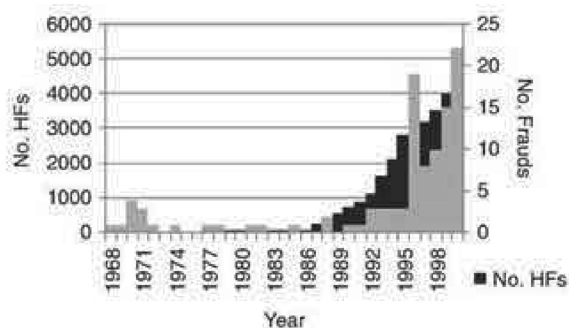
As hedge fund assets under management once again near the 2007 pre-crisis peak of roughly $1.77 trillion, it is evident that asset allocators have regained their confidence in the alternative asset management space. This time around, however, investors are increasingly focusing on extensive due diligence practices to more thoroughly filter out managers who pose potential left tail and fraud risks. And rightfully so, as the increase in hedge fund assets and products offered increases the likelihood that new fraudulent schemes will emerge. In his Hedge Fund Fraud Casebook, author Bruce Johnson notes that charges of fraudulent hedge fund activity rise as the number of hedge funds rises (see chart below from Johnson's book). Fortunately, third party due diligence providers and increased investor awareness of fraud detection techniques are assisting allocators in conducting rigorous due diligence.



[4]

One way that service providers can help mitigate the risk of fraud is by conducting comprehensive background investigations on key personnel within a hedge fund organization. These important investigations should be conducted by someone who has true investigative experience. Our colleague David Fisher, a 24-year veteran of the US Secret Service and 9 years in an investigative unit of the US Air Force, has been conducting background investigations of trading managers since 2008 and shares some of his insights here [5]. Additionally, investors, registered investment advisers, and others in the alternative investment space can use a variety of analytical techniques to help them identify managers who may pose potential operational or fraud risk.

In a paper titled Predicting Hedge Fund Fraud with Performance Flags [6], authors Nicolas Bollen and Veronia K. Pool suggest that fraud can be predicted by using performance as an indicator. The authors infer that a suspicious pattern of returns suggests a heightened risk of fraud. As a quantitative screen, managers who have been convicted of fraud typically exhibit a pattern in data quality, including: a significant number of monthly returns exactly equal to zero, recurring similar or identical monthly returns, long strings of identical returns, and a lack of variety in the last digit of the monthly return. Some of these concepts were first expounded in a previous AAA post [7]. It goes without saying that there are exceptions to these indicators, but using data patterns as a preliminary screen to scrutinize managers can be helpful when trying to identify potential fraud and operational risk. There are several advanced statistical and mathematical techniques to help identify if a series includes data that has been fabricated. Persi Diaconis, a Professor of Statistics at Stanford University and probably the world's best expert on randomness, has spent decades developing techniques to solve applied problems concerning randomness (see this sketch [8] of Persi's life, as well as his publications [9]on randomness and statistics).

Misreporting performance can also indicate a manager's operational risk. A finalized performance table for a particular fund should be identical for newsletters, presentations, and other marketing materials. Reporting inconsistency among documents should raise doubts about the manager's operational procedures. If there are discrepancies in performance it is best to contact the manager directly to determine the cause.

A manager's monthly estimates can also raise red flags about misreporting and potential operational risks. An investor should be concerned or at least curious if there are substantial differences between the

estimated and official returns. Vigilant investors will consider the following: the pricing characteristics of the asset classes and instruments within a manager's portfolio; the length of time between the end of the month and reporting of the estimate; and the length of time between the reporting of the estimate and the official return. For example, if a long/short equity manager changes the February 2010 monthly return in their November 2010 newsletter, this merits a request for an explanation. This would be less alarming however, if the manager invests through credit default swaps, collectibles, or real estate. Inaccurate estimates and delayed reporting can provide insight into the manager's operational processes.

It is important that a manager's performance has been audited by a reputable accounting firm. Failure to properly audit returns raises significant questions about the cleanliness, integrity, and validity of the data itself. Properly representing returns and highlighting the assumptions and limitations in a clear and ethical manner is another indicator of the manager's integrity. It is also important for a manager to be registered with the appropriate regulatory bodies.

Investors should understand a manager's strategy and how the returns are generated. It is crucial to marry the qualitative with the quantitative here, that is to be able to "tell the story" of the track record and explain the best and worst periods of performance related to the specific trade or market event. Comparing performance to industry peers and hedge funds that invoke a similar strategy is also a wise step. Transparency is the best antiseptic in that people usually refrain from engaging in fraudulent behavior if they know they are being watched. A secretive hedge fund that is opaque and reluctant to give transparency should raise a yellow flag in itself. Such an approach to transparency is more appropriate for a private proprietary trading shop that trades its own money, rather than a hedge fund marketing itself to outside investors.

Lastly, managers who conveniently report returns on different dates within the month may pose operational risk. Managers vary significantly in the frequency with which they distribute newsletters and the level of transparency they provide. Managers who offer transparency only when performance is flattering raise questions as to the reliability and integrity of their marketing materials and reporting. Sincerity and consistency in the distribution of these materials can be significant in identifying potential operational risk. Investors who seek to detect operational and fraud risk should pay close attention to a manager's newsletters and other marketing materials that display performance.

Using these techniques, intelligent investors partnering with vigilant service providers can mitigate the risk of fraud in the rapidly evolving alternative investment space.

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