CHAPTER 15
Conclusion

If you were not hiding under a rock, living in a cave, or staying on a island 300 miles west of Fiji during 2008 and early 2009, you probably believed that the hedge fund industry, the fund of funds industry, and Wall Street for that matter were all coming to end. That was the tone found in every article, news bulletin, and segment in the popular press. It seemed that without a doubt, the end was near or maybe even upon us. The collapse of Lehman and the fire sales of Bear Stearns and Merrill Lynch as well as the hundreds if not thousands of hedge funds that closed or went out of business have sent shockwaves through the system during this time. These actions have caused many to literally scratch their heads, wondering what, if any, future was left? Most were feeling this way even before the revelation about Madoff, which has only added more fuel to the fire and left many scared and frightened and asking why—and what comes next.

WHAT WE CAN AGREE ON

On more than one occasion in late 2007 and early 2008, the authors both agreed that there would always be a Bear Stearns. On more then one occasion in 2008, we both agreed that Lehman would be sold and would not go bankrupt, and on December 11, 2008, we both agreed that there was no excuse for being taken in by Madoff except for lack of due diligence and laziness. We were right about one of three.

Even with all of the aforesaid, the collapse of the banks along with Fannie Mae and Freddie Mac, the bailout of the auto industry, and the massive losses experienced by investors of all sizes, we both believe that hedge funds, fund of funds, and Wall Street will survive. More importantly, we believe that the United States and the rest of the world will survive the credit crisis and the economic crisis and that when we do come out of all this, we will be stronger and better equipped to weather such storms in the future.

To repeat, Wall Street is not dead, hedge funds are not dead, and fund of funds are not dead. In the coming weeks, months, and years, there will be continued consolidation, but mark our words: 5, 10, 15, and maybe even 20 years from now, there will be hedge funds, fund of funds, and some mythical place called Wall Street.

Continued Growth

In the near short term, such as by early 2010, we expect there to be renewed growth in new fund launches. We think that there will be consolidation and that many more traditional asset managers will begin to find ways, mostly through acquisition, to enter the alternative investment business. We believe that 2010 will be a year in which fund managers will develop new strategies. It will be a year in which managers retool, redevelop, rekindle their ability to perform in the marketplace, and grow bigger and bigger businesses.

Over the span of time this book was written, some funds have gone out of business because of their inability to perform and deal with liquidity issues. Some funds failed because they couldn't adapt to market changes. Some very large well-respected fund of funds, such as Fairfield Greenwich, Tremont, and Maxim were dealt death blows from their exposure to Madoff, while others have seen the need to drastically change their business models because investors were withdrawing whatever assets they had left.

This is okay. It is expected, it is needed, and it is what the market must do to fix itself and move on. These things work themselves out, which is, after all, what markets do. The year 2008 marked the first major retrenchment in the hedge fund industry.

Unfortunately, right now there seems to be an enormous amount of resentment between Wall Street and Main Street and everywhere in between. Hopefully, over the next year or so market conditions will improve and confidence will be restored. Time is a precious commodity, and it heals all wounds.

DON'T OVERLOOK DUE DILIGENCE

In reviewing the events of 2007–2008, one thing that we have all learned is that due diligence cannot be overlooked. It is a serious, meticulous, deliberate process. Madoff was exposed, not because he was caught in a due diligence review, but because the market forced his investors to withdraw and he could no longer feed his greed or need. While neither of us believes in the efficient market theory, it is clear that the efficiency of the market eventually caught up with Madoff. However, we believe that if Madoff's investors had performed comprehensive, in-depth due diligence, the fraud would have been exposed sooner. Clearly, the market allows for some funds to succeed and for some to fail. But for smart investors, this is not a way for anyone to make investment decisions, let alone use as an investment theory or plan.

This period of time has taught us that picking managers and understanding how money is managed and how wealth is created and opportunities are exploited is really important. There are no short cuts. We think that the single most important lesson that we all learned from the credit crisis, the Madoff and mini-Madoff frauds, and the rampant market volatility is that there is no substitute for good, solid, thoughtful due diligence, before and during the investment process.

Many investors learned, albeit too late, that many hedge fund managers had the same trade "on" and that when it went bad for one, it went bad for all. Many hedge fund managers were positioned in the same crowded trades. Portfolios were hit with significant losses because nobody could sell or get out in time or knew what many securities were worth. We do not know whether this could have been avoided, but we do know that many investors simply failed to do enough due diligence and frankly did not know what their investment managers were investing in. They simply believed in the manager and the returns and his or her experience and did not ask enough questions. Had they asked more or different questions, individual results would have been different, given that investors used so many funds that put on the same trade.

Due Diligence Helps Avoid Losses

Good due diligence would have caused some investors to reduce or avoid these losses. Had an investor taken the time to perform due diligence on Madoff, Agape, and others, they most likely would have weeded out the fraud, at least for themselves, maybe even for the masses. However, this is tough work; it is not glamorous, and it is quite a task. Madoff was, or shall we say is, a master manipulator. He preyed on emotions, greed, and envy and doing so allowed him to scam people for 30 years. Sure, Harry Markopolos and some others dropped dimes on Madoff over the years, but he was too good at his fraud to get caught. It is our responsibility as investors to perform the due diligence and always remember that if it seems too good to be true, it probably is. Think of how many billions of dollars would have been saved if the Madoff professional investors had practiced what they preached. The number is mind-boggling. In this instance, greed and envy proved not to be good for anyone.

There are many who are saying that they performed solid due diligence on Madoff and that they were simply scammed; that has been the defense of many feeders in response to investor lawsuits. The courts will decide whether these claims are true. We believe, however, that one of the ways to avoid making the same mistake twice, or even for the first time, is to focus on how a manager actually manages money. It is important during the due diligence process to ask how the investments are made—not simply what counterparties are used to execute the orders but the process behind the decision making. It is clear that everyone on ''the Street'' talks to each other. It is clear that many use some if not all of the same trading strategies, but you need to know this and you need to demand answers.

HINDSIGHT IS 20/20

The losses of 2007 and 2008 in the fund of funds industry showed us that some fund of funds turned out not to be as diversified or noncorrelated as they claimed, and that some fund of funds were not performing the level of due diligence required to avoid the problems experienced by others. The events of 2007 and 2008 demonstrated that strategies that were supposed to be noncorrelated were, in fact, correlated, and managers were exposed when the financial markets ceased to function. Trades were taking place, but not at rational levels. We believe that many fund of funds were not doing enough research into portfolio management and, as a result, their performance did not deliver the steady results they once provided. However, remember that one bad apple does not spoil a bunch, nor does it mean that the whole industry is spoiled. Quite the contrary; the fund of funds industry is alive and well and thriving in the post-meltdown world. That's the beauty of what the hedge fund industry is all about.

To use another produce analogy, if you peel back an onion, you find various layers, one after the other, until you finally reach the core. The same can be said for the fund of funds industry. Due diligence is the knife that lets you get to the core and allows you to find the right fund to fit your specific needs. The hedge fund industry is multi-layered as well. It truly offers something for every investor, regardless of the level of assets. Whether it's a multi-strategy fund, a separate account product, a sector-based or diversified fund of funds, or even many different single-manager products, the industry has something for everyone. The problem is figuring out the right fit. Never settle for unsophisticated due diligence or poor manager selection processes. They will do you in.

Playing Both Sides

Investors understand the value proposition of being able to go long and short the market. There is a simple truth that everybody who invests understands: markets don't always rise. One needs to be prepared to make money when markets rise as well as when they fall. Hedge funds are supposed to be the tool that delivers on that need and fulfills that promise. Fund of funds are supposed to create diversified portfolios of hedge funds that meet and exceed this expectation. What we learned in 2007 and 2008 is that many funds were unable to fulfill that promise or deliver on that need and, as a result, many fund of funds did not diversify their investment portfolios. In other cases, fund of funds managers invested in strategies that they did not fully understand; they just wanted to follow the crowd. This tells us one thing of great importance: we need greater levels of due diligence. We need to understand how money is managed on all levels. As investors, it's our responsibility to ask questions and get answers.

It's the responsibility of the money manager to provide good answers, and it's the responsibility of the investor to follow up and confirm whether or not those answers are true. This is not something that stops once the investment has been made. It is something that is ongoing and should be done continuously. Fund of funds get paid for postinvestment monitoring and review.

The lesson we've learned is not that not all hedge funds are bad, not all fund of funds are evil, and not all separately managed accounts are negative. What we've learned is that we must do due diligence. That is certainly not something that we learned yesterday or three years ago or one year ago; it's something that everybody has known. But because of the pace of growth in the industry and the pace of growth of those providing services to the industry, we think that due diligence has been lacking because people just did not feel they had to do the work. Now they know the consequences.

STILL, WE BELIEVE

On a going-forward basis, we think there's an opportunity to continue to achieve noncorrelated returns in hedge funds and fund of funds, and that each provides a unique and different service within the marketplace. The key is for investors to make sure that the funds to which they allocate deliver on the promise that they offer. Due diligence involves understanding how money is being managed, by whom, and who is checking on it to make sure the data is correct. It's about asking questions, getting answers, making sure the answers are understood, and making sure that what you see is really what you get. What we've learned since 2007 is that a lot of what we saw was not what we got and the only way to ensure that it is, going forward, is to have constant contact. It's a matter of following up, demanding meetings, and making withdrawals if you don't get the answers you want.

There are plenty of good money managers out there; the hard part is finding them. Once you find the ones you like, make sure you establish a good relationship with them. It is a lot of work, but it's your money so, to quote the Nike Corporation, ''Just do it!''

It's important to realize that if you, as an individual or institutional investor, have a relatively modest amount of money to invest, somewhere less than $5 million, fund of funds are probably the best way to access the hedge fund industry. However, you still need to perform a substantially high level of due diligence. If you are an institutional investor, fund of funds can be even more important, because you are able to offload a significant amount of the work to trained professionals as opposed to doing the work yourselves. Again, you still need to be constantly performing due diligence.

We don't believe that fund of funds or single-manager strategies are the end-all or be-all for everybody; nothing is. Everybody is unique. Everybody has different issues. Everybody has different wants. Everybody has different needs. And frankly, everybody needs different money managers and different strategies.

The only thing that determines whether the right investment choice is for a particular portfolio instead of someone else's is that the investor believes the manager will deliver on the promise made in the marketing pitch, in the meetings, and in the performance once the money has been invested. It's not saying, ''Well you're a square hole, so we'll put the square peg in you.'' No, it's quite the opposite. It's finding out what actually fits instead of just trying to fit something to what you need. When you make an investment, you must make sure that it is the right investment for your specific needs.

THE ANSWER ON FEES

People have asked us over the past 12 months as we've been researching and writing this book, ''Where do you see fees going? What do you see happening?'' While we both agree that fees are fees and some funds are able to charge some fees while other funds aren't, we also believe that fees for the most part will remain under pressure as managers react to the changing sentiment and poor results of 2008. As funds continue to try to gather assets, they will offer sale prices or discounts—a mistake, in our opinion. Once the price is lowered, it most likely will never go up. Discounting to gather assets sets a level of worth and puts a lot of pressure on the manager. After all, in the wake of the fallout of 2008, managers are now required to build out more robust infrastructures including managed accounts, and that is costly. Do the math—lower fees, higher expenses. It sounds as though either higher returns are needed or more assets. By discounting, the manager may take risks that he would not normally take in order to achieve higher returns. Possibly, the manager has decided that he really wants to be in the asset-gathering business and manage for mediocrity.

On the fund of funds fee front, we believe that fees will also remain under pressure. There may be some funds that eliminate or reduce the incentive fee in lieu of a higher management fee. Investors need to pay attention to the manager and how he is managing the fund assets. Separate account management platforms will increase as investors demand asset pricing verification, security collateral protection, and greater transparency.

We also believe that regulatory oversight is good and should be enhanced. Hedge funds increasingly are being bound by rules that make them more like mutual funds in terms of standardized reporting (i.e., forcing managers to be Registered Investment Advisors), and this is also a good thing. The problem we have is that for the regulations to be meaningful and protect the investors, they must be enforced. The regulators seemed to completely drop the ball when it came to monitoring, investigating, and dealing with one of the largest frauds of all time. Like many others, we have a real problem with what happened with Madoff and other frauds. We want the regulators to regulate, and we want Congress to make sure that the government agencies are doing their jobs. Regulations aren't worth much more than the paper they are printed on if nobody enforces them. We believe that regulation that is done simply for window-dressing purposes is pointless.

Our goal is not to call for more or less regulation; we want investors to make their own decisions with good information. Our goal is for you to understand that you need to make an educated decision, a decision that is right for you. If you make a good decision that you continually monitor, you most likely will achieve your portfolio aim. There may be losses; that is okay, it is to be expected. However, you have no one to blame but yourself if you don't do the work. So do the work. Check with the auditor. Pay for a background report. Understand how the hedge fund or fund of funds fits in your portfolio. Ask questions. It's your money, and you need to pay attention to how it is being managed.