



A GOOD FRAUD IS HARD TO FIND

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I am a firm believer in the theory that it would be nearly impossible to identify a well-orchestrated fraudulent hedge fund scheme in time to prevent the fraud. That said, most of the recently reported hedge fund frauds have been far from well-orchestrated. In many cases, the most basic level of due diligence would have exposed these investments as being unsuitable or at the very least questionable. I have always been willing to walk away from a hedge fund manager with the potential for high returns if I could not get completely comfortable with their operation. I can speak specifically about my experience with Bayou Management, LLC.

During the first half of 2005 I looked into Bayou as a potential investment recommendation for our clients. I had come across them in one of the many public hedge fund databases. Their strong performance history led me to take closer look into how they were generating their returns. It didn't take long before I made the decision to pass on Bayou. I did not know or believe that Bayou was a fraudulent firm when I decided to pass on them, but as I will discuss below, I uncovered several issues that eliminated them from further consideration.

Behaving badly

The allure of the high return potential from hedge funds may have caused some investors' scrutiny of them to be much more lax than it should be. While the only way to completely eliminate the risk of investing in a fraudulent hedge fund is not to invest in hedge funds at all, there are measures you can take to diminish your risk of investing with a dishonest manager. There is nothing groundbreaking about these measures, but investors do have to take them. Some of the basic steps in our due diligence process are as simple as:

- Reading the Private Placement Memorandum and Partnership Agreement
- Verifying assets under management independently
- Confirming Auditor and Legal Counsel
- Checking references (based on independent sources)
- Reviewing audited financial statements for consistency and any material qualifications
- Conducting a background check on all of the principals of the firm, including such matters as disciplinary history with regulators and legal judgments or proceedings
- Having multiple on-site visits and interviewing multiple members of the firm to verify consistency of their stories

While the above steps can give you an indication of potential wrongdoing at a hedge fund firm, the choice to invest or not to invest is largely based on a qualitative assessment of all the

information that has been collected. Unfortunately, many investors in hedge funds do not take the time necessary to know their managers as well as they should. We have always taken the approach of trying to know our managers as well as they know themselves.

The way I see it, there are primarily two types of hedge fund frauds. There is the hedge fund that is set up with the intention of stealing their investors' money from the outset, and there is the hedge fund that starts out with the intention of being legitimate but ends up becoming fraudulent, typically in an effort to hide poor performance. Investors have a much better chance of avoiding the second scenario than they do the first. The reason for this is that there are often signals that a manager gives when they are starting to behave badly, whereas when a hedge fund is fraudulent from day one they may be better able to disguise these signals. Bayou Management, LLC falls firmly in the latter camp.

From the beginning, Bayou had a very small chance of getting on our approved list of hedge fund managers, simply based on the fact that they traded through an affiliated broker dealer. This is almost always a 'Silver Bullet' when we evaluate hedge fund managers. The existence of an affiliated broker dealer within a hedge fund complex makes it too easy for the fund to steal the investors' money, even aside from the issue of facilitating excess compensation from trading activities. I have never been able to get comfortable with these arrangements. Bayou did not try to hide their broker dealer affiliation. Their risk disclosure stated:

The Funds' primary broker is an affiliate of the Manager. Consequently, the commissions paid by the Funds are:

- A. not arm's length
- B. not necessarily at the lowest cost;
- C. because of the Manager's trading strategy, substantially higher than many other funds;
- D. and
- E. profitable to the Manager even if the Funds should break even or incur losses.

Bayou said that because of this structure, they would not take a management fee but only take a performance fee. Intuitively this didn't feel right to me, I would have much preferred that Bayou charge a standard management fee and trade through an unaffiliated broker dealer. In order to better understand this arrangement, as well as Bayou's investment approach, I attempted to set up a meeting with the portfolio manager, Sam Israel, III. My requests for a meeting were delayed on several occasions.

In an effort to learn more about Mr. Israel, I spoke with two former Omega analysts who I knew, both of whom were currently managing their own very successful hedge funds. Bayou's marketing presentation stated that Sam Israel had been a General Partner and Head Trader of Omega Advisors. Both of the hedge fund managers said that they did not know Sam Israel and could not vouch for him. I found this to be very unusual, considering the role these two hedge fund managers played during their time at Omega Advisors. It seemed to me that if Sam Israel was the head trader for Omega Advisors, these two hedge fund managers would have known

him well. I continued to try and schedule a meeting with Sam Israel, but now I was being told that I should probably talk with Dan Marino, Bayou's co-founder and CFO/COO first, and that he would contact me once he recovered from the flu. Dan never contacted me.

At this point I asked Bayou if I could review their offering documents. To my surprise, I was told that they didn't use 'traditional' offering documents but rather they relied on an investor questionnaire which they felt better met Patriot Act requirements. Since the function of an investor questionnaire is totally different from that of a private placement memorandum, this explanation can only be characterized as bizarre.

More red flags

It was at this point that I had made the determination that something was not right with the firm and decided not to continue my research on them. I should reemphasize that at the time of my analysis I did not know that Bayou was doing, or had done, anything fraudulent. I did suspect, from the cues described above, that something was not as it should be.

There were several other, more serious, red flags that would have likely been discovered had we continued with our due diligence process. It was later reported that Bayou's auditor, Richmond-Fairfield Associates, was owned and operated by Dan Marino. Because we dismissed Bayou as an acceptable investment option very early on in our process, we did not get to the point in our due diligence where we evaluated the auditor.

Our standard approach to evaluating an auditor is to review the fund's audited financials, call the auditor and verify that they actually performed the audit, and make a qualitative assessment of the audit firm. We would have certainly taken issue with Richmond-Fairfield Associates being owned and operated by a principal of Bayou, as well as being unknown, and their apparent absence of a significant stable of other hedge fund clients. It was also reported that Bayou changed their auditor shortly after their inception. This too should have been a red flag to existing investors at the time. However, it might have been more difficult to turn up for new investors doing their diligence years after the change occurred.

Potential investors also could have verified their legitimacy by checking, to the maximum extent possible, Bayou's assets under management. Bayou had stated that they were managing over \$400 million in assets when in reality they were only managing about \$150 million.

There are a number of ways to verify investment firm's assets under management. The most common way for an investor to do so is to review their audited financial statements. However, only reviewing audited financial statements may be imperfect AUM diligence, because it gives the manager essentially 15 months where they can steal the money (the reason they have 15 months is that is typically the time between the end of one calendar year and the time when the following year's audit comes out). This risk can be mitigated by periodically getting statements from the prime broker. Some managers will provide you with statements on a one month lagged basis, while others will not give you any type of transparency at all.



Another way to keep a tab on the assets in a fund is to find out who manages the relationship at the prime broker and call them periodically. In order to do this, you typically need to get the contact information from the hedge fund manager.

Yet another way of confirming the assets under management of a hedge fund manager is by looking at the Securities and Exchange Commission 13F Filings (a requirement for all firms with at least \$100 million in assets under management invested in U.S securities).

The easiest way I've found to access this information is through www.nasdaq.com/reference/ownership.stm, where you can search by firm name. The information provided here is also imperfect because it is only available quarterly, 45 days after the end of the calendar quarter. An additional issue is that the report is limited to U.S. equity securities, including common and equivalents, convertible preferred and convertible bonds. The report does not include non-U.S. securities, fixed income, real estate, or cash equivalents. Therefore, this method is clearly less effective for managers with material assets in non-U.S. equities.

I have found that most hedge funds will go out of their way to help potential investors confirm their assets under management. In the event an investor cannot verify that a firm's assets under management are at least in the ballpark that the firm represents, the investor should not, under any circumstance, consider investing in the fund.

No guarantees

The reality of investing in hedge funds is that even if you dot all the 'i's and cross all the 't's, there is still no guarantee that you will not end up investing in a fraudulent operation. If a hedge fund manager is determined to steal your money, he/she will probably find a way to do it. That said, by doing the necessary research you can substantially reduce the chance of investing in an outright fraud. The strict due diligence process that we follow has forced us to pass on some truly exceptional hedge fund managers who are, more likely than not, completely legitimate. This is an opportunity cost that we are more than willing to incur. We'll pass on the prospect of 30% annual returns in order to reduce the risk of having our client's money stolen every single time.