
Investment Research | **Kevin E. Lynch, CFA, CFP, Charles Colfer, CFA, ASA, and Tomas Kukla**

ROGERSCASEY'S BUY-RATED HEDGE FUND MANAGERS HAVE NO EXPOSURE TO MADOFF INVESTMENT SECURITIES LLC

On December 11, the Securities and Exchange Commission charged Bernard L. Madoff ("Madoff") and his investment firm, Bernard L. Madoff Investment Securities LLC, with securities fraud for a multi-billion dollar Ponzi scheme that he allegedly perpetrated on advisory clients of his firm. According to the initial statement from the SEC, "Madoff admitted ... that the firm was insolvent and had been for years, and that he estimated the losses from this fraud were at least \$50 billion." While the details released to date suggest some similarities with prior frauds (the Bayou collapse in 2005, for example), the scale of this case, and the potentially catastrophic losses for individual investors, are staggering.

We would like to take this moment to inform our Clients that none of Rogerscasey's BUY-rated hedge fund or hedge fund of funds managers has any direct or indirect exposure to Madoff or any Madoff-related entity. Rogerscasey itself also does not have any direct or indirect exposure to Madoff or any Madoff-related entity. We have contacted all of our BUY-rated hedge fund of funds managers and confirmed that there is no exposure to the investment advisor, broker dealer, or any other entities related to Madoff, in particular any of the feeder funds that invested with Madoff. Additionally, we have confirmed that none of the multi-strategy or single strategy hedge funds on our BUY-rated platform has any exposure to Madoff or related entities in their funds, feeder funds, or side pockets. We believe that this absence of exposure amongst our BUY-rated hedge fund of funds managers is, at least in part, due to the institutional quality of these managers and the resources they are able to dedicate to due diligence, and particularly operational due diligence.

It is worth noting that two of our BUY-rated hedge fund of funds managers redeemed Madoff-related exposure several years ago. The last of these positions was terminated in 2003 as operational due diligence resources were substantially increased and the weaknesses in the Madoff-related structures became apparent. Based on our understanding of the situation, any attempt to recoup losses from prior investors would be very difficult to enforce beyond a two year time horizon, particularly as it is not known when Madoff commenced the alleged fraudulent activity.

While Rogerscasey never rated Madoff directly (it would appear from media reports that there was no Madoff fund per se, but rather a number of feeder funds whose assets Madoff managed), we had rated two of the feeder fund platforms, Fairfield Greenwich and Tremont, based on a number of meetings from 2002 to early 2004. Both feeder fund products were rated SELL based largely on concerns about the integrity of the Madoff structure. To quote some of the observations from our meeting notes at the time:

- June 4, 2002 – We are exceedingly negative on Madoff as a hedge fund.
- November 21, 2002 – [Tremont's] largest exposure ... is to Madoff ... where Tremont receives limited independent third-party transparency. ... The only third-party, independent transparency that Madoff provides to its investors is being 100% in cash at the end of each year, so that its auditor can verify with Madoff's banker ... that the cash is real. Madoff has no prime broker and no plan administrator. It acts as a broker/dealer, self-clears, and sends its

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own trade confirms to its investors all of whom have "cash" accounts.

- February 27, 2003 – [Fairfield Greenwich] claims its due diligence is based on [employee name] at their firm checking the trade confirms that Madoff's broker dealer sends them. However, our point of view is that, since Madoff is self clearing, it could be making up its statements and tickets.
- February 26, 2004 – Although Tremont claims to receive access to Madoff's positions, the magnitude of the exposure and the truth of Tremont's transparency remain extremely disconcerting. ... The Madoff exposure is a potential disaster. Even though some products would not be directly affected ... Tremont's products will still see their reputations vaporized when Madoff rolls over like a big ship.

The Research team at Rogerscasey has not had any formal meetings with either organization since 2004.

Again, based on media reports, we were not alone in having concerns about the integrity of the Madoff operation. It is unfortunate that the various red flags evident in this case did not trigger some form of regulatory intervention that might have prevented the potentially catastrophic losses it appears investors may suffer.

Rogerscasey places a heavy emphasis on the quality of our due diligence process and the quality of due diligence conducted by our BUY-rated hedge fund of funds managers. As a result, our BUY-rated hedge fund of funds managers tend to be larger in size so they are in a position to dedicate significant resources and personnel to operational due diligence. In general, we like to see the operational due diligence team have veto rights over the inclusion of managers in portfolios and

to see ongoing operational due diligence after initial investment.

The red flags evident in this case cover a number of areas. We highlight several of them here, to emphasize the fundamental importance of each one in effective due diligence:

CREDIBLE INVESTMENT STRATEGY

Madoff claimed to run some form of split-strike conversion strategy. There is at least one mutual fund that we are aware of running this type of strategy. As this mutual fund's performance track record is entirely consistent with the mechanics of this type of strategy (long stocks, short calls, and long puts), there are months, and indeed some years, of negative performance. Madoff's returns, on the other hand, were apparently too good to be true. It is critical, therefore, that investors or their advisors have an understanding of the strategies they are investing in that is at least sufficient to assess the consistency of past returns. It is also important that hedge fund of funds managers have sufficient expertise within their staff to assess the strategies their underlying managers are investing in.

OPERATIONAL DUE DILIGENCE

It is critically important to evaluate the operations, back office staff and systems of multi-strategy and single strategy hedge fund managers. This is an area where increased emphasis has been placed in recent years. One key factor for effectiveness in this area is the operational due diligence resources in place at a hedge fund of funds with dedicated, experienced staff that can review the back office and operations of their underlying hedge funds. We consider it best practice in this area that the head of operational due diligence at a hedge fund of funds should have a reasonable level of seniority within the organization and should be in a position to

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veto investment with any hedge fund where there are operational concerns.

TOP-TIER THIRD PARTIES

Investors rely on third parties (administrators, custodians, auditors, etc.) as a check on the integrity of their investments. The quality of these service providers is obviously critical. The absence of any of these functions, or the use of an unknown entity, should be a major cause for concern and should generally prevent an investment taking place. Specifically, a hedge fund or hedge fund of funds should have the following in place:

- An independent custodian. Madoff appears to have had custody of the assets within his firm, making it impossible to confirm investors' balances independently.
- An independent administrator to value the portfolio independently and strike monthly net asset values. (There are occasional exceptions to this rule where high frequency trading managers may self administer in the absence of an administrator capable of handling a high volume of trades. In these exceptional cases, there must be other checks in place.)
- An independent auditor with the expertise to audit potentially complex investment strategies.

While the above are "must haves" in any due diligence review, the following are practices that would generally raise additional warning signals:

- The hedge fund owns and trades through its own broker/dealer. This presents a clear conflict of interest unless the broker/dealer business is owned by the fund with all trading profits accruing to the fund. Madoff utilized its own broker/dealer business when executing trades.

- The fund employs several family members in key senior positions. While not necessarily a deal breaker, this practice always has the potential to limit the independence of the functions being performed by these related personnel.

This case, once again, emphasizes the importance of due diligence. Rogerscasey places great importance on the operational integrity of our BUY-rated multi-strategy and single strategy hedge funds. We have also seen our BUY-rated hedge fund of funds managers dedicate increased resources to operational due diligence over the last number of years, designed to avoid the pitfalls that can lead investors into the type of fraud allegedly carried out by Madoff.

While Madoff may not technically have been running a hedge fund, this episode is, nevertheless, a black eye for the industry as several of the feeder funds investing with Madoff seem to have been marketed as hedge funds. A final lesson learned from this situation is the reinforcement of the importance of prudent diversification, whether by instrument, geography, or manager, in a well constructed portfolio. No matter how successful a manager has been, past performance never guarantees future performance. Diversification, among other benefits, provides a risk management measure that can protect investors from the potential catastrophic loss of their entire investment portfolio.

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ABOUT ROGERSCASEY

Innovators in investment research since 1968, Rogerscasey is among the nation's leading global providers of comprehensive investment solutions for a broad spectrum of corporate and public retirement plans, endowments, foundation, financial intermediaries, healthcare systems and large high net worth individuals. Rogerscasey has over 125 employees, including 25 senior investment consultants and 30 research professionals, operating in seven offices across the United States, Canada, and Europe.

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