



Self-Regulatory Organizations in the Canadian Securities Industry



NATIONAL POST

Hedge funds are simply too complicated

You shouldn't need a huge checklist before you buy

Jonathan Chevreau

Tuesday, March 22, 2005

The Portus saga has the rest of the Canadian hedge fund industry in heavy damage control mode.

The Portus receiver, KPMG, has issued a question and answer package that revolves around if and how investors will ever see their money back; several questions address hedge funds and funds of funds.

Meanwhile, Abria Alternative Investments Inc. has issued a lengthy Investor's Guide to Selecting Hedge Funds and Funds of Funds.

Abria sent me a copy of this guide along with a letter from its CEO, Henry Kneis, responding to a recent instalment of this column. There I had argued average investors might be better off avoiding such complex investments, whether or not they are governed by the accredited investor rules.

One point to which Kneis took exception was a quote attributed to David Bruce, senior investment advisor with ScotiaMcLeod. Bruce argued the best hedge for investors is simply a low-cost, well-diversified portfolio. This could be as simple as a balanced mutual fund because it contains a broadly diversified selection of stocks and bonds, and often cash.

I picked up Bruce's "balanced fund" quote because it fit with the simplicity of a theme I've often written about: the Rip Van Winkle portfolio. That's a low-fee balanced fund and a global equity fund. They provide the three major asset classes, global diversification and two portfolio management teams overseeing both asset mix and security selection. All for an annual fee below 2% --less than what most hedge funds would charge.

Bruce strives to provide comparable simplicity and transparency for clients, building

portfolios largely around the enhanced passive (index) funds of Dimensional Fund Advisors Canada. Clients and advisor agree to the asset allocation, which may include a global fixed-income fund and equity funds tilted toward value and small companies.

Together with some iShare exchange-traded funds, these building blocks provide Bruce's clients with exposure to 9,000 securities.

Once in place, little tinkering is necessary except annual rebalancing. Counting Bruce's fee, portfolios cost up to 1.6%, in line with the Rip Van Winkle portfolio.

Pretty simple, right? Compare that to the extensive due diligence Abria suggests hedge fund investors should practice in order to avoid a future Portus scenario.

The Abria tip sheet is four pages long. I counted 55 questions they suggest need answers before plunging into a hedge fund investment. These are divided into the following categories: fund maturity and size, risk characteristics, the people behind the fund, what they are offering, understanding the nature of pro forma returns, requesting audits for every year the fund has been marketed, independent calculations of the fund's net asset value, tax treatment, currency risk and finally operational risks and business continuity.

Abria cites John Mauldin's book, *Bull's Eye Investing*, which calls for similarly exhaustive due diligence before committing to a particular hedge fund. Mauldin says in every case where hedge fund fraud occurred, investors "simply did not do their homework."

He takes fully 18 pages to list hundreds of questions investors should pose to prospective purveyors of hedge funds.

The corollary of this is precisely the point made in the column to which Kneis objected: that individual investors don't need this kind of aggravation. It's exhausting merely reading these questions, let alone answering them.

There's no question that if you are a wealthy investor plunging \$1-million into a hedge fund, this is the kind of due diligence you should be exercising.

But few financial advisors will want to go through such humongous checklists on your behalf, assuming they have the skills required to do so.

Kneis's point is that a hedge fund of funds like Abria does all this work for you.

However, Bruce is not convinced even wealthy investors should be tempted by hedge funds. "Hedge funds are best suited for institutional investors who have full-time staff to keep on top of these 'black-box' under-regulated investments."

Nor is Bruce a lone voice. Adrian Mastracci, fee-only advisor for Vancouver-based KCM Wealth Management, yesterday issued a cautionary warning against betting the farm on one investment.

Entitled "All my savings went poof!," it refers both to the \$700-million-plus entrusted to Portus and another US\$300-million that blew up recently in a Florida hedge fund.

"Much of this awful pain can be avoided," Mastracci says. It can be "as simple as following a few easy commandments." Like Bruce, Mastracci stresses diversification, asset mix, costs and risk.

In short, the KISS (Keep it Simple Stupid) principle may be all the hedging most investors

will ever need.

see:

