

Hedge funds

In the garden of good and evil

NEW YORK AND LONDON

A spectacular story raises a simple question: why don't investors in hedge funds take more care?

IT HAS all the ingredients of an airport best-seller: fast-talking salesmen, gullible rich folk, millions of dollars kited around the world, a humble whistle-blower—even a purported suicide note. The complaint filed against Bayou Management on September 1st by American federal prosecutors alleges fraud and seeks to return what cash can be recovered to investors in this troubled group of hedge funds. This is only the latest twist in a complicated saga.

Bayou's boss, Samuel Israel III, promised exceptional returns from rapid-trading techniques, deployed mainly in both buying equities and selling them short, when he opened the first funds in 1997. By 1998 Bayou was already lying about its results, allege federal gumshoes.

In 2004, perhaps trying to shore up the funds' assets, Mr Israel consigned a chunk of investors' money to private-placement programmes that were supposed to produce returns of up to 100% a week. In a flurry of intercontinental bank transfers, one, for \$100m, was flagged by a bank employee and bagged by Arizona prosecutors this May. That may be all that is now left of the \$440m in assets that Bayou claimed earlier this year.

In July, Mr Israel told investors that he was winding up the funds and would return their money. In August one of them went to the fund's office to demand his cash and found instead a suicide note written by Bayou's chief financial officer (who, fortunately, is still with us), detailing wrongdoing. Various investors and the federal government are now suing Bayou.

Bayou's troubles concern its investors the most, but they also highlight a wider problem. Because lightly regulated hedge

funds don't publish much information, a fund can go off the rails for a while undetected. And because hedge-fund strategies usually sound like rocket science, investors may suspend their own critical faculties, relying excessively on a fund's reputation and on outside advice.

Still, a minimum of due diligence should have raised questions about Bayou, which had had a couple of brushes with regulators. And financially, "this fund was an outlier on any chart you can imagine," says Michael Markov of Markov Processes, who has developed software to analyse hedge-fund performance. Comparing Bayou's performance with those of other similar funds and strategies showed anomalies, he says. Bayou did not report the very highest returns but it did show by far the lowest volatility, or risk. Its returns rose smoothly each month, while those of its competitors did not. It didn't add up.

To folk who want to invest in hedge funds, as well as those who want to invest like hedge funds, Markov Processes has a lot to offer. Its founder emigrated from the Soviet Union in 1989, an ace in mathematics and programming. In New York, he wrote software by day and at night studied finance at "Barnes & Noble University", the textbook branch of the large bookstore chain on the corner of Fifth Avenue and 18th Street. This has long been a magnet for poor, smart, driven students willing to sit in the aisles and learn on their own.

Among the books he stumbled upon was a classic text on investing by William Sharpe, a professor at Stanford Business School who would later share a Nobel economics prize for his work on how efficient markets should price assets

to reflect their risk. In a subsequent paper, Mr Sharpe put forward ideas on analysing the performance of investment managers by regressing their returns against various benchmarks. The aim is to figure out whether a manager's performance is attributable to his ability to pick securities, to leverage, to the specific sector in which he invested—in other words, whether he is genuinely producing "alpha" returns for each unit of risk run or is simply running more risks.

With another Russian émigré, Mik Kvitchko, Mr Markov was able to write a software program that captured the gist of this. Mr Sharpe himself found the work impressive, which was enough to launch a business. At first, the clients were investors evaluating mutual funds. In recent years, they have grown to include 200 of the world's largest financial institutions, and increasingly their interest has been in what and how well their hedge-fund investments are doing.

"Reverse engineering" a hedge fund's performance from the numbers supplied is a complicated business. The algorithms used for mutual funds had to be rewritten repeatedly because hedge-fund managers shift strategies, sell stock short and hold illiquid assets (which allows the unscrupulous to price at will for a time). Their infrequently published results, typically no better than monthly, are another problem. But after much testing, and depending on the strategy, Mr Markov reckons he can usually determine what a fund is doing and whether it does it well. Many that appear hot are merely the beneficiary of a risky quirk, such as leverage.

Daily results, Mr Markov says, would provide real transparency in most, but not all cases. That would no doubt please investors as well as the Securities and Exchange Commission, which has spent much of the past year grappling with what sort of disclosure to require in order to pre-empt trouble. At the end of the day, though, it is up to investors to do their own due diligence—or risk ending up down in the Bayous of this world. ■