Ten Rules to Consider When Investing Your Money

With the recent scams in the industry, here are a few thoughts I would suggest the hedge funds and their investors consider:

1. Never give your cash to the person managing it. I always want to send a check to an independent administrator or custodian. The investment manger should have limited power of attorney on the account, not full power of attorney to deal with the cash. If the person managing it has access to the actual cash, they have the opportunity to steal or misappropriate it. With an independent custodian, there is no worry of that, unless the manager and the custodian get together to defraud the investors which is why I have rule 2.

2. Make sure the custodian and money manager are independent. To help prevent collusion between the manager and the custodian, make sure they are reasonably independent. Sure they'll be friendly to each other, since they do business with each other, but you'd like the ownership structures of the two firms to be different. Ideally, only a small part of the custodian's business would be with that one manager, so you know the custodian has little incentive to fabricate statements or embezzle funds.

3. Look for independent calculations of NAV's. In many hedge funds, there's a tendency to let the manager value some of the instruments because "They're too complicated for an independent custodian to value," or "I can't let anyone calculate the NAV, since then they'd know our investment scheme." If that's the case, investors are letting the person managing the investments make up the track record. A number of legitimate, law abiding managers, over the years, have had the opportunity to smooth their results by valuing their instruments in a smoothed out fashion, rather than having to deal with the gyrations of the actual marketplace and true mark-to-market prices. This makes Sharpe ratios higher than they really are and deludes both the manager and investor into thinking the investment is less risky than it really is.

4. Make sure the fund has an annual accounting audit. I would like it more if it's an independent firm that specializes in audits in the area of investing being considered. Some of the larger accounting firms may not have the specialized experience that certain smaller independent accounting firms may have. The important thing is that they work from independent statements from the custodian, not the manager and verify the valuations of the instruments in the portfolio themselves, rather than relying on the manager to value the portfolio or provide the list of investments held. This is then a true check of the manager at least once per year. Auditors of the fund should be able to describe to the investor the process they used in auditing the fund.

5. Monitor the investment in the environment in which it exists. If you decide to buy a leveraged, long-only stock fund and it appears to be making big profits in a down stock market, be suspicious. If most of the market neutral managers are making between 10-20% and yours is up 50%, be suspicious. Understand enough about the manager's strategy to know when and how profits will be made and when losses are to be expected. When something you don't expect happens, find out why. If something is not to your liking, move on at your first opportunity. There's thousands of other worthwhile deals out there.

6. Understand how everyone in the deal is compensated. Many investors simply look at the bottom line, when making a purchase. Investors should read the legal paperwork on the investment fund and note who is involved in making money from the fund. I like to know each firm's role, how they perform their function and are their fees reasonable for the contribution they'll be making to the fund. If somebody is making more than a typical fee from the fund, I get concerned.

7. Ask yourself whether the returns you are considering are repeatable. So many investors chase a great track record, never considering that maybe the environment the manager has just been through has matched up beautifully with his/her strategy. Maybe an environment that will do just the opposite is right around the corner. Understand enough about the strategy used to determine its consistency and repeatability before investing.

8. There's risk with every investment. If you haven't figured out the potential risk with an investment, you haven't looked hard enough. Every strategy has some risk, even if it's a low probability event. My experience is that higher probability risks, low severity risks are usually more manageable. It's those low probability, higher standard deviation moves that everyone ends up remembering for years due to phenomenal profits or extraordinary losses. Many investors and managers treat very low probability risk as "no risk", and that's dangerous because low probability, high severity events do happen.

9. If these guidelines are not met, move on. There are thousands of quality investment funds for investors to consider. If there is a fund you are considering that looks great, but doesn't meet all of the guidelines you desire to keep your funds safe, move on to another choice. Find a fund that does meet your safety guidelines. The investment you are considering may be completely legitimate and you may miss out on a great deal, but it also may be a disaster in the making. Why take on the stress, when there are so many legitimate funds that you can invest in that will meet your criteria?

10. Legitimate funds should consider adopting these guideline for themselves. Serving as a NASD and NFA arbitrator, over the years, I have found that the investing public has little ability to separate the legitimate deals from the scams. If the legitimate funds used independent custodians, pricing of their NAV's, independent accountants and provided as much transparency as possible, then the scams would look suspicious by comparison. We'll never completely eliminate the scams, but we can make it more difficult for them to blend in with the legitimate managers.

Following all the above suggestions does not guarantee investing success. However, it should eliminate the majority of the nonsense we all to often see in the industry such as fabricated statements, embezzlement, commingling of personal and investor assets, hiding losses, Ponzi schemes, etc. Successful investing is not easy. It takes a lot of work, discipline, resources, intelligence and a little luck along the way can, of course, help the cause. These guidelines help make sure investors can worry about the return on their capital, not worry about the return of their capital.

Tom Basso
CEO, Trendstat Capital Management, Inc.
480-970-3600 or tom@trendstat.com