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Review

Over the Hedge Fund: Pruning Investment Dangers

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A nonprofit group's guide to spotting danger signs at hedge funds.

Amaranth, Long-Term Capital, and Madoff Investment Securities were all hedge-fund accidents waiting to happen. And all gave off visible warning signs that investors could have seen.

So argues the Greenwich Roundtable in "Avoiding Mistakes" (greenwichroundtable.org). The nonprofit education group highlights 22 case studies of unnamed, failed hedge funds and shows how to recognize signs of impending doom.

Some of these funds dissolved in a divorce between founders, others defrauded investors, and some went against their investment mandate. Isolated warning signs aren't necessarily telling, but a combination of several should be alarming.

A chart—A Taxonomy of Hedge Fund Accidents—offers due-diligence checklists, including background checks and reviews of service providers, such as fund administrators. Some red flags: an inadequate track record, lack of independent valuation, poor risk management, multiple marketing firms, and hard-to-understand strategies.

Once investors commit money to a hedge fund, they should watch for excessive leverage, liquidity problems, concentrated positions, unreasonable volatility, inadequate transparency, hubris, inexplicable performance numbers, style drift, rapid growth, back-office problems, and poor staff dynamics.

Investors should also be sensitive to signs of managers' emotional immaturity and character flaws. Managers typically invest their own money alongside their investors'. But the manager's risk appetite should be consistent with the investors'. Many frauds and Hail Mary passes have come from managers whose assets were inadequately diversified away from their own fund.