BUSINESS

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# Hedge funds: Do some mislead their investors?

**By Ian Pollock**
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**Nearly 40% of hedge funds have published inaccurate figures about the success of their investments, research has found.**

Three academics at Oxford University examined monthly investment returns published by 18,383 hedge funds between 1994 and 2011.

They found that 6,906 funds had revised their previous performance figures at least once.

The researchers said this defective data would mislead potential investors.

But they also drew another conclusion of vital interest to investors: the existence of corrections was a good indicator of subsequent poor returns.

"As soon as you detect a revision it is an excellent signal about the future expected returns of the fund, and that is a negative signal," said Tarun Ramadorai, a professor of financial economics at Oxford University and one of the authors of the research.

**'Widespread problem'**
The research was **published** in March 2012 by Andrew Patton of Duke University, and Tarun Ramadorai and Michael Streatfield of the Said Business School at Oxford University.

They found that while most "revising" funds had indulged in both upward and downward revisions of their past data, the average size of the downward changes was much bigger than the average size of the upward ones.

Professor Ramadorai and his colleagues described the frequency of revisions as a "widespread problem."

"On average, initially provided returns present a more rosy picture of hedge fund performance than finally revised performance," they said.

"This suggests the danger of prospective investors being wooed into making decisions based on initially-reported histories which are then subsequently revised," they added.

**'Good fund managers'**
The international hedge fund industry is huge, made up of thousands of privately-owned firms, investing billions of pounds for very wealthy private individuals and professional investors such as pension funds.

The biggest 10% of firms are estimated to hold about 80% of the industry's investments.

Guy Saintfiet, a specialist in hedge funds at the consultancy Aon Hewitt, said the Oxford study painted a fair picture.

"It is one of many studies that confirm there are flaws in data provided by hedge funds," he said.

"It confirms how important it is for investors to do proper due diligence."

Robert Howie, a hedge fund specialist at the consultants Mercer, stressed that just screening the available data on past performance would not be a good way of picking a hedge fund in which to invest.

"A lot of hedge funds are really good fund managers and create a lot of value for their investors," Mr Howie said.

"They have well-run organisations [and] good back offices so part of picking a hedge fund is understanding how they make money, how they might make money in the future, and on top of that if they are they well-run businesses."

**Predicting poor returns**

The researchers looked at the investment return data of hedge funds, which are published each month on a variety of public databases.

The academics found that:

38% of the funds in their sample had changed a previous return by at least 0.01%, at least once
more than 20% of the funds had revised a previous return by at least 0.5%
more than 15% of them had changed a return by at least 1%.

"These are very substantial changes, comparable to, or exceeding the average monthly return in our sample period of 0.64%," the researchers said.

They went further, deducing that the revision of inaccurate figures indicated funds which were more likely than "non-revising" funds subsequently to lose their investors' money.

"We find that on average, revising funds significantly underperform non-revising funds, and that there is a far greater risk of experiencing a large negative return when investing in a revising fund," the academics argued.

The trade body for hedge funds, the Alternative Investment Management Association (AIMA) said the researchers had overstated their case.

"Minor revisions to hedge fund valuations are routine and happen for perfectly understandable reasons," said Andrew Baker of the AIMA.

"Calculating the value of a hedge fund, especially those dealing in illiquid or hard-to-value assets, is not an exact science, especially when it is done to a deadline earlier than a formal net asset value (NAV) is struck in order to file a report to a commercial database provider.

"Investors in hedge funds know this very well, and indeed they can be further reassured that regulatory requirements around the marketing of performance track records are very strict in this field,"

**Why is this?**

Pondering the question of why the revisions took place, the academics said some might be innocuous, merely involving the correction of previous innocent mistakes.

But they found that errors in entering data, such as using the wrong plus or minus sign, putting the decimal point in the wrong place, or transposing adjacent numbers, had taken place with only 3.3% of funds.

Many of the revisions had come in the wake of financial crises or stock market crashes.

This might suggest that some funds were merely updating recently-published figures to bring them in line with fast-moving reality.

But the academics found that in fact many of the revising funds had changed their figures going back far longer.

The researchers raised the possibility that revisions were due to bad management of the funds' operations, such as incorrectly valuing assets, or even dishonesty.

"Most of the revisions pertain to financial crises, but the guys have gone back to revise history that was seven, to 10 to 12 years old in many cases, up to 15 years in some cases," said Professor Ramadorai.

"It seems a little bizarre [but] it is a common-place experience."

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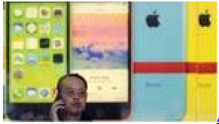
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