Ten Questions for Your Hedge Fund Manager

The hedge fund industry has experienced explosive growth, particularly over the last decade. While investors and regulators pressure hedge funds to operate more openly, some practices remain veiled.

Here are ten things you should ask a hedge fund firm so that you can be sure there are no secrets:

1. ***Do you gate funds?*** If multiple investors seek simultaneous withdrawals, the manager might have to sell off a large number of holdings to meet those requests. This could cripple the fund. Gating helps hedge fund managers prevent a run on the fund. Managers can limit withdrawals during redemption periods by gating funds.

2. ***Can you spell out your fee structure?*** Hedge fund managers get a management fee based on the fund's net asset value, plus a percentage of the investment gains. Typical management fees range between one and four percent a year. Hedge fund managers also get a performance fee, anywhere in the ten to fifty percent of gains range. 20% is the general standard. Fund of funds investors incur an extra layer of fees that can also include an incentive fee. Investors could see as little as 2% of the profits.

3. ***Is your incentive skewed toward risks?*** Discounting personal investments, most hedge fund managers don't lose money when the fund does poorly. In this scenario, the manager shares only in the upside potential and not the downward losses. Therefore, he or she may be more willing to take risk.

4. ***Does the fund cover general partners' litigation expenses?*** Some funds cover the litigation costs for the general partners.

5. ***Are investors treated equally?*** Hedge fund managers can make side deals with the limited partners without disclosure. "Side letters" document the arrangements, which are like formal

exceptions. Side letters give hedge fund managers the flexibility to charge lower fees for certain limited partners, ease the minimum investment amount, and change liquidity rules.

6. ***Can you change the high watermark**?* High watermarks protect investors from paying performance fees when they've lost money in the fund. While this might be great for investors, some hedge fund managers maintain control to reset the high water mark or eliminate it altogether.

7. ***Your fund is big, does that mean it's better?*** Size doesn't necessary imply performance. Imperial College of London studied hedge fund performance during the period of 1999-2011. If found that hedge funds with less than $10mn strongly outperformed larger funds.

8. ***What ethical investing principles guide your decision-making?*** The hedge fund industry typically values investment gain over corporate citizenship. Many hedge funds have profited substantially by driving up oil prices and shorting mortgages, among other practices.

9. ***Do you keep side pockets?*** Side pockets help managers prevent having to liquidate at fire sale prices. It involves separating illiquid investments from shorter-term investments. Side pockets can take years to liquidate and difficult for investors to assess. Analysts' estimates of assets in side pockets industry wide range from $50 billion to $200 billion.

10. ***Are your K-1's timely?*** Because hedge funds receive partnership tax treatment, investors must report gains and losses to the Internal Revenue Service. Hedge fund managers should supply the information on a K-1's in ample time for investors to complete their tax returns. Many hedge fund managers cannot meet this obligation.