



Investment Commentary

Re-Establishing Trust With Our Investment Managers

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ThresholdGroup

Helping Families Achieve What Matters Most

After the events that have rocked financial markets during the last several years, trust between investors and investment managers has probably never been more strained. Consider everything from the fraudulent practices of Bernie Madoff to the alleged scheme of Texas billionaire banker R. Allen Stanford. Now consider the over-reaching promises of those who: (1) offer hedge funds as protectors of capital but instead end up imposing gates on redemptions; (2) promote the high yields of structured investment vehicles on the belief that pooling risky assets would make their risk go away; or (3) preach the virtues of active management and diversification in traditional investments and then delivered neither.

All of this has led to an extreme loss of trust, and it comes at a terrible time. Just as the market environment favors investors placing dollars with traditional active and alternative managers, the actions of the few have undermined the faith of the many. Retail investors pull money from stock and bond funds in favor of money market funds and Treasuries, while institutional investors allocate away from active managers in favor of passive investing.

It may be timely to recall that one of President Reagan's more memorable quotes was made in reference to relations with the Soviet Union, and was taken from the Russian proverb "*doveryai, no proveryai*" - Trust, but Verify. If capital markets are to effectively foster capital formation and serve the needs of investors, trust must be re-established, and will only exist if investors can verify that investment managers have their best interests in mind.

This restoration can happen only if the role of rebuilding trust is recognized and embraced by three parties: (1) the regulatory agencies; (2) the investment management industry; and (3) investors as represented by consultants and fiduciaries such as family offices and other investment advisory firms.

Regulatory Agencies

Regulatory agencies must improve oversight of systemic risks and re-establish authority to prevent a repeat of the financial market meltdown witnessed in 2008. In part, regulatory authority is designed to protect investment managers from themselves as well as contribute to the "normal" market conditions critical to fundamental investment principles such as active investing and diversification.

Credit policy that lowered the cost of borrowing allowed hedge fund managers to transform modest investment strategies into double-digit producers by piling on ever-higher amounts of leverage while ignoring the risks of the underlying investments. These managers believed that economic growth would not be interrupted, and thereby created a "virtuous cycle" as rising asset prices fueled more consumption and additional borrowing. No one need be reminded that once the bubble burst and asset prices fell, banks and hedge funds were forced to sell, pushing asset prices down even further, and creating a "vicious cycle". Traditional investment managers who rely on their skill in security selection and benefit from diversification were hurt by a market that did not distinguish between good companies and bad, leaving no place to hide.

Ideas for reducing the likelihood of systemic risk include tighter restrictions on easy credit, standardized contracts for derivatives such as credit default swaps and interest rates swaps, marked-to-market pricing of assets and improved regulation of companies deemed too big to fail.

Investment Managers

To win back the trust of investors and their assets, managers must align their interests with those of their investors and demonstrate true transparency surrounding their strategies and the risks associated with them.

Compensation for hedge fund managers (generally a 2% management fee and a 20% incentive fee) is often designed with incentives for unreasonable risk-taking, rather than incentives that align managers with investors. Lucrative management fees encourage asset gathering regardless of the strategy's capacity and risk. And the steep total fees that hedge funds command require large absolute returns to encourage investors to commit, creating an incentive for managers to use cheap leverage to ramp up returns. Many hedge fund managers underestimated the now apparent mismatch in the liquidity of their assets and liabilities, possibly because a constant stream of new inflows allowed them to do so.

The hedge fund industry is recognizing its issues, and as a group is recommending substantial changes designed to reassure investors and regain their trust. The Hedge Fund Standards Board is recommending higher standards of transparency disclosure and independence. Hedge fund-of-funds should apply pressure to hedge funds by only investing with hedge managers who abide by these standards.

Investors and Their Advisors

Regulators provide the oversight necessary to limit the possibility of systemic risk and market crisis; investment managers can acknowledge their past transgressions by aligning interests and providing transparency, but without investors putting their faith and trust behind the stated changes, capital formation will be severely restricted. It is the role of advisors to conduct the due diligence necessary to verify that the decisions managers are making are real and accurately reflect the identified risks.

Advisory research teams, as representatives of families and their wealth, must have a complete understanding of the investment manager's strategy, its expected performance and its risks. These risks must be regularly monitored and the basis for changes in a portfolio's risk exposure understood. Risks are diverse, ranging from investment risk to operational and business risk. For traditional managers whose portfolios are transparent and held at the client's custodian, the advisor must understand whether the portfolio holdings, as well as buy and sell decisions, reflect the strategy's investment philosophy. Regular conversations with portfolio managers are opportunities to assess whether the manager is adhering to its stated investment philosophy or is taking on additional risk by allowing style drift. Quantitative analysis that relies on returns, as well as portfolio holdings is useful as a check on the qualitative assessment of investment risk.

In considering traditional equity and fixed income investments, managers must provide near complete transparency, and the advisory firm must remain diligent and thorough in its evaluation of managers — with a process consistently aimed at best practices. Hedge funds, however, to protect their trading strategies, have generally been reluctant to provide investors with complete transparency regarding their investment strategy, the details of security holdings and positions, and a clear outline of the risk exposures in their portfolios.

For hedge funds, hedge fund-of-funds and other alternative investments that provide limited transparency to both the investment strategy as well as the portfolio's holdings, managers must

identify and advisors must understand each strategy's complete range of risks. This includes: equity and interest rate risk, credit risk, commodity risk, currency risk, counterparty risk, the risk from leverage, liquidity risk and asset/liability matching risk, among others. ***The trust an advisor fosters between investor and investment manager can be permanently impaired if the investment manager or the advisor misrepresents the risks of an investment.***

Until a year ago, hedge funds often offered investors a take-it-or-leave-it option to invest with limited transparency, vague descriptions of liquidity and a set of potential conflicts of interest related to fund administration. It was a seller's market, and clients accepted these terms in order to gain access to the investments. Investors accepted that hedge funds were accurately representing the risks of their strategies and that they would deliver big absolute returns and preserve capital. Generally, hedge funds believed the promises they were making about the risks and returns of their strategies. Under "normal" market conditions their funds generally behaved as described, allowing investors to trust hedge funds and accept less than complete transparency.

Today, the costs of trusting hedge funds by accepting incomplete transparency is apparent, and many investors have chosen to step away from illiquid investments. As a result, hedge fund investing has been transformed from a seller's to a buyer's market. Anxious to retain its investors, hedge funds are increasingly meeting advisors' demands for more complete transparency, independent administration and custody, and portfolio liquidity that more accurately reflects the terms given to investors.

With these improved terms, it is critical that advisors and family offices ask the right questions to ensure that each manager is in fact acting upon their stated practices. To accomplish this, the advisor must employ best practices in its evaluation of potential investments. A complete list of best practices is beyond the scope of this paper, but includes¹:

- Performing thorough due diligence on the reputation, experience and background of managers and principals in the firm, employing as broad a range of resources as practical.
- Considering carefully the investment risk associated with the loss of key people, and if the risk is material, whether the firm's redemption provisions adequately mitigate the risk.
- Conducting due diligence of the stability of the manager's overall business: What are its governance and compensation structures, nature and breadth of ownership, degree of client concentration and stability of the client base?
- Understanding the manager's historical performance, factors contributing to that performance and the manager's ability to operate a fund successfully in varying market environments.
- Reviewing the manager's decision-making policies and risk limits.
- Being comfortable that operational functions are appropriately independent from portfolio management to mitigate potential conflicts of interest.
- Being aware of the manager's prime brokers and other trading counterparties, and ensure that counterparty risk is managed appropriately.

- Confirming that the manager maintains appropriate procedures and controls to protect against inappropriate or fraudulent conduct.

Conclusion

Threshold Group continues to believe that active managers and alternative investment strategies offer the opportunity to add value over passive investments and can offer capital protection. By adhering to best practices in evaluating manager's practices and claims, and demanding transparency and an alignment of interests, we believe we can help build trust between our investors and their investment managers, allowing our clients to capture this value-add opportunity while practicing effective due diligence aimed at protecting capital.

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About Threshold Group

Threshold Group is a multi-family office created by George and Jane Russell to serve a select community of goal-oriented families. Our organization combines the intimacy and personalization of a single-family office with the depth and resources of a multi-family office. Wholly owned by its founding family and entirely independent in its advisory relationships, Threshold evaluates each family's needs to provide an appropriately customized service plan. With a heritage based on the creation of Russell Investments, the concept of open architecture and independent due diligence are foundational to Threshold's culture. The Threshold approach is designed to create fully integrated service plans based on broad oversight, valuable integration of services and meaningful collaboration among best-in-class professionals. Our goal is provide successful families with the resources, relationships and freedom to achieve what matters most.

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¹ Principles and Best Practices for Hedge Fund Investors, Report of the Investors Committee to the President's Working Group on Financial Markets, January 15, 2009

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