Pricing Tactics Of Hedge Funds Put to Question; Some Managers Seem To Err on Sunny Side In Choosing Valuations


Abstract (Summary)
"Hedge-fund managers purposefully avoid reporting losses by marking up the value of their portfolios," according to the authors of the study, Nicolas P.B. Bollen, an associate finance professor at Vanderbilt University, and Veronika K. Pool, an assistant finance professor at Indiana University. If that is the case, the authors wrote, investors may "underestimate the potential for losses in the future and may overestimate the ability of hedge-fund managers."

Hedge funds don't operate under the same sort of spotlight. Most aren't registered with the Securities and Exchange Commission, and many are domiciled in offshore tax havens such as the Cayman Islands. Finally, some funds are audited only on an annual basis, meaning monthly valuations don't necessarily get checked by an outside auditor.

Previous academic research has found that a variety of hedge-fund strategies generate smoother returns than the underlying economics might justify. The recent paper by Mr. Bollen and Ms. Pool builds on this work but is different in that it suggests a manager "is going to round up returns to make sure they're slightly positive" rather than smoothing out both gains and losses, Mr. Bollen said.

Full Text (953 words)

New academic research suggests that some hedge-fund managers may cherry-pick flattering prices when valuing securities that don't actively trade in an effort to improve the performance of their funds.

Investors should take heed because this massaging can help make the difference between a winning or losing month, the research found. For hedge-fund managers, such statistics on the number of winning and losing months have grown increasingly significant as the number of hedge funds has exploded -- to more than 7,500 -- and managers vie to attract and retain investor capital.

How to price hard-to-value securities has become a hot-button topic on Wall Street in recent months as debt markets froze up. This made it difficult at times for banks, brokers and hedge funds to determine accurate prices for some debt securities that trade infrequently or have wide gaps between offers to buy and sell.

The most recent known case of hedge-fund pricing issues occurred at Ellington Capital Management, a $5.2 billion debt-focused hedge fund, which said in a Sept. 30 letter to clients that it would temporarily suspend withdrawals from two of its funds because of upheaval in the credit markets that affected its holdings of illiquid securities.

"There is no way to determine net asset values that would be simultaneously fair both to investors redeeming from these funds and to investors remaining in the funds," the firm said in the letter.

There have been no suggestions that Ellington has done anything improper. The letter said the firm's actions aren't in response to pending withdrawal requests, margin calls or any other issues.

A spokesman for the firm declined to comment. The move by Ellington was reported in the New York Post.

So far, investors, auditors and regulators have focused on the way banks and brokers value these securities. But the new research suggests hedge funds may be an even bigger area of concern.

The academic research found a significant difference in the number of funds reporting a slight gain compared with a slight loss in any given month. That difference was most pronounced for funds that trade illiquid securities; it didn't show up in funds that primarily trade stocks or futures contracts, which have active markets and easily obtained prices. This suggests that some funds could be fudging results.

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potential for losses in the future and may overestimate the ability of hedge-fund managers."

The study used a hedge-fund database from the University of Massachusetts to analyze monthly returns from 4,268 hedge funds with varying investment styles from 1994 to 2005.

Markets have settled down since the August credit crunch, thanks in part to the half-percentage-point interest-rate cut in September by the Federal Reserve. Hedge-fund adviser Hennessee Group LLC said yesterday that its hedge-fund index rose 2.26% in September after a nearly 1% decline in August. That index was up more than 10% for the year through the end of September, compared with an 11.5% gain for the Dow Jones Industrial Average and a 7.7% rise for the Standard & Poor's 500-stock index.

Valuation of infrequently traded securities first sprang to public view as an issue this spring when two Bear Stearns Cos. hedge funds blew up. One of the funds initially reported a 6.5% loss for April. A few weeks later, investors learned that the fund was actually down about 20% for that month. The fund told investors that the change was because of downward revisions in the price estimates it received for hard-to-value securities.

Fund managers can have a lot of leeway in determining whether such securities have lost or gained money. As long as they remain consistent, they can, for example, choose whether to use the bid or offer price of a security, which can sometimes vary widely, or pick among different quotes offered by competing brokers. So if a hedge fund is looking at a possible loss for a month, a manager could pick the more optimistic prices for some securities to push the fund into positive territory while ignoring those that could exacerbate losses.

Because they are publicly traded, banks and brokers typically face scrutiny over the estimates they use, from both investors and auditors. The recent market turmoil also prompted regulators to pore over the valuations being used by brokers.

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Typically, hedge-fund returns should fall along a familiar bell-curve pattern with a peak that is likely to be in slightly positive territory. That is how the returns play out for equity-neutral strategies, which bet on stocks either rising or falling in value. But that doesn't happen for strategies that deal with illiquid securities.

"This is perhaps no surprise: Distorting returns is more feasible when the opportunity for exerting managerial discretion is higher," the paper said.

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