Diligence This: Managers Face Hard Questions after Shaky '18

By Lydia Tomkiw January 16, 2019

The dust is settling on 2018 hedge fund returns, revealing some winners but overall negative performance across the market – and promising in the year ahead an even greater focus on deep research and due diligence from investors and consultants selecting managers, industry experts say.

Overall, **Hedge Fund Research**'s index ended 2018 down 4.07%, while hedge funds saw investors **yank** over $14.5 billion in 2018 flows through November, according to **eVestment**data**.** At the same time "2018 was very fund-specific, with some funds performing very well, while other funds faltered," eVestment said in a December report. **Bridgewater Associates**, **Renaissance Technologies**, and **D.E. Shaw** were among big-name firms that saw funds outperform in 2018, as **reported**, while **Och-Ziff Capital Management**, **Greenlight Capital**, and **AQR Capital Management** saw prominent funds end the year with negative performance.
"It was a disappointing year in terms of hedge fund performance if you are just looking at the indices," says **Jamie Gnall**, v.p. of alternatives research and advisory at **Wilshire Associates**. "However, I will say, I completely agree that it was much more fund specific than in years past."

There was greater dispersion across managers Wilshire follows, Gnall added. "Last year was the year you could have added value doing [manager selection]."

For funds that had a bad year in 2018, investors will have a range of questions: how they attract and retain talent both on the investment and operations side; whether the managers face additional redemption requests; and if their recent losses pose any challenges to payment arrangements with third-party service providers, says **Gary Berger**, a partner heading the emerging manager platform in the alternatives practice at **KPMG**.

"It will create higher hurdles and more due diligence for potential investors that are going to allocate capital to a fund that is in a loss position," he says.

The due diligence process takes time, between a year to 18 months for emerging hedge fund managers, Berger says. "It's not shortened in any respect," he adds.

The question now for funds that were down is understanding how much of performance was tied to market-related reasons and what was self-inflicted by managers, says **Michael Rosen**, principal and CIO at **Angeles Investment Advisors**, a consultant and advisor that invests in hedge funds.

“I think the days of hedge funds selling themselves as exhibiting positive returns irrespective of market movements are long over,” he says.

Angeles has moved away from investing in multi-billion multistrat hedge funds and turned to smaller, niche-focused funds, Rosen says. That brings its own set of challenges and can mean spending time helping firms on the operational back office side as well as waiting for compliance audits to be conducted, adding time to the due diligence process. “We are looking for true competitive advantage and that often is found in niche areas,” he says.

The year ahead will see an intensified focus on attribution at the sector, securities, and strategy level, says **Alan Kosan**, senior v.p. and head of alpha research at **Segal Marco Advisors**. Segal Marco is also putting an increased focus on looking at manager cybersecurity efforts, data governance, ESG factors and how managers approach them, workplace diversity, how artificial intelligence is being applied, and how connected macro themes are to securities selection by portfolio managers.

“These are areas of growing importance to distinguish one manager from another,” he says.

Investors will be allocating money to hedge funds in 2019, but it will likely involve movement from one manager to another based on performance, Berger says.

“It will be good news for some managers and bad news for others,” he says.