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#15

Hedge Funds' Scandalous Behavior

Overview: Several academic studies have shown hedge funds to be poor investment choices for prudent investors. Now, several scandals have added to the evidence on this being a poor asset choice.

The investing world was rocked with the news of another hedge fund scandal, as Galleon Group founder Raj Rajaratnam was arrested with five others in an insider trading scandal. The news refreshed the not-too-distant memories of the Bernard Madoff and R. Allen Stanford scandals and thrust hedge funds back into the spotlight. It also serves as another example of why investors are best served by avoiding these investment vehicles altogether.

On October 16, 2009, Rajaratnam was charged with securities fraud and conspiracy to commit securities fraud. The SEC also issued civil charges of insider trading against Rajaratnam and the other five people implicated in the scandal, including a high-ranking official at IBM.[1]

Rajaratnam's firm Galleon Group was considered an exceptional performer, recording average annual returns of 21 percent per year for its largest fund. The firm eventually oversaw more than $7 billion in assets before withdrawals reduced its level last year and still managed $3.7 billion at the time of the arrest.[2] Less than a week later, the firm announced it would liquidate all its hedge funds.[3]

Rajaratnam's arrest was just one of a number of recent high-profile scandals involving hedge funds. The Madoff and Stanford cases have been well documented. Madoff was sentenced to 150 years in prison for running a $13 billion Ponzi scheme which ensnared a staggering number of people, including high-profile investors such as actor John Malkovich and baseball hall-of-famer Sandy Koufax.[4] Stanford is awaiting trial on charges of leading a $7 billion investor fraud.[5] The following are other hedge fund scandals that have erupted in the past year.

Arthur Nadel and Scoop Management
Not long after news of the Madoff scandal broke, business colleagues of hedge fund manager Arthur Nadel approached him about conducting an audit of his funds at Scoop Management. The firm's assets under management appeared to have grown from about $10 million to $350 million in 10 years.

Similar to the Madoff scandal, Scoop investors were shown statements reporting 8 percent to 12 percent growth annually.[6] Nadel agreed to the audit, but then fled before being arrested two weeks later and indicted on securities fraud and wire fraud charges.[7]

Nicholas Cosmo, Agape World and Agape Merchant Advance
Nicholas Cosmo, who already had a conviction for financial mail fraud in 1997, was arrested in January 2009 for allegedly running a $370 million Ponzi scheme. According to the complaint, Cosmo would promise investors significant returns — even reaching as high as 80 percent. This came despite losing $80 million in investor funds on commodities trades.

Besides the money lost on commodities, Cosmo also spent more than $200,000 on a restitution order from his 1997 fraud case and more than $100,000 on jewelry, hotels and limousine service.[8]

James Nicholson and Westgate Capital Management
In April 2009, James Nicholson, president and managing member of Westgate Capital Management, LLC, was charged with securities fraud, investment advisor fraud, bank fraud and improper structuring of withdrawals. According to prosecutors, Nicholson falsely told investors his firm had as much as $900 million in assets under management. Upon his arrest in February 2009, the firm held around $100 million. Prosecutors also allege he misrepresented the consistency and performance of some of his firm's funds.[9]

Study Shows Hedge Fund Misrepresentations
Misrepresentations like those alleged by prosecutors in the Nicholson case are unfortunately more common than investors may think. In what now looks like an eerie premonition to the Rajaratnam case, New York University's Stern School of Business released a study two days before the arrests detailing how some hedge fund managers are dishonest about their funds.

The study reviewed 444 due diligence reports on hedge funds commissioned between 2003 and 2008. The authors focused on misrepresentations related to past regulatory and legal problems and performance, and found "that both types of misrepresentation are common in the data."[10]

According to the data, 41 percent of the funds in the sample have some form of legal or regulatory problem, more than twice the frequency of problems reported in the 2006 Form ADV filings. Regarding performance, 42 percent of funds had a misrepresentation or inconsistency problem. The authors cited one example of a manager who stated his fund's assets were $300 million higher than the actual number.[11]

The authors also found three kinds of fund managers when it came to disclosing past problems:
- Strategic Liars: Managers who disclosed a past problem, but failed to disclose additional past problems that should have been mentioned
- Liars: Managers who did not disclose past problems, despite having issues that needed disclosure
- Truth Tellers: Managers who disclosed all past problems

The authors found that 6 percent of fund managers belonged in the Strategic Liars category and 9 percent fell into the Liars category.[12]

Warren Buffett once said, "If you don't feel comfortable owning something for 10 years, then don't own it for 10 minutes."[13] Given the scandals and misrepresentations surrounding the hedge fund industry, it's a wonder that investors would feel comfortable with their savings in these vehicles.

1 Jenny Strasburg and Chad Bray, **Six Charged in Vast Insider-Trading Ring.** *The Wall Street Journal*, October 17, 2009.
2 Ibid.

[3] Joseph Checkler, **Galleon to Wind Down Hedge Funds.** *The Wall Street Journal*, October 21, 2009.
[4] Kevin McCoy, **As Victims Cheer, 'Evil' Madoff Gets 150 Years.** *USA Today*, June 30, 2009.
[5] **Financier Wins a Transfer After Having a Fight in Jail.** *New York Times*, September 29, 2009.
[6] Andrew Clark, **Fears of a Madoff-Style Scandal as Florida Fund Manager Goes Missing.** *The Guardian*, January 19, 2009.
[7] Kevin McCoy, **2 Arrests in Alleged Ponzi Schemes.** *USA Today*, January 28, 2009.
[8] Ibid.
[9] Chad Bray, **Two Indicted on Charges Tied to Fraud.** *The Wall Street Journal*, April 24, 2009.
[10] Stephen Brown, William Goetzmann, Bing Liang and Christopher Schwarz, **Trust and Delegation.** Working Paper, October 16, 2009.
[11] Ibid.
[12] Ibid.
[13] Dick Davis, **The Dick Davis Dividend.** (John Wiley & Sons, 2008).