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COMPLIANCE GROUP  
BEACON VERIFICATION SERVICES

MARCH 2008 UPDATE

# ATTEST **BVS**

As the first quarter of 2008 comes to a close, we wish the best for you and your associates. This month's feature article will focus on Hedge Funds. There are many questions regarding the relationship between GIPS and Hedge Funds, and we will attempt to address any uncertainties in the following editorial. In addition, we will introduce you to a new member of our Beacon family as well as update you on the upcoming conferences at which we will exhibit this year.

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## Hedge Funds Enter the GIPS Arena

Let's cut to the chase: there is no question that GIPS compliance is going mainstream in the alternative asset world, particularly with hedge funds. In the last six months, we have seen a tremendous increase in the volume of unsolicited calls from fund managers inquiring about GIPS compliance and verification.

We attribute this growing demand to one underlying source: institutional investors, or more directly, the consultants that work on their behalf. Institutions have only recently begun to place emphasis on asset allocations towards alternative asset classes, as it is now widely accepted that such allocations increase overall portfolio diversification while decreasing risk. As these institutional investors continue to place more dollars with alternative managers, particularly hedge funds, they also demand increased transparency in a sector that has historically thrived on secrecy. In the next few paragraphs, we will discuss the complex items that fund structures typically encounter. We will also spend some time discussing

the feasibility for hedge funds to claim GIPS compliance - it's better than most think.

### COMPLEX ISSUES:

#### Return Calculation

In most cases, the return a given fund experiences will be the return of the composite. This is because, in all but the rarest of circumstances, each hedge fund a firm manages will reside in its own composite (a composite being defined as an aggregation of accounts, or funds, with similar investment strategies). However, funds are fundamentally different from separate accounts. Funds have share classes, affiliated and unaffiliated investors, onshore and offshore feeders, classes restricted from new issues, side pockets, etc. With all of these complexities, what the firm should present as the return of the composite is frequently not an easy question to answer. It will certainly differ from firm to firm, but keep the end goal in mind - you want to present a return that (CONTINUED)



There is no black or white answer on how to calculate the return of the composite, but fair representation and full disclosure, as always, should be the guiding principles.

is most representative of what a normal, full-fee paying prospective investor would have returned. If you have a share class that is restricted from certain investments which typical investors and future fund investors would have access to, you likely would want to consider calculating and presenting performance on the assets of the unrestricted share class. There is no black or white answer on how to calculate the return of the composite, but fair representation and full disclosure, as always, should be the guiding principles.

#### Net of Fees Calculation

In our experience working with hedge funds, the net of fees calculation is often one of the most difficult challenges that firms face. How do we calculate the net of fees return for a hedge fund that, for example, charges a 1% management fee and 20% of profits,

subject to a high water mark? Perhaps this seems easy – you simply report the net of fees return that the fund administrator provides you, right? Unfortunately, it is not quite that simple. The following are some important considerations: Does the fund have limited partners that do not pay fees (almost all funds do)? Does the fund have legacy investors who pay a discounted fee or who do not pay an incentive fee? Does the fund have onshore/offshore feeders which experience slightly different expenses? Again, there are numerous items to consider.

With all of these options, there are three general ways in which net performance can be presented:

1. **The first option** is to present the net of fees return that is most representative of what a full fee-paying investor would have received. In most cases, this can be achieved by simply tracking the return of an underlying, full fee-paying investor of the fund. Remember, most funds are structured as limited partnerships, whereby each limited partner owns a percentage of the fund. With this structure, the gross of fees return of all limited partners should theoretically be the same; however, the net of fees returns would differ based on the different fee structures of the underlying investors.
2. **The second option** is to calculate the net performance using the actual fees which all investors in the fund paid. Because most funds contain a significant portion of non-fee paying assets, the actual fees of the entire fund can understate what a new, full fee-paying investor would pay.
3. **The third method** is to net down gross performance by the maximum applicable fee (in our example 1% and 20%). This works as well, although manual data entry and calculations must be performed to arrive at a net of fees return.

There is no correct choice here. Each option has its own benefits as well as its own potential weakness, and the choice will always have to be made on a firm by firm basis, depending upon the unique characteristics of each firm. (CONTINUED)



### Disclosures

It is certainly worth mentioning that disclosures for hedge funds carry significant importance. Methods and share classes used for composite returns, net of fees returns assumptions, the usage of leverage and derivatives are all items that warrant special attention in a GIPS compliant presentation. In a normal long only strategy, these disclosures are often not required, but in a hedge fund structure the language used to describe the performance being presented is vitally important, due to the inherent complexities discussed above.

### The Good News

Our experience in working with hedge funds leads us to believe that GIPS compliance is more applicable and attainable for hedge funds than is commonly believed. A particularly difficult task for many managers with whom we work is defining their composites and grouping all like managed accounts into these composites. As discussed above, this is rarely

an issue given the unique nature of hedge fund structures. Each fund is housed in its own composite where the performance of the composite is simply that of the underlying fund. Performance should be readily attainable via the fund administrator or internal documentation. Thus, the time consuming tasks lie in drafting policies and procedures and creating composite presentations with complete and accurate disclosures.

Of course, the complex issues regarding calculations and fees need to be addressed, but after the initial work involved in addressing these issues is complete, the ongoing compliance of hedge funds is typically a fairly smooth process.

*\*\*\*Please note that the Executive Committee of the GIPS has formed a working group to address the complex issues surrounding hedge fund compliance with the GIPS. We expect initial drafts of such guidance to be released sometime in 2008.*



## Beacon Verification Services Conferences 2008

Beacon Verification Services will be exhibiting at the following conferences in 2008.

We look forward to seeing you there!

<p><b>GIPS Standards Annual Conference</b> 25-26 September 2008 Westin Copley Place Boston, Massachusetts</p>	<p><b>Advent Software</b> 8-10 September 2008 Bellagio Hotel Las Vegas, Nevada</p>	<p><b>Schwab IMPACT® Conference</b> 23-26 September 2008 Georgia World Center Atlanta, Georgia</p>
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## Employee Spotlight: James Hendricksen



James Hendricksen is a data analyst serving our client base with the initial and on-going verification of GIPS compliance.

James joined Beacon after completing his BS in Finance with a concentration in Investments at the University of Tennessee at Chattanooga. While at UTC, James served as the president of the accounting and finance honor society, Beta Alpha Psi, and was also honored with the UTC Distinguished Student Award. He is a member of the CFA Institute and Chattanooga Society of Financial Analysts. James will be taking the CIPM exam in the coming months.