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Upfront

Risky Business **Nonprofits court trouble with hedge funds**

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INVESTMENT

Risky Business

Nonprofits court trouble with hedge funds

In 2001, the Art Institute of Chicago lost \$43 million of its endowment in fraudulent hedge funds. Shocking as it was, that scenario might become more common as nonprofit organizations sink more money into these unregulated investment pools.

In the last three years, the \$2.3 billion Duke Endowment changed its portfolio to reduce dependence on equities by increasing its assets in alternatives, including hedge funds. The \$1 billion Catholic Healthcare Partners, a nonprofit health system, is now considering a foray into hedge funds. And the Robin Hood Foundation, a New York-based charity with several prominent hedge fund man-

agers on its board, has almost 100 percent of its resources in these often-risky asset pools.

“More and more endowments and foundations are investing in hedge funds, driven in part by reports of good returns,” says John Griswold Jr., executive director of the Commonfund Institute in Wilton, Conn., a portfolio manager for nonprofit institutions. A Commonfund study of 204 nonprofit American healthcare organizations found that 29 percent planned to increase allocations to alternative funds, of which 42 percent were hedge funds.

Although anecdotal reports of outstanding hedge fund returns fuel

expectation of good performance, getting a grip on actual returns is difficult, and observers caution that charlatans abound. Hedge funds are unregulated, and the only funds that report their returns are the ones that choose to do so. Most issue reports only when they have good news, says Edward Siedle, president of the Benchmark Companies in Ocean Ridge, Fla., which investigates financial mismanagement for nonprofit institutions.

“I’ve investigated many hedge funds that never reported their performance, good or bad,” says Siedle, “and even if they do report, you have to consider the veracity of the reports. Many of the funds I’ve investigated

reported results to investors that turned out to be lies.” He believes more than half of hedge funds engage in some type of fraud. And while the hedge fund industry itself has a number of indexes and research databases, Griswold says that poorly performing hedge funds often just close up shop, leading to survivor bias in the available data.

Many nonprofits have lost assets in fraudulent hedge fund schemes – but the vast majority does not disclose it. “They usually try to hide it,” says Siedle. “I’ve investigated many hedge fund frauds where the client in the end says, ‘I don’t want to sue.’” Nonprofits have not gone public when they have been defrauded

because it is the “kiss of death” for a public charity, adds Dale Kindregan, relationship manager for endowments and foundations at Russell Investment Group in New York City. A media report that a charity has lost money in a fraudulent financial scheme could severely damage its ability to get donations, she explains.

Furthermore, nonprofits just getting into hedge fund investing may have already missed the boat. It’s tough to find one with a proven track record that is still open to new investors, says Griswold. “The best managers have closed or are closing and these smaller nonprofits will be forced to invest in lesser-quality managers, so they’ll probably be disappointed that their returns may be less than expected,” he says. Griswold adds that even hedge funds with the best records will probably not have



The Art Institute of Chicago has taken legal action to recover millions lost in fraudulent hedge funds.

the same large returns going forward.

He believes that to control risk and diversify properly, an institution must devote at least \$100 million to \$200 million to hedge funds and invest in at least 15 to 20 funds. One alternative to investing directly in a single fund, Gris-

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wold says, would be to invest in a “fund of funds.” Even that requires a great deal of due diligence. “It’s a very labor-intensive due diligence process to understand these often-complex investment strategies,” Kindregan says, “and if you’re not willing to invest in the labor then don’t do it.”

But outsized returns remain a lure. “Nonprofits generally have lower expectations in the next decade for returns from U.S. public equities and U.S. fixed income investments and are anticipating that they will get higher returns – or at least more stable absolute returns – from hedge funds,” says Kindregan. Currently, there are hedge funds and hedge fund of funds that are promising a 9 percent or 10 percent return, along with lower-than-stock market volatility, she adds.

–Elayne Demby