

Manager Reports – Timing and Content

Hedge funds typically utilize two types of reports: one that reports capital values and fund performance, plus a narrative report that may be sent less frequently. Keep in mind that there are two distinct purposes met by the two report types, and every fund has a “reporting plan” whether it is articulated at the outset or grows by best intentions. Since reporting decisions will have their own inertia once implemented, APM suggests that managers carefully consider their long-term communication plans before sending the first report.

Legal Issues

It is important to realize that report content has marketing and legal implications, so your reporting plan should be discussed with counsel. In addition, content must be carefully reviewed. Managers should note the following extracts of Rule §206(4)-8 adopted in 2007, which applies to both registered and non-registered managers of hedge funds:

It shall constitute a fraudulent, deceptive, or manipulative act, practice, or course of business... for any investment adviser to a pooled investment vehicle to:

- (1) Make any untrue statement of a material fact or to omit to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading, to any investor or prospective investor in the pooled investment vehicle; or*
- (2) Otherwise engage in any act, practice, or course of business that is fraudulent, deceptive, or manipulative with respect to any investor or prospective investor in the pooled investment vehicle.*

In the text of the release, the SEC further notes that “we read the language of section 206(4) as not by its terms limited to knowing or deliberate conduct.” In legal speak, “scienter” or intent is not required. So it is *very important* that reports be carefully vetted.

Reporting Performance

Over 90% of APM-administered funds report numbers monthly. While there is a valid argument that quarterly capital value reports might encourage investors to focus more on the long-term, monthly reports have become the standard for the following reasons:

- Many investors (all institutional and funds-of-funds) will require monthly reporting.
- If a manager agrees to provide monthly numbers to some investors and does not provide that same reporting opportunity to all investors, it would appear to pose some significant legal risks. An investor with a preferred reporting frequency might observe a disturbing performance trend and withdraw prior to other investors becoming aware of the problem. At the least, this may irritate those less-informed investors.
- Even if all investors would accept quarterly reports, a regular monthly report can eliminate many phone calls to the manager.
- During a bad patch, frequent and regular communication is usually beneficial; a down 15% quarter may come as a surprise and precipitate concerned phone calls, while a series of 3 down 5% months may not.

What about intra-month estimates?

APM discourages intra-month reports except in extraordinary cases.

Behavioral finance suggests that it’s a lose-lose proposition to provide information upon which the recipient cannot act. “Prospect Theory” states, in essence, that individuals are much more distressed by losses than they are pleased with equivalent gains. Researchers have quantified this concept, concluding that it takes a \$2 gain to offset the distress of a \$1 loss.

What about intra-month estimates? continued

How does this apply to a hedge fund? By and large, it means that for most people, the more volatility they are permitted to observe, the unhappier they are likely to be. An investor may be happy with a +1% month but submit a withdrawal request if he or she had viewed the daily or weekly volatility.

While some professional investors may say that they're "seasoned" and understand volatility, legal prudence would again suggest that reporting frequency should be the same for all investors. If preferred access to weekly results during the month of May, for example, influenced some investors to submit withdrawal notices in time for the June 30 quarter-end, other investors without access to such early information and whose withdrawal notices were delayed until September 30 might have a beef. Accordingly, if daily or weekly performance is reported to any investor, it should go to all.

What about special content for certain investors?

As noted above, differential reporting can create possible liability risk. As a rule of thumb, content – whether returns, risk reports, or portfolio details – provided to one investor should be made available to all.

Narrative Reports

A periodic well-written report is an efficient way of communicating with investors. If the report covers expected questions about the fund's portfolio and perhaps the market or economy in general, it can be very helpful to investors and save the manager a lot of phone time covering the same ground person-by-person. On the other hand, a poorly drafted report can generate more questions than it answers plus introduce possible legal liabilities.

Note that letters to investors may pose serious legal risks per the brief Rule §206(4)-8 discussion above. Accordingly, you should have your attorney review at a minimum your first several letters. Some managers may choose to have counsel review all communications to investors and prospects.

To help with the drafting process, APM has created a short list of general rules that we've accumulated over 20+ years in the business:

- **Avoid promissory language.** If you think oil will go up, say you think oil will go up for such-and-such a reason, not that it will go up or has to go up.
- **Make balanced statements.** State the downside if you discuss the upside.

- **Discuss proper legends with counsel.** Your attorney will guide you on the use and placement of a number of possible disclaimers such as:
 - "This material does not constitute an offer to sell interests in the fund."
 - "Past performance is no guarantee of future results."
 - "Contains selected information and should not be viewed as a complete description..."
 - "Contains forward-looking statements..."
- **Be careful with scope of content.** If you're not an economist or don't manage a macro fund, perhaps it is best not to launch into a lengthy explanation of why things are as they are in the world. Not only are such discussions risky in terms of getting it right, many investors are over-sensitive to hubris. If you're a stock picker, investors will likely prefer to see comments on stocks you own or are considering. Likewise, don't discuss sex, politics or religion unless such analysis is part of your investment process.
- **Choose a reasonable schedule and report regularly.** Some managers find that written reports are self-therapeutic and/or help them to clarify their own thinking. Others find the task more daunting. Keep in mind that if the fund is successful, you will be writing reports for years, so do your best to start with a format and content that match your writing style. A long report that does not flow well is worse than a shorter one that is well-organized and cogent. Similarly, a report that is delivered regularly will prevent more phone calls. Generally, for a fund delivering investor capital accounts monthly, APM suggests that quarterly or even semi-annual narrative reports may be adequate.
- **Make a point.** Good reports flow. In addition to having a beginning, middle and end, they state facts, share observations, and draw upon them for conclusions. After getting to the end of the report, the reader should understand how it all fits together.

Narrative Reports continued

- *Use an editor.* Get another person to read the report before it is finalized. There's nothing like a lay reader to help you identify unwarranted assumptions and poorly understood jargon. Plus, they might catch the odd typo.
- *Be careful about "standardizing" narrative letters.* It may be tempting to create a report template where, for example, the letter always starts off with a comparison table with one or more indexes; followed by general market observations and then portfolio specifics. In any one narrative report, you may want to compare your results versus pork bellies for some reason, but, if you're using the formula just stated, you probably wouldn't want to include pork bellies in the initial index table. The reason is that you likely wouldn't want to create an expectation to see pork belly performance in every report in the future.
- *Retain flexibility.* A corollary to the previous suggestion is that keeping report content fluid is usually helpful over the long run. It is best, in our opinion, to have some component of a report eclectic in nature – so you can discuss topics of interest but not create expectations that you'll necessarily continue that discussion in every report going forward.
- *Think about the implications of discussions of relative performance.* If a narrative report includes index comparisons, there are several things to think about and consult with your legal counsel on:
 - What inferences exist in the choice of the indexes used for comparison? Would a comparison solely to T-bills and bonds imply that the fund has a similar risk profile? In an always-hedged long-short equity fund, does the use of the S&P 500 imply something that could be misleading?
 - Investors use statistical comparisons to evaluate investments. Comparing a market-neutral portfolio to the S&P 500 is probably valuable because the stats help measure the extent to which the fund is not affected by the market. In other words, if the intent is to be different from the market, perhaps it's a good idea to show what the market did over the same time period.

- What about just listing a whole slew of indexes? For one thing, it's hard to compare well against every index. For another, the point of an index comparison can be lost when there are a large set of numbers in a table. Keep in mind, we are discussing *narrative* reports – it's a good idea to use numbers that can be discussed and explained in the report.
- You should consider the choices in an index table semi-permanent, as a change in benchmarks can raise questions from investors. Accordingly, try to select indexes that you will want to compare to 2 years from now, and to get those choices approved by your attorney.
- *Be careful when using statistics.* APM suggests that where statistics are used (r^2 , correlation, beta, etc.), most funds should consider including a comparison with the S&P 500 with dividends reinvested. Regardless of whether the S&P 500 is what you consider your "benchmark," it is a universal yardstick for statistical measurements, and one used in almost all APM-produced "Perf Reps."

It is worth repeating that every fund has a "reporting plan" whether it is articulated at the outset or grows by best intentions. Since reporting decisions can affect investor satisfaction, marketing, and the burdens and legal liabilities of management, we suggest that the reporting plan be one that is thought out in advance and vetted with advisors.

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