

*Memo to the Hedge Fund Investor***By Michael C. Deutsch**

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Extended bull markets often lead to collective amnesia on the part of money managers and investors. As investors chase high returns, they often ignore warning signals and make increasingly risky bets, only to suffer painful losses when the proverbial bubble bursts. The recent meltdown

of the sub-prime market is the latest example of just such an occurrence. For many investors, particularly those who allocated substantial portions of their portfolio to highly leveraged hedge funds, it has been nothing short of the rudest of awakenings.

Over the last decade, an increasing number of investors have often achieved superior returns via hedge fund investments. These alternative investment vehicles, however, remain subject to the same risks and pitfalls that exist with any type of investment, including volatility of markets and poor execution of investing strategies. In fact, the risks associated with investing in hedge funds are often significantly higher than those associated with, for example, mutual funds. Unlike hedge funds, mutual funds are required to provide investors with voluminous disclosures and are subject to broad SEC oversight.

Hedge funds are often highly leveraged and can be disproportionately vulnerable to dramatic changes in market conditions. As a result, hedge funds can suffer dramatic losses over short periods of time. While the overall market might show resiliency in the face of volatility, significant leveraging might nevertheless spell quick doom for a hedge fund. Investors who commit capital without conducting due diligence and ascertaining at least a general understanding of a hedge fund's focus and risk tolerance may, as the sub-prime debacle illustrates, be blindsided by a discreet market "crash."

Before investing with a hedge fund, investors should closely examine the fund offering memorandum and subscription documents for important information

regarding fund strategies and risk management. Since hedge funds generally concentrate on a specific strategy, such as small cap, emerging markets or risk arbitrage, investors should carefully evaluate whether they are willing to allocate a sizeable portion of their portfolio to a fund's particular focus.

If this due diligence process leads to a level of comfort with a particular manager, investors should still contact fund services providers (including prime brokers) and review hedge fund rankings by trade publications before committing capital. This brief investigatory process can serve to confirm or expose a fund's reputation and track record.

In the wake of the sub-prime mess, many damaged hedge fund investors have been exploring the possibility of legal recourse. Mere underperformance, however, does not give rise to a viable cause of action. With that said, a hedge fund's failure to adhere to its offering memorandum and/or subscription documents may give rise to a cognizable legal claim. The forum for a claim, which could be arbitration or federal or state court, is generally subject to a pre-dispute agreement in the hedge fund's subscription agreement.

Investors who believe that their losses are the result of inappropriate conduct by a hedge fund's management should immediately contact a securities attorney for a consultation, as claims are subject to various statutes of limitation. However, while careful due diligence prior to investing cannot insulate against potential losses, it may eliminate the need to ever consider legal action. **C&K**

Michael C. Deutsch is a partner with, and co-founder of, Singer Deutsch LLP, a full-service securities, commodities, and employment law firm with offices in Los Angeles and New York City. Singer Deutsch's clients include individual investors, brokers, traders, investment bankers, analysts, financial advisors, hedge fund and private equity executives, and other securities professionals. Mr. Deutsch, a member of the New York and New Jersey Bars, previously served on the Board of Directors of Red Star Asset Management, a hedge fund based in New York and Moscow.