

INVEST AT YOUR OWN PERIL

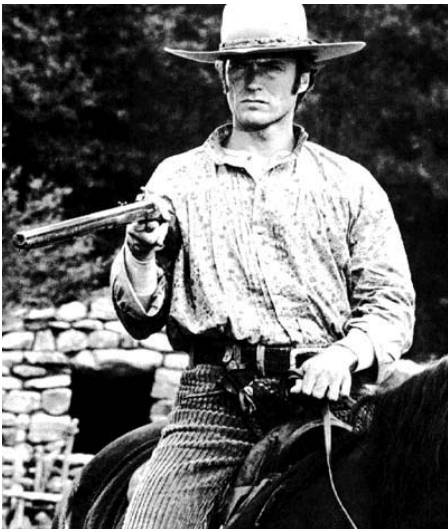
JULY 2004

Congress and the Securities and Exchange Commission are falling all over themselves trying to figure out how they are going to go about regulating the growing hedge fund industry. All of the regulatory bodies including Congress, the Securities and Exchange Commission, the National Association of Securities Dealers, and the usual Attorney Generals have failed miserably in identifying and preventing securities fraud of any sort before it occurs. With such a blatant dismal track record I am perplexed at why they currently want to add more to their plates and take on the hedge fund industry. Logic would dictate that before taking on any additional responsibilities, one would want to be successful in their initial task. *"Don't bite off more than you can chew"* is a cliché that comes to mind. Currently, hedge fund investors number around 250,000, whereas mutual fund investors number in the tens of millions. Here is a tip guys, prioritize. We have covered countless examples of hedge fund fraud and the various scams that have fleeced investors of billions. If hedge funds were a television show it would be HBO's *"Deadwood."* It is the wild, wild, west of investing; volatile, lawless, and wrought with fraud and crime. However, to each his own. If hedge funds are your pick, who am I to tell you how you should lose your money? Currently, hedge funds are only open to sophisticated investors. If the SEC and other regulators wish to avoid widespread problems, keep that rule intact and buyer beware.

EXERCISES IN FUTILITY

In an example of how futile the SEC is in handling hedge funds, this past April they sent out a questionnaire to many big bad investment houses seeking information on conflicts of interest involving hedge funds and how they are sold, marketed and funded. *"Does the SEC actually think that Wall Street is going to give up their secrets?"* They have a better chance of getting Coca-Cola to give up its formula. *"When the FBI is investigating the Mafia do you think they send out a questionnaire?"*

The NASD is currently preparing to announce its first "victory" against a firm regarding hedge funds. UBS Paine Webber has been accused of marketing violations in regards to hedge funds. They have been fined a whopping \$85,000, which is the equivalent of you or me paying a 25-cent curse word fine to our kids when we slip. The fine was for distributing sales literature to investors that lacked adequate risk disclosure. Of course UBS neither admitted nor denied wrongdoing.



Unfortunately, for all of the investors who are getting taken in the "Wild Wild West" world of hedge funds, there will be no recourse.

To articulate how absurd this fine is I will breakdown the profits of a typical hedge fund.

UBS PIE IN THE SKY HEDGE FUND
ASSETS OF \$100 MILLION
ASSUME HEDGE FUND SHOWS 5% RETURN

2% MANAGEMENT FEE ---\$2 MILLION
20% OF PROFITS-----\$1 MILLION
TRADING COMMISSIONS---\$1.5 MILLION

CLIENT GETS A .5% RETURN \$500,000

BROKERAGE FIRM SCORES BIG \$4.5 MILLION - \$85,000 FINE = \$4,415,000

Wall Street is going all out to expand their hedge fund business. Hedge funds are extraordinarily lucrative to brokerage firms with current revenues upwards of \$10 billion according to *The Wall Street Journal*. Hedge funds and brokerage firms are working very hard to expand and attract clients by any means necessary. Barry Goldsmith, Executive Vice President of Enforcement at the NASD stated to *The Wall Street Journal* that brokers have begun recommending hedge funds as some investors' sour on mutual funds. "With the mutual fund issues out there, there are opportunities to market these products to a broader base of investors." Translation: Brokers are scaring their clients out of mutual funds and flipping them into hedge funds for a fat commission payday. Brokerage firms are in the process of starting up as many hedge funds as possible. There is no regard for the experience of the people who will manage them. Steven Galbraith, Principal made the eloquent point, "*The barriers to entry in this business are nonexistent...It's roughly equivalent to creating a lemonade stand.*"

Wall Street firms are pulling out all the stops to expand their "*Prime Brokerage*" divisions. This is a business that provides services to hedge funds such as clearing trades, lending securities, and cash. The profit margins for prime brokerage firms tops out at 45%, making this a big bottom line booster according to *The Wall Street Journal*. Firms love this business so much they are willing to actually pay for computer systems, free or discounted office space and plan Heidi Fleiss-like parties at fancy hotels and bars to introduce the hedge funds to investors. If you recall previous articles here in the *Markowski Monthly*, these expensive computer systems allowed hedge funds like Canary Partners to illegally trade in and out of mutual funds. The entire mutual fund scandal revolved around hedge funds and brokerage firms bending the rules. The brokerage firms saw no problem in being the facilitators for these transactions and were more than happy to oblige their hedge fund companies by ripping off investors. Hey, "Pimping ain't easy!"

Currently hedge funds are only for sophisticated investors and they have a buyer beware feel to them. Let it stay that way. If people want to pay ridiculous commissions for lackluster performance so they can tell their golf buddies they own a hedge fund, let them do so. There is no possible way the SEC will have the manpower or know-how to tame this bastion of lawlessness. Just slap a warning on this type of investing like a cigarette pack, only allow sophisticated investors to lose their money and buyer beware.

