Change of tack as hedge fund industry takes on board lessons of the crisis

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The 2008 slump in hedge fund performance may now be well behind the industry and after bottoming out, the sector’s assets under management have resumed growth. Nevertheless, even those firms that are again earning performance fees recognise that in a number of ways hedge fund management has been changed by the crisis and that there will be no return to the balmy pre-2007 days any time soon.

On one level, the return of volatility and the opening up of a broader range of opportunities, coupled with the relative disappearance of gearing, suggest that in the future, gains are destined to come to a greater extent from the effectiveness of managers’ investment strategy, market insight and execution, and less from the scaling effects of leverage, whose capacity to result in punishment as well as reward has been amply demonstrated.

On another level, managers – and their investors – are coming to grips with the educational effect of the crisis, which made brutally clear that they were exposed to a much broader range of risks than they had imagined, and that the tools and concepts on which they had relied to identify, measure and manage risks in some cases had shortcomings that left them far more exposed than they realised.

Arguably the hedge fund industry is unlikely to see unprecedented, seismic events on the scale of the Lehman Brothers bankruptcy or the Bernard Madoff fraud again at any time in the near to mid-term future, if indeed at all. But it may well be that the industry will find itself exposed to asset price bubbles again before too long – memories are short in the financial sector.

What’s changed permanently, say practitioners, is the understanding by managers and investors not just of the scale of risks they run but their scope. The answer for investors, whether they be funds of hedge funds, institutions or high net worth individuals and families, is now seen to lie in transparency – the willingness of managers to share information to which they clung tightly in the past, and that the investors never believed it was crucial to insist on receiving.

But transparency in itself is no all-encompassing answer to the harsh questions posed in 2007 and 2008. The usefulness of information depends critically on the ability of investors to organise, analyse, understand and act on it. For example, an institution with fiduciary responsibility that lacks the capacity to utilise the new information it is receiving from managers is potentially exposed to greater risk of legal action from disgruntled underlying investors than it would have been if they had not received that information at all.

Over the past year or so, investing through managed accounts has been eagerly embraced by a wide range of investors not only as an answer to the liquidity problems that plagued the industry in 2008 and early 2009 but as a short cut to obtaining effective transparency from underlying managers. However, managed accounts also move responsibility for operational issues to the investor. Unless they have resources and mechanism in place to take on that responsibility, they have shed one kind of risk only to take on another.

For their part, managers too recognise that simply providing investors with information they previously held tightly to their chests is not enough. With the resumption in investment appearing to come much more from institutions than from the industry’s traditional high net worth clientele, reinforcing a trend already evident for several years, there are signs that managers are being pushed toward greater investment of cash and management attention in risk management systems.

Firms that in the past have tried to carry out risk management on the cheap with makeshift in-house systems, and that now may be finding it harder to instil confidence in investors, are scrambling to equip themselves with tools deemed to be “institutional class” and the people to operate them.

All this presents a huge opportunity for providers of risk management solutions to boost their business. However, they were not left unscathed by the crisis either. Risk management and reporting software firms are also under greater pressure to ensure that their products can deliver the information and analysis managers will require, and to guard against offering solutions that “fight the last war”. They are also facing the need to strike a balance between the ability to meet every conceivable client requirement and the need of smaller fund managers for adequate tools at affordable prices.

Meanwhile, large investors such as institutions are recognising the need to deploy risk management tools of their own to assess their portfolios as a whole as opposed to individual investments, as well as to provide them with greater resources in screening potential investment opportunities for red flags that would indicate operational inadequacies or, more seriously, fraud. The kind of faith placed by large investors in the likes of Madoff is a thing of the past.

The fallout from the Madoff affair has also alerted service providers to the risks they were running even when they thought, like the custodians of the feeder funds in Luxembourg, Ireland and elsewhere, that responsibility for oversight of the manager and the assets had been left with the underlying investors. UBS may have won a legal battle in Luxembourg against the threat of facing hundreds of individual lawsuits but it’s not yet clear that it and other providers are out of the wood. Moves by the European Union to redefine the responsibilities of custodians to Ucits and other funds may move the goalposts again.

All these factor are weighing on members of the hedge fund industry as they re-examine their approach to measuring, understanding and managing risk in the coming months and years. On the most basic level, managers and investors face the same delicate balance they have always done about the trade-off between risk and returns, albeit with their knowledge refined in the light of their experience over the past three years.

Without risk the hedge fund industry could offer no meaningful returns, but all the evidence points to the balance being skewed by a long period of prosperity and rising asset prices that came to an end two years ago. One of the key priorities for the future is to develop a better understanding of extreme risks that were not adequately picked up by risk management tools in the past, and to develop strategies that offer protection against large market gyrations and the collapse of generally understood relationships between asset prices.

A survey of 34 large pension funds and asset managers from around the world conducted by MSCI Barra in August and September last year found that institutional investors are rethinking their previous approach to risk management, which had largely involved a reporting and controlling function of investments within asset classes.

The report found that while investors used a wide range of risk measures including tracking error, value at risk, beta and volatility, the fact that their measurements were mostly applied within rather than across asset classes had potentially resulted in overestimation of diversification benefits, since the same underlying factors might drive what had been assumed to be quite distinct types of asset such as publicly-traded equities and private equity.

Another rethink concerns the organisation and status of risk management within investing organisations. Many participants in the MSCI Barra survey reported that risk management had traditionally been the responsibility of the chief investment officer, and that often risk managers not only had little investment expertise but tended to be junior to portfolio managers, limiting their impact on investment decisions.

Some of the pension fund managers interviewed acknowledged that the crisis had brought home the realisation that they did not have enough transparency into the activities of their external managers, for example how illiquid hedge funds could become or how leveraged some investments were.

MSCI Barra says the institutions surveyed were most surprised by the "sudden and violent appearance" of liquidity and counterparty risk and their impact on investments across all asset classes. "Both types of risk had been largely ignored up until this crisis and are still not well understood," the report says. "Going forward, almost all survey participants highlighted the need to better understand these two types of risk and are looking for guidance from consultants and risk management vendors."

The report says that a major rethink now appears to be underway regarding a number of areas within the industry. First, the position of risk management within institutions is being upgraded, gaining status and seniority, with reporting in some cases switched from the chief investment officer to the chief executive, for example. In addition to their control functions, risk managers may develop investment expertise in order to be able to provide 'independent' advice to investment management teams.

Finally, institutions are looking to carry out risk management on a firm-wide rather than asset-specific basic in order better to understand common factors across asset classes. "Traditionally risk management was a reporting role, but now it is moving towards managing, policing and intervening," says one pension fund sponsor quoted by MSCI Barra.

Respondents also indicated that they planned to invest significantly in improved risk management tools, with particular focus on the weaknesses exposed by the crisis, including identifying, measuring and managing counterparty and liquidity risk and adding or enhancing stress testing and capabilities for measuring extreme risks. They are also seeking to identify the underlying drivers of risk and return across asset classes and complementing quantitative criteria with qualitative risk assessments.

Finally, the report confirms that among pension scheme sponsors, risk management capabilities will become a more important factor in the selection of external managers. "Asset managers with a fully integrated risk and portfolio management process will have the competitive edge," the authors conclude. "Counterparty and liquidity management will be scrutinised, and [pension] plan sponsors will require more transparency from hedge funds."

Please click here to access the Hedgeweek Special Report on Hedge Fund Risk 2010 [1]

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