

Risk monitoring and transparency are the key drivers for 2010

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The drive to provide hedge fund managers with the latest tools to raise operational efficiency and improve performance has been lent impetus by the industry's roller coaster ride over the past two years.

Despite dire predictions for the industry's health in late 2008, the current signs are positive: following the losses suffered by most funds in 2008, the industry bounced back in 2009 with its best calendar-year returns in a decade. Returns of 3.1% (according to the Credit Suisse/Tremont Hedge Fund Index) in the first quarter of 2010 added to returns of 18.6% in 2009. The first quarter of this year moved the hedge fund industry a step closer to making up for the 19.5% drawdown between June 30 and December 31, 2008 and funds have now recouped 91.9% of all 2008 losses.

This rebound has helped turn the tide of capital and persuaded investors, notably institutions, to reallocate to hedge funds. Credit Suisse estimates that total industry AUM currently stands at \$1.5 trillion as of March 2010 and recent surveys indicate that managers and investors are optimistic about growth in 2010, putting AUM between \$1.7 and \$2 trillion by the end of the year, which is above pre-credit crisis levels. About half of this growth is expected to be produced by capital inflows and the remainder from performance.

Nevertheless, while the bare stats present a picture of stability, there is a strong undercurrent of change and desire for reform. Investors had already woken up to risk and reporting issues before the crisis broke, but are now practically falling over themselves to be the first to demand that managers are equipped to deal with markets better than they were in 2008, and that they possess state-of-the-art tools for valuing assets and monitoring risk.

As Gerry Buggy, Global Head of Hedge Fund Solutions at Thomson Reuters, says: "The changes are profound. Performance may have come back, but the industry is not going back to its old ways."

Although the sophisticated processes employed by banks did not prevent the meltdown in 2008, Buggy believes there is still a lot to learn from the sellside. "A lot of what we at Thomson Reuters do on the sellside has not been replicated on the buy-side in the alternatives space. Sellside pricing, operations, valuation processes have a rigour which we have not yet fully witnessed in hedge funds."

One possible reason for this is that little pressure for change existed because many institutions had – and still have – small hedge fund portfolios and insufficient resources to support them. Thus, the necessary due diligence was not always applied. "But it is all changing now," says Buggy. "The pressure on fees and operating methods means buy-side alternatives firms are growing up, particularly in terms of processing and reporting."

He sees evidence of increasing "intelligent pressure" whereby demand for change goes beyond wanting to see evidence that regulators' boxes are all ticked. "Hedge funds are not going to get caught up in a Lehman now; there is more analysis of capital pledged, rehypothecation and prime risk, and smart collateral management is now the watchword. The relationships between various parties are scrutinised for conflicts and people are looking for valuations and data that are sourced independently."

Counter-intuitively, the fact that markets have bounced back has actually increased the need for a coherent risk approach. As returns and confidence rise, the more complex trading strategies are returning and this requires careful management. Robert Boardman, head of algorithmic trading sales at ITG, says: "Risk was constraining many trading strategies, even profitable ones. Good managers were just not trading and one of the largest fund's turnover was down to a quarter of where it was."

The return of volumes means more funds, more assets and greater demand for risk systems. One of the problems for investors looking to manage risk more holistically is that although many strategies appear similar, in fact they vary greatly when investors look under the bonnet and view the individual assets. But how can this be achieved in practice? "Lots of funds give us their whole portfolio to value so we are able to create our own valuation models and understand the data behind them," says Buggy. "We can aggregate where most people are working in silos, and aggregation is vital for risk reporting."

Indeed, risk systems are likely to dominate vendor suites in the coming year following the failure of many of them in 2008 and in view of the market risks that may still lie ahead. Jeremy Rowlands, chief executive of Caliburn Capital, a fund of hedge funds firm, says 2008 was the classic stress test. "We saw problems related to market risk, tail risk and operational risk. The industry still has to deal with this. It needs systems that are effective in addressing all these areas and that also link the risks. Risk is a factor of all three - you can't look at them in isolation or you won't solve the problem."

He reserves particular ire for the way the industry has dealt with tail risk. "It has been too ready to take steady returns and ignore the potential tail risk," Rowlands says. "It is admittedly hard to deal with risks you haven't observed because most risk processes are quantitative and backward looking. Tail risks are forward-looking and qualitative."

Some believe that managed accounts, which have grown in popularity hugely since late 2008, represent the best way to observe and measure all risks. Hans Hufschmid, chief executive of GlobeOp says: "It takes a lot of work to set up the infrastructure for a managed account, but at least you get exactly what you want. Managed accounts don't mitigate tail risk but they do allow you to calculate it."

It is less certain that the risks can be ascertained and mitigated in the wider industry. "Investment banks have shown you can link and aggregate all risk classes," says Buggy. "But it is only possible to do this in alternatives if hedge fund disclosure improves."

As well as risk, 2008 was clearly a catalyst for a better approach to transparency and liquidity, between which there is a strong connection. Liquidity mismatches in the hedge fund world were endemic prior to 2008 - funds of funds offered monthly liquidity even though underlying funds had longer lock-ups, and single strategy funds could not meet redemptions because of the illiquidity of their assets. Says Rowlands: "Liquidity should be appropriate to the underlying strategies. Part of this is about analysing and understanding the client base better. High net worths were traumatised by 2008 and they have a great suspicion of locking up their money for longer. But institutional money, both before the crisis and now, will sacrifice liquidity for performance. We have taken money from investors in the last few months who have argued that we should extend the liquidity of a portfolio. In credit in particular, opportunities can take a year or two to play out."

Transparency has increased through better and more frequent reporting and through the use of Ucits structures and managed accounts. But, as Rowlands acknowledges, transparency is only as useful if the sophistication of the customer allows it to be. "Intelligent transparency is the aim - you want to know the risks and be sure there are no nasty surprises around the corner. In this respect, granular transparency does not always help."

For an underlying investor or a fund of fund, a big operational risk report that shows all the assets held and the counterparty exposures of each manager can offer reassurance about fund governance and operational risk, but does not enable the investor to manage market risk, Hufschmid says. "You have to trust the manager to manage the risk - after all, if you could do it all yourself you wouldn't employ the fund manager at all."

The desire for transparency goes beyond processes and technology to expectations. Many investors did not recognise before 2008 that hedge funds do not necessarily guarantee their capital is safe over the short-term. Caliburn says in the last 18 months it has been pushed to polarise its strategies as investors demand to know whether funds are predicated on absolute returns or intelligent beta. "If the latter, there is also the risk of negative returns," says Rowlands. "If an investor expected

managed beta, then returns in 2008 were pretty good; if absolute returns were desired then they were not so good." Calburn has seen good flows into alpha-only institutional portfolios and much interest in its greater China portfolio, which represents asymmetric returns against an index. "But interest has returned more slowly to our multi-theme portfolio which is a blend of the two approaches. Post-2008 you have to be very clear about defining the level and nature of the risk that a hedge fund or fund of fund delivers and how the fees relate to that."

This is central to the hedge fund thesis: those that communicate well, upgrade their systems and processes and - importantly - can demonstrate they have done so, will be able to set fees that reflect the value they add. As Rowlands says: "Headlines about fees coming under pressure have been around for years now. The reality is the level of fees will be tied to the value added to operations and to investment strategies. The more value added, the less pressure on fees."

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