Hedge Funds – a risk manager's viewpoint

Asking the right questions

Hedge fund regulations, if well thought-out, can improve the information available to investors while poorly contrived regulations merely increase costs and raise barriers to entry for potentially innovative products. They can also impose a drag on performance by reducing the manager's scope to achieve the best Information Ratio and actually increase risk by giving a false sense of security.

Investors would be unwise to rely solely or even primarily on regulations. Doing so is like relying only on traffic signs to drive your car: better than nothing but no substitute for looking where you are going. What should you be looking for?

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Two obvious sources about the risk of the fund are the due diligence typically carries out by fund distributors and others, and the fund fact sheets provided by the manager of the fund.

Given the diversity of hedge fund strategies, their due diligence and governance processes are surprisingly uniform across funds. While the information they provide can be useful, it is rarely adequate: risk measures that are not directly relevant to the investment strategy can distract from the real issues, which are often not fully addressed.

Risk management is not the same as risk minimisation.

Risk is the necessary condition for active returns. Yet few fund fact sheets or performance and risk reports give clear information about the link between risk and investment strategy. So you need to delve deeper to find out what you need to know. A few rules of thumb can be helpful.

1. Risk management is not the same as risk minimisation. Risk that is expected to lead to extra return should be nurtured and managed. Otherwise it should be eliminated. Failure to understand which is which means some sources of risk are unmanaged, leaving the fund vulnerable to unnecessary losses; while risk that the portfolio manager intends to take can be damped down by poorly- contrived risk controls.

2. Measurement should include gearing and counterparty risk as well as market and factor risk. In combination they all affect portfolio outcomes.

3. Whether your risk measure is VaR, CVaR, tracking error or volatility you will want to know:

Does it measure everyday risk - the likelihood of your target return being achieved, or extreme loss? Extrapolating from one to the other is highly misleading.

Is the time frame suitable? A one-month VaR is unhelpful if your investment horizon is three years, and vice-versa.

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4. What are the main sources of expected return? Investment managers typically have four to six themes in their portfolios. Too few themes and the fund may be too concentrated. Too many can be hard to manage, increasing volatility (if the risks compound each other) or dampening returns (if they are offsetting). Themes should be as independent as possible so as neither to offset or compound each other. Management of the covariances between strategies is as important as the risks in the strategies themselves.

5. Is there equal likelihood of gain and loss? If not, what drives this asymmetry?

6. Controls should be integral to each theme or strategy. Explicit target returns and loss limits (which are not the same thing as stop-losses) for individual themes are an excellent sign that the portfolio manager actively links risk with return. A stated exit strategy for each theme, for both good and bad outcomes, reflects discipline: a crucial quality.

A skilled risk manager can suggest ways to target risk to improve the fund's Information Ratio.

7. A robust risk management process is an invaluable resource that can complement and enhance the portfolio manager's investment selection skills. By quantifying the complex, compounding and offsetting relationships in the portfolio, a skilled risk manager can suggest ways to target risk to improve the Information Ratio, in effect offering an informed second opinion.

   For this the risk manager needs to be at once independent of the portfolio manager, close enough to understand his strategy and in a position of enough authority that his views are not easily dismissed.

   Accountability is key: by recording decisions and their rationales, luck is less likely to be mistaken for skill.

Sustainable active returns are impossible without risk. If you do not manage risk constructively, you leave yourself exposed to nasty surprises.

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Enhanced oversight and regulation may benefit the industry by increasing investor confidence. But even the best thought-out rules and controls cannot substitute for thoughtful research and commonsense on the part of the investor. Finding out what you need to know means asking the right questions.

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