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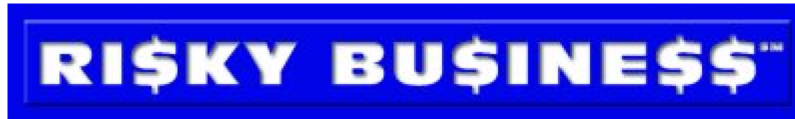
RISKY BUSINESS

Promise or Peril? **June 21 2005**



In the ensuring months, this column will examine some of the many challenges and trends that affect hedge funds and fund of funds. Institutional investor preferences, risk management, regulation, valuation, transparency, litigation, and performance metrics are just a few of the topics on the list.

Introduction

The growth in the hedge fund industry has been nothing short of meteoric with assets now exceeding one trillion dollars and no end in sight. At the same time, the winds of change are blowing hard. Hedge funds and fund of funds just getting started are facing tough competition. Veteran managers don't have it much easier as they prepare for a turbulent market, new challenges in the form of investor demands and imminent regulation.

Nimble players will capitalize on new opportunities. Others will fall by the wayside. Whether the industry offers promise or peril remains to be seen. One thing is sure. Perseverance, savvy and the ability to weather change are essential as never before.

Impact of Institutional Investors

Pension funds, foundations and endowments are increasingly allocating monies to hedge funds for a variety of reasons, not the least of which is an attempt to diversify and enhance returns. This trend is already having a dramatic impact on hedge fund practices.

Beneficiaries, shareholders and regulators are asking trustees to better justify their investment decisions. This means that hedge fund managers will be under pressure to provide more and improved information. Accustomed to being given first class treatment, large investors may have no choice but to look elsewhere if a hedge fund or fund of funds refuses to open their books.

This is a sea change for managers who could long afford to turn away investors rather than let in the light. "Back in the old days, investors were high net worth individuals who wouldn't ask for transparency," said Mark Szycher, director of research for Westport-based Weston Capital Management, a firm that manages alternative investments for high net worth individuals and institutions.

In addition, low interest rates, anemic equity market conditions and changing demographics continue to tempt endowments, foundations, and pension plans to invest in hedge funds (or fund of funds) in search of better performance. This may make sense as long as the risk-return tradeoff is well understood, investors pass the sophistication test, and the fund offers a suitable way to meet a stated objective. Inevitably however, some losses will occur, irregardless of the process used for security selection. When institutional investors are involved, especially those already making headlines for funding deficiencies, the net result is litigation and regulation.

Litigation and Regulation

After Enron and other large corporate bankruptcies, neither taxpayers nor shareholders will sit idly by and watch precious dollars slip away from their pension. On the non-profit front, Congressional and state lawmakers are putting together Sarbanes-Oxley like regulation that includes a focus on financial policies and procedures.

Regardless of hedge fund culpability, lawsuits are expensive and time-consuming to defend, not to mention their impact on public acceptance of alternatives. Regulation will impose similar constraints in the form of changed incentives and higher costs.

Far from remote, only a handful of pensions, endowments, and foundations have to lose money

before statutory mandates and highly publicized lawsuits change things for all hedge funds, good and bad. Senior officials are worried. In early June 2005, Alan Greenspan warned that "continuing efforts to seek above-average returns could create risks for which compensation is inadequate. Significant numbers of trading strategies are already destined to prove disappointing, a point that recent data on the distribution of hedge fund returns seem to be confirming." [1]

Valuation

The U.S. Securities and Exchange Commission cites hedge fund valuation as a key concern, adding that "the broad discretion that these advisers have to value assets and the lack of any independent review over that activity gives rise to questions about whether some hedge funds' portfolio holdings are accurately valued".[2] Valuation has taken center stage in recent court cases as well. Many of these litigations examine the process used to determine the value of illiquid securities or assets with embedded derivative-like features.

Even when a model is universally accepted, there may be issues having to do with calendar period, data form or price frequency. This can lead to model risk, making it difficult to make good decisions based on valuation – and related performance – numbers.[3] Discounts for lack of marketability can vary and aggregating portfolios may be difficult. The use of derivatives, uncertain cash flow timing, expected behavior of model inputs, underlying collateral and/or provisions to net or terminate a trade early can be just as important.[4]

Performance

Diversification potential is an oft-cited reason for investing in hedge funds (or fund of funds). In the past, correlations have been either negative or low positive, depending on strategy. Importantly, new research about the non-normality of returns invites a second look. Just as notable is the fact that past performance is no longer likely a good gauge of expected price patterns. Different economic conditions, regulation, increased competition, arguably fewer arbitrage opportunities and the institutionalization of the hedge fund industry paint a different picture for the future.

Investors are not alone. Hedge fund managers are equally interested in empirical research results. After all, price patterns directly influence the way they identify, measure and manage risk. Hedge ratios and standard performance numbers frequently assume normality. Non-normality makes it hard to interpret and use the Sharpe Ratio and other popular metrics.

Even if everyone agrees on a proper probability distribution for a particular type of hedge fund, the questions remain. Will the mathematics support the diversification decision? Will client service professionals be able to provide a straightforward explanation to individuals and less savvy institutions? How will the distributions vary by purpose and investment scope and will that make it harder to compare alternatives?

What Lies Ahead

These and other weighty topics are just the beginning. Shrinking violets may want to start scouring the want ads.

Endnotes

1. "Remarks by Chairman Alan Greenspan: Central Bank Panel Discussion to the International Monetary Conference, Beijing, People's Republic of China", Federal Reserve Board, June 6, 2005
2. "Staff Hedge Fund Report Fact Sheet: Implications of the Growth of Hedge Funds", U.S. Securities and Exchange Commission, September 2003
3. See "Asset Valuation: Not a Trivial Pursuit" by Susan M. Mangiero, FSA Times, published by the Institute of Internal Auditors, First Quarter 2004, for a list of questions pertaining to model validation.
4. Mangiero, Susan, "Research from Our Experts: Derivatives Valuation - One Size Does Not Fit All", The Michel-Shaked Group, 2003

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