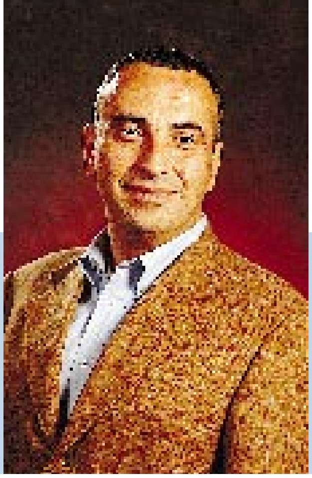

Frederick Francis

Vice-President, Securities Finance and Global Products, RBC Global Services

The Role of the Prime Broker

Prime brokers have understood and managed the risk of hedge funds for years.

Risk is key for institutional investors establishing a hedge fund strategy. Prime brokers have understood and managed the risk of hedge fund investments for years. Typically, the prime broker finances the investments and, therefore, they are often the fund's largest financial stakeholder. Clearly, the prime broker is concerned with risk management and their needs are closely aligned to that of the institutional investor.

In addition to investment financing, a prime broker performs additional key functions for hedge funds, including settlement and custody, securities lending, and fund valuation and accounting. This gives the prime broker complete transparency on the fund. The provision of these services puts the prime broker in a unique position to carry out the necessary risk management policies and procedures. Managing risk for hedge fund investments is not dissimilar to assessing investment risk in traditional asset managers.

A comprehensive risk assessment matrix can help measure and monitor the risk involved in a hedge fund. One such approach is a framework that considers the "Four P's"— people, processes, portfolio characteristics and performance. People and processes consider macro/quantitative criteria, while portfolio characteristics and performance consider micro/quantitative criteria.

Under each category, there is a checklist of criteria that are measured on a pre-qualification and/or ongoing basis. The categories are weighted and the criteria are given a score that reflects the level of satisfaction. The final total is compared with a benchmark score in order to determine whether a prospective hedge fund meets the risk parameters.

The primary objective within the "people" segment of the checklist is to determine whether the hedge fund has strong financial backers and to determine if the principals of the firm have made substantial personal investments in the fund. This demonstrates their commitment and confidence in the business and can be a useful indicator.

The next element to look at is the strength of the management team and any synergies that the key players bring to the running of the fund, such as expertise, leadership and skill.

The priority within the "process" segment is to determine the investment strategy employed and to estimate its probability of success given the strategy's past performance and expected performance in the context of the current and expected market outlook.

Other elements to examine are the trading model being employed, the adequacy of documentation (i.e. legal agreements, investment policies and operational procedures) and the sufficiency of management's control and oversight of the investment and operations activities.

The "portfolio characteristics" segment entails a solid understanding and overview of the fund's daily transactions and positions in order to perform in-depth analytical calculations related to its financial strengths. Traditional accounting and market ratios such as leverage, liquidity, margin, diversification, asset quality, Value-at-Risk, and correlation are measured and compared to an appropriate benchmark in order to determine the risk exposure on a daily basis. Corrective actions (increasing margins, liquidation of certain positions, etc.) may be necessary to realign the portfolio balance sheet.

A thorough review of both past results and projected performance can be undertaken in order to evaluate the likelihood that the fund will meet the targeted return, and to assess the fund with respect to survival risk. This review considers historical monthly returns over the life of the fund, the consistency of returns over some money market benchmarks, and the growth of the capital raised.

Identifying the unique characteristics of a hedge fund and applying basic approaches to assess traditional asset managers can be useful in clarifying and demystifying hedge fund risk. ■