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Hedge Funds Under the Microscope

A new way to monitor hedge funds offers a third-party risk assessment of traditional long-only managers and hedge fund portfolios.

Recently, many plan sponsors have considered

investing in hedge funds. They have been confronted with two big stumbling blocks: risk measurement and transparency. Understanding portfolio risk is important for any manager or sponsor, and it is critical for hedge fund investments. Plan sponsors need to ensure that their managers are taking reasonable risks and, importantly, understand how a particular hedge fund fits into their overall plan.

Risk assessment is much more difficult for hedge funds as they tend to be more active, and most use short positions and/or derivatives. The transparency issue compounds the risk measurement challenge, which revolves around the reluctance of hedge fund managers to disclose information about their underlying investments.

Most sponsors that have made an allocation to hedge funds accept these limitations and rely on exposure or risk reports from different managers to monitor the plan's investments. However, there are inherent risks associated with manager self-reporting. As well, it makes any comparison across different investments almost impossible as all of the data is usually calculated in a unique and proprietary manner. Another challenge lies with the fact that manager reports offer no insight into how the fund fits within the overall plan.

STRESS-TESTING

What is a plan sponsor to do? Fortunately, a new way to monitor hedge fund investments is emerging that consists of an independent, third-party risk assessment of both traditional long-only managers and hedge fund portfolios. This approach addresses both the issues of

transparency and risk measurement.

To help address transparency, the manager will only provide security level detail to the risk vendor. The risk vendor enters into a non-disclosure agreement with the manager, making hedge fund managers more willing to provide security details. The risk vendor is then in a position to perform a detailed assessment of each of the hedge fund portfolios, while only providing the summary risk statistics to the sponsor.

A security level value-at-risk and stress-testing analysis is an effective way to understand the risks of each manager, especially hedge funds. Relying on historic, standard deviation can grossly understate real risks. By their nature, hedge funds are more active. As a result, looking only at past performance is a dangerous way to control risks. Unlike standard deviation, a holdings-based risk assessment reacts immediately to changes in the underlying portfolio. As well, the securities can be aggregated across all portfolios to identify concentration risks.

In addition to providing sponsors with a better way of monitoring hedge fund managers, this type of risk assessment also allows sponsors to assess the plan's total risk. This means keeping an eye on the asset/liability gap. In particular, a value-at-risk analysis will allow sponsors to view the risks of all of their assets, both traditional and alternative, alongside their liabilities. Indeed, understanding the probability of having the plan's surplus wiped out leads to better investment decisions and a more stable plan.

An allocation to the right hedge funds can provide positive returns in difficult markets, and ultimately contribute to a much higher risk-adjusted return for the entire fund. With the advent of independent risk assessment, sponsors can now properly monitor these investments. ■