Opalesque Exclusive: In many cases monthly hedge fund reporting doesn't provide accurate illustration of portfolio risks

Tuesday, April 27, 2010

From Kirsten Bischoff, Opalesque New York: As the hedge fund industry recovers and managers begin to rebuild asset bases, much of the focus is on determining how the financial crisis has impacted asset flows within the industry, and if these changes indicate new paradigm shifts. There are indications that while investors do not want to miss out on the strong performance hedge fund managers have had in the aftermath of the financial crisis, they are still wary towards the industry in general and their cautiousness is showing in the distribution of new assets.

Asset flows tracked by BarclayHedge indicate that the larger, older, more established hedge fund firms with strong infrastructures are seeing the majority of inflows. This is largely attributed to investors maintaining a sense of caution returning to an industry that was hit by liquidity impairments that saw approximately $174bn (12%) of industry assets locked up in some way during the height of the liquidity crisis (Credit Suisse Tremont Hedge Fund Index). Although, currently only $61bn remains illiquid (as of March 31, 2010), investors are now more vigilant than ever in their quest for exerting more control over their assets, whether by investing in only the most liquid strategies, negotiating lesser liquidity terms with managers, or maintaining control through investments via managed account platforms.

Industry observations from hedge fund administration firms such as Custom House have indicated that managed accounts and managed account platforms continue to benefit from investors desire for more control. Custom House, which has rebuilt its asset base to pre-2008 levels, now has fully one third of its funds under administration requiring daily NAVs - a number driven mostly by managed account clients.

Whether or not managed accounts have really taken hold and have staying power, or are just a prolonged trend powered by the double hit of the liquidity crisis and fraudulent behavior (Madoff, etc) is yet to be seen. 2007 saw 344 hedge fund failures and research by hedge fund consulting firm Castle Hall found that hedge fund operational failures driven by fraud and/or malfeasance looted $80bn from the industry, across some 327 cases.

At present, the tight asset-raising environment has meant more fund managers are willing to run managed accounts, which is a significant change to prior attitudes. However, investors have also come to realize that while a managed account can give greater control

and greater transparency of investments it also requires a much higher level of due diligence, oversight, and risk management, which is where the managed account platforms have come in.

"The act of assuming that arbitrary suspensions are naturally an economic good for an investor is more often than not, a case of "financial Stockholm syndrome", where the investor has come to unnaturally and irrationally identify with his captor," says Andy Weisman, CEO of Connecticut-based WR Group, when discussing the liquidity issues of 2008 (and in some cases of 2009 and 2010) that drive many investors towards hedge fund platforms like WR Group.

Platforms have benefited as more investors sought ways to invest into funds through managed accounts only to find out that while such investments added levels of transparency into their investments, so too did it add their responsibility to manage and adequately monitor this information. Most provide manager due diligence, portfolio analytics, and various forms of daily reporting that aggregate and organize the many various streams of information into systems used by the investors on their platforms.

"Unless you have the ability to parallel what a manager has created in terms of infrastructure (ie multi primes, oversight of multiple ISDAs, margining arrangements, etc) then you put yourself in the position where you drive up costs or create operational nightmares...Because we invest significant partner capital alongside our clients we created a consortium where we're working together with other organizations to drive down costs." In fact, WR Group, which has already established relationships with major fund of funds organizations such as Zurich based Harcourt, will be announcing new multiple strategic partners in the upcoming weeks.

In a recent white paper to be published in SwissHedge next month Weisman discusses some of the situations that the firm has seen unfold over the past two years, and how the firm's information oversight assisted multiple times in alerting the team to problems in real-time, allowing for real-time reactions.

He points out that while hedge fund failures and frauds took their toll on the industry during the financial crisis, most managers are very diligent about their operational and portfolio risk. What platforms like WR Group seek to do is provide the best measure of that risk possible, something he points out in the paper is not always entirely possible when most hedge fund reporting consists of a monthly or quarterly report written by the managers and almost always distributed 1-2 weeks after that month or quarter has ended (which can mean anywhere from a 6 week to a 14 week delay on information about what

is occurring within the portfolio). Additionally, most reporting consists of giving transparency to month end or quarter end positions that in theory should be a representation of positions that were on during the course of the month, which is not always the case.

Single or multiple day spikes in risk as fund managers take advantage of various positions can cause a significant change in the risk profile of a fund, something that is not always reflected in the positions divulged in monthly investor letters (if positions are divulged at all).

"Investment professionals at most organizations absolutely need to be able to talk about portfolio positions with end investors or board of directors," Weisman told Opalesque. "We have the ability to look at every security in our portfolio and determine things such as the trade volume of that security to calculate what portion we could trade out of assuming that the 10% of the average daily volume was the daily max - how long would it take to get rid of 30% or risk? Or 50% of the shorts? Or determine how positions have migrated over the past 3 months."

"Investor letters make for interesting reading, but they don't allow you as the investor to engage in anything resembling asset management," he says.