What Institutional Investors Want…but Aren't Always Getting

"If you can't measure it, you can't manage it."
—Peter Drucker

For too long, investors have struggled to gain control of their hedge fund investments. Rather than full transparency or managed accounts, investors should start by demanding better risk and performance data.

How Much Transparency Do You Really Want?

There is a natural tension in the hedge fund industry. Hedge funds don't want other asset managers to replicate their portfolios, but investors don't like uncertainty and they are worried about fraud. Where to strike the balance? After LTCM, the Madoff scandal and the financial crisis, many investors argued for increased transparency. Some investors have demanded full transparency or managed accounts.

There is a downside to full transparency. While both the investor and fund manager may want to prevent a fund's holdings from becoming public, controlling access to that information can be difficult. In terms of keeping the information private, the less people who know the better.

Setting up a managed account should be easy in theory. In practice, managed accounts place a significant operational burden on fund managers. Monitoring and rebalancing managed accounts can be time consuming, distracting and expensive, requiring additional systems and personnel.

Monitoring risk and performance at the managed account level will significantly increase expenses. Many investors simply lack the resources necessary to monitor multiple managed accounts.

This is not to say that investors should settle for a black box. They should not. Even if hedge funds do not provide full transparency, they should provide meaningful information to their investors. In addition to monthly account statements from the fund administrator, hedge funds should provide enough risk and performance data for investors to form a clear picture of the risks they are taking. To avoid any possibility of fraud, this information should be produced by an independent third party and easy to process and aggregate.

What You Should be Getting from Your Fund Managers

At the very least, your hedge fund managers should be providing you with

- Value at risk
- Stress test results
- Factor sensitivities
- Liquidity data
- Performance attribution

Value at risk (VaR) is not a perfect risk statistic, but it is widely understood. Significant changes in VaR can be a sign of style drift or other problems. To make comparison with other funds as easy as possible, VaR should be reported using standard methodology and parameters.

Stress tests and factor sensitivities help investors understand the risks that hedge funds are taking. They also allow large institutional investors to better manage their overall risk.

Historically, risk software providers have focused on market risk, but in extreme markets or when funds face significant redemptions, liquidity can be very important. Funds should provide statistics indicating how quickly they can liquidate their portfolio.

Performance attribution explains how much of a fund's performance was due to exposures to various risk factors and how much was alpha. This is important not only for evaluating performance, but as a means of ensuring the fund is taking appropriate risks. If a fundamental long/short equity fund attributes all of its profits to a bet on interest rates, something might be wrong. On the other hand, if a long/short fund focused on emerging markets has a bad month when emerging markets significantly underperform, you might not be worried, but you would want to know exactly how much of that performance was due to exposure to emerging markets and how much was due to other risk factors and stock specific risk.

In the past, most hedge funds have used one risk system for internal reporting and separate services for independent external reports. These independent external reports would often drop positions or contain mapping errors, producing numbers that were at odds with internal reports.

At Northstar, our risk/performance platform includes market risk, factor sensitivities, liquidity data and performance attribution. We import data directly from fund administrators and prime brokers for our clients. We ensure data accuracy through a robust reconciliation process. This makes life easier for our clients, and allows them to use the same platform for both internal and external reports. As a result, investors get better data.

Conclusion

Investors should demand better risk and performance data from hedge fund managers. The time for excuses is over.

Disclaimer

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