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Risk Management: The due diligence challenge and branding opportunity

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Ever since the 2008 crash, risk management considerations have taken on a significantly higher importance in decision making among those conducting due diligence when evaluating a prospective hedge fund investment.

Hedge fund firm owners have felt the impact. As they have often been told since 2008, risk management — as considered by prospective investors — encompasses operational, technology and regulatory risk as well as investment risk. Sophisticated investors — from family offices, endowments and foundations, to institutional plan sponsors and their consultants — expect to receive communications from a hedge fund that presents and explains how each of these risk management categories are addressed.

In its 2015 Alternative Investment Outlook report, the accounting and consulting firm Deloitte made three useful observations for hedge fund firm owners that link this due diligence challenge with a marketing opportunity. To quote Deloitte:

- "An argument can be made that brand and reputation are at least as important as investment performance to the vitality of an investment organization."
- "If managed correctly risk management is a competitive differentiator and can be transformed into an asset that drives brand equity and provides a measurable, positive return in the form of increased asset retention and new asset flows."
- "Managers who make risk management a part of the core value proposition of their firms will have a compelling story to share with current and prospective clients."

Deloitte rightly urges hedge funds to "identify opportunities to positively impact brand perception." But how should portfolio managers take advantage of this? For emerging manager hedge funds as well as established funds there are some implications as to where the majority of their personal time and effort should be spent.

While many aspects of the support to identify and mitigate operational, technology and regulatory risk could be fully outsourced, with risk management protocols being created and put in place by outside service providers, the same cannot be said for the category of investment risk management. When it comes to portfolio management, the starting point for that type of risk management is both internal to the firm and subjective. Unlike operational, technology and regulatory risk management, whose protocol features are primarily objective based in the eyes of investors conducting due diligence — and more generically similar among both hedge fund firms and strategies — investment risk management is based upon the personal investment beliefs and opinions of the portfolio managers who created the strategies. Therefore, communications about such information needs much more customization in order to take into account the style and idiosyncrasies at each firm.

Money managers mix and match their ingredients, use different proportions and come up with different end results for the risk management protocols they employ in their work to assemble and manage their basket of holdings. Which investors buy into which investment manager's recipe for portfolio management and the investment risk management behind it? That's part of what makes competition in the money management business. A hedge fund's investment risk management is where the biggest opportunity for branding lies.

What steps can management at an emerging manager hedge fund take to improve their ability to mitigate investment risk and then communicate this to prospective investors who are conducting due diligence on the fund?

Branding — what to say, and where
Back before the 2008 crash a surprising number of hedge fund managers thought they could get away with simply claiming they had an investment process and then a 'risk management overlay' for monitoring their portfolio. This communicated that portfolio risk management was an afterthought rather than a core element that existed throughout the investment methodology. As we've heard prospective investors complain when hearing such an explanation, "That only tells me they alert themselves once the horses are out of the barn, and that's not good enough."

Frumerman & Nemeth advises its hedge fund clients that there are four key areas within their investment process storyline where they need to communicate how they handle portfolio risk management: research and security selection, asset allocation-based decision making (including position risk-sizing), trade execution, and portfolio monitoring.

A hedge fund portfolio manager or sales person needs to be prepared to both talk a prospect through investment risk management at the initial in-person sales presentation and leave it with him or her in printed form.

A hedge fund's portfolio management approach to risk is not something that can simply be recited verbally at a single meeting with a prospect. By the time that prospect meets with fellow investment committee members to discuss the possibility of investing with the hedge fund enough time has passed that the likelihood of the prospect remembering enough vital detail to share with his or her fellow decision makers is extremely low. Conversely, the likelihood of the prospect messing up re-telling the hedge fund's risk management investment process story is extremely high. That's why this content also needs to be delivered in written form.

Since this risk management strategy explanation is text based — content that goes beyond a bullet point or two — a flip chart pitchbook is the wrong marketing document to rely on for getting this information across. While it is the perfect tool for communicating data in tables and graphs a flip chart is a poor tool for communicating text based content that goes beyond some brief, bullet point phrases.

Instead, this risk management story needs to be woven throughout a hedge fund's explanation about its investment beliefs and its investment process. This total storyline belongs in its own stand-alone marketing collateral document, presenting in sentence and paragraph form a cogent, compelling and linear telling of the hedge fund's story of how it invests, and how it manages portfolio risk. Such a marketing collateral piece contains the subjective based information that an investment committee is going to be discussing when debating whether to allocate to one manager or another, when performance is similar. Importantly, this is the very content that differentiates a portfolio manager from his or her peers, and this is what lies at the core of brand differentiation among portfolio managers.

There is double-duty use of this investment risk management copy as it also supplies the needed content for responding to DDQ and RFP essay questions that ask for elaboration about a hedge fund's risk management protocols.

While the savvy hedge fund firm owners recognize that they need to be able to communicate about how they handle portfolio risk management through their research and security selection, asset allocation-based decision making, trade execution, and portfolio monitoring, the savvier ones know one thing more: whether their risk management process is going to be perceived to be of institutional quality. So, how can an emerging manager hedge fund, or even a large established hedge fund, make that determination?

Due Diligence Self Exam
As Global Risk Management Advisors counsels, there are four sets of portfolio management-related risk management questions that prospective investors delve into that hedge fund firm owners should ask themselves to give their businesses a quick self-assessment.

1. Risk Management Governance
Can the fund show it has a formal risk management committee composed of senior members of the front and middle office that is responsible for monitoring investment risks, developing and overseeing the firm's risk management guidelines and serving as the overarching governing body for risk management?

2. Risk Management Processes and Controls
Can the fund communicate formal risk management processes that are cohesive and integrated with the investment process? Specifically, can it explain how its integrated process is sound, repeatable and sustainable? Can the hedge fund demonstrate how its risk management protocols are helping to identify alpha producing investment opportunities, properly “risk-size” positions, and take necessary defeasance measures, if needed, should an investment not pan out as expected?

3. Risk Management Transparency and Reporting
Can the fund provide all of the necessary risk statistics and analysis that is required to attract and retain institutional investors? For example, can the hedge fund provide prospective investors with information such as risk and performance attribution, alpha calculation, volatility, beta/delta-adjusted exposures and correlation data?

4. DDQ and Fund Marketing Materials
Do the current Due Diligence Questionnaire answers and marketing collateral meet today’s institutional quality litmus test by clearly describing and delineating how the hedge fund measures, monitors and manages its investment risks as well as the risk management processes, controls and governance that it has in place as the pillars of its overall risk management framework?

Not only do hedge funds need to be able to answer these questions, they need to be able to provide supporting documentation to demonstrate the veracity of their claims. Hyperbole will not cut it. Further, given today’s risk related regulatory requirements, hyperbole could trigger regulatory examination or enforcement action.

Do the work, gain the branding advantage
Crafting the needed explanation of a fund’s investment process, with risk management considerations woven in throughout, requires taking a buyer-focused re-examination of how the portfolio manager thinks and invests, and taking what may just be in that manager’s head and putting it into print. Being able to respond to the governance, controls and reporting questions about portfolio-related risk management requires having investment and risk management policies and procedures and staff oversight in place, along with a paper trail documenting transparency and reporting that investors want to see.

The hedge fund firms that make it easier for prospective investors to gain comfort factor about how their funds seek to identify and manage risk in running their investment portfolios are the ones that will begin to develop a brand identity for how they invest and find it easier to out-market competitors and attract assets.

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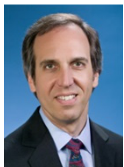

helps financial services firms create brand identities for their organizations and develop and implement effective new marketing strategies and programs. Founded in 1987 pre-Crash, Frumerman & Nemeth's work has helped money management clients attract over $7 billion in new assets, yet they are not third-party marketers. The firm was named the *2014 Top US Hedge Fund Marketing Firm of the Year* for the second consecutive year by Acquisition International Magazine’s International Hedge Fund Awards, named the *Best North American Public Relations Firm* by Hedgeweek’s 2014 USA awards, named *Communications & Sales Marketing Consultancy Firm of the Year - USA* for the M&A 2014 Awards by Acquisition International, named *Overall Marketing Company of the Year - USA for the 2014 Business Excellence Awards* by Acquisition International, and named *Best Buyer-Focused Positioning Strategies Consulting Firm of The Year - USA* for the 2014 Finance Awards by Wealth & Finance International. Mr. Frumerman can be reached at info@frumerman.com, or by visiting www.frumerman.com.

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