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Portfolio Risk Management: The Challenges Of Doing It And Communicating It To Institutional Investors

SEI's recently released fifth annual global survey of institutional hedge fund investors, *The Shifting Hedge Fund Landscape*, shines a spotlight of attention on the subject of risk management; both how it is being carried out and how it is being communicated. Risk management expert Sam Won, CEO of Global Risk Management Advisors (www.grmainc.com) and communications marketing expert Bruce Frumerman, CEO of Frumerman & Nemeth Inc. (www.frumerman.com), sat down to discuss SEI's findings and the implications for hedge fund firm owners.

QUESTION:
Recent reports regarding investment risk management are giving hedge fund firm owners some good news and bad news. SEI reports that funds that have and can communicate with detail about risk management procedures within their strategies will have a competitive edge. The bad news, however, seems to be twofold. Investors are requiring more risk management related information than ever before, yet funds appear to not be keeping up with this demand. Also, the attrition rate of funds appears to have much to do with unsuccessful downside risk management. Is risk management going to top the To Do list for hedge fund firm owners this year?

BRUCE FRUMERMAN:
I know we all recognize that the second most common reason hedge funds close their doors is from falling below their high-water marks and being unable to rise back above it. (The first being a failure to raise enough assets to stay in business.) So, I agree.

SAM WON:
I second that. As Credit Suisse recently reported, more than two-thirds of hedge funds are below their high-water marks and 13 percent haven't earned incentive fees since at least 2007. The majority of these are emerging managers with assets under $100 million. But even big firms grapple with the challenge of recovering to earn their incentive fees again. Citadel only recently passed its high-water mark for all its investors after the group's flagship funds returns took a big hit in 2008. So if hedge fund firm owners had been in need of a big wake-up call to the importance of rethinking how they deal with risk management this was certainly it.

QUESTION:
The SEI survey reports that "understanding risk" is seen as one of the top challenges of hedge fund investing, yet only one in five of those polled agreed that "most hedge funds do a good job of risk management." Does Global Risk Management Advisors find this perception to be on the mark?

SAM WON:
We do. Even though it has been several years since the financial crisis began, most funds have done little to put in place risk management elements that can help them make more educated investment decisions. The small minority of funds that do claim that they have risk management in place tend to focus largely on producing risk measurement reports of

data-based characteristics that they use as 'window dressing' to satisfy investors. As the SEI survey shows, institutional investors are wanting more out of hedge fund managers when it comes to risk management.

QUESTION:
SEI's survey reports that the three top types of risk related information institutional investors are seeking from hedge fund managers are leverage detail, valuation methodology and risk analytics. While leverage detail may be more of an objective "just the facts" type of reporting, aren't the subjective views of a hedge fund manager as to what constitutes valuation methodology and risk analytics for him likely to be fairly different from that of his competitors? And doesn't this lack of standardization make it more challenging for institutional investors when analyzing hedge funds' investment processes?

SAM WON:
That's true. And that's part of what has created the due diligence challenge for hedge fund investors. Institutional investors, from corporate pension plans to multi-family offices, have been looking to improve how they vet the institutional quality of a hedge fund manager's risk management system, from one end of the investment process to the other. This includes conducting more in-depth compare and contrast analysis among funds under consideration.

The starting point for this due diligence vetting, however, is determining internally what should be the risk management characteristics of the total portfolio the institution requires to meet its investment objectives. My firm has been working with institutional investor clients on establishing these very guidelines, customized for their organizations' particular situations and needs. And a point the SEI survey findings reinforce is that sophisticated institutions, endowments, foundations and multi-family offices are taking more risk management process-related information into consideration before making their investment decisions.

As institutions continue to become smarter about risk management for their own portfolios hedge funds will need to step up their game if they are to attract assets and reduce their own downside risk exposures within their strategies.

QUESTION:
Let's start with what hedge funds should be doing to reduce the odds of drawdowns at their funds and deliver better risk-adjusted returns.

SAM WON:
When smart hedge fund firm owners become aware of fixable deficiencies in their investment processes they're more than anxious to take steps to improve the effectiveness of their strategies. However, being so close to the strategies they created sometimes they can't see the forest for the trees, so they may not be aware of what elements of their risk management protocol they need to re-think.

Problems we see among larger hedge fund firms differ somewhat from the challenges many small emerging firms face. The inability to successfully mitigate drawdown risks at the larger hedge funds often comes down to four specific issues. The fund has flawed limit structure and limits for its market, credit and liquidity risk exposures. The portfolio manager is relying on the wrong indicators for risk and in some cases, incorrect calculations of his risks. The fund has inadequate governance and policies and procedures for risk management. The portfolio manager is not properly risk-sizing positions and managing concentration and liquidity risks.

What may be a surprise to many people, including those within the hedge fund industry, is that a significant number of larger managers have only recently begun to think about doing something more formal about risk management.

As for the smaller and mid-size hedge fund managers, our experience has shown that they often have no formal risk infrastructure, staff, processes, controls or governance for risk management. Too many of these portfolio managers rely on 'seat of the pants' risk management and are under the misguided notion that they can control their market, credit and liquidity risks by knowing their positions well and by managing their gross and net market exposures. Also, the emerging manager funds tend to be reactive in terms of cutting risk or holding on to positions too long, whether they are profitable or losing positions.

QUESTION:
How should hedge fund firm owners rethink going about meeting the growing demand for more detailed information and explanation about risk management within their strategies?

SAM WON:
In our work we find that investors today are looking for managers to demonstrate that they can manage risk as well as produce return. And investors are looking for explanations about risk management protocols that can support a hedge fund firm's contention that it has a repeatable process that has the potential to generate sustainable investments results.

To that end, institutional investors are looking for better transparency in four major areas. They want more transparency as to concentration risks such as sector, geography, market cap and single positions. They want to know more about liquidity risks, including price impact from risk defeasance. For example, for equities, many funds try to use a percentage such as 25% of average trading volume for the past three months as a measure of liquidity for their positions. Statistics such as this are not reliable indicators of liquidity because when markets become stressed liquidity can evaporate even in the most liquid markets. This is why we advise our hedge fund clients that liquidity statistics should be benchmarked against "stressed market periods" and must include some measure of price impact from risk defeasance.

Next is leverage. Investors are keenly aware that leverage was a big factor in contributing to not only the financial crisis but also the downfall of many fund managers in 2008. Today, many investors want to know what leverage a fund is taking on a periodic basis.

Also important is having a risk-based measure of risk for the portfolio as well as for any sizable positions in the portfolio. Investors are interested in seeing risk-based portfolio statistics such as value-at-risk as well as risk measures such as stress tests so that they have an idea of potential draw-down risk and loss under "worse case-like" scenarios.

Hedge fund firm owners would be wise to start providing robust risk transparency around these four areas if they want to be seen to be 'institutional quality' and be able to attract and retain investors for the long run.

QUESTION:
But just having risk management protocols in place is obviously not good enough. SEI's report, referencing a recent Ernst & Young survey of both fund managers and institutional clients, noted that "the lack of adequate risk management was investors' most commonly cited reason for not hiring a hedge fund they had considered, yet fund managers gave that factor the lowest ranking among reasons they had not been hired." So, even assuming hedge funds do have what might be considered adequate risk management protocols in place, it seems that there is a significant communications disconnect between the sellers and buyers. Why aren't hedge funds improving their communications?

BRUCE FRUMERMAN:
This hedge fund firm communications problem has two causes. The first is that portfolio managers too frequently speak in shorthand. They may say one sentence, implicit in which are three or four other points of elaboration. But they're only thinking this part, not saying it. Not a good selling technique. Investors aren't mind readers. The second issue is risk management communications-specific. Too many hedge funds are telling too little about how they think about risk management and what they do about it. This is a pre-crash communications habit many need to break.

QUESTION:
How are you counseling hedge fund clients differently today about communicating their views and approaches to risk management?

BRUCE FRUMERMAN:
One big change is the need to be more explicit in stating steps in the investment process that are either risk management considerations or actions taken. In the past, many portfolio managers might have made brief reference to these types of points when giving a verbal presentation to a prospective investor, but rarely did they commit all of this information to paper. So, it may not have even made its way into an answer in response to some institution's RFP question.

When Frumerman & Nemeth is working with a hedge fund to create or refine the story it tells about how it invests we dig to uncover investment process steps that institutional investors care about and want to hear. Often we uncover steps a hedge fund might be taking in the regular course of running its strategy that it hadn't been mentioning to prospects when pitching them. How come? Was it something extremely proprietary? No. Nine out of ten times it just hadn't occurred to the portfolio manager that someone might care to hear about this little point or that, which, it so happened, demonstrated risk management thinking and was an actual, tangible step the firm took to help mitigate risk.

QUESTION:
Can you offer an example?

BRUCE FRUMERMAN:
I'll give you two. When one fund made the determination to put on or take off a position, it would carry out its trading only over one trading day. The portfolio manager would not take on overnight risk on trade execution. Well, that's a risk management related step within the investment process that was in the fund's interest to state explicitly. Institutional investors and investment consultants want to be told this information.

Here's another. A portfolio manager of an about to launch hedge fund had allocation sizing rules in his head but didn't know if this needed to be put in writing. Nowadays, the answer is yes, it does. And so he did.

QUESTION:
So, where does the risk management content belong in marketing materials?

BRUCE FRUMERMAN:
You can't communicate everything investors want to learn about today in just a handful of bullet points on a flip chart. A separate marketing document is needed that explains investment process and addresses risk management in greater detail.

A firm has two basic choices about how to address risk management in writing. The older approach, which was more acceptable before the 2008 crash, was to write a Risk Management subhead and put two or three sentences beneath that to insert that at the very end of the firm's investment process explanation, after copy stating the sell discipline. We counsel taking a smarter approach to communicating about portfolio risk management. As Sam rightly noted, risk management is something that sophisticated investors expect to see integrated throughout a hedge fund's investment process, from idea generation onward. That's why a firm's marketing materials need to be communicating a linear, chronological explanation about its investment process, touching upon risk management considerations and steps taken each time that occurs within the portfolio management team's workflow.

Of course, when all that information is only in the portfolio manager's head and only bits and pieces have made it onto paper the hedge fund finds it much more challenging to close sales. Emerging managers in particular need to make it a priority to commit to paper and use in their sales marketing efforts this year a cogent, compelling and linear explanation about how they invest, with sufficiently detailed information about risk management included within their investment process story.

QUESTION:
Your comments are echoing a recurring theme SEI noted in its report: "Throughout the five years of this annual survey program, our findings have shown that investors want above all to understand the philosophy and strategy that underlie a hedge fund portfolio, and not just the composition and attributes of the portfolios themselves."

BRUCE FRUMERMAN:
Absolutely right. The hedge funds that will have a clear competitive advantage for attracting and retaining investors are going to be the ones that have institutional caliber risk management embedded in their strategies, and can educate and persuade people to understand and buy into how they invest.

HEDGEWORLD:
Thanks Bruce. Thanks Sam.

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