



The Return of Risk

February 25, 2009

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Before the financial crisis the hedge fund industry was an industry fixated on returns. The industry claimed to have figured out a way to offer out-sized and absolute returns, no matter the market conditions. The crisis and the subsequent blow-up of hundreds of funds has reacquainted everyone with return's alter ego - risk. In this new world, investors are now demanding an intimate knowledge of the type and level of risk involved in generating returns. Managers that hope to raise capital in this environment will need to demonstrate that they have given as much thought to risk mitigation as they have to generating alpha. The following are the major types of risk and how a hedge fund can manage them:

1 - Portfolio Risk - The recent market volatility exposed some of the drawbacks of the legacy technology used by many hedge funds to understand their portfolio risk. Managers were forced to navigate the markets with systems that could only offer outdated views (typically end-of-day reports) of risk and return. These legacy portfolio management systems struggle with real-time reporting because they pre-date the advent of the FIX (Financial Information Exchange) protocol and therefore cannot not display the real-time impact of executions on a fund's risk and return profile. This lack of real-time transparency can no longer be tolerated. Newer, real-time portfolio management systems place the FIX protocol at the center of their activities and ensure that a manager has an execution-by-execution real-time view of risk and return.

2 - Counter-Party Risk - The demise of Bear Stearns and Merrill Lynch and the bankruptcy of Lehman Brothers in 2008 abruptly brought the subject of counter-party risk to center stage. Overnight multiple prime broker relationships have become a prerequisite for all funds no matter of the size. To attract (or retain) assets, a fund must now demonstrate that they have diversified their counter-party risk. The operational complexity (and cost) involved in building a multi-prime infrastructure should not be underestimated (see "A Guide to Overcoming the Operational Challenge of Multi-Prime" by Peter Curley, Nirvana Solutions, October 2008). At the very heart of this complexity is the requirement to collect and aggregate the disparate cash, position, and transaction information, across multiple custodians. Additionally, the infrastructure must be flexible enough to support new, in vogue, risk-reducing structures, such as tri-party arrangements and separately managed accounts.



3 - Operational Risk - Anecdotal evidence suggests that investors' operational due diligence has become increasingly more stringent since the crisis. A fund must show that they have acquired a formalized middle and back-office functionality. Investors need to feel that the inner workings of the fund are completely transparent and that any area where there is potential for conflict, such as valuation or administration, is handled by an independent third-party. Any suggestion that a manager is relying too heavily on unproven processes or unsuitable infrastructure, such as Microsoft Excel, will result in the investor simply moving on to the next investment opportunity.

The renewed interest in risk mitigation comes at a time when funds are already under intense pressure dealing with redemptions and poor performance. For many funds the added burden of these new requirements will necessitate that they give a serious look at the outsourcing options available to them.

Fortunately, a number of service providers, including the mini-primes and fund administrators, are in the process of creating new outsourced multi-prime service platforms that can meet these new requirements in a cost-effective manner.