

Hedge Fund Risk Fundamentals: Solving the Risk Management and Transparency Challenge

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Richard Horwitz's new book provides a clear primer for understanding hedge fund risk. While *Hedge Fund Risk Fundamentals* refrains from using any formulas, the book is a must-read for every risk professional who wants to see how complex risk issues can be explained in a non-technical way.

The book begins with basics that most risk professionals will be all too familiar with, but Horwitz's explanation of risk concepts in a clear and intuitive way provides a good example for risk managers who need to be able to explain risk in understandable terms to colleagues and clients. Beyond the clear explanations, the book also identifies what risks hedge funds take and explains what investors in hedge funds should be looking for as sources of risk and return.

Transparency is one of the most overused words in the hedge fund business today. However, as Horwitz notes, there is no question that hedge funds, up until recently, operated in a "trust me" world. Operations were small, quiet and low profile, and portfolio managers rarely talked about their funds with anyone outside of investors in a specific fund. Therefore, it was quite difficult to obtain specific information about the composition of various funds.

But the Long-Term Capital Management debacle changed everything. In 1998, LTCM's losses exploded onto the front pages of newspapers, just as institutional interest in hedge funds was beginning to grow. Major brokerages lost millions, because they did not understand the risks LTCM took with the money they loaned the firm.

Rather than shuttering the otherwise highly profitable business of lending to hedge funds, brokers started asking fund managers – sometimes on a daily basis – about what was in a specific fund and what were the risks? The hedge funds that needed leverage to prosper were forced to comply.

Why the fuss over transparency? Well, one reason is that fund managers traditionally worry about the "short squeeze." They fear when the market knows they are short,

it will call in the stock and run up the price of stock sold short – and a short sale has unlimited loss potential.

But that is not the only reason why hedge fund managers have in the past been reluctant to divulge details about their funds. These managers have also expressed concern that investors will reverse engineer their investment process, if they can see how the managers are trading. This concern stems from the fact that investors in funds are often competing hedge fund managers that have the ability to reverse engineer strategies.

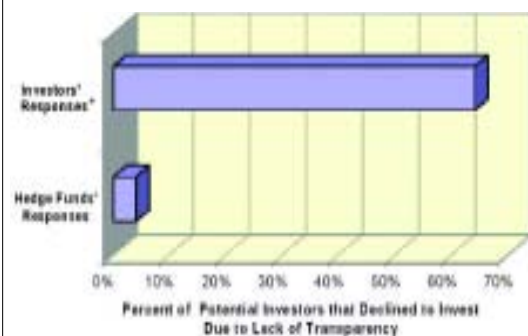
For these reasons and more, hedge funds are reluctant to share their positions with any investor.

Transparency Solution

Many hedge fund managers still do not think that investors want transparency – but this is a misnomer (see chart, below).

Why do investors in hedge funds need transparency? As fiduciaries in the legal sense, they need to know that managers are investing under the guidelines of the offering document — and in a manner consistent with the objec-

Investor Transparency Study



*This chart was extracted from *Hedge Fund Risk Fundamentals*; the results were based on a study conducted by the Alternative Investment Management Association in 2002.

tives of the fund. It is reasonable for an investor to ask for this, particularly in the wake of the LTCM and Beacon Hill disasters.

In addition to being a useful tool for investors, transparency can provide benefits to the hedge funds themselves. From a hedge fund perspective, transparency enables firms to aggregate risk across the enterprise, so they can see if all their fixed-income managers use a yield curve flattener. This effectively allows them to understand what risks they face.

Horwitz's goal is to bridge the transparency divide between investors and hedge funds. While he explains that there is nothing nefarious about most investors' need for hedge fund data, he also empathizes with the problems transparency has caused some hedge funds in the past.

Keeping both parties in mind, Horwitz presents a compromise method for hedge funds to provide transparency: revealing risk attributes without revealing actual holdings.

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He answers key questions about which risk metrics should be monitored and provides the beginning of a framework for how to distribute risk metrics to investors.

Users of Barra or Northfield will be quite comfortable with Horwitz's approach. The goal of risk reporting in his method is to share with investors the specific risks being taken, so that they can understand if a hedge fund manager is following through with his or her investment promises. This approach makes sense, because the real issue is not whether or not the manager is long INTC and short MSFT

but that he or she is long chips and short software.

On top of outlining a transparency approach, Horwitz also lays out a technology framework utilizing the omnipresent Bloomberg system. He calls for hedge fund managers to input their holdings into a Bloomberg terminal and have the Bloomberg calculate the risk stats.

This approach works well for securities modeled by Bloomberg, but will fall short for private securities or securities where pricing is an issue — a group that includes most mortgage derivatives, many 144As and other illiquid securities. These securities need to be hand priced by the hedge fund manager, allowing stats to be calculated — but there will be no independence. Pricing for these

securities can and should be audited.

Beyond discussing transparency, Horwitz also reviews basic risk terms and delves into the types of risks that hedge funds take. The book begins with an easy-to-understand discussion on the power of diversification. He explains the power of diversification in simple, comprehensible language — and leverages this same straightforward approach to explain other risk topics throughout the book.

On the negative side, it is disappointing that Horwitz does not spend more time on performance attribution (PA); he does briefly touch on this important subject, but it's the shortest chapter in the book. The reason this is disappointing is because Horwitz himself notes that “equity hedge fund managers are often unaware of their ‘style bets.’” But if this is true, then it certainly is also true that Horwitz should have spent more time analyzing PA — in the interest of readers. Moreover, since he devotes many chapters to risk attributes, it would not have taken Horwitz much time to weave more PA data into the book.

Overall, however, *Hedge Fund Risk Fundamentals* provides an excellent overview of the risks that hedge fund managers take. Horwitz's review of the risks taken by hedge funds, from operational risk to investment risk, is quite thorough.

What's more, Horwitz's proposal for how to provide transparency is a realistic approach to solving the problem. This approach is not perfect for everyone, and other authors will likely suggest alternative methods for accomplishing this goal in the future. But Horwitz's tome should at least help the hedge fund community begin the journey toward transparency. ■

