Managing hedge fund risk

CHRISTOPHE CHOUARD SHEDS SOME LIGHT ON HEDGE FUND RISK MANAGEMENT

Funds of hedge funds face an increasing tension between meeting demand from investors for greater liquidity and the need to generate returns and secure capital on terms consistent with their investment time frames.

Fund managers that give in to the temptation of promising liquidity greater than that of their underlying investments are structured to create a liquidity mismatch which can undermine the performance of their funds and in doing so increase risk.

The raison d'être for hedge fund investors has always been high absolute returns, that is, returns that are not correlated with the ups and downs of the financial markets.

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Investor demand for absolute returns, coupled with controlled risk, is what has driven the growth of the fund of hedge funds industry. To meet their needs, fund managers are constantly devising innovative investment solutions across a broad spectrum of instruments and asset classes.

Having entrusted their money to a fund of hedge funds manager, investors have an interest in understanding how these managers are able to keep their promises on returns, risk mitigation and diversification relative to conventional asset classes. But they also need to be familiar with how managers plan to deliver on their liquidity-related commitments.

Central to the risk management process for fund of hedge fund managers is careful asset allocation. Generally allocations are made based on a manager's view about which strategies will perform, which funds have the best investment process, track record and the highest calibre experts, and by diversifying investments through the meticulous construction of the underlying fund portfolio. Fund of hedge fund managers who try to go one better by offering investors better liquidity than that of the underlying funds create an asset VS liability mismatch that significantly increases risk for their investors and heightens the probability of widespread contagion in the event of a significant market shock.

Not all fund of hedge fund managers are offering investors better liquidity. In fact, in recognition of the fact that it often takes time for an opportunity to crystallise into returns, many fund managers have begun offering liquidity on a less frequent basis. Equally, they say, greater control over their investment capital insulates their fund performance from mass redemptions associated with broad market sell-offs as we saw in August last year. Some of these underlying fund managers, including many of those in the 'top-flight', are now only offering liquidity quarterly or semi-annually, and are extending notice periods to 90 or 180 days. Some funds are even introducing one-year or two-year lock-ups.

Investors, on the other hand, will often try to reduce risk by looking for investments that are liquid, meaning that they can be sold off quickly and at a good price if the investor thinks that returns will fall short of expectations. However, and somewhat counter intuitively, artificially improved liquidity can actually increase risks.

In the event of large-scale redemptions, fund of hedge funds managers that have offered investors overly favourable liquidity relative to that of the underlying funds leave their clients exposed to lower returns, or even losses, as the manager is left with only a few options: sell the most liquid funds, but in doing so will alter the quality and structure of the portfolio and increase the risks to investors; borrow to meet the required redemptions, but this would increase leverage and hence risk; or temporarily suspend redemptions, but this could damage their reputation and could trigger a wave of additional redemptions once the suspension is lifted.

To avoid these situations, liquidity mismatches should be reduced and managed with great care to avoid exposing investors to unforeseen risks. Moreover, managers need to be extremely open about these sorts of mismatches and the due diligence process should include not only a detailed examination of the fund's investments and operational risks, but also whether liquidity of assets is in line with liquidity that is provided to investors, and how its leverage is financed.

Written by Christophe Chouard, managing director and head of sales at HDF Finance