Reward Beyond the Risk

Hedge funds can trim volatility

BY SCOT BLYTHE

Hedge funds have certainly attracted their fair share of opprobrium, between some of the rather more spectacular blowups, concerns about market distortions, and their high fees.

Indeed, hedge funds are sometimes characterized as fee-collection schemes masquerading as investments, notes Jim McGovern, managing director and CEO of Arrow Hedge Partners and past president of the Canadian chapter of the Alternative Investment Management Association.

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WHAT IS A HEDGE FUND?

On the one hand, a hedge fund has fewer regulations to follow; a hedge fund is also able to take long and short positions and invest in futures and other financial instruments that are generally denied to conventional mutual funds. The aim is an absolute return, a positive return, year in and year out, with manager skill devoted to smoothing volatility and thus offering better risk-adjusted returns than a passive investment in a benchmark.

But not every hedge fund succeeds. They have to be treated as a small business – just like an individual stock is a business, with managers, balance-sheet reporting obligations, a regular tallying of profits and losses as well as sturdy back-office operations. Hedge funds that produce profits, and produce them transparently, succeed; those that fail, just like a public stock, go out of business, McGovern says.

"As a business, hedge fund managers must make money," he notes. And McGovern welcomes that: "It shows the system is working: when people don't perform, they're out of business."

That's much more difficult to stomach for the investor. Except that 87% of the companies once listed on the Standard & Poor's 500 have also disappeared, he points out.

EVALUATE THE NUMBERS

So to evaluate a hedge fund manager like a stock, there are three types of due diligence criteria involved.

The first set of criteria bear on qualitatively evaluating the managers and their pedigree as well as their fee structure.

The second set focuses on the investment objectives and their quantitative measures, such as their correlation to long-only markets, the length of their drawdowns – the time it takes to recover from a loss – and their volatility.

Finally, there are risk considerations, such as leverage, portfolio concentration, liquidity, and not least, tail risk: whether an ostensibly low-risk play is subject to sudden shocks in the market.

This is not to be gainsaid, although it is hard to predict. For example McGovern cites the 22% loss on the Dow in 1987. That was a probability that should occur once every 8.5 million years. Yet, it happened. And that's what counts, it's the outliers that matter to clients, the extreme situations. Yet, these same outliers may create structural opportunities for skilled managers to exploit. What's the difference? "Really, truly understanding what you're doing," says McGovern.

ESSENTIAL DUE DILIGENCE

Nevertheless, he admits that due diligence is "really hard work." For instance, Bayou Management, whose founder was recently in the news for faking a suicide, pitched Arrow Hedge Partners about a year before it blew up in a haze of false accounting. It had created its own accounting firm and brokerage to disguise its trades.

That was upfront due diligence. But there's also a need for continuing due diligence.

Jim McGovern, managing director and CEO, Arrow Hedge Partners

Amaranth Advisors, which went down in the fall of 2006, morphed from a multi-strategy fund to a directional bet on energy prices. Moreover, the size of the bet was too large for its capital base; in effect, Amaranth became the market. Apart from that, penalties for redemptions should have been regarded as a red flag.

OTHER CONSIDERATIONS

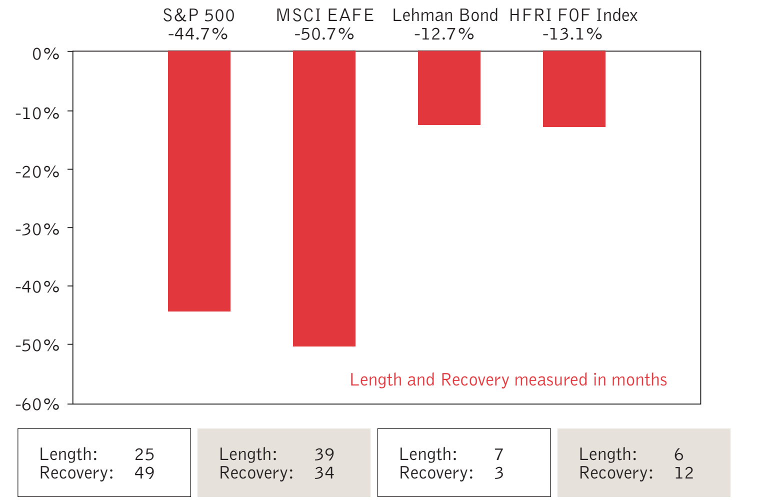
Fee structures reveal whether a hedge fund manager's incentives are aligned with those of the investor. Leverage, too, is a concern: "Leverage combined with hubris will usually bring down a hedge fund," McGovern says.

Then there's the size question. As more assets are accrued, often there are fewer opportunities to exploit, but nevertheless, the manager is "clipping a management fee" just on the assets, not their performance.

Hedge funds, when they work, have a return profile somewhere between bonds and equities. As such, they can have a useful role in portfolio diversification.

Yet, there is not enough data, McGovern admits, to warrant large exposure. Indeed, classical portfolio optimization would suggest a 100% weighting in hedge funds. McGovern suggests a 10% to 20% exposure. There's another aspect to risk management: client expectations. Risk aversion is not the same as loss aversion; drawdowns do matter. It's for that reason McGovern recommends a hedge fund of funds. The advantages are diversification and active management across styles, thus mitigating the idiosyncratic risk of a manager meltdown. But again, as Portus Alternative Asset Management and Norshield Financial Group demonstrate, funds of funds require due diligence too. AER

HISTORICAL DRAWDOWNS



Source: Hedge Fund Research Fund of Funds Composite Index Jan 1990 to Dec 2007