A Matter of Trust: The Issue of Risk Transparency

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Despite the recent surge of interest in absolute return strategies, professionally managed hedge funds have a short history in the capital markets. A.W. Jones established the first hedge fund in 1949, and George Soros, Julian Robertson, and Michael Steinhardt pioneered the modern industry in the mid to late 1980s.[1]

Early on, wealthy individuals developed hedge funds to preserve and grow capital:

> *Successful investors, often the heads of proprietary trading desks, decided to forgo their lucrative seven and eight figure Wall Street remuneration packages to establish boutique organizations as the primary vehicle for managing their own personal assets. Earning a return on their own assets (as opposed to collecting fees from outside investors) was the primary motivator for early hedge fund entrants.*
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> (Ineichen [2000, p. 8])

Investors in the first hedge funds were friends and family of early managers, seeking a return on invested capital independent of movements in the equity markets. Given the trust investors had in those managers, hedge fund managers were not asked to justify their investment process or prepare risk management reports.

Family offices were the first investors to allocate significant pools of money to hedge funds. Perceiving absolute return strategies as an intelligent way to preserve and grow capital, they helped create a limited partnership structure to invest alongside managers.

Since the investors in the partnership were friends, everyone involved knew how the manager played poker, and the manager showed his cards whenever appropriate. Given the commonality of interests between manager and investor, the early relationships among general and limited partners had the most essential elements of a successful partnership: understanding and trust.

Then, high net worth individuals encouraged foundations and leading endowments to adopt absolute return strategies in their portfolios. Many high net worth investors adopted hedge fund investments in foundations they had founded. As they sat on the investment committees of college endowments and other groups, they influenced institutions. Harvard University began managing funds internally using absolute return strategies in the late 1980s, and Yale University first identified absolute return investing as a distinct asset class in 1990.[2]

Without any impetus to change, hedge fund managers continued the business practices that saw them through the initial stages of the industry's growth. In a cottage industry with a limited number of sophisticated buyers, the early adopters tended to have continuing close personal relationships with hedge fund managers and access to information when needed. Institutions also took comfort in the significant co-investment by managers in the fund, creating a principal mentality and a strong coincidence of interest with buyers.

THE LITTLE ACORN BECOMES THE OAK

Over the last three years, institutional leaders have provided tangible support for institutions seeking a viable alternative to their reliance on traditional marketable securities. On August 31, 1999, CalPERS released a statement that it would invest as much as $1.1 billion in hedge funds. In 2000, David Swensen, Yale University's chief investment officer, described the rationale and evidence behind Yale's highly successful commitment to alternative assets. In the fall of 2001, the largest European pension fund ABP targeted over $5 billion for hedge fund investment (see "ABP Readies First Step").

Since these events, global asset flows into hedge funds have soared. The hedge fund industry currently manages over $550 billion in more than 6,000 funds. In 2001, approximately $144 billion flowed into hedge funds, a phenomenal increase from the record $6.9 billion of inflows in 2000.[3]

Interestingly, the industry as a whole still accounts for less than 1% of institutional assets. While endowments and foundations have broadly adopted hedge fund strategies in a small percentage of their multiasset class portfolios, pension funds have not. Without the support of the largest pools of investment assets in the world, hedge fund investing remains a cottage industry.

THE ISSUE OF TRANSPARENCY

The reluctance of large pools of institutional capital to adopt hedge fund investments suggests that their decision-makers are uncertain about the rewards or the risks of investing in hedge funds. The tremendously successful historical performance of leading institutions provides evidence of the potential reward. Yet hedge funds are capital-constrained strategies, so large investors might assume that past performance will not be indicative of what is to come.

More likely, the absence of regulation and the opacity of hedge fund investments may give the appearance of more risk than large funds are willing to bear. Both are intricately linked to job risk, probably the most important factor in the equation. Pension fund managers seeking to minimize job risk have little incentive to shift assets away from traditionally accepted investment strategies. As Keynes reminds us, "worldly wisdom teaches that it is better for reputation to fail conventionally than to succeed unconventionally" [1964, pp. 157-158].

The hedge fund industry stands at a fascinating crossroads. Should public market returns not revert to the boom experience of the past two decades, hedge funds are poised to become a larger component of institutional portfolios. But if it does not address the concerns of the institutional community, the industry may only limp forward.

The lack of risk transparency in hedge funds and the related effect of job risk may be the foremost concern of pension trustees and other large institutions with a fiduciary duty to exercise prudence and care in the management of funds. Hedge fund managers have not "institutionalized" the dissemination of information that occurs naturally between friendly partners. Instead, hedge funds have become more and more secretive about their activities. In the words of one pension fund manager:

> *So you suggest we invest in a venture that is not regulated, has no transparency of positions and investment philosophy, is illiquid, and is run by a bunch of 30 year olds?*
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> (quoted in Ineichen [2001, p.44])

Industry Landscape

Making matters worse, capital inflows to hedge funds have given more bargaining power to leading funds. Although the industry consists of approximately 6,000 funds, only 20% of those funds manage more than $100 million.[4] The majority of the capital influx has been invested with established funds, creating a shift in market power toward these managers. Demand for investment far exceeds the supply available in brand-name hedge funds, such as SAC, Renaissance Technologies, and Farallon. At times, highly regarded managers have used their market power to charge higher fees and reduce transparency of their activities.

Furthermore, these highly regarded managers have little incentive to disclose more information. Many closed funds derive no economic benefit from conveying additional information to investors. One investor who demands position disclosure can easily be replaced by another investor who does not. The voracious appetite for leading funds may not last, but it is a reality in the market today.

With the limited capacity of the industry, investors who insist that they receive full transparency face an adverse selection problem. If leading funds tend to be opaque, only weak performers that need to attract assets will offer disclosure.

Understanding the signaling implicit in a lack of disclosure, the next generation of top performers will have a strong incentive to follow the path set by current market leaders in limiting information. While there are some exceptions, the industry norm hinders the progression of institutional investment in hedge funds.

To move the industry forward, we must fully understand what transparency means, why investors want it, and why managers opt for silence.

Transparency Unveiled

For clarity, transparency in hedge funds relates to several disclosures in ascending levels of detail.

Investment Strategy. At the most peripheral level, managers can provide transparency of the investment philosophy, tactics, and securities a manager intends to employ in the normal course of business. This information is available in a fund's offering documents and may be reiterated in communication between partners.

Risk Exposure. Disclosure of risk would describe aggregate portfolio-level information, including but not limited to concentration (across strategies, geographies, industry sectors, and positions), leverage, return composition, stress-testing, and other quantitative risk measures (VaR, APT). These risk factors can be made available in a consistent form, allowing an investor to aggregate data in a multiple-manager portfolio.

Positions. The most detailed form of transparency is a see-through portfolio where an investor has access to all the trades and positions in the fund. The debate around position transparency also involves the frequency and time lag of disclosure. For example, high-turnover strategies may require disclosure more often and sooner than would lower-turnover strategies.

Organizational Structure. Information about the manager's organization often sheds more light on risk than would any one trade or position disclosure. In addition to the names, résumés, and responsibilities of the investment and support staff, organizational disclosure can also include the structure of compensation and the amount of co-investment in the fund, both in absolute terms and relative to the liquid and total net worth of the individuals.

While managers and investors tend to agree on providing strategy and some organizational disclosure but preventing position disclosure, differences of opinion arise with risk exposure transparency. Disclosure of investment strategy is a prerequisite for any investor reporting to an investment committee or board of directors, because opacity of strategies compels investors to make blind judgments that most institutions are unwilling to make.

For example, although the great Michael Steinhardt generated returns for many years that were the envy of any investor, institutional-oriented funds may have had difficulty justifying an investment. Steinhardt provided investors in Institutional Partners, LP, with nothing more than an annual financial statement, a semiannual market value, and a monthly single-paragraph report that commonly said little more than "Congratulations. Your fund returned 2.5% for the month." Even when meeting face-to-face, Steinhardt rarely discussed specific activities in the partnership.

Real-time, detailed position information, however, is irrelevant to investors who have neither the ability nor the need to act on that information. Few hedge funds allow investors to redeem more frequently than monthly if not quarterly. Hedge fund managers worry that more data will encourage investors to scrutinize trades and increase manager turnover, hindering the flexibility so desired by managers. Investors who understand the ramifications of position disclosure generally are comfortable investing without it.

And while investors need risk exposure transparency to understand the sensitivity of their portfolio to economic and market factors, many managers do not provide this information.

INTERESTS OF THE INVESTOR

As institutional investors call for risk transparency, it is helpful for hedge fund managers and the community at large to think about the impetus for the call.

Fiduciary Duty

Investors have a fiduciary duty to act with prudence and care in the management of funds. Although the 1974 ERISA Act does not clearly specify the requirements of this fiduciary duty, it is incumbent upon pension funds to make prudent investment decisions using the best information available.

Without disclosure, Michael Steinhardt placed his clients in a difficult position in January 1994. Despite a long record as a top performer, Steinhardt's loss of roughly 20% in early 1994 left investors holding a black box. Was

Steinhardt's "style" out of favor and therefore ripe with opportunity, or had the magician lost his touch and signaled a time to head for the exits?

Without knowledge of the activities in the fund, it was impossible for investors to make a well-informed decision regarding the future allocation of their capital.

Avoid Disasters

Highlighted most recently and notably by the demise of Long-Term Capital Management in 1998, hedge funds have a history of blow-ups. The diverse practices employed by hedge fund managers are complex for even the smartest fiduciaries. An investor researching these strategies for the first time is at a disadvantage to more experienced investors.

Institutional investors presume that if they know the activities a hedge fund is pursuing, they will avoid the kind of problems that plagued Long-Term Capital Management in 1998, Victor Niederhoffer in 1997, and Askin Capital in 1994. Although this assertion may not be correct, investors nevertheless believe that the probability of catastrophic loss declines when more information is provided.

Moral Hazard

Incentive fees are a real option given by investors to hedge fund managers. Unlike the early hedge fund managers, many new managers are at least as motivated by the fees generated by managing large pools of assets as by investment returns. Unless investors closely align their interests with the manager, perhaps by requiring a significant co-investment by the principals, they may face a principal-agent dilemma.

Further, the incentives of a hedge fund manager change if performance suffers. The imbedded call option in the form of the hedge fund incentive fee increases in value as volatility rises. A manager with a high-water mark who is losing money has an incentive to take on substantially more risk. If a manager does not have its own capital at risk alongside investors, its potential upside is balanced by only the investor's downside.[5]

Portfolio Management

Most hedge fund investors, whether institutions, family offices, or a fund of funds, take an overall portfolio approach to their hedge fund investments. Understanding the concentration, liquidity, leverage, and exposure of each hedge fund in the total portfolio is required to aggregate the total portfolio and reveal biases. Investors cannot effectively monitor exposures and rebalance their portfolio without sufficient information to estimate a fund's characteristics.

Information

Just as stock-pickers search for incremental insights into companies, so do fund investors attempt to dig for information in the day-to-day workings of a fund manager. Initially, investors want information describing a fund manager's strategy, risk guidelines, and controls. In addition, investors want the most information available about the organization and its individuals to make sound investment decisions and gain an edge on their competition. Unfortunately, some investors also are motivated by material to fuel cocktail party chatter.

INTERESTS OF THE HEDGE FUND MANAGER

While industry associations and service providers take efforts to accommodate new investors in the asset class, they must also take into account the interests of hedge fund managers.

Protecting the Product

As is the case in any business, fund managers sell a product. The product desired by investors is investment returns. More specifically, hedge fund managers are in the business of generating ideas and executing on those ideas.

An *edge* that can make one investor more successful than the next can be defined by either having better information, or processing information better than the marginal investor. Both edges flow from information, about either a company (ideas) or a market (execution). The more information fund managers keep to themselves, the better their chance of maintaining an edge over the competition. Conversely, the faster the managers disseminate information, the more rapidly their organizations must reinvent themselves just to stay in place, let alone improve.

Great hedge fund managers often live in fear—fear of a missed piece of analysis, a more knowledgeable competitor, or a misguided opportunity set. Most are all too aware of the poker warning, "If you look around the table and can't find the patsy, *you are it*."

Investment Flexibility

The last few years have seen a drain of talent from Wall Street and mutual funds to hedge funds. While many argue that this is a consequence of economics (and it is hard to argue against the point), successful fund managers also are drawn to the intellectual and emotional challenge of navigating a broad spectrum of investment alternatives.

Rather than be locked down by non-investment-related criteria, such as selling all stocks that fall out of the S&P 500, or be tied to a market-driven benchmark, hedge fund managers enjoy the flexibility to explore the world in search of opportunities that offer an asymmetric trade-off of risk and return.

Stealing Ideas and Gossip

Hedge fund investors who meet with investment managers all day are notorious for slipping information they have heard elsewhere. One hedge fund manager told me in a recent meeting that he once offered full position disclosure on both sides of his long/short equity portfolio. That occurred until four years ago, when one of his investors shared his best short idea with a large institution, which subsequently created a squeeze by buying 20% of the float.

More notably, predatory trading may have bolstered the final steps of LTCM's fall. As bits and pieces of information about LTCM's book leaked out,

> *Knowledge of Long-Term's portfolio was…commonplace. Salomon was, and had been, pounding the fund's positions for months. Deutsche Bank was bailing out of swap trades, and American Insurance Group, which hadn't shown any interest in equity volatility before, was suddenly bidding for it. Why this sudden interest, if not to exploit Long-Term's distress?…The game, as old as Wall Street itself, was simple: if Long-Term could be made to feel enough pain—could be "squeezed"—the fund would cry uncle and buy back its shorts. Then, anyone who owned those positions would make a bundle.*
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> (Lowenstein [2000, p. 174])

While LTCM's example may be an outlier, the actions of limited partners and Wall Street are exactly what concerns hedge fund managers in disclosing information about their portfolios.

COUNTER-ARGUMENT TO CONCERNS OF THE INVESTOR

Although pure in theory, the interests of investors are not benignly applied in practice. In fact, the same people who want transparency from hedge fund managers are partially responsible for the evolution of the industry away from it.

Risk Measurement Is Not Risk Management

The call for transparency for fiduciary duty reasons begs a logical question: what will investors do with the information once they have it?

Managing risk is more complicated and more subjective than measuring risk. The quantitative processes and skills of risk measurement are essential but not sufficient to a successful risk management program. Judgment about those metrics and the actions taken based on this judgment are far more important than the calculation of numbers that might foretell such problems.

As demonstrated by the demise of LTCM, even the most sophisticated computer models tracking known positions and built by Nobel laureates may not adequately perform risk management. If the models of top quantitative scholars fail, how can a relatively uneducated fund investor interpret complex event-driven and relative value transactions?

While a basic understanding of a fund manager's risk controls and reporting lines does help investors assess the risk in a fund, disclosure might not alter an investor's decision.

Recourse to Prevent Disasters

Even if fund investors were to benefit from full transparency and were to interpret the data in a sensible way, they might not be in a position to act if something goes wrong. Hedge fund documents typically have no risk guidelines.

Although managers may give an indication of the maximum leverage in a strategy in a marketing presentation (for example, 4:1 leverage on a merger arbitrage portfolio), the offering documents typically bear no mention of restrictions. Encumbered with unrestricted lockups on their capital, an informed fund investor may have no recourse to exit a fund if something goes awry.

COUNTER-ARGUMENT TO CONCERNS OF HEDGE FUND MANAGERS

Nor are hedge fund managers immune from incurring significant costs from their lack of transparency.

Accountability

By failing to disclose information, hedge fund managers might jeopardize the very product they are protecting. As any experienced investor in securities or funds knows, successful investments rarely take a smooth path from beginning to end. When performance is strong, it is easy for managers and investors to feel smart—although they usually are not as smart as they appear.

When times are tough, however, it is easy for managers and investors to point fingers—although they usually are not as dumb as they appear.

For an investor in a fund, differentiating between the wise and the waste is dependent on quantitative and qualitative information. The more a manager keeps secret, the higher the likelihood an investor will draw uninformed conclusions, which could hurt the manager unjustly.

Lack of Understanding

If investors are not well informed, a hedge fund manager also might lose the flexibility investors so desire when it matters most. Without an in-depth understanding of the people, the strategies employed, and the expected biases and risks in a hedge fund, investors have tremendous difficulty evaluating the performance of a fund.

Look at the flight of capital from fixed-income arbitrage strategies in 1994 and again in the fall of 1998, and one can see how an investor lack of understanding can impact the ability of managers to take advantage of the best opportunities.

FUTURE DIRECTIONS

Thus far, hedge fund managers and investors have allowed the evolution of the industry to dictate the degree of transparency. As the cottage industry becomes institutionalized, the divergent interests of fund managers and investors create tension regarding transparency. Industry associations, prime brokers, and software companies have attempted to bridge the divide, but none is properly positioned and motivated to catalyze meaningful change.[6]

A buyer industry consortium does not offer hedge fund managers an economic incentive to improve disclosures. Without taking the interests of hedge fund managers to heart, moving the industry forward is a daunting task.

Prime brokers are saddled with declining economics and conflicts of interest, as housing relationships with hundreds of hedge fund managers does not lend itself to trusting relationships with confidential information. Increasingly, hedge funds are working with multiple prime brokers, effectively eliminating the potential for any one to provide a comprehensive understanding of a fund's risk exposure.

Finally, software providers such as RiskMetrics and MeasureRisk have created technology to automate risk measurement. But risk management requires the judgment of an individual beyond quantitative metrics.

Offering the best band-aid for a wound cures a symptom but not the cause. A short time ago, close relationships, implicit trust, and a deep understanding of activities allowed the passage of information from managers to investors. Can the industry find a way to break the momentum that has built over the last ten years, and start afresh?

In an era with unprecedented mistrust of corporate executives and American business, the hedge fund industry, replete with short-sellers, ironically has an opportunity to restore trust among its participants. The industry can and should re-establish the trust and communication between managers and investors.

Open relationships between managers and investors may pave the way for capital flows into hedge funds far above today's levels, and market participants will be enriched by the result.

Enhanced Organizational Disclosure

One simple but elegant solution is a mandated disclosure of the amount of a manager's net worth invested in the fund. As intermediaries dance about finding ways to prove they are protecting investors, a single disclosure can go a long way toward returning trust to the business.

By disclosing the amount and importance of a manager's co-investment, a manager lays down his cards for everyone around the table to see. If a manager has substantial skin in the game, an investor can mitigate the principal-agent problem and gain some assurance that a manager will feel both the pleasure and the pain alongside the investor. Without a co-investment, an investor may have little tangible evidence to trust a hedge fund manager.

Doing their part, investors can provide a manager with an assurance that they will neither disclose nor act on ideas originated by the manager. Hedge fund managers frequently create "side letters" to meet specific needs of new clients. To my knowledge, no managers have used these letters to trade transparency for guaranteed confidentiality.

Independent Risk Manager with Proper Incentives for All Parties

A possible next step might be inclusion of an independent risk manager—one whose reputation and accountability is directly tied to the maintenance of confidentiality. By offering either economic or strategic incentives, an investor may persuade a hedge fund manager to open its door to a single, trusted individual. The hedge fund manager and risk manager could then review risk disclosures with the knowledge that information that passes between them remains behind closed doors.

The investment manager could work with the risk manager to package the information in a way that is acceptable to clients, and the third-party risk manager can ensure independent judgment for those clients. Although structuring an appropriate vehicle that has sufficient incentives for the manager and collective benefits for investors is no easy task, it might be worth the effort.

Further, I surmise that this risk manager needs to be located in an investment organization, rather than work for an independent service provider. Hedge fund managers need to derive a tangible benefit from external risk management, and the opportunity to add attractive capital or obtain better terms from clients could serve as such a benefit. In addition, investors need to exercise judgment about risk and be impacted by the results. Unfortunately, both the ability to offer incentives and the dependence on judgment are absent in service providers.

CONCLUSION

I don't know if these suggestions will work, but they certainly offer a possible solution that addresses the issues and concerns of both managers and investors. Investors could sleep at night, knowing they are fulfilling their fiduciary duty, trying to avoid disasters, managing portfolio level decisions, and accessing at least the same information as every other investor. Fund managers can offer transparency without jeopardizing the integrity of their product or restricting their investment mandate. Finally, they can enlist the services of the risk manager to help educate their clients.

For change to occur, the industry must confront its barriers to resistance. Hedge fund managers have a low tolerance for change, as only those with difficulty attracting capital have sufficient dissatisfaction to question the status quo.

Nevertheless, if investors continue to encourage broad education and participation, it may be only a matter of time before the leading hedge funds of tomorrow elect to ease the movement from an exclusive club to a building block of institutional portfolios. By reinvigorating the relationship between investors and managers in the future, the industry can ensure its place in institutional portfolios for many years to come.

ENDNOTES

[1]I use "hedge fund investments" interchangeably with "absolute return strategies." See Peltz [1999, p. 51].

[2]According to Jane Mendillo, formerly vice president of Harvard Management Company. See also Swensen [2000, p. 114].

[3]See "Hedge Funds Garner Record New Money" [2002].

[4]Statistical sample calculated using the Altvest database.

[5]A high-water mark is the highest market value attained by the manager on which incentive fees are paid. If returns fall below the high-water mark, the manager must earn back the shortfall before accruing additional incentive fees.

[6]Work performed by the Investor Risk Committee of the International Association of Financial Engineers can be found at http://www.iafe.org.

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