FORTUNE FAVORS THE TRANSPARENT

How hedge fund managers can answer the call for transparency

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In the five years since Lehman, Madoff and the financial crisis, calls for transparency within the hedge fund industry have grown louder and more frequent. Regulators need transparency into funds to monitor systemic risk. Investors, recognizing the potential for substantial hidden risks in their hedge fund investments, require transparency from their managers to help manage that risk. And managers have wrestled with the challenge of aggregating data across multiple prime brokers and counterparties.

The result is that the bar has been substantially raised – to today's investor, the monthly transparency report issued with statements is old news by the time it is received, and lacks sufficient granularity to support meaningful analytics or stress testing. Today's largest investors are demanding increased transparency to:

- **Know** what and where their assets are
- **Understand** exposures, concentrations and correlation to manage risk
- **Gauge** their level of liquidity
- **Optimize** treasury and collateral management
- **Validate** investment performance and manager fees

In five short years, we have seen the notion of transparency evolve rapidly in three discrete phases: fraud protection, risk management and investment performance.

Transparency is not a singular concept, but rather a spectrum of activities ranging from limited disclosure of key exposures (translucency) to detailed disclosure of trades, positions and even the underlying economics of derivatives holdings. In five short years, we have seen the notion of transparency evolve rapidly in three discrete phases: fraud protection, risk management and investment performance.

PROTECTION AGAINST FRAUD

The first phase came immediately after the Madoff investment scandal. Investors wanted protection against investing in questionable funds, and began to require independent third-party administration as a means of verifying their assets, validating valuation policies and monitoring liquidity terms.

Third-party administration became a condition of investment. Investors were interested not only in having a third-party administrator, but also in assessing the quality of that provider. Managers found themselves competing on controls, which in turn drove a shift from smaller boutique firms toward large institutional providers with scale, business resiliency and financial strength. Many smaller firms were acquired by larger institutions that could offer brand recognition with investors, "industrial-strength" capabilities and bundled arrangements combining administration with brokerage and/or banking services.

A WINDOW INTO RISK

Having gained independent verification of assets, investors quickly realized these measures fell short of the true need. Though valuations and holdings were affirmed, investors still lacked understanding of what those holdings were and how they might react under different scenarios, creating "black holes" in their portfolios.

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As investors and managers came to realize that transparency could aid in performance as well as risk avoidance, they began to look at transparency in a new light.

Investors discovered they needed an accurate picture of their market risk based on consistent data sets across managers. Subsequently, calls for trade-level transparency gained traction. Trade-level transparency – achieved through prorated holdings disclosures, managed accounts or funds of one – delivers granular data on portfolio holdings, including:

- Identifiers, quantity, market value
- Valuation sources
- Currency and sector exposures
- Credit ratings, payment histories

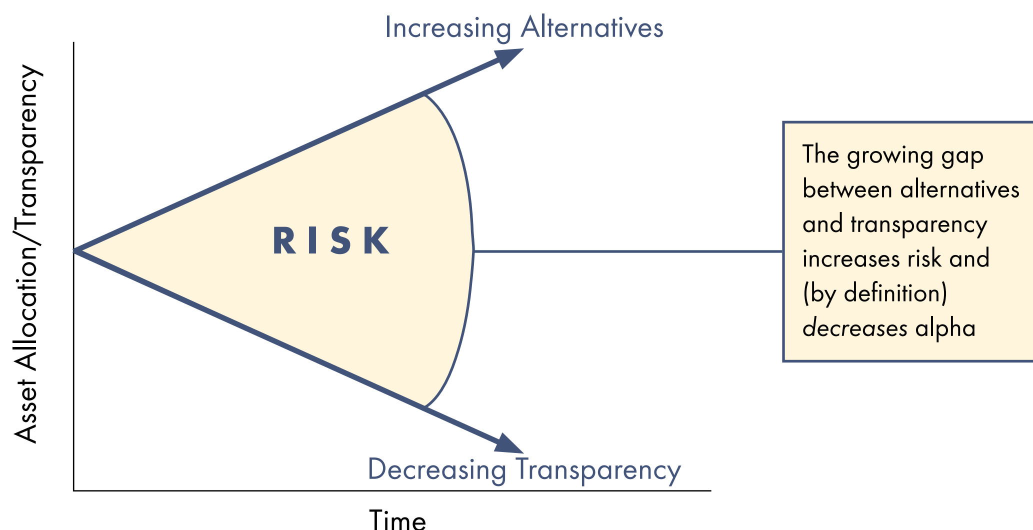
The issue? Transparency into holdings data is of limited value unless the investor has the tools and expertise to translate that data into actionable information. Moreover, managers – concerned about protecting the intellectual property of their trading strategies – are often reluctant to provide this level of detail, or do so on a month- or quarter-lag basis.

In the end, investors fell short of the true need: an understanding of their risk profile – sensitivity to credit events, market volatility and correlation/convexity – and of how their portfolios would react in a market crisis.

TRANSPARENCY AS A DRIVER OF ALPHA

Discussions around transparency tend to focus on risk avoidance and protection against investment loss. However, transparency and sound operations can also help drive investment alpha.

Alpha is typically defined as investment performance above risk-adjusted benchmarks. Institutional investors are attracted to the performance potential of hedge funds. But traditional hedge funds are structured in opaque limited partnerships, which offer limited visibility into exposures, convexity and correlation. This leaves investors with risk concentrated where it is least visible. Because alpha is the risk-adjusted measure of return, this increase in risk – by definition – creates a decrease in alpha.



Source: Northern Trust

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HOW ARE INVESTORS USING ALL THIS?

While institutional investors are demanding a great deal of data, not all data is created equal. The value of information is in its utility. How are investors putting it all to use?

There's no single answer – each investor has a unique governance framework and informational needs. For instance, a large pension plan may require extensive reporting and detail to make allocation decisions and support an overlay on its hedge fund portfolio, while a small plan might be concerned primarily with returns-based analysis, seeking basic exposure reporting, investment guideline compliance and monitoring for style drift.

No matter the investor's size or sophistication, however, there's a gap between having data and being able to extract useful information from it. Investors often find they need to hire in-house specialists or outside vendors to aggregate large volumes of information and translate data into actionable insight.

While this process incurs costs, for those in a position to act on that data, the expense can be well worth it. Advances in technology make it possible for both managers and investors to leverage transparency and actively manage operational and counterparty risks, thus increasing risk-adjusted performance.

Enforcing Style and Asset Allocation Discipline

Institutional investors are seeking high-quality transaction and position data to enforce style and asset allocation discipline across multiple managers. The reason is clear – the landscape is littered with firms that stepped outside of their stated strategies.

Monitoring style discipline in opaque alternative assets, while challenging, is a necessity. Aggregated on a total portfolio level, style drift can cause significant variance from policy for institutional investors. Investors want assurance that managers are delivering the style exposure they promised.

Rapid Redeployment

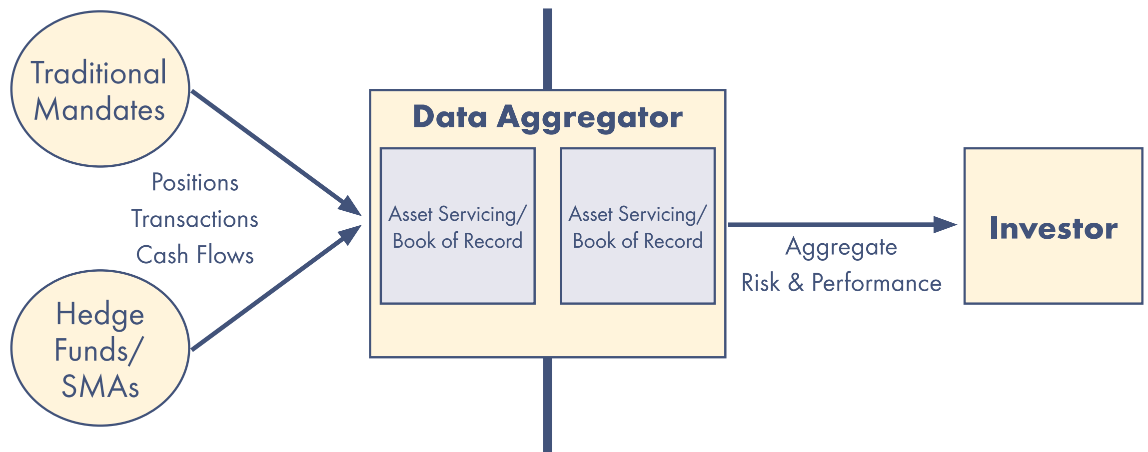
High-quality operational data can also be used to support rapid cash optimization strategies in tactical asset allocation or macro-overlay approaches. Such strategies can require significant investment in data warehousing and risk analytics. Following are two examples from our client base.

- One in-house-managed pension plan redeploys cash across its strategies daily, leveraging detailed cash forecasting across all asset classes, including collateral movements, private equity capital calls and distributions, and hedge fund liquidity terms.
- A sovereign wealth fund uses a derivatives overlay strategy to adjust external manager exposures to meet the house view of currencies, interest rate curves and other factors. As their administrator, we can connect their hedge fund allocation to their overall daily reporting, so they can apply the overlay strategy across the entire portfolio.

Risk Transparency

While investors continue to seek holdings-level transparency, many managers are reluctant to disclose this level of detail as they seek to protect their proprietary trading strategies. Risk transparency is emerging as one option that can meet the needs of both investors and managers.

Using this model, a third-party provider takes in trade-level data from across the investor's total portfolio and delivers risk analytics to the investor. Managers need not disclose proprietary trading strategies, thus protecting their intellectual property, and investors get the desired intelligence on total portfolio risk. As an added benefit, investors no longer need to commit time, resources and expertise to converting trade-level data into risk.



Source: Northern Trust

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WHAT ABOUT MANAGERS?

Investors are not the only ones seeking to use transparency to their advantage. As the hedge fund industry has grown, managers have begun seeking new ways to drive alpha. As a consequence, many firms have dramatically expanded their enterprises, taking on new:

- Asset classes
- Investment strategies
- Fund structures
- Fund domiciles/markets

All of these factors add to the complexity and expense of operational controls. Given the relationship between transparency and risk, managers are seeking increased levels of transparency into their administrators' controls to identify and address operational risks. The issue is the administrator's ability to provide enough transparency; managers cannot address operational risks they cannot see, which can bring down performance if left unaddressed.

Advances in technology make it possible for managers to receive real-time transparency into administration activity, so they are trading based on better data and can identify and address issues. Strategy and attribution tagging functionality drive the translation of data into information – building data views around the manager's book structure. Finally, managers are looking to administrators to deliver enhanced portfolio analytics – risk, compliance, performance – to help them track their performance, monitor exposures and risks and drive a more efficient investment strategy. Together, they help create what we call Operational Alpha® – which can be leveraged by managers in a variety of ways.

Opportunistic Trades

Operational Alpha often manifests itself in a firm's ability to take advantage of a market opportunity. Take, for example, two high-profile market events – the 2006 Amaranth meltdown and Sowood's losses in the 2007 market turmoil. Both firms held large numbers of complex positions that became illiquid when counterparties pulled out. Firms that were able to book and analyze assets quickly were at a competitive advantage to beat the rest of the market, make offers and reap the benefits over time.

While investors and regulators led the initial drive for change around transparency, managers are finding more and more reasons to get on board.

Optimizing Manager Liquidity

Operational Alpha can also take the form of optimized processes. Cash, collateral and leverage can boost or drag performance. With transparency and control, some investors can boost performance significantly.

As an example, one advisor client invests in the same suite of hedge funds through both a traditional fund of funds, as well as a managed account structure that offers daily transparency into those funds. This enables the client to manage cash and collateral across the entire portfolio of managers, and generate more than 50 basis points in improved performance compared to the opaque fund of funds.

Operational Friction

As firms grow, complex capital and legal structures create friction that can impair good investment decision making. Building out operational solutions – in the form of advanced accounting and investment allocation systems – helps to minimize the drag that legal and structural complexity can place on performance.

The results add value to managers and investors alike: the investment manager gains efficiency and scale in its operational processes, while being able to offer more tailored offerings to individual stakeholders. Transparency creates the ability to "look through" legal and capital structures, allowing for more detailed risk and performance solutions.

TRANSPARENCY IS HERE TO STAY

While investors and regulators led the initial drive for change around transparency, managers are finding more and more reasons to get on board.

- **From the investor perspective** – transparency can satisfy board demands and re-establish trust in manager relationships.
- **From the manager perspective** – investing in resources to support transparency can strengthen client relationships, satisfy regulatory demands, enhance cost efficiency and improve investment performance.

We believe that over time, investors will favor managers who can provide transparency, and so will the markets. Managers who deliver transparency to investors – and take advantage of transparency provided by administrators – will be at a distinct competitive advantage. So transparency is no longer just good governance; it's fast becoming good strategy.

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