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Hedge Funds - Gold Mine or Minefield?

by: Richard C. Kang

Readers of Canadian Hedge Watch have probably seen it too many times - the countless references to various hedge fund "blowups" of the past. These incidents include the collapse of Long-Term Capital Management and Beacon Hill, but also include the actions of rogue commodity traders such as Nick Leeson of Barings. Even the Enron fiasco has been defined by some as a hedge fund collapse. These, and other events, have reached investors of all sizes and in all areas of the globe. Early this year in January, a Japanese hedge fund, the Eifuku Master Fund, lost all its US$300 million in only seven days of trading. The fact that the fund's Japanese name can be translated as "good fortune" didn't help its manager who in a letter to investors on January 15th stated that "Substantial trading losses have consumed nearly all the fund's capital". Consider that when you're having a bad week.

Despite seemingly continuous references to these events, members of the hedge fund community along with the mainstream press have begun to educate the investing public on the benefits of alternative investments, and in particular, hedge funds. This document attempts to provide the investor with an introductory review of the possible "banana peels" inherent in hedge funds. By noticing these factors, one would hope to minimize the possibility of a blowup. In addition, there are a variety of arguments that provide considerable evidence as to the potential advantages, arguments that make them an integral part of a truly diversified and robust investment portfolio.

Whether an investor is about to invest in a fund-of-funds or is considering building their own portfolio of hedge funds, one must remember that this is not like buying their respective counterparts of the past, the traditional mutual fund or portfolio of stocks/bonds. Due diligence, both quantitative and qualitative, are necessary before and after putting money into any investment. The burden increases when you deal with hedge funds. There are various additional concerns for hedge funds that go beyond what investors have had to consider when choosing a mutual fund or a traditional investment manager in the past.

Often times, when deciding on whether to allocate a proportion of a portfolio's assets in a specific investment, the main area of focus is its investment strategy and process. However, when an investor buys a hedge fund, they are really buying into the business that is the specific hedge fund company. The principals of the hedge fund company are responsible for every aspect of the

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Performance Data: CSFB Tremont Hedgeindex

Benchmarks	June 03	YTD
CSFB/Tremont Hedge Fund Index	0.83%	7.94%
MSCI World $	1.77%	11.45%
S&P 500	1.13%	10.76%
Dow Jones	1.53%	7.72%
NASDAQ	1.68%	21.51%
MSCI EMG MKT	5.47%	13.90%
S&P/TSX	2.05%	6.73%
Sub Indices		
Convertible Arbitrage	-0.62%	8.15%
Dedicated Short Bias	-6.01%	-19.48%
Emerging Markets	2.02%	13.06%
Equity Market Neutral	0.46%	3.17%
Event Driven	1.80%	11.03%
Fixed Income Arbitrage	0.34%	5.67%
Global Macro	1.63%	10.39%
Long/Short Equity	0.79%	7.19%
Managed Futures	-2.21%	10.50%

The CSFB/Tremont Hedge Fund Index, the only asset-weighted hedge fund benchmark, was designed to establish a standard for tracking and comparing hedge fund performance against other major asset classes, like the S&P, on a global basis. Its web site provides interactive tools that allow users to manipulate the information and customize their research. www.hedgeindex.com

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DYNAMIC MUTUAL FUNDS

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in their investment process. These companies are often small but are given the task of managing very sizeable assets. Actions or inaction, errors or omissions by an individual (or individuals) in the company could have drastic consequences. A clear and focused business doctrine will provide appropriate policies and procedures, segregation of duties and other controls within the manager's operation. All of these are prerequisites for an investor's due diligence into how the company operates.

When considering hedge funds, one must also focus on the following issues related to its business risk:

- Management team and staffing requirements
- Ownership and funding of company
- IT/systems infrastructure
- Legal and tax structure
- Service providers (prime broker, lawyers, auditors, etc.)
- Short, medium and long term goals
- Marketing strategy (target market, capacity in terms of total AUM)

What you are really trying to determine is a company's business risk, so that you can assess whether the enterprise has a strong chance of being sustainable. This sounds obvious but is rarely a consideration when deciding on which mutual fund to purchase. For the advisor of a client who is new to hedge funds, this is a critical difference from mutual funds that needs to be made clear to clients. And we haven't even looked at the investment process yet! We're still trying to figure out if the company will be around sometime in the future when we need our money back. In this young industry, with so many managers having a life within the hedge fund world for three years or less, exacting analysis of a company's sustainability is paramount.

Hedge fund managers, like any other participant in the financial services industry, are required to take reasonable steps so as to understand the regulatory environment in which they operate:

- The hedge fund manager must be properly registered, or licensed, with the local regulatory body. Although complex and time-consuming, this requirement is absolute. Being licensed means having passed the educational and industry experience requirements as well as having, among other things, proper insurance and working capital amounts.

- Having proper compliance-related policies and procedures is part of the role of any portfolio manager. Management should ensure that subordinates are properly educated on compliance issues related to their role, and to some extent, to the company as a whole. One caveats of note: the field of hedge fund compliance is very new, and may be considered "uncharted territory" by many participants.

- Many hedge fund companies are very small in terms of the number of personnel. However, they should not be so small that the manager and his or her work can not be evaluated by others in the firm within a compliance context. Another concern is whether the firm is so small that there is a significant risk if one or more individuals are lost (by death or by movement to a new organization).

- Firms must ensure that they are kept informed of new rules and regulations from the regulatory bodies. In the past, compliance issues, and the time and resources invested to these issues, were considered a drag on performance. Those days are long gone. With the blowups of the past and with the hedge fund industry's desire to erase their myth as "black box secret rogue traders for the super rich", firms now prepare judiciously for compliance readiness. While it is the manager's responsibility to prepare themselves for full regulatory compliance, it is the investor's responsibility to ensure that all possible steps have been taken by that manager, before they decide to invest.

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There are various other issues that could be added to this list. Obviously, the firm and its clients would be better served if this work was implemented with the help of legal counsel and/or a compliance consultant. As part of one's due diligence, it would be helpful to see if the firm was working with a specialist in this area. This will include retaining a securities lawyer to deal with various related issues.

The focus thus far has been on qualitative factors for a hedge fund manager or a fund-of-funds. There obviously should be a quantitative analysis as well. In this regard, the analysis focuses on performance measurement, both for backtested models and real historical returns as well as possible benchmarks or targets for future performance. The problem is that these types of analysis on hedge funds, and in most alternative investments, may require methods different than those used for traditional investments. Issues to consider that are significant, and in cases unique, to hedge funds include:

- Benchmark analysis and its flaws relating to survivorship bias. A manager should be able to tell the investor what is their target return. If they give a hedge fund index as a target, be aware of the differences of various hedge fund indices. Also be aware of their decision to use a hedge fund index as a relative benchmark return, versus the risk free rate plus a certain percentage amount as an absolute benchmark return.

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• When considering the analysis of past returns of hedge funds in general,one issue to consider is nonlinearity. In most portfolio theory, there is an assumption that returns are lognormal (i.e. bell curve). Hedge fund returns have shown nonlinearity causing doubts of whether various measures, such as the Sharpe ratio, are suitable.

• An investor should always consider volatility of returns. How bad was the fund's worst month, quarter, or year? What was the fund's maximum drawdown (peak to valley), and how long did it take for the fund to get back to that peak?

• Correlation analysis is important. How do the returns of the hedge fund behave in comparison to the rest of your portfolio (or certain components of your portfolio)? Ideally, hedge funds are built to have little to no correlation to traditional asset classes like stocks and bonds. Hopefully, this means that when your portfolio is starting to head down like it probably has over the past 3 years, the hedge fund component of your portfolio will not also be going down.

• Is the manager's strategy dependant on precise skill, or vague luck? Were past returns based on hitting "homers" on few trades? It's safer to find a manager who has a highly repeatable strategy, rather than a manager who looks for a single big event or winning period to drive a good year of returns.

The above points on quantitative analysis are just a very elementary start. Certainly, almost any investor with a PC and spreadsheet program can do the calculations themselves. However, aside from past performance there are other factors to consider. An investor must also consider liquidity as an important factor before entering into an agreement with a hedge fund manager. Obviously weekly or monthly is better than quarterly or yearly. However, liquidity does not necessarily refer to the speed at which you can redeem your investment. The internal "liquidity" of the managers decisions will have a tremendous impact on the returns of the fund in extreme situations.

One big factor for many hedge funds is their use of leverage. It is one of the main factors in the collapse of LTCM, Beacon Hill and Eifuku. In fact, many hedge fund "blowups" of the past have had to do with faulty methodologies whose results were magnified by the use of leverage In layman terms, leverage multiplies the effects of a manager's trading talent. If they're good, leverage really helps. If they're off, leverage really hurts. Its best to know ahead of time what is the manager's maximum allowable amount of leverage. Take a look at past results to see what was the average dollar and percent exposure of the fund on a monthly basis after taking leverage into consideration.

One caveat from that last sentence: Hedge funds are like fruit. So make sure you are comparing apples to apples and oranges to oranges. 10 to 1 leverage is commonplace in certain subgroups of hedge funds such as convertible arbitrage. However, a fund classified as macro or short only would be considered extremely speculative if it applied the same degree of leverage.

A last thought on analysis of past returns. Remember, they're past returns. The best one can do is look for any funny patterns or large drops in the fund's value over certain time periods. For example, plotting monthly returns (charts and graphs are always helpful in finding the pros and cons of an investment), you might discover that for a large period of time there is a great dispersion of returns, where at other times, returns are quite constant. Is this because of market factors, a change of strategies (i.e. style drift) or maybe a fund structure, the investor has a second source to verify fund values. An investigation of the manager's activities with its prime broker(s) will shed even more light on the client's activities. In many cases a manager has more than one, but a possible warning sign is when a manager has several prime brokers. If the manager is taking speculative bets, their hope is to spread their bets among many accounts so as not to attract "unwanted" attention should a major position turn against them. Operating with several prime brokers can allow the manager more freedom to act with a multitude of smaller accounts, and no single broker gets too nervous when a bet goes sour.

So with the potential of fraudulent managers, why would anyone take the chance with hedge funds? We are really in a very interesting time for hedge funds. Demand has increased as traditional asset classes have forced investors to look at "alternatives". As a result, there has been a constant supply of new products for these investors. Just look at the tables in this copy of Canadian Hedge Watch and compare it to its very first issue. Everyone from the largest institutional fund to the small retail investor has access to some sort of hedge fund product. With the attention hedge funds have received in recent years among investors, regulators have recently begun to focus their attention there as well. Certainly, if their role is to protect the investor, it is in the best interest of all if the regulators set out the rules for the field. The truth is that rules and regulations specifically oriented towards hedge funds haven't been made yet. In the US, the SEC is now beginning the process to determine the rules for hedge funds. However, some managers simply look at hedge funds as unconstrained mutual funds that will allow them to operate their investment strategy without the traditional regulatory burdens of a mutual fund. This could lead to a dangerous trend, and regulators seem poised to prevent that.

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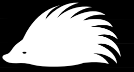

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There is now, and will continue to be, increased scrutiny towards regulators with regard to hedge funds and other new and innovative products. In addition, with the inclusion of hedge funds and other alternative investments by very large institutions (Ontario Teachers, OMERS, CalPers, University of Toronto and many large US university endowments), investors can feel more comfortable that various experts have found good reason to include these products in their portfolio.

The question then is, how do you go about choosing a hedge fund or portfolio of hedge funds and at the same time minimize the potential for future blowups? Certainly, at the end, the responsibility of due diligence falls at the hands of the investor. They can hire an accountant and lawyer to assist, but really, who signs the subscription agreement? That would be the investor. The art and science of analyzing hedge funds is a relatively new field. I personally feel that quantitative analysis can only go so far, since it only looks at past returns. Everyone has great backtested results. I'm yet to find someone who shows backtested results that don't consistently beat their target and then outright crush the benchmark when real trading begins. It's just hard to trust data in the hedge fund world. Another example is the role of various hedge fund indices and its inherent flaw, survivorship bias. That's a whole other article for a future Canadian Hedge Watch edition.

What we really need is greater risk transparency and more sophisticated risk management controls within hedge fund companies and the funds they manage. By transparency, I do not necessarily mean that investors should be given position transparency since managers are often unwilling to provide this information, but what investors need is a snapshot of the hedge fund's risk exposures that does not conflict with the manager's sensitive information. Then, investors have an opportunity to determine their potential risks from a hedge fund investment upfront. This goes a long way to managing a client's expectations and allows them to be better equipped to handle market or fund-specific surprises.

Finally, I end with a confident note for the industry. Although this article started as a brief discussion of hedge fund blowups, the reality is that only a very small percentage of hedge funds collapse in such a spectacular manner as LTCM. These blowups of the past have provided good lessons for managers of today. Hedge fund managers realize that risk management protocols are a "must have" not a "nice to have" feature within their investment methodology. Furthermore, sophisticated investors, especially institutions who have recently put substantial amounts into various alternative asset classes, demand well-articulated risk management not just for the investment process, but for the firm as a whole. Many firms have acquired risk management advice and infrastructure (from firms such as RiskMetrics and Algorithmics) to satisfy the requirements of these institutional investors. Further scrutiny from regulators will assist in implementation of these protocols on a grander scale. Whether this will actually result in minimizing the chances of so called "blowups" is up for debate. However, the increased evaluation by regulators combined with a greater demand for compliance from large institutional funds should provide greater security for the new hedge fund investor.

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Interview with Henry Kneis of Abria

Mr. Kneis, the Chief Executive Officer of Abria, has over fifteen years of securities industry experience, specializing in equity derivative and proprietary arbitrage trading. He was the CEO of a Canadian investment-dealer that was a member firm of the Toronto Stock Exchange and the Investment Dealers Association of Canada, capitalized at $100 million. He managed a proprietary trading portfolio for the firm and its affiliates with aggregate balance sheet assets of $3 billion. As a senior partner in an entrepreneurial and aggressively growing business unit, Mr. Kneis was a key contributor in all aspects of the business development, from building infrastructure, to generating and researching new trading opportunities, to marketing products.

Abria Trust posted solid returns since its start March, 2000. Its annualized return as of May 31, 2003 was 9.78%. This return was achieved with a astonishingly low annualized standard deviation of 1.90%.

- **How did Abria Trust start?**

Having spent my whole career working in a proprietary trading organization, it was time for a change. In September of 1987, I was the second employee for First Marathon's proprietary trading desk and my first experience of market neutral investing was the October 1987 crash, which I traded through, making significant money for the firm. You could say that that was the formative experience of my career and I have been a market neutral investor and practitioner ever since. By the middle of 1999, the group had grown to 200 people with multiple trading desks and global offices, with over $3 billion in assets and I needed a more entrepreneurial environment. I also felt that the time had come to deliver proprietary trading techniques, previously the exclusive domain of financial institutions, ultra high net worth investors and institutions to a wider audience. Hence I founded Abria in July 1999, spent 6 months on structuring the product to enhance tax efficiency among other things and the Trust itself was founded in March, 2000.

- **What was your experience in managing fund of hedge funds investing prior to starting Abria?**

I founded a market neutral, fund of funds at my prior firm in January of 1999. Prior to that, I had spent my whole career employing market neutral strategies or running proprietary trading desks employing the same. All of the portfolios traded, managed or supervised by me have had positive returns in each quarter of existence dating back to 1987. Running a multi-strategy, market neutral proprietary trading operation is similar to running a market neutral, fund of funds so I guess you could say that I have nearly 16 years experience in the field.

- **How many hedge funds are included in Abria Diversified Trust?**

17 as of June 30.

- **What styles of hedge funds are represented in the fund?**

All market neutral. Includes convertible arbitrage, fixed income arbitrage, Mortgage Backed Securities Arbitrage, Equity Market Neutral, Statistical Arbitrage, Mutual Fund Timing Arbitrage.

- **What is your hedge fund selection process in respect to Abria Diversified Trust?**

The Fund will not invest in any sub-fund whose strategy is known to rely on unhedged exposure to emerging market currencies or securities, high yield or distressed securities or short volatility and will only invest in

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