Managed Accounts
A rocky path to transparency – and then?

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Hedge Funds are still high up on the radar screen of many investors. A disappointing performance in 2008 and fraud cases like the one of Bernard Madoff have led investors to ask for much higher transparency standards than a few years ago. Hand in hand with transparency standards go the desire to be protected against fraud by the mandated hedge fund and the segregation of the invested capital from the rest of the managed assets. No less important for the investor is to understand which trading strategy the hedge fund follows and which risks are taken. This is important to understand the degree of contribution by the hedge fund investment to the risk of the overall portfolio. A frequently chosen route of co-operation between investor and hedge fund that can fulfil those requirements is the managed account.

This article tries to shed some light on the necessary steps from a risk management perspective to build such a managed account and to calculate the required risk sensitivities. Further it discusses how the expensively created risk figures could be used by the investor.

Roadblocks to transparency
A very important decision when building a managed account is the choice of the provider of the platform. The platform often is internet-based software, which calculates risk figures, like equity and interest rate sensitivities, Value-at-Risk and stress tests. An advantage of large providers is the broad spectrum of covered instruments. On the other hand, it turns out that small providers of managed accounts are more flexible when implementing client wishes than large vendors of established systems. Part of this wish list could be, for example, the quick and efficient inclusion of new and complex financial instruments and adjusting the software to the IT environment of the investor.

Simple instruments, like cash equities, are being sufficiently covered by all providers. There are larger differences when it comes to modelling more complex instruments, like derivatives, for whose risk modelling sophisticated mathematical models are required. Since there are no two market participants (for example, hedge fund and the provider of the managed account platform) using exactly the same modelling methodology, there will be discrepancies between the risk figures that are calculated by different models. Here, the goal is not to achieve exact identity between the risk figures, but to come to a sufficient degree of conformity between the different models and to understand the reasons for any discrepancies. For example, one model should not show a significant reduction of interest rate sensitivity while the other model shows the opposite. In addition, it is important not only to have mathematical models for risk modelling, but also the corresponding historical data. A library for pricing inflation derivatives is not particularly useful if the necessary historical data are not available and/or cannot be maintained going forward. Another crucial point is trade positions, for which no or insufficient financial models and/or data histories are available. In this case it is impossible to include those positions in the risk report. Thus it is very difficult for the investor to gauge their risk impact without detailed knowledge of those products. Particularly in turbulent times those “blind spots” can lead to unpleasant surprises.

Transparency – and then?
When the risk figures have been produced under significant costs, the next question is: what to do with them? It is not immediately clear that this question is difficult to answer. The spectrum ranges from “nice to know”, where the investor tries to understand the current positioning of the hedge fund, to fully fledged integration of the risk figures into the in-house risk framework of the investor.

Regular risk calls based on the risk report, for example on a weekly basis, can help the investor to understand the hedge fund’s risks in the context of the market environment as well as their own portfolio better. Institutionalising such a call can have the effect that the investor as well as the hedge fund are forced to look into the risk report in detail. The investor needs to firstly understand it and secondly to bring it into context of the overall portfolio. The hedge fund, on the other hand, needs to be able to elucidate the risk report.

With fully fledged integration the market risks of the hedge fund investment, like, for example, equity and interest rate sensitivities, can be aggregated with the corresponding risk figures of the balance of the investor’s portfolio. This would give a picture of the complete risk profile of the overall portfolio and the market risks of the hedge fund would be internalised.

A positive for complete integration is that the full transparency also can be used for active risk management of the hedge fund in the context of the other investments. This could mean to, for example, reduce undesired directional equity exposure of a hedge fund via hedging transactions. However, in this case the question arises why the hedge fund manager is being paid his fees, if ultimately the investor takes over the hedging of individual exposures. Usually the determination of the relevant risks of a hedge fund in the context of the overall portfolio is the result of the due diligence process, a prior step in the risk assessment of a hedge fund which absorbs many resources. A further point when integrating a hedge fund investment in the in-house risk management system is compliance. If, for example, the directional equity exposure of a hedge fund is to be shown in the weekly risk report and to be discussed in front of a larger group, amongst them the head of equity trading, conflicts of interest could arise: the proprietary equity desk either could copy the hedge fund’s positions or build contrary trades.

Managed accounts for hedge funds are an important tool to address the desire for more transparency. When marching the path to a fully functional managed account for hedge funds, however, numerous obstacles need to be overcome. At least equally important for the investor is the question of what should be done with the desired transparency. The range here is very broad, from a purely informational additional risk report to full integration of the hedge funds into the in-house risk management framework including active risk management.

What is the right balance between transparency and costs? For investors making their first steps in hedge funds and managed accounts it might make sense to start on a “nice-to-know” basis. This would help the investor to understand the strategy, the risks and how they are managed by the fund in the daily production process. Depending on the complexity of the strategy and its instruments, resources required could range from one to several man hours per week. Building this sort of know-how on the investor side can also help the hedge funds, when investors over time get more comfortable with the strategy and this might open doors for future mandates.

More active risk management, including hedging unwanted hedge exposures, requires a very good understanding of the strategy and could be interesting from the point where the hedge fund allocation starts to have a noticeable impact on the return distribution of the investment portfolio, so practically from hedge fund allocations of more than 5%. Fully fledged integration into the investor’s risk management framework might make sense for portfolios with larger hedge fund allocations than 10% or for investors that receive additional benefits from the integration. An example for the latter could be an insurance company getting a relief on capital charges from rating agencies or their regulator when it is able to internalise the hedge funds’ risks.

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