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Transparency and liquidity still seen as top priority

2009-08-01

Tête-à-tête

What is the most important lesson for hedge funds coming out of the financial crisis?

Transparency and liquidity are still the two words dominating the discussion of a post-financial crisis hedge fund world. Even if investors were not already demanding (and receiving) greater transparency and information about the funds in which they invest, the coming regulation of the industry will highlight this need. The widely expected and probably inevitable regulation is likely to centre heavily on reporting and clarity around just what a hedge fund is doing and how it is doing it. The general consensus seems to be that these are all things investors should know before investing and have a right to monitor.

The mismatch of liquidity offered to investors with the actual assets of many portfolios has left behind a residue of concern. It is unlikely funds will be in a position to acquire the kind of leverage they had access to in the recent past; at the same time investors will be much keener to check that assets and redemption terms match. Fund managers have a lot to gain from being clear about the kind of liquidity they can offer and at the same time need to plan for the possibility of clustered redemption requests. Preparation for the worst-case scenario seems to be one of the lessons coming out of the financial crisis.

While none of this is new, the constant repeating of these two main issues seems to indicate that the industry is listening and taking on board not just the concerns of investors but the tone of the regulatory framework in which they are likely to work in future.

Mick Swift, Abbey Capital

In this new climate hedge funds must provide investors with greater control over how their money is being managed. Liquidity and transparency are now the key facets of investing. In 2008 there was a mismatch between liquidity conditions provided by hedge funds and the liquidity of the underlying markets they invested in. This led to the imposition of lock-ups and gates. Throughout this period the managed futures industry did not impose any extraordinary withdrawal restrictions as managed futures remained open for business. The use of managed accounts provides visibility of underlying positions but importantly also allows better cash management and asset administration. The importance of this became clear in 2008. From a FoHF's perspective, the use of managed accounts provides liquidity and transparency. Where it is feasible and practical, managed accounts might be the only acceptable structure for FoHFs in the future. It may no longer be acceptable for underlying hedge fund managers trading in liquid instruments to refuse a managed account.

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Bob Park, FINCAD

Building and maintaining investor confidence is mission critical. Funds with investment management infrastructure that include a robust risk management governance framework are poised to recover faster than those without. At the heart of this is the need for better transparency in derivatives valuations and stronger internal risk, compliance and audit functions for early detection of errors. Robust and timely models that provide risk measurement with greater transparency into the methodologies and assumptions used to calculate the value of derivatives are needed to improve accuracy in valuations, stress testing, and scenario analysis. Coinciding with this will be a greater emphasis on multiple independent valuations and verification. Hedge funds not equipped with the in-house resources to conduct these independent valuations should be looking to third-party solution providers to obtain unbiased pricing or benchmarking of their financial instruments.

Robin Johnson, Eversheds

The answer is simple: transparency and disclosure. It is vital that hedge funds do not get regulated out of existence or become so restricted in their activities that regulation in effect distorts the market. Hedge funds have an important place within the financial community but the bad apples have had a disproportionate effect on the positive contribution that the hedge fund industry is making to the markets. Hedge funds have got to accept that transparency and disclosure will mitigate the need for regulation. While some funds argue their investors do not require more disclosure and transparency, the truth is the investors are no longer the key people to satisfy. Regulators' focus on hedge funds is unprecedented; there is also greater focus on the investors and whether they have conflicts of interests or fully understand the products and investments the funds are making. Increased pressure on fund managers from their ultimate investors to understand activities fully requires hedge funds to make a bigger breadth of disclosure and transparency.

Christopher Jones, Mishcon de Reya

The most important lesson to be learned is to carefully think through your structure when launching a fund. For instance, do not offer monthly redemptions if you are investing in potentially illiquid assets. You have to look at the worst-case scenario and then structure accordingly. It is a matter of risk assessment. Make sure your drafting to cover redemption suspensions and gates works. Do not always go for the cheap and easy option of having administrator-nominated "professional" directors on your fund or feeder board; they may be less robust and more likely to think about short-term interests and minimising risk for themselves if a crisis hits. Try and set up with more than one prime broker; this strengthens your negotiating position on important issues such as rehypothecation and reduces counterparty insolvency risk. If a scenario seems so unlikely it is not worth assessing, think again. Another main lesson is the unthinkable does happen, so you need to have a plan for it.

Thomas Weber, LGT Capital Partners

The crisis showed that in times of credit crunches the ability to leverage one's balance sheet by using assets to gain additional finance disappears very quickly. There is no doubt the risks associated with such leverage were underestimated by many managers who were then forced to reduce the size of their balance sheets at the behest of their bankers at highly inopportune times when markets were at their most volatile. This can be further illustrated by what happened in Asia where capital markets were weaker and more volatile than in the west yet, because most hedge fund managers employed less leverage than their western counterparts, far fewer funds failed to survive and drawdowns were, in general, more sober. Therefore, the most important lesson learned was not to rely on cheap securities finance opportunities as a way of enhancing returns. However, that is the same lesson that should have been learned in previous credit crises (such as 1994 and 1998), so one must hope that it has been heeded more strongly this time.

Colin Berthoud, youDeviser

One of the biggest lessons that hedge funds can learn from the financial crisis is to stay flexible and seek a wide variety of advice. Determining which investments will perform well has proven to be an even more difficult task than ever. Very few managers were successful at making big, instinctive bets on their own. However, most of the hedge funds that use resources for idea generation beat their regional indices last year. Being able to pull your next investment from a wide variety of idea contributors provides hedge funds the flexibility they need to profit in a volatile market. This strategy works well because unlike traditional sell-side research, ideas are based on how the market is likely to value a stock near term - not a year from now. The average life span of a trade idea is 23 days. As the market continues to challenge the keenest of hedge funds, a need always arises for good investment advice. Paying for performance serves as a powerful tool for hedge funds, encouraging their brokers to develop ideas that work in the hunt for alpha.

Ken Heinz, Hedge Fund Research

The most important lesson is the benefits of structural transparency. Transparency, like regulation, will not protect investors from market losses. But with its broad expansion and wider acceptance through separately managed accounts which use independent third-party security pricing, independent risk monitoring and analytics and service providers that satisfy certain threshold credibility requirements, structural risks are greatly mitigated. This does not alleviate the risks associated with real asset price fluctuation but provides some assurance that performance will be a function of the risks that investors have chosen to take and not a function of risks of which they are unaware. Mitigation of systemic risk in financial markets has a number of pillars which merit consideration, but through the financial crisis and industry consolidation over the last two years, transparency has become the institutional standard for hedge fund investment and the industry has evolved to better serve investors in the next stage of growth.

Graham Miller, Marketcetera

As the new market takes shape, hedge funds will no longer have the luxury of investing heavily in inflexible proprietary systems, nor will they have the time or resources to build custom trading platforms themselves. Scalability and efficiency are paramount and companies should look for flexible, manageable solutions that do not swallow internal resources with maintenance, integration and implementation headaches. They should focus on finding other ways to do business like open source and hosted solutions to help manage costs and improve control in this new and heavily regulated environment. With fewer resources both in human and non-human capital, trading platforms should free up internal resources and enable traders to focus on trading strategies, not business logistics. The biggest lesson to learn is to shift the focus from proprietary IT infrastructure spending and look towards open solutions and other technologies that minimise impact on IT staff and budgets and provide competitive advantage and a better return on investment.

Peter Heaps, Carne Global Financial Services (Cayman)

Proper oversight, transparency, liquidity management, independence and a robust infrastructure are key aspects that hedge funds need to incorporate. In other words, 'good corporate governance'. All hedge funds should adopt these principles. One need only look at regulated investment funds, such as the EU Ucits III, to see what management principles are inherent in those funds. As a matter of regulation, there is responsibility and accountability for decision making, investment performance, compliance, risk, financial control, capital, internal audit and supervision of delegates. These principles are prescribed in the interests of investor protection. Those persons with the responsibility for acting in investors' best interests, typically a hedge fund's directors, should take these matters into account in conducting their management oversight and discharging their fiduciary responsibilities. Investors need reassurance that a fund will do exactly what it says on the tin.