Operational Risks at Hedge Funds: Caveat Emptor!

Hedge Fund Manager Evaluation in a Climate of Fear, Volatility, Uncertainty and Doubt.

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The credit crisis, high-profile fund closures/failures, unprecedented volatility and persistent economic uncertainty have done little to diminish the appeal of alternative investing. In fact, such events have increased the desire as well as need of some investors to adjust asset allocation strategies to include the most accomplished and talented alternative investment funds and managers.

With the proposed lifting of hedge fund advertising and solicitation restrictions via the JOBS act, existing and new investors as well as intermediaries may be inundated by new marketing approaches and literature replete with promises of supplemental wealth creation and protection, uncorrelated returns, low volatility and the diversification benefits offered by hedge fund investing. However, successful participation in the complicated and opaque alternative investing world is significantly more difficult than the traditional investment options. The sources of "alpha" can keep an investor or consultant in a constantly steep learning curve, which can significantly challenge the most experienced investor or investment professional. Separating myth from reality, the outstanding from the mediocre, and the ethical from the fraudulent is a mandatory but difficult task. Investors and intermediaries need to keep in mind that exceptional absolute returns often come with substantially increased strategy complexity and less transparency i.e. greater operational risk: the risk of underperformance or loss resulting from inadequate or failed internal processes, people or systems.

Investors embrace investment risk but process (operational risk) must be avoided. Investors must identify continuity and consistency in the operational environment. Therefore, a "thorough" operational risk assessment prior to any decision to invest in a fund and continual monitoring after the investment is made are compulsory. Such activity is reflective of an institutional-caliber due diligence process and a fundamental component of a sound and intelligent investing strategy.

When investing, there is a tendency to focus on quantitative components when determining manager selection. Subsequently, a significant degree of attention and resources become directed toward analysis of investment strategy, models that drive investment decisions, historical returns and other "familiar" metrics such as volatility. However, in hedge fund investing, qualitative issues and the process of executing strategy and decisions have far greater impact on return realization and business performance. Research demonstrates that 'alpha slippage' (underperformance or performance drag) and catastrophic events such as fraud or fund failures tend to result from operational issues. As such, an integral component of manager evaluation should focus on obtaining a deep understanding of fund culture, the execution process/blueprint and operational infrastructure, including key service providers such as prime brokers and independent administrators.

While greater transparency and understanding of cash and collateral management, liquidity, fees, portfolio financing and pricing as well as other critical areas are mandatory, a simple, "check the box" documentation review (candidly, a surprising number of funds don't have a properly-documented and staffed specialized operational risk management function) is insufficient. Investors must see evidence that a fund not only adheres to documented process and procedures but does so consistently. The ability to report, verify and replicate performance instills confidence that profits, performance and net-asset-value (NAV) have integrity. Success therefore requires experienced human resources and robust technological capabilities, internally as well as externally (the use of independent administrators and 3rd party pricing services has markedly increased. Evaluating the resource capabilities of service partners is important, as the "right" partners can enhance the profile and attractiveness of the fund). The sophistication of trading techniques and infrastructures required to support a hedge fund require extensive, specific experience, intimate familiarity with the inner workings of such funds and the strategies they employ to appropriately assess operational risk.

What is a "thorough" operational risk assessment process?

A "thorough" operational risk assessment rigorously analyzes enterprise-wide processes. However, there are limits. Furthermore, in a climate of unprecedented volatility, tail risk events are more likely and history doesn't necessarily repeat itself the same. Some risks cannot be eliminated - only identified, managed and mitigated. But if there are no provisions for the identification, management and mitigation of operational risk, lax internal fund management and broad investment mandates in combination with inappropriate or inexperienced operational assessment only serves to increase the possibilities for unfavorable outcomes. When contemplating an allocation to a hedge fund, the 'devil is **ALWAYS** in the details'. Among the numerous issues to consider

➢**Behavior, Integrity and Commitment**. The actions of employees should support the greater good of all stakeholders. Whether someone's behavior is illegal, unethical, self-serving, or contrary to a fund's policy and whether the internal climate exists to prevent such activity is crucial. Background checks that identify educational and behavioral characteristics that correlate with success as defined by the fund prospectus is essential. This means a separate risk management function; a budget commensurate with the fund's risks; documented policies, procedures, and controls; appropriate fund governance; and consequences for improvisational or inappropriate behavior. The walk and the talk must be in sync. Senior managers must respect controls and all employees must feel empowered to support operational risk management.

➢**Standards and Empowerment**. The standards for managing and controlling the fund must be explicit, easy to understand, and transparent. Employees know the risks and, in some cases, create them. Involving them directly in risk management is more efficient and employees should be encouraged to identify, address, and comment on the fund's operational risks.

➢**Metrics and Benchmarks**. Should be timely, actionable, accurate, and transparent to all. In the right environment, having information available to all employees can reduce losses. Procedures should reflect best practices. These must include written policies and guidelines, valuation policies, compliance monitoring, regulatory reporting, review of external and internal risks, control self-assessment, process controls, internal and external audits, identification of process versus policy gaps, and exception reporting.

➢**Process flows, Gaps and Exceptions**.. There must be a step-by-step definition of how the operating environment works from the point of view of both the client and the fund. This becomes the basis of an audit. Process flows also can help identify individual or serially untoward events and identify policy gaps. They should start with existing conditions, not ideal ones, and identify risks as well as opportunities. Gaps should be prioritized, and a plan should be developed to address them. The key is to balance risks with rewards and to select important events and controls. Every risk doesn't have the same weight. As such, not every policy variance has the same importance or can be addressed instantly. There should be a clear, practical procedure for granting exceptions.

➢**Controls and Documentation**. Operational risk drivers change over time. Therefore, a defined, dynamic process should be in place that keeps policies relevant as well as documented and supported by a philosophy and strong governance process.

What are the time and economic costs of a "thorough" operational risk assessment process?

Area of Review	Time (Hours/Days)
Technology	24 Hours / 3 Days
Front Office	16 Hours / 2 Days
Risk Reporting and Controls	32 Hours / 4 days
Operations	40 Hours / 5 Days
Legal	24 Hours / 3 Days
Documentation and Validation	48 Hours / 6 Days
	TOTAL: 184 Hours / 23 Days[1]

1 Generally, it requires a 5-peson team to perform a thorough operational risk assessment. This does not take into consideration initial investigation, documentation of findings, discussion and validation with the fund representatives and final documentation of a full report as well as travel time/expense. The cost per operational risk assessment engagement is approximately $193,200, which does not include the expense of continual monitoring required post-allocation.

When restated for investment size, the cost expressed in basis points highlights a critical issue for investors.

Size of Investment	Cost of Operational Risk Assessment in Basis Points
$50 million	39 bps
$100 million	19 bps
$250 million	8 bps

Summary

Comprehensive operational risk assessment of a hedge fund prior to investing and continual enterprise-wide monitoring after an allocation is made are fundamental components in achieving consistent, exceptional uncorrelated returns as well as enabling investors to meet fiduciary and governance responsibilities.

About The Author: Bryan K. Johnson is Founder and managing partner of Austin,Tx-based consultancy Johnson & Company, which provides alternative investment consulting services to institutional and private wealth investors, consultants and alternative asset managers. Bryan has 20+ years experience within alternative investments. Previous to launching Johnson & Company, he served as Global Head of Marketing and Business Development for the Alternative Investment Group at Moody's Investors Service (MIS), responsible for the deployment of Operational Quality (OQ) Ratings For Hedge Funds. Prior to his tenure with Moody's, he served as chief expert witness for The Attorney General of Texas and The State of Texas in the evaluation of hedge funds and private equity firms as acquirors of the assets of Texas Genco in the multi-billion dollar true-up of Centerpoint Energy (CNP:NYSE)

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