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ALTERNATIVE INVESTMENTS

Risk Management for Hedge Funds: Introduction and Overview

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Abstra

Althoug ... ng for more than twc ... e analysis, beta, an ... -fund investm ... ment for hedge fu ... earities— and ... nd manag ... set of risk analytics ... e goal of creating ... hedge-fund investm

Despite ... instabilities of hedge ... grow at a rapid pace. Lured by the prospect of double- and triple-digit returns and an

unprecedented bull market, investors have committed nearly $500 billion in assets to alternative investments, and major institutional investors such as the trend-setting California Public Employees Retirement System are starting to take an interest in this emerging asset class. However, many institutional investors are not yet convinced that “alternative investments” is a distinct asset class, i.e., a collection of investments with a reasonably homogeneous set of characteristics that are stable over time. Unlike equities, fixed-income instruments, and real estate—asset classes each defined by a common set of legal, institutional, and statistical properties—“alternative investments” is a mongrel category that includes private equity, risk arbitrage, commodity futures, convertible bond arbitrage, emerging market equities, statistical arbitrage, foreign currency speculation, and many other strategies, securities, and styles. Therefore, the need for a set of risk management protocols specifically designed for hedge-fund investments has never been more pressing.

Part of the gap between institutional investors and hedge-fund managers is the very different perspectives that these two groups have on the investment process. The typical manager's perspective can be characterized by the following statements:

- The manager is the best judge of the appropriate risk/reward trade-off of the portfolio and should be given broad discretion for making investment decisions.

- Trading strategies are highly proprietary and, therefore, must be jealously guarded lest th

- Return

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- Regula ... rformance; the wh

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- Institutions must fully understand the risk exposures of each manager and, on occasion, may have to circumscribe a manager's strategies to be consistent with the institution's investment objectives.

- Performance is not measured solely by return, but also includes other factors, such as risk, tracking error relative to a benchmark, and peer-group comparisons.

- Risk management and risk transparency are essential.

- Institutions operate in a highly regulated environment and must comply with a number of federal and state laws governing the rights, responsibilities, and liabilities of pension plan sponsors and other fiduciaries.

- Institutions desire structure, stability, and consistency in a well-defined investment process that is institutionalized and not dependent on any single individual.

While there are, of course, exceptions to these two sets of views, they do represent the essence of the gap between hedge-fund managers and institutional investors. However, despite these differences, hedge-fund managers and institutional investors clearly have much to gain from a better understanding of each other's perspectives, and they do share the common goal of generating superior investment performance for their clients.

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