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ALTERNATIVE INVESTMENTS

# Risk Management for Hedge Funds: Introduction and Overview

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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 they be lost to competitors.
  - Return is the primary objective.
  - Risk management is secondary to return.
  - Regulatory compliance is a necessary evil that detracts from performance; the whole should be greater than the sum of its parts.
  - The hedge fund 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.
- Contrast this with the perspective of the institutional investor:
- As fiduciaries, institutional investors have a duty to act in the best interests of their commensurate beneficiaries.
  - Institutional investors are subject to a higher degree of oversight, 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.

In this article, I hope to contribute to the dialogue between hedge-fund managers and

institutional investors. I will discuss the challenges of risk management and risk transparency as part of the investment process, and how existing risk management practices and hedge-fund tools can be used to address these challenges. I will also discuss the importance of risk management and risk transparency in the context of the current regulatory environment, and how these factors can be used to improve the performance of hedge-fund investments. I will conclude with some thoughts on the future of risk management and risk transparency in the hedge-fund industry.



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