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3 Things Many Hedge Funds Don't Understand About Risk Management

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(Excerpted from comments Sam Won made speaking at HedgeWorld's 2011 Fall Fund Services Conference on Oct. 26.)

Too often there is a significant gap between what some hedge fund managers believe to be risk management and what sophisticated, risk management-focused institutional investors know to be so. A hedge fund can quickly move from an investor's inbox to the trash when the fund exposes its misunderstanding of some principles of risk management. Here are three examples of mistakes to avoid.

Knowing what your market exposure is (e.g., long, short, gross and net) does not mean that you know what your risk exposure is.
Just because you track the market value of your portfolio (e.g., price times quantity), does not mean that you know what the market risks are in that portfolio. For example, suppose there are two positions that you are long in your portfolio: $1mm of exposure to Alcoa and the same exposure to Pfizer. Although from a market value perspective both positions are identical, they do not have the same market risk. For one thing, Alcoa's recent volatility was almost twice that of Pfizer's. So, the Alcoa position would be significantly more "risky" just on a volatility basis.

Most portfolio managers would probably agree that the risk profiles of these two positions are not the same yet when they manage their overall portfolios they assume that it is sufficient to know their long, short, gross and/or net exposure (e.g., market value) to understand and manage the market risk of their portfolios.

Here's another example. Some fund managers claim they manage their risks by increasing or decreasing the gross and/or net exposure levels of their portfolio. What's wrong with this picture? First, they mistakenly assume their long and short exposures naturally offset each other and that market risk can be managed simply by modulating gross or net exposure. Second, this approach doesn't address what is driving the market risks of the portfolio (e.g., volatility, momentum, etc.); it's only a belated, reactive response to the portfolio's current market price level. Third, in times of high volatility we have seen many managers give up upwards of 5% in friction costs trying to cut risk after the markets already moved against them. You cannot predict or control the market price movements of a portfolio. So, it is a futile exercise for a fund manager to try to manage market risk by merely tracking and trying to adjust the exposure level of a portfolio.

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Market risks are not linear.
Many risks in a portfolio can have either explicit or imbedded optionality. In times of crisis or in stressed markets most investment portfolios' performance and risks do not behave in a linear fashion. This is why the losses and/or gains in many fund managers' portfolios have recently moved in non-linear ways and have been far greater than expected or estimated. This year we have all read about a number of marquee name managers who racked up considerable losses because the non-linear risks in their portfolios when combined with leverage created a deadly combination that put them in positions where they are now down in many cases over 40% on a year to date basis.

Correlations are not either "0" or "1".
How often have we heard many knowledgeable market analysts and fund managers make pronouncements that correlations are moving to "1"? This flawed notion assumes that markets behave in almost a binary fashion. It also incorrectly assumes that the correlation values that lie between "0" and "1" are somehow less important or not important. In reality, correlations values can be between -1 and +1 and, especially in volatile markets, there are many values between these two numbers that can adversely affect a portfolio.

It is crucial for fund managers to understand what the current correlations are in the portfolio as well as what happens to risk and performance when the correlations in that portfolio are stressed.

For example, we encountered a fund manager who did not realize how closely correlated his fund was to the Russell 2000 Index. We wanted to say to him "Dude, your investors are not going to pay you two and twenty for glorified beta." In addition, our analysis revealed that he had put much of the portfolio on a one-way bet on economic recovery and so he did not realize the extent to which the performance of his portfolio was so closely correlated to cyclical sector stocks.

We have had a number of institutional investors tell us that one of their chief concerns is whether their managers are delivering true beta. For that reason, nearly all of the institutional investors we are aware of evaluate their managers' performance on a regular basis to check whether they correlate to any of the major benchmark market indices. In addition, we are finding that more investors are also looking to determine whether their fund managers are able to fully evaluate and track the correlations within their portfolios they manage.

After 2008, investors are keenly aware that an integral part of whether a fund manager understands his risks can be determined by whether he knows what his correlations are in his portfolio.

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