

How to avoid hedge funds' risk

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Publication: The Toronto Star

As an investor, how can you avoid the next Amaranth?

As more and more individuals invest directly in hedge funds or through packages called funds of funds, it's essential to police risk since the U.S. Securities and Exchange Commission offers little oversight. A U.S. appeals court recently voided the right of the U.S. Securities and Exchange Commission to register funds and check their books.

Amaranth Advisors LLC, based in Greenwich, Conn., lost \$6 billion (U.S.) in a wrong bet on natural-gas prices last month and is liquidating. The aftershock of that trading debacle goes far beyond the industry. The San Diego County pension fund, for example, invested \$175 million in the fund and lost an estimated \$45 million. It was one of the most high-profile hedge-fund meltdowns in recent times.

The industry's opacity has often frustrated regulators and big investors. Even private watchdogs may not be able to spot the next wreck. Robert Krause, chief risk officer of Event Capital Markets LLC () inspected Amaranth's risk management for investors three years ago.

"We found their process to be very robust with very good diversification and risk controls," Krause said in an email message. "Apparently some time afterward the managers felt they could not generate the returns they desired and decided to concentrate positions. If true, this increased the risk to the fund."

Like most of the 8,000-plus funds in the \$1.2 trillion industry, as a partnership, Amaranth wasn't required to report holdings like a retail mutual fund, which is guided by stringent U.S. federal laws.

Some large hedge funds are diligent in policing risk, but most managers have small workforces and focus on trading, so there isn't a lot of internal monitoring.

How good is the industry at regulating itself? There's no way to tell for sure, although it's certainly not as rigorous as banking or mutual funds.

In the Managed Funds Association's "Sound Practices for Hedge Fund Managers," for example, only nine pages of the 150-page document were devoted to risk management last year. The Washington-based group is the main trade organization for the industry.

Granted, getting a real-time picture of portfolio risk is like trying to get a clear photograph of a moving freight train. It is impossible for any regulator to effectively oversee complex, difficult-to-value holdings.

Amaranth was registered as a commodity-pool operator with the Commodity Futures Trading Commission and told the SEC in a letter dated Sept. 11, 2004, that it "devotes significant resources to regulatory compliance."

In the same missive opposing the SEC's planned hedge-fund rule, Amaranth's general counsel, Karl Wachter, noted "Amaranth does not 'operate in the shadows' outside of regulatory scrutiny."

There are plenty of dark corners to the industry, yet how do you spot a risky portfolio before it's too late? Susan Mangiero, managing member of BVA LLC in Trumbull, Conn., sees risk management as an essential part of the investment process.

"Investment risk management shouldn't be a stand-alone activity," Mangiero says. "It should be part of the entire process. Valuation is another important element."

How do you know if your portfolio or hedge-fund manager is taking too much risk? Unless you are an expert, you will need to hire someone to scout and monitor funds, or funds of funds. Here is a list of things to do and questions to ask:

Investment managers should find a due-diligence consultant. If independent - they work only for you and don't earn a commission from funds - they will be able to scour offering statements and other documents to identify problem areas. Don't expect them to be able to monitor portfolio risks on an ongoing basis, though. Hedge funds aren't required to do timely reporting of portfolio positions.

Assess liquidity, operations, credit and market risk. Can you get your money out quickly? Many funds require an initial "lock-up" period that prevents easy redemption.

How much leverage, or borrowed money, is the portfolio using? Are the major positions hedged by derivatives or securities that are negatively correlated or move in the opposite direction? Do the funds you're considering have "side pockets" containing highly illiquid or hard-to-value investments?

What's their risk-management policy? Do they have a chief risk officer? Request independently audited financial statements and ask them to outline what would happen to their portfolio in a worst-case scenario.

The larger hedge funds and consultants have modelling software that can show you the downside of a particular portfolio. Even with a risk sleuth and software, the complexity of some holdings makes it hard to spot trouble areas.

Eric Siegel, managing director of an \$11 billion fund of hedge funds for Mesriow Financial Holdings Inc.'s Advanced Strategies unit in Chicago, told me that half of his staff of 62 is focused on research and does extensive due diligence with fund managers and executives. I asked him which type of risk stands out when he's vetting a fund.

"The biggest risk to us is the one we fail to identify," Siegel said.

Predicting the next hedge-fund blowup is like forecasting the next devastating hurricane. You don't know when it will occur, but you may know where storms are likely to strike. Although it's all a dicey matter of probabilities, it helps immensely if someone can give you some odds.

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