



Assuaging Investor Fears Through Better Risk Management Practices

Quality Risk Management & Operations (QRMO) Limited

Investors Pressure Funds to Improve Risk Management

Over the past five years of relatively benign markets, it seems Asian hedge funds have been lulled into a false sense of security where the perceived need to have risk management practices on par with global standards is alarmingly low. However, the current credit crisis is bound to change this precarious perception. As the finance industry continues to cope with the widespread fallout from the US subprime mortgage debacle, investors – especially large institutional investors – are becoming increasingly concerned about their fiduciaries having proper risk management infrastructures in place, and rightly so. In fact, as funds in the Americas and Europe continue to face mounting pressure from investors to conduct and demonstrate better risk management, it is inevitable that Asian funds will be expected to follow the same path as their global counterparts, especially as large overseas institutional investors look to allocate more capital to Asian alternative investments. In this regard, Asian funds should not view risk management as a cost, but should see this trend as an opportunity to increase their marketability to investors and to obtain a clearer picture of their risk/return profiles. Whether Asian funds realise it or not, the days of working solely off of spreadsheets and putting together a skeleton staff are quickly coming to an end.

Better Risk Management Means More than Adopting Sophisticated Software

Importantly, having a solid infrastructure entails more than just upgrading spreadsheets to more robust risk management software platforms. In fact, it's about having the right people to understand how to maximise such platforms, ensure proper risk mitigants are in place and to interpret risk measurements meaningfully and report them effectively to the fund manager and investors. Without highly skilled risk managers, risk software is rendered useless, ie the two are inextricably linked.

A Matter of Cost and Availability

Although most Asian hedge funds are realising the need for better risk systems and risk experts in order to achieve "best practice" standards, obtaining them tends to be prohibitively expensive. For instance, hiring a senior risk expert and implementing superior risk software can cost US\$300,000-500,000 per annum – an extremely hefty expense for many of the smaller Asian funds below US\$50 million AUM, which represent a large portion of the Asian hedge fund universe. Compounding the problem is the fact that risk experts are extremely scarce in the finance industry. Fortunately, there have been advances among several pioneering service providers – QRMO being one of them – to address these issues.

Independence and Transparency Are the Keys to Addressing Operational Risk

Another widely overlooked issue is the independence and transparency of the risk management function. Many studies cite operational risk as the greatest risk facing hedge funds. This is true to a degree, but operational risk is a rather broad term. Unfortunately, many people seem to equate system failure with operational risk. While this is not wrong, it is not entirely correct. For example, software vendors will claim operational risks will be minimised if you have good systems in place. Again, this is true but having good systems is only half the equation. The other half is the human element, ie the people within the fund actually using the system. First, people need to be trained as experts of the system.

Although entirely possible, it both time consuming and costly. However, the more prickly and insidious issue not being seriously addressed is the lack of independence and transparency. For instance, take many of the widely publicised collapses of large hedge funds over the past few years. Given their size and resources, it is safe to assume that they were using sophisticated risk management software. However, did simply having such software in place effectively minimise risk? In retrospect, it does not seem so. Even if good software systems were in place and were able to aptly measure the market and credit risks facing such funds, how was risk taking allowed to reach such frighteningly high levels? A more pointed question to ask is where were the risk managers in these situations? Perhaps they did not have enough clout to voice out their concerns or maybe they knowingly fostered inappropriate risk taking because higher returns meant fatter bonuses. The point here is that without independence and transparency and proper checks and balances,



internal risk systems and risk experts – no matter how good they are – will never address the human element of operational risk fully.

Keeping Up with Due Diligence

The best way for an investor to assess whether a fund's risk management function is transparent and independent of the investing function is through continuous due diligence. As such, in the current market environment Asian funds should prepare for an increased level of due diligence. Those that do will attract larger pools of capital and those that do not will simply fall behind. Investors will request to see if the fund has sound compliance, operations and risk management procedures in place that are aligned with "best practice" standards and that such procedures are well defined and documented. An immediate red flag is raised if a fund is missing such procedures or is unable to produce necessary supporting documentation, especially in a timely manner. The less a fund is willing to divulge the more suspicious investors will be. Audit trails play a significant role and will be thoroughly investigated on an ongoing basis. Funds should expect sophisticated investors to communicate with a fund's service providers, requesting reports as necessary in order to cross-check against a fund's internal reports.