

A game of risk for macho men

By **Simon Osborne** | 27 March 2009

The co-founders of hedge fund risk management service provider QRMO take a look at the world of risk.

What is risk?

Answer: If risk can be likened to a rugby game (and I think it can), then "market risk" would be illustrated by the fact that Hong Kong Sevens tickets for this weekend's event are selling at half the price of tickets in 2008. "Credit risk" is the possibility that whoever promises to buy them from you declines to pay when he can find them cheaper elsewhere.

Now that the markets have gone back up, perhaps we can all forget about risk. But it's a game of two halves, and a second half slump cannot be ruled out. We asked Albert Chiu and Angus Hung, who are also the co-founders of Hong Kong risk management practice QRMO what they were seeing in the world of risk.

What new trends are you seeing developing with risk management due to the credit crisis?

Chiu: Prior to the current market downturn, fund managers were able to ignore investor requests for greater transparency in risk management practices and limited the information available to third parties. But now, increased regulation, scrutiny and transparency are on the horizon for the hedge fund industry. Investors and regulators are demanding improvements in governance and risk management frameworks.

This would include proper corporate governance, such as a board with both executive and non-executive directors. Senior executives and the risk manager need to independently report to the Board to provide a balance.

Independent and transparent risk reporting -- investors directly accessing reports at any frequency they want and obtaining comments on the risk profile of the funds. Also the maintenance of proper segregation of duties in the control functions.

Also, the risk manager ought to have the ability to enforce actions on stop loss breaches such as directly closing out positions which are in breach of hard limits. *(Reporter: if a credit analyst/risk manager has ever elbowed aside a trader and directly closed out a position in an investment bank or hedge fund, I will eat my hat).*

Hung: The credit crisis has caused different impacts throughout the financial industry. For financial institutions, the capital requirement on derivative holdings will be dramatically increased and that will go hand-in-hand with more advanced measurement on risks. Especially on capital adequacy stress tests.

For the hedge fund industry, most of the market and credit risks are still controlled and monitored by the fund manager. But the collapse of many prominent hedge funds due to poor performance or frauds like Madoff's also show

that operational risk is a very real issue that needs to be addressed adequately.

Undoubtedly, the tightening of controls and increased demands on transparency by the investor as well as the overall power and clout of investors will increase, particularly with respect to fee structures as well. Proper infrastructure and risk controls have now become the main trend in hedge fund risk management.

What new items are hedge funds asking from you in risk reports?

Chiu: There are quite a few. P&L attributions, P&L contributed by long and short strategies, Monte Carlo VaR with auto-regression, mean-reversion and jump diffusion processes, VAR back-testing.

Hung: Some investors are asking for more complicated measurements such as CaViaR or CHICAGO which try to capture the fat tail risk. Specific sensitivity analysis is sometimes requested by auditors. They're also asking for independent valuations on illiquid assets.

How have investor demands changed concerning risk management in hedge funds?

Chiu: As well as the points I've already mentioned, investors generally see there as being three lines of defences against various types of risks. The first line of defence is the hedge fund managers themselves as they dynamically manage risk every day -- they usually know best what risks are acceptable. The second line of defence is an independent, yet fully integrated, risk management and compliance function. The third line of defence is an internal audit or validation function to provide independent testing and verification

What advice on risk matters would you give to someone starting a hedge fund? Resist saying, 'hire us!'

Hung: Invest properly on the operational and system infrastructure which suits your strategy and the products you trade in. Stick to the risk limits you have set and be disciplined. Lastly, make sure you have considered key-man risk and staff-turnover risk.