Setting standards for hedge fund transparency

Pleas from hedge fund investors and counterparties for high-quality, independent pricing and risk data have prompted a new back- and middle-office support company called GlobeOp Financial Services, to add risk and pricing information to its offerings. Launched last November and based in New York and London, GlobeOp hopes the direct access to hedge funds' trading position and risk data it has now negotiated will give it an edge over other hedge fund performance monitoring firms.

GlobeOp's chief executive officer, Hans Hufschmid, says: "There has been tremendous demand for transparency from investors and credit departments at banks and brokers." GlobeOp recently signed a licensing agreement to provide Reuters' Kondor+ deal capture, position-keeping, portfolio valuation and risk measurement system on an application service provider (ASP) basis to its hedge fund clients and their investors and counterparties. It will also track and report on the funds' compliance with investment guidelines.

Because GlobeOp handles its clients' back-office services, the firm says this will make its net asset value (NAV) and risk reports more reliable – a marketing angle the firm hopes to exploit while memories of Long-Term Capital Management (LTCM) and the more recent Manhattan Investment Fund debacles weigh on the minds of potential hedge fund investors and lenders. "We want to develop GlobeOp as the industry seal of approval," Hufschmid says.

A handful of companies now maintain Web sites that provide investors with hedge fund performance information and news. These include New York-based Altvest and The Tuna Group, and Bermuda-based HedgeWorld. HedgeWorld's site gives subscribers access to the Tass+ database of hedge funds maintained by its part-owner, Tremont Advisors, and also provides a fund matching and crossing service via the Bermuda Stock Exchange.

But lack of access to the funds' actual portfolio data forces them to rely heavily on quarterly NAV reports, which are neither independent nor timely, and provide no way to estimate risk. In a departure from this, one New York-based company, PlusFunds, launched a site earlier this year that provides real-time NAV and risk data, along with the ability to trade hedge fund shares. The hedge funds that participate in PlusFunds provide their actual portfolio data to a system that generates NAV and risk measures via a partnership with rating agency Standard & Poor's.

Hans Hufschmid, GlobeOp: 'There has been tremendous demand for transparency'

However, despite assurances that position information is never revealed, it remains to be seen how many funds will feel comfortable handing PlusFunds – or GlobeOp – their portfolio data. Hufschmid says GlobeOp signed its first two (undisclosed) hedge fund clients in May, and expects another six by mid-summer.

GlobeOp officials say funds should be eager to take this step, as it will give investors and credit providers more confidence. Sophisticated plan sponsors such as the California Public Employees' Retirement System (CalPERS) now see hedge fund investments as part of their asset allocation schemes, but they want adequate data from their investment managers.

Meanwhile, Hufschmid argues that creditors, armed with better information, will be willing to improve their lending terms. Ira Rosenblum, a principal at GlobeOp in New York, says this may help lenders discriminate among funds when there is a high-profile meltdown – such as LTCM – rather than shutting off liquidity to the entire sector.

GlobeOp officials met with credit departments of major hedge fund counterparty banks and brokers in mid-May to develop a set of risk/return data that these institutions would find most useful. "We've worked with several broker-dealers to create standardised VAR measures, volatility analysis, stress testing and scenario analyses," Rosenblum says.

Survey

Some evidence of the timeliness of GlobeOp's initiative is provided by a recent survey of hedge funds' risk management and reporting practices.

The survey, which has been produced by New York-based consultants Capital Market Risk Advisers (CMRA), claims that most funds have not substantially increased their risk reporting – despite growing investor demand for risk information since the LTCM crisis. However, the majority of the funds who responded to the surveyed did say they calculate and use various risk measures – such as value-at-risk, liquidity risk measures and scenario testing – for internal reporting.

The CMRA survey (available at *www.cmra.com/html/hedge_fund.html*) polled roughly 30 hedge funds of various sizes, representing five styles: fund of funds, managed futures, risk arbitrage, long/short and macro. Although the sample size is very small, the survey highlights some interesting trends.

"In an environment which has treasured its confidentiality, the survey shows there is an increasing demand for information and increasing capabilities for providing this information to the market," says Richard Horwitz, vice-president at CMRA in New York.

About 30% of the hedge funds surveyed said their investors are asking for more reporting on concentration measures (by geography, asset type, industry type and strategy) than before LTCM. Between 20% and 30% of the funds said investors are requesting more liquidity measures (such as cash on hand and leverage ratios). Between 30% and 40% of the funds say investors are asking for more risk-adjusted performance and VAR measures.

Another 30% are asking for more leverage information, with almost 20% asking for "much more". The one area which hedge funds are most keen to protect – data on their actual holdings – is also under siege. Thirty-six per cent report that more investors are asking for position-level information than before LTCM.

However, despite this, CMRA says that the majority of funds have not increased their risk reporting since the LTCM crisis. Only 26% of those surveyed report VAR figures to investors, although more plan to begin reporting VAR this year, which should raise that figure to slightly over 40%. More than 80% of the funds provide risk ratios such as the Sharpe ratio. Just under 60% of the funds surveyed report leverage statistics, but it is thought that this will rise to 70% by the end of the year. ■

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