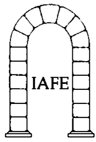

Investor Risk Committee

Hedge Fund Disclosure for Institutional Investors

IRC Committee Chairs

Maarten Nederlof (Deutsche Bank) and Tanya Styblo Beder (Caxton Corporation)

IRC Steering Group Members

Mark Anson (CalPERS), Bill McCauley (III Offshore Advisors), David Mordecai (AIG)

Introduction

The Investor Risk Committee (IRC) was launched by the IAFE in January, 2000. To date the IRC of the IAFE held two working sessions on the topic "What is the right level of disclosure by alternative asset managers?" Members of the IRC quickly focused the discussion on investments by institutional investors in hedge funds.

The IRC consists of individuals from hedge fund investment managers, herein referred to as "Managers" and from a variety of institutional investors including pension funds, endowments, foundations, insurance companies, fund of funds and others, herein referred to as "Investors". See Appendix A for a detailed listing of the IRC's participants to date.

The work of the IRC is timely - it is estimated that Investors now make up about 20% of all hedge fund assets and that this will continue to grow - Investors observe that hedge funds will aid in meeting liability and growth targets.

The result of the IRC's work is a set of findings that can be used by Investors and Managers to benchmark their practices relative to their peers. Remarkably, after very lively initial debate, members of the IRC reached consensus on a number of critical issues quickly. This document sets forth the IRC's findings. It is a starting point that the IRC hopes will enable greater participation by Investors in this rapidly growing area.

For purposes of this document, the IRC adopts the definition of a hedge fund used in "Sound Practices for Hedge Fund Managers"[1] published in April 1999: "a pooled investment vehicle that is privately organized, administered by a professional investment management firm … and not widely available to the public." As such, a wide variety of investment vehicles are included in this definition – small and large (in assets or staff), operating in one market or many, following a single, simple strategy or a combination of complex strategies, operating on-shore or off-shore under varying organizational structures, etc.

[1] This 80-page document may be down loaded from http://www.hfmsoundpractices.com/

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IRC Findings

1. Investors have three primary objectives in seeking disclosure from Managers:

   - Risk monitoring: ensuring that Managers are not taking on risks beyond represented levels in terms of allowable investments, exposures, leverage, etc.

   - Risk aggregation: ensuring the Investors' ability to aggregate risks across their entire investment program in order to understand portfolio level implications

   - Strategy drift monitoring: ensuring the Investors' ability to determine whether a Manager is adhering to the stated investment strategy or style

2. IRC Members agreed that full position disclosure by Managers does not always allow them to achieve their monitoring objectives, and may compromise a hedge fund's ability to execute its investment strategy.

   Despite the fact that many Investors receive full position disclosure for many of their investments, the 80 members of the IRC who have participated in the meetings to date were in agreement that full position disclosure by Managers is not the solution. Managers expressed significant concerns over the harm that full position disclosure could cause for many common hedge fund strategies (for example macro and risk arbitrage). Investors agreed they did not wish to force disclosure that would be adverse to the Manager, and therefore to their investment. In addition, many Investors expressed concern over the operational difficulties associated with processing such vast quantities of diverse data.

3. IRC Members agreed that the reporting of summary risk, return and position information can be sufficient as an alternative to full position disclosure. Such summary information should be evaluated on four dimensions: content, granularity, frequency, and delay.

   - Content: describes the quality and sufficiency of coverage of the Manager's activities. This dimension covers information about the risk, return and positions on an actual as well as on a stress-tested basis.

   - Granularity: describes the level of detail. Examples are NAV disclosure, disclosure of risk factors (APT [1], VAR[2], etc.), disclosure of tracking error or other risk and return measures at the portfolio level, by region, by asset class, by duration, by significant holdings, etc.

   - Frequency: describes how often the disclosure is made. High turnover trading strategies may require more frequent disclosure (for example, daily) than private or distressed-debt investment funds where monthly or quarterly disclosure is more appropriate.

   - Delay: describes how much of a lag occurs between when the fund is in a certain condition and when that fact is disclosed to Investors. A fund might agree to full or summary position disclosure, but only after the positions are no longer held.

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4. IRC Members agreed that usability of any alternative disclosure depends upon sufficient understanding of the definitions, calculation methodologies, assumptions and data employed by the Manager. This may be accomplished in a variety of fashions including discussions between Investors and Managers; by the Manager providing for adequate transparency of their process; or via independent verification.

5. IRC Members should benchmark their practices relative to their peers. IRC Members agreed that a major challenge to peer group performance and risk comparisons as well as aggregation across managers is the use of a variety of calculation methodologies, assumptions and data employed in the market place. IRC Members did not, however, feel that "one size fits all," and felt that multiple peer groups may be relevant depending on the nature of the Investor as well as the strategies employed by the Manager. Investors and Managers believe that an industry effort should be made to improve the ability to conduct comparisons across Managers as well as multi-Manager portfolio analysis.

6. IRC Members agreed that detailed reporting is not a substitute for initial and ongoing due diligence reviews, on-site visits and appropriate dialog between Investors and Managers.

7. IRC Members agreed that market, credit, leverage, liquidity and operational risks are interrelated. Accordingly, exposure to these risks in combination should be included in the dialog between Investors and Managers.

Conclusion

The IRC's goal is to provide the consensus of a substantial group of Managers and Investors regarding "What is the right level of disclosure by hedge funds?" The IRC invites all Managers, Investors and other interested parties to comment and assist this industry group in the evolution of this document. The IRC, through the International Association of Financial Engineers, plans additional forums on related topics and solicits your input regarding items of interest to you and the IRC's work during 2001. Topics suggested to date include:

1. Develop an industry consensus on a "generally accepted technique" for mapping position data into risk factors and/or methodologies for calculation of risk statistics.
2. Develop a questionnaire to be filled out by Managers that will generate a "scatter plot" of current practices.
3. Develop a questionnaire to be filled out by Investors that will address minimum standards for the evaluation of alternative asset managers.
4. Develop sample templates for disclosure within various strategy types, including sample methods for bucketing Managers into various strategy types and how to handle the "other" category of managers.

About the IAFE

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The IAFE is a global organization devoted to defining and fostering the profession of financial engineering. Collaboration and networking between academics and practitioners are major objectives of the IAFE. After spending almost a decade on its founding mission - to define and foster the emerging field of financial engineering - the Association turned its focus towards the established sectors of the field and another of the IAFE's missions – to promote informed exchanges among members to further understanding, share best practices and establish standards on pertinent aspects of technology, credit risk, the impact of wireless and e-commerce, legal, regulation, risk management, tax, and accounting. The work of the Credit Risk Management Committee is part of this mission.

Education is a major component of the IAFE's activities. The IAFE sponsors numerous sessions where new products, strategies, quantitative finance and technologies are discussed among practitioners and academics and where public policy issues are debated. The IAFE publishes the Journal of Derivatives which represents a merger with the IAFE's former publication the Journal of Financial Engineering. Past issues have carried articles by such luminaries as Nobel Laureates Harry Markowitz and the late Merton Miller.

Visit IAFE at www.iafe.org

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Leigh Williams	Fidelity
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Rudy Yaksick	Independent Financial Researcher

[1] APT refers to the Arbitrage Pricing Theory, but we consider any models that use a linear combination of risk factors that can be combined to explain the risk of a particular holding or portfolio of holdings.
[2] VAR refers to Value at Risk, a probabilistic statement about the estimated capital at risk of loss within a given confidence interval over a given period of time.

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