The Main Benefit of Hedge Fund Transparency is Transparency

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Since the Financial Crisis of 2008 hedge fund transparency has evolved from being a rarity to the norm. Having worked both for a FoHF where we required transparency from our managers as a condition of investment, to two transparency services (RiskMetrics HedgePlatform and now Vidrio), I have watched the evolution of this feature of hedge fund investing evolve firsthand.

There are many benefits to allocators who receive transparency. Transparency can be provided either directly through managed accounts, or indirectly through aggregators who receive the position files and show the effects of these holdings (exposure, risk description) but blind the position names to investors. Exposure decomposition, statistical and factor analysis from holdings, P&L analysis, and analysis of changes in portfolio composition over time all offer meaningful information to hedge fund allocators.

However, it is often overlooked that the main benefit transparency is the transparency process in and of itself.

Specifically, managers who offer transparency to investors are giving a form of proof that the money allocated to a fund by investors is, in fact, going into securities and not being fraudulently diverted into an illegal scheme. Certainly, a fraudulent manager might still find a way to siphon money away from a fund, but transparency makes this more difficult. A classic example would be Madoff's "split-strike collar" strategy. If anyone had transparency into this fund, they would have seen that there were no security holdings at all. Of course, a manager executing a Ponzi scheme probably wouldn't offer fund transparency. Which makes refusing to participate a red flag in and of itself.

For all the due diligence, trust, and monitoring that allocators perform when allocating money to hedge funds, the fact remains that due to the investment structures hedge fund vehicles use, allocators often have to rely on faith that the managers are acting in good faith and being honest stewards of the assets given to them to manage.

Managed Accounts overcome this concern as investors usually have full, daily or real time visibility into their holdings. But Managed accounts require either significant capital to compel the manager to create such an account or require additional fees when pooled managed accounts are created via a platform.

For traditional allocators to commingled hedge funds, transparency programs can help assure and verify that their assets are being used in a manner consistent with expectations.

Transparency programs generally work as follows:

- On behalf of a participating client, transparency services reach out to the hedge fund manager and request to receive a position file on a monthly basis.
- An NDA is put in place as well as guarantees for the safe and segregated handling of confidential holding information
- The preference is to receive the holdings file from the fund's administrator. This alleviates data aggregation and delivery work on the fund's staff, but also helps assure the full position file will be received without omissions and adds an additional point of verification that the securities are accurately depicted.
- Once the position file is sent to the transparency platform, the service provider organizes the file and enriches the positions with exposure attributes and additional terms and conditions needed for risk analysis
- The holdings file is prepared for risk processing and sent to a risk engine which will generate analytics such as value at risk, factor decomposition, scenario and stress tests, and other risk statistics
- Holdings are processed at the fund level but are also processed with other fund holdings to create portfolio (FOF) level analytics. They are also processed at different sub exposure intervals. This way a FOF operator can analyze their portfolio and trace sources of risk down to the fund level, and then further to which asset types, sectors, and geographies are driving risk concentrations
- Generally, the FOF will not see down to the security by name. Though this is possible if the hedge fund allows this degree of transparency.

Absent the availability of security holdings, an allocator can still perform risk analysis using the return profile of a fund. Though, this is a thinner input for risk analysis and, if the manager is falsifying returns, does nothing to alert an allocator to a fraud.

Essential to the risk analysis process is compiling the risk and exposure results into month over month time series graphs and tables. This style drift analysis can alert an allocator if a manager has departed from their stated strategy. This may be OK, but an allocator will want to know the rationale for the departure, and it may be a good time for a call or meeting with the fund if style drift is detected.

Another element to consider is liquidity alignment. With transparency, allocators can assess if the underlying holdings of a manager are matched to the fund terms. A

manager with many private holdings, real estate, or other illiquid positions may not be able to meet redemption demands if the fund structured with terms allowing monthly withdrawal notifications.

In all, transparency is a benefit to allocators with a fiduciary duty to ensure client monies are being responsibly handled. Above all, an allocators job is to be a good steward of client trust and assets. Avoiding fraud is job one, and holdings-based transparency is an essential tool in the due diligence process.

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