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Monitoring Managers:

How to Avoid Another Madoff

Rebuilding the confidence of the investor base continues to be one of the greatest challenges facing the hedge fund industry. Financial reregulation affects fund managers and institutional investors, providing the latter with ammunition to demand greater transparency alongside more onerous due diligence requirements. Poor industry performance has made it harder to rebuff increasing investor demands: As of the end of June 2010, the Credit Suisse/Tremont Investable Hedge Fund Index (now the Dow Jones Credit Suisse Blue Chip Hedge Fund Index) was down over 8 percent versus June 2008. Finally, high-profile cases of fraud, with Madoff perhaps the most far reaching, have also led to greater governance demands on investment firms.

REGULATORY TRENDS

While many fund distributors might hope that such regulated fund structures as UCITS (Undertakings for Collective Investment in Transferable Securities) would address retail investor concerns on hedge fund risk, results thus far have been mixed. To date, the UCITS market has been dominated by traditional asset management firms, whereas hedge funds have had less success developing their UCITS vehicles. This divergence in relative fortunes suggests that so far the structure, in and of itself, has not necessarily alleviated retail investor concern. A frequently cited example is the Brevan Howard Absolute Return Bond Plus Fund, which was restructured earlier this year, having failed to grow in spite of positive performance.

Institutional investors are also facing regulatory challenges now. Solvency II, due to be implemented in all EU member states by 31 October 2012, will dramatically alter the appeal of alternative assets, particularly for those firms unable to aggregate their investment risk. It is estimated that about 5 percent of hedge fund AUM (assets under management) are held by insurance and reinsurance firms.[1] Solvency II will require the investor base to either undertake detailed calculations of underlying market risk in its alternative assets, which will include hedge funds and private equity, or face significantly higher capital requirements. Understandably, this regulation is a source of considerable concern to the hedge fund industry as a whole.

MONITORING MANAGERS

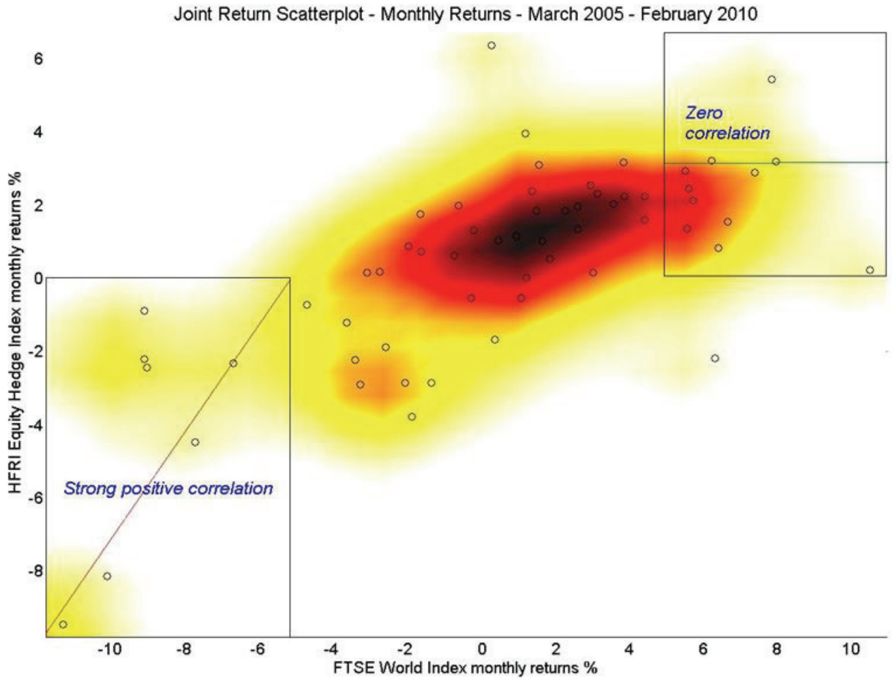
Although a major appeal of hedge funds is the opportunity to access a return stream that is less correlated with equity or fixed-income markets, the asset class is still affected by these underlying markets, as illustrated by the recent financial crisis.

Hedge fund managers are expected to execute a specific strategy, and for investors in multiple managers, it is critical that managers observe their mandates. In practice, their own prospectus seldom provides a binding legal requirement for them to do so. Consequently, monitoring ‘style drift’ serves as an objective first screen for flagging unexpected behaviour based on reported returns.

Multifactor models can successfully monitor most hedge fund strategies and managers using underlying asset market returns, thus providing investors with a basis for monitoring style drift and conducting single-manager and multi-manager stress-testing.

Figure 1. Relationship between HFRI Equity Hedge Index and FTSE World Index

This chart dispels the assumption that hedge funds are uncorrelated with underlying equity markets. When diversification is most critical—in times of equity market distress—hedge fund returns have been strongly correlated.



Source: Confiance Risk Monitor Limited.

The following table illustrates the relative success of such a model with various strategy indices. Eight out of ten strategy indices have statistically significant results, which represents over 88 percent of the aggregate index.

CASE STUDY: OPTIMAL MULTIADVISORS

Eighteen months after the event, the debate continues as to whether investors or their consultants could have, and should have, detected fraudulent behaviour with Madoff feeder funds. As a case study, we have chosen Optimal Multiadvisors' Optimal Strategic U.S. Equity Fund, one of several Madoff feeder funds. The same analysis could similarly apply to others, e.g., Fairfield Sentry.

A cursory view of the cumulative performance of the Optimal fund versus the Credit Suisse/Tremont Blue Chip Index Multi-Strategy Index suggests that this fund's returns, which of course we now know were fictitious, were unaffected by underlying market movements.

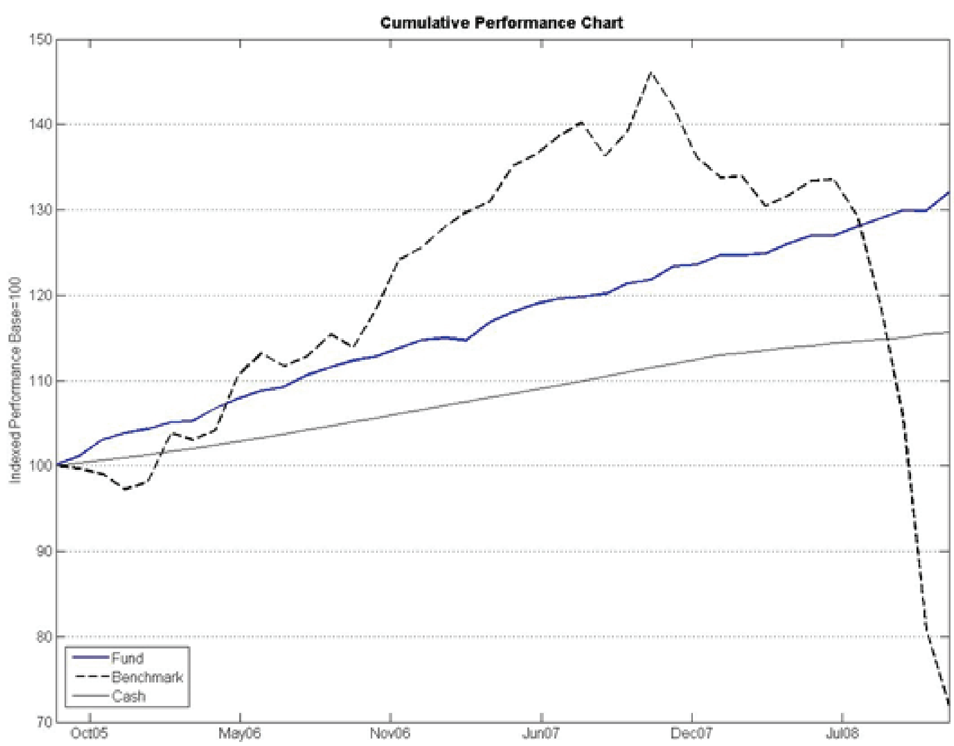
On closer inspection of the return series, it is apparent that some monthly returns were far more credible than others. Even though the fund's exposure (beta) to underlying equity, credit, and interest rate markets was much weaker than one would have expected given the strategy (split-strike conversion, long collar), there was one period during the fund's final eighteen months in which the reported return was so unanticipated, investor action could have been reasonably expected.

The model estimated an annualized alpha for the fund of about 8 percent per year and an expected monthly return for November 2007 of –0.22 percent. November was a month in which the prevailing market conditions for the strategy and the Optimal Strategic U.S. Equity Fund were markedly negative, with particularly weak U.S. equity markets and rising volatility. In spite of these factors, the fund returned a reported +1.28 percent, which represented a standard deviation error of greater than 3 for the model. In this instance, it would have been possible to assume that month's return was at least highly unusual. Flagging suspected manager style drift can, at a minimum, provide grounds for further enquiry and may be the catalyst to request full position-level transparency to independently assess fund market and liquidity risk. Of course, fraudulent activity can take place in an instant, and the best method to ensure compliance is full-blown, real-time transparency. Even returns-based analysis, however, can provide valuable and actionable information.

Table 1. Explanatory Power of Multi-Factor Model

Index Name	RSQ	Model Valid	Index Sector Weight
Credit Suisse/Tremont Blue Chip Index Convertible Arbitrage	45%	Accept	4%
Credit Suisse/Tremont Blue Chip Index Dedicated Short Bias	9	Reject	1
Credit Suisse/Tremont Blue Chip Index Emerging Markets	67	Accept	9
Credit Suisse/Tremont Blue Chip Index Equity Market Neutral	39	Accept	3
Credit Suisse/Tremont Blue Chip Index Event Driven	27	Accept	22
Credit Suisse/Tremont Blue Chip Index Fixed Income Arbitrage	48	Accept	1
Credit Suisse/Tremont Blue Chip Index Global Macro	23	Accept	19
Credit Suisse/Tremont Blue Chip Index Long/Short Equity	72	Accept	16
Credit Suisse/Tremont Blue Chip Index Managed Futures	5	Reject	11
Credit Suisse/Tremont Blue Chip Index Multi-Strategy	40	Accept	15
Total			100.00%

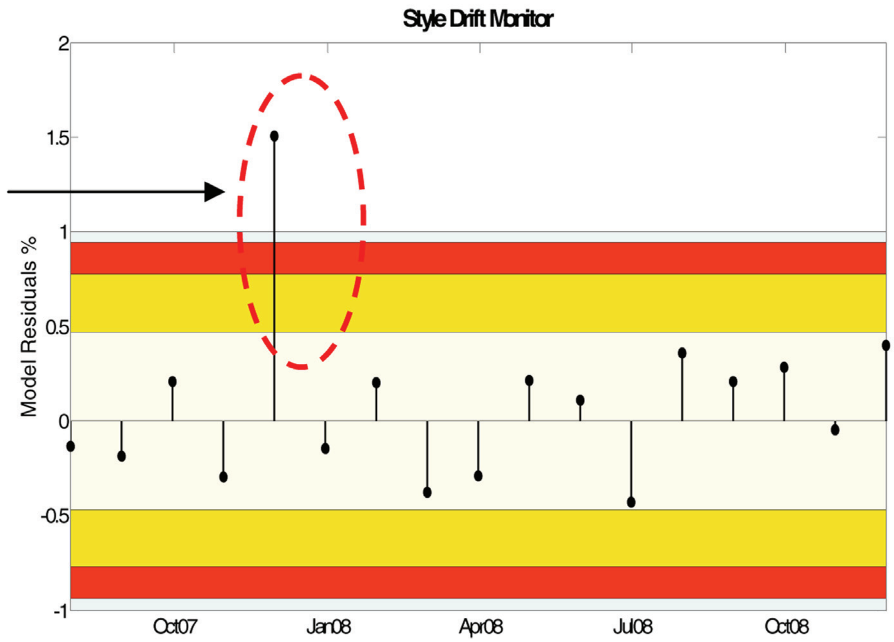
Figure 2. Cumulative Performance Chart: Optimal Multiadvisors' Optimal Strategic U.S. Equity Fund vs. Credit Suisse/Tremont Blue Chip Index Multi-Strategy Index



Source: Confiance Risk Monitor Limited.

Figure 3. Style Drift Monitor: Optimal Multiadvisors' Optimal Strategic U.S. Equity Fund

The area shaded yellow represents a greater than one standard deviation error. The area shaded red represents standard deviations between 1.6 and 2. Breaches outside of the red-shaded area are highly infrequent, let alone breaches of this magnitude.



Source: Confiance Risk Monitor Limited.

SUMMARY

Lack of due process facilitated the Madoff fraud, yet investors, armed with nothing other than reported returns, are able to build a framework to assess style drift and detect possible manager breaches. These are important consideration for the boards and directors of such feeder funds, as well as their insurers, in terms of demonstrating the appropriate level of oversight and governance. In the case of Madoff feeder funds, litigation is likely to continue for years, and even if the law does not change as a result, courts' interpretations as to reasonable governance may. In summary, the current climate of regulatory change, poor industry performance, and increased scrutiny means investors are likely to be much better armed for next time!

NOTES

1. Preqin Research, "Overview of the Global Hedge Fund Institutional Investor Universe: 2009," Preqin Research Report (December 2009).

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