To Our New Subscribers

Thank you to our new subscribers and welcome to the fourth issue of the ARM quarterly newsletter! We hope to make this publication valuable to you with several brief articles that provide unique insights, some ideas about how to address specific problems and introduce potential risks that may not yet be on your radar.

The primary authors are Dave Ingram and Max Rudolph. In this issue we return David Ensor as a guest author. We are all active participants in the risk management, actuarial, investment and insurance spaces, and have been for many years.

Subscribers can suggest topics for articles and ask questions of the authors during our follow-up webinars and discussion sessions. Ever cognizant of regulatory requirements, leveraging them to add value to your company in practical ways, will be our focus.

Published by Actuarial Risk Management (ARM), the Strategic and Risk Solutions for Executives (SRSE) subscription consists of two paid tiers. The newsletter is free to all.

A webcast is available at either the company or individual level, as well as a follow-up one-on-one discussion with the newsletter authors that extends the general webcast. More info can be found at the final page of this newsletter.

We hope you find a solution that works for you!

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We hope you will join us on our journey!

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Hedge Funds – usually a misnomer: Part 1

Most, if not all readers will be familiar with the hedge fund "origin story", in which in 1949 Arthur Jones created a "*Hedged* Fund", which was intended to earn good returns, while hedging against downside losses through a process resembling what would now be called a long/short approach - in which equities that were expected to rise in value were purchased, while those expected to decline were sold short.

Of course, from a very modest beginning, and slow growth over the first couple of decades, the "industry" has grown to a huge scale (managing some USD 4.5BN in assets globally) and come to be regarded as a separate asset class - one seen and used by many (re)insurance companies, pension funds and Sovereign Wealth Funds (SWFs) as a means of "diversifying" their investment risk away from fixed income or long-only public equity investments. It has also created a class of hedge fund multi-billionaires (perhaps most famously, George Soros); and, incidentally, gave such legendary investors as Warren Buffett a first vehicle to deploy their talent.

While investors who backed the best managers have also seen extraordinary returns over time, there have also been spectacular disasters - most notably the collapse of Long Term Capital Management (LTCM) in 1998 in the wake of the Russian debt crisis, and default on its GKOs (or rouble obligations). LTCM's operations in the midst of market turbulence proved extremely fragile, requiring the intervention of the Fed to coerce the largest US banks into a bailout to avoid a potential cascading financial collapse.

And LTCM is a good example of what is an abiding and often opaque "sin" of hedge funds- the (over)use of leverage. At its peak, LTCM was estimated to have had perhaps only USD 1 of equity for every USD 100 of debt (so convinced were its managers of the infallibility of their arbitrage approach), with much of this extraordinary leverage not obvious because of the complexity of LTCM's use of derivatives and margin loans, and the fact that its managers were subject to far too little hard scrutiny from those providing that leverage - the very banks press-ganged into bailing it out.

Naturally, the apologists and those with the financial incentives to promote the use of hedge funds as a "diversifier" (also known as investment advisors), continue to claim that LTCM's management (which included 2 Nobel Prize winners in Economics) had over-reached, and that its basic strategy of exploiting arbitrages in pricing between different markets, which depended on extreme leverage to generate its returns, was an anomaly within the overall industry in terms of its subsequent fragility.

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Hedge Funds: Part 1 (cont’d)

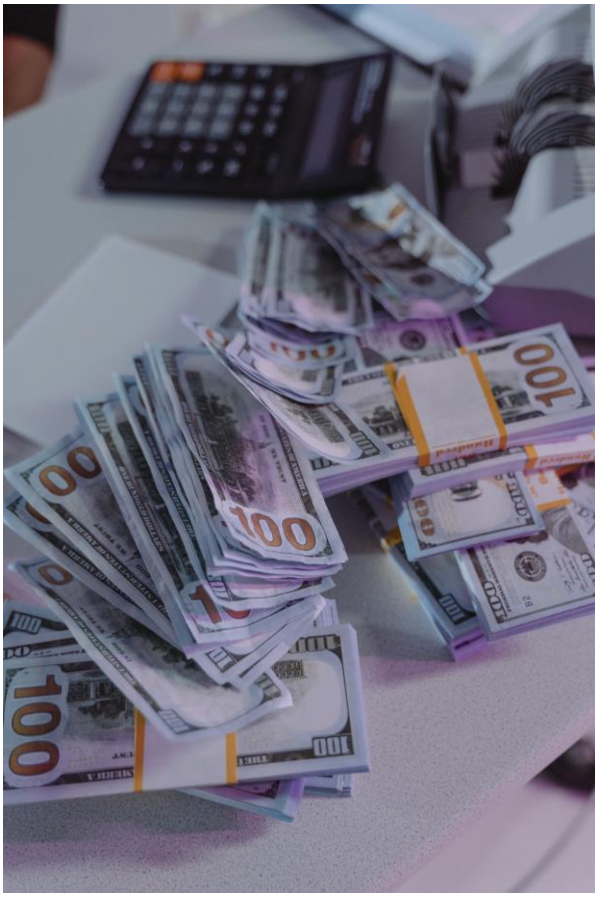
reached, and that its basic strategy of exploiting arbitrages in pricing between different markets, which depended on extreme leverage to generate its returns, was an anomaly within the overall industry in terms of its subsequent fragility.

Perhaps.

However, as with many investment sub-sectors, one has to consider “survivorship bias” (the “feeble” either fade away or are taken out and “shot”). The survivors crow about their performance, carefully ignoring any reference to the fallen, or the halt and lame.

Meanwhile, hidden leverage lurks, such that investors often have little or no insight into (let alone control over) the risk/reward ratio it should be reasonable to expect, or which they were “promised”, particularly when hedge funds come in many “flavours” and are subject to “style drift” in the same way as more “conventional” asset managers are. Are hedge fund managers adding sustainable value in a truly risk-diversifying way, or are they the hedge fund equivalent of the closet-indexers and crowded-trade followers? Do they even try to hedge their risks?

In a follow-up article, we shall discuss “flavours”; whether investors can really understand the risk-reward ratio; and the hidden risks of leverage.



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