

11.11.2009 Chief risk officers-the newest new hedge fund thing

Kristin M. Fox

The autumn of 2008 will go down as The Great Fall of the financial system, as the broadmarket indexes and three storied U.S. financial institutions collapsed and the masterminds of previously unfathomable Ponzi schemes, Bernard Madoff and Alan Stanford, were exposed for lining their own pockets with billions of dollars of other people's money.

2009 issued in a new era, with the financial game re-set to zero and all previous bets were off. What worked a year ago or even 10 years prior didn't ring true anymore. It was time for change. Faith in the system was gone and somehow even the safest seeming things could no longer be trusted.

Risk became the new key word as everything was suddenly at risk. Systemic risk. Trading risk. Operational risk. Too-big-to-fail risk. Headline risk. Risk tolerance Risk intolerance. But the biggest issue of all for investment managers and investors became "How do I take my risk off the table?"

Hedge funds, which traditionally were viewed by the consumer press as deep murky pools of risk to begin with, borrowed a page from the corporate culture and began hiring chief risk officers. This begs a number of questions, including what is a chief risk officer at a hedge fund and can he really take risk off the table? What can he do that a portfolio manager or chief investment officer can't?

In the last year the headlines in the trade press have announced that many large hedge funds, including BlueCrest in London, have hired CROs, while the recruiters search to fill many newly created CRO positions. Many start-ups are coming out of the gate with a CRO on board. The job descriptions may be different, but the mandate for the chief risk officer remains the same: Control the risk without destroying returns.

"The role of the Chief Risk Officer varies from fund to fund," says Leslie Rahl, founder and managing partner at Capital Markets Risk Advisors, a New York-based risk advisory and consultant. "At its best, a CRO wears both strategic and control hats, but in some funds it is primarily a 'cop' role, while at others it is a marketing role. It is impossible to make money without taking risk and risk is not a four-letter word. Only unintended risk-risk that is not understood and undertaken without a reasonable chance of reward-is a problem. The most effective CROs think strategically about how to allocate the firm's scare risk appetite, as well as ensure that risk is diversified within limits and well understood. A CRO also worries about what could go wrong and the least likely events and whether the fund could withstand them, leaving the portfolio manager to focus on the more likely outcomes. You need both perspectives," says Ms. Rahl.

Brian Newton is the Chief Risk Officer at Armored Wolf, Aliso-Viejo, Calif.-based boutique investment management firm launched by PIMCO veteran, John Brynjolfsson, in late 2008. The firm's main product, the Armored Wolf Alpha Fund, is a macro hedge fund that focuses on the

asset classes most influenced by or influential to inflationary and deflationary pressures, including commodities, global inflation-linked bonds, and liquid emerging markets instruments. Newton believes that there are a number of issues investors should look at when they examine a hedge fund's risk culture. He sees these three as the most significant questions that need to be asked because the answers will tell the investor if the CRO really has the ability to manage risk, or if the role is really more like a paper tiger's-all show and no teeth.

The first thing to ask is to whom does the CRO report? At Armored Wolf, the CRO reports to the Chief Executive Officer instead of the Chief Investment Officer because we believe this reduces the potential for conflict and helps mitigate risk, says Mr. Newton. It depends upon the structure of the firm, but a CRO should never answer to a trader, portfolio manager or chief investment officer because that would completely undermine the CRO's position and render it meaningless.

The CRO should be independent of the investment team. Having said this, the CRO must recognize the critical need for an effective, professional relationship with the investment team. Regardless of how comprehensive a monitoring and reporting system might be, there will always be issues that are outside the scope of these tools. In those instances the investment team must bring such items to the CRO and agree on the best way forward.

Risk management is a process that should evolve with the environment and includes all those involved with investment decisions.

Next, an investor needs to know how the CRO is compensated. The CRO's compensation should be directly tied to performance, which adds another layer of risk control.

Portfolio managers should have incentives to manage proactively the risks they take in seeking returns in their respective sectors. For example, at Armored Wolf, capital allocation to portfolio managers is affected by performance with both drawdown and outsized return being penalized. The thinking is that realized risk is relevant and that the magnitude of returns is positively correlated with the risk taken. Of course the penalties are asymmetric, with drawdowns more heavily penalized but outsized upward moves also result in capital allocation reductions.

The CRO and all portfolio managers have deferred compensation invested in the fund, and hence to the extent the fund suffers drawdowns, all are directly affected. In addition, a portion of the CRO's deferred compensation is subject to forfeiture in the event of large drawdowns within a calendar quarter. This incentive focuses the mind of the CRO and is intended to overcome any reticence to either close risky positions or put on hedging trades to ameliorate risks attendant with positions which are seen to be expensive to close and where expected risk will fall. An example of this would be an emerging market position that has ex-ante risk heightened by, for example, an election after which risk should revert to a more acceptable level. Closing and then re-opening the position would be costly.

The third significant issue is: Can the CRO pull a trade off the table? A risk officer who is being given proper leeway to do his job should have the ability to pull a trade off the table if he has ample reason to believe that the portfolio is at risk. If the portfolio manager or Chief Investment Officer can override the CRO, then that risk position has no teeth and cannot be effective.

Should an issue arise that if left unchanged exposes the fund to undue risk, the CRO must have the authority either to close the relevant position(s) or to execute trade(s) that

adequately mitigate the risk. The CRO's compensation plays a part here as it should be designed in such a way as to encourage him to make appropriate decisions.

Risk in all its parts

Much is made of the word risk, but what is risk and how can it be managed. Understanding what the chief risk officer does is critical, but it is equally important to understand how he does his job. The following questions are designed to help the investor understand what risk is and how the CRO can manage it. Mr. Newton offers a list of questions that investors should ask while performing due diligence, along with some potential answers and red flags.

How does the CRO monitor risk (all kinds) on an on-going basis? What information does he have? How often does he get it? Is it proprietary?

In order to address this comprehensively, let's partition risks as follows: investment; operational; regulatory; and other, which includes business continuity, cover and succession. For all types of risk the approach is tailored to the setting, as it must be. Smaller firms are likely to have a more focused investment process and thus a generic approach to risk management will misuse limited resources.

Investment risk

Daily quantitative reports may be generated showing volatility at various horizons, such as VaR based on historical and Monte Carlo approaches, etc., at the fund, sector, strategy and security levels. Also risks should be monitored relative to sector benchmarks, again measured over various horizons. Portfolio managers see this information weekly or when the composition of their portfolio changes, as should a fund's investment committee if it is a separate entity. Keeping relevant parties in the loop is an important element of risk management.

Operational risk

In the small-team setting operational issues are known to the entire team when issues arise, so monitoring is a part of being on the job. As firms grow, the reporting of exceptions / issues should be formalized and the frequency of compliance monitoring exercises will increase. Reports from compliance will be reviewed by the CRO as will exception reports. Any substantive issues should be reported to the CRO upon discovery and resolved by the CRO or with the assistance of the investment or management committees.

Regulatory risk

The Chief Compliance Officer is responsible for regulatory risk and issues arising in this area will be brought to his attention, possibly by the CRO. The CRO, however, must ensure that the compliance program is sufficient for the firm. Compliance and risk officers should work together and be in agreement.

Does the CRO participate in investment meetings/decision-making process? How/when does he interact with portfolio managers and traders?

The CRO should participate and offer guidance on realized risk (P&L, volatility of the fund and component sectors) as well as expected risk. The investment process may include a monthly meeting of all portfolio managers, the investment committee, analysts and the CRO should be included in this meeting.

Does the CRO need to have the requisite domain expertise in buying and selling securities/commodities/derivatives? CFA? Investment strategy, decision-making and execution?

The CRO should have a broad range of experience in investments including sectors and

instrument types. Having said that, given the breadth of markets and instruments it is unlikely that any one person would have experience in all dimensions accessed by a fund. However, experience in a range of areas (equities, fixed income, currency, etc) and instruments (cash instruments and exchange-traded and OTC derivatives) is important as is the ability to come up the learning curve quickly when opportunities involving new sectors or instruments present themselves.

Managing CRO risk expectations

Finally, an investor must manage expectations of what a CRO may or may not do, for as Ms. Rahl pointed out earlier, "It's impossible to make money without taking risk."

Kristin M. Fox is the Founder of FoxInspires LLC, a firm specializing in providing unbiased investor education. FoxInspires provides access to intelligence and information, which helps investors and managers understand each other better and assists them in making wise choices based on that knowledge. FoxInspires' clients include hedge funds, ultra-high-net-worth investors, institutional investors and wealth management advisers. FoxInspires was formed in August of 2008.

Previously Kristin was Vice President of News & Research, as well as Executive Editor for HedgeWorld. Kristin was responsible for building the news and research at HedgeWorld, which was sold to Reuters in 2005. Her responsibilities included all aspects of the daily news, and any publications and other information products affiliated with HedgeWorld.

Prior to joining HedgeWorld, Kristin was an editor for Crain's Pensions & Investments, where her duties included editing and producing P&I Daily. Before her tenure at Crain's, Kristin was President of Hedge Fund Research, Inc., Chicago, Ill... Email: kfox@foxinspires.com