

# EDHEC Funds of Hedge Funds Reporting Survey

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# Introduction

## Section 1



# Introduction: The FoHF Reporting Quagmire

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- ◆ Why should FoHF reporting differ from Mutual Fund reporting?
  - Hedge fund strategies are more complex than traditional buy-and-hold strategies
  - Relevant information has never been clearly defined
  
- ◆ Why is the question of FoHF reporting becoming so urgent?
  - FoHF manage USD 541bn and control over half of the hedge fund industry  
*(Source: InvestHedge)*
  - Most institutional investors gain exposure to hedge fund strategies through FoHF

# The Specific Characteristics of Hedge Fund Performance

## Section 2



# Extreme Risks

## Statistical Properties of Hedge Fund Strategies (from January 1997 through December 2004)

	Skewness	Exc. Kurtosis	Bera-Jarque Statistic	Significance
Convertible Arbitrage	-1.07	2.31	31.15	0.00
CTA	0.13	-0.08	0.29	<b>0.87</b>
Distressed Securities	-1.84	9.20	303.26	0.00
Emerging Markets	-1.24	5.66	117.58	0.00
Equity Long Short	0.05	0.86	1.94	<b>0.38</b>
Equity Market Neutral	0.46	0.49	3.37	<b>0.19</b>
Event Driven	-2.12	10.18	378.62	0.00
Fixed Income Arbitrage	-4.57	28.73	2829.46	0.00
Funds of Hedge Funds	0.20	3.11	29.06	0.00
Global Macro	0.93	1.49	17.91	0.00
Merger Arbitrage	-2.27	9.65	354.5	0.00
Relative Value	-1.38	3.73	67.49	0.00
Short Selling	0.48	1.14	6.67	0.04

➤ Hedge fund strategies show significant extreme risks

# Key Drivers of Hedge Fund Performance

Hedge Fund Strategies' Long-Term Exposures to Major Risk Factors (Panel A)

**Unconditional Correlation Coefficients**  
(from January 1997 through December 2004)

	Equity Factors					Bond Factors					Other Factors			
	Implied Volatility (VIX)	Δ Implied Volatility (VIX)	Value versus Growth	Small Cap versus Large Cap	Δ Small Cap versus Large Cap	S&P 500 Index	Yield Curve	Credit Risk	Δ Credit Risk	Lehman Global Bond Index (LGBI)	Historical Volatility of the LGBI	T-Bill 3 months	US dollar	Goldman Sachs Commodity Index
Equity Market Neutral		-0.31		0.34	0.23	0.43	-0.33	-0.23	-0.31	0.22		0.34		
Convertible Arbitrage		-0.21*				0.26	**		-0.55			**		
Merger Arbitrage	-0.22	-0.50		0.25		0.58	-0.26	-0.25	-0.58			0.25		
Distressed Securities	-0.41	-0.59		0.36		0.56	**		-0.75					
Long/Short Equity	-0.29	-0.57	-0.23	0.36		0.74	**	-0.24	-0.50				-0.22	0.21*
CTA	0.23	0.20				-0.19			0.26	0.42	-0.29			0.23

\* Factor that became significant with the unsmoothing procedure

\*\* Factor that became insignificant with the unsmoothing procedure

➤ Hedge funds are exposed to a wide variety of risk factors

# Key Drivers of Hedge Fund Performance

## Hedge Fund Strategies' Conditional Exposures to Major Risk Factors (Panel B)

### Conditional Correlation Coefficients

(from January 1997 through December 2004)

	Equity Factors						Bond Factors					
	Implied volatility (VIX)		Change in Implied volatility (VIX)		S&P 500 return		Change in Term Spread		Change in Credit Spread		Historical volatility Bond return	
	L	H	L	H	L	H	L	H	L	H	L	H
Equity Market Neutral												
Convertible Arbitrage			0.06	-0.65					-0.08	-0.77		
Merger Arbitrage	0.09	-0.42	-0.21	-0.67	0.59	-0.22						
Distressed Securities			-0.21	-0.72	0.56	-0.33						
Long/Short Equity					0.60	-0.13					0.27	0.06
CTA Global					-0.52	-0.32						



Insignificant Factor

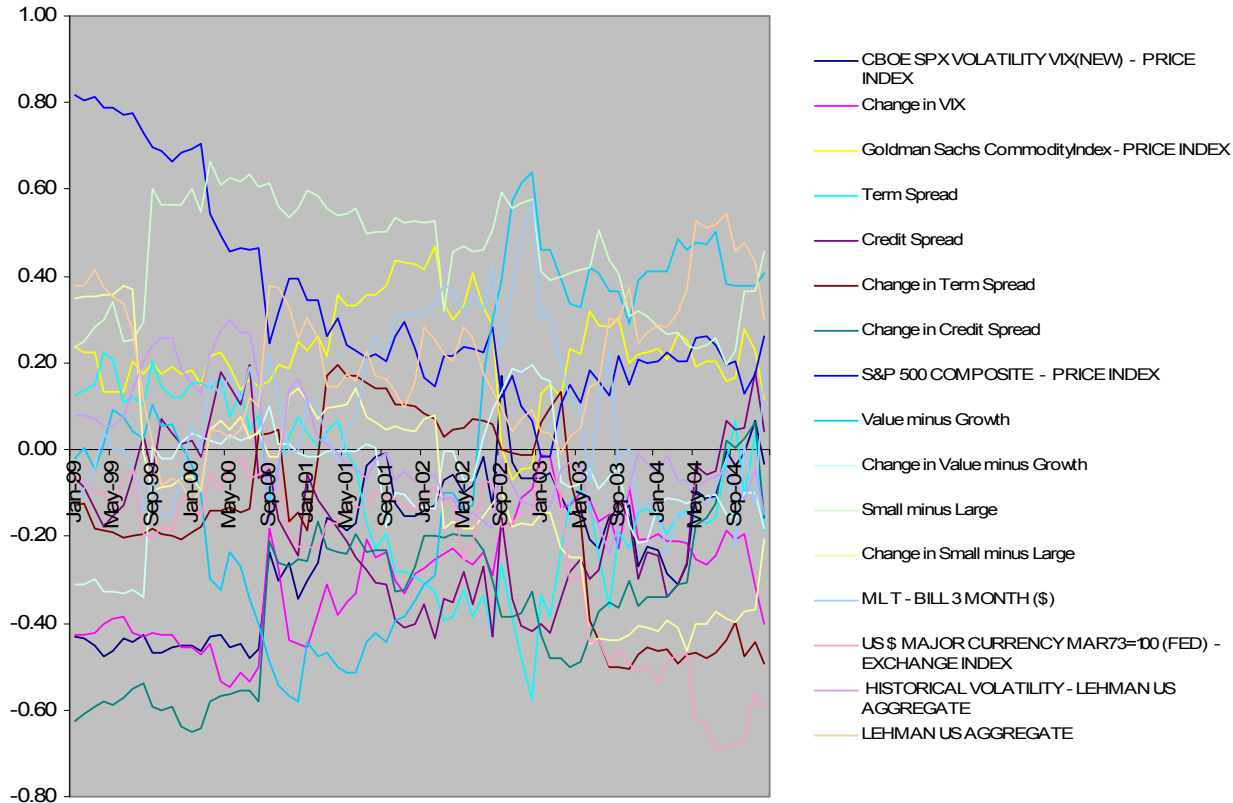
Significant Factor showing stable correlation with the style index

➤ Hedge funds' risk factor exposures are non-linear

# Key Drivers of Hedge Fund Performance

## Hedge Fund Strategies' Dynamic Exposures to Major Risk Factors (Panel C)

24-month rolling window correlation coefficients of the Equity Market Neutral with risk factors (from January 1997 through December 2004)



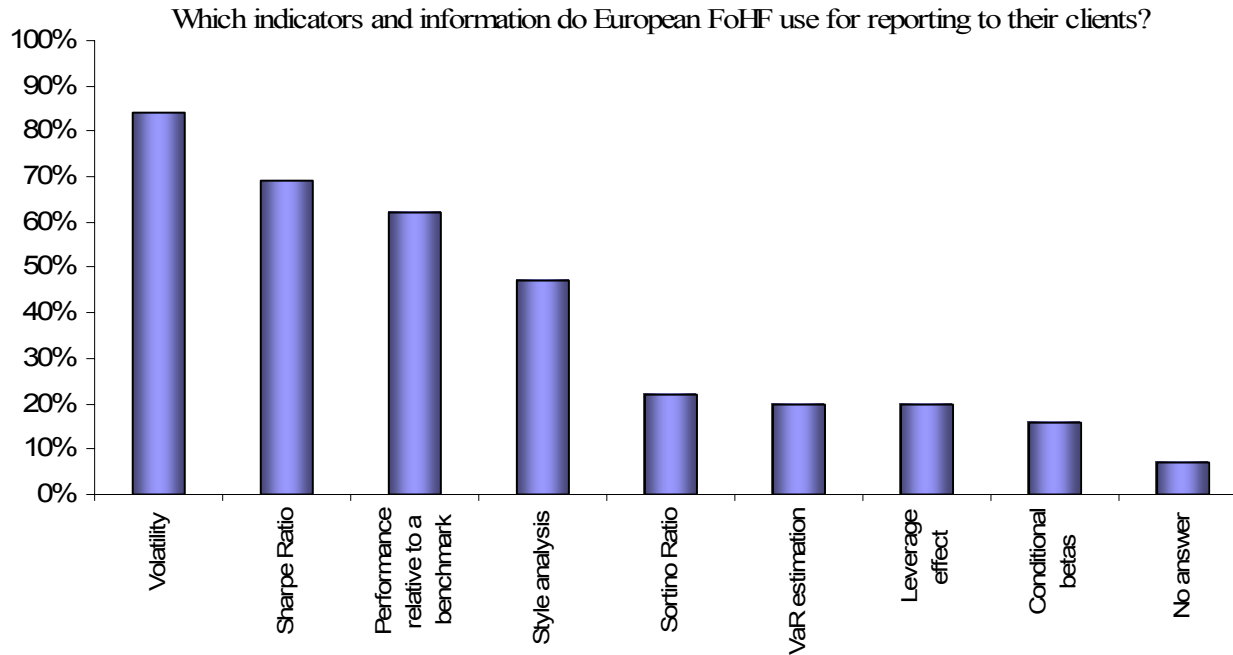
➤ Hedge funds' risk factor exposures are time-varying

# The Current Practices of Market Participants

## Section 3



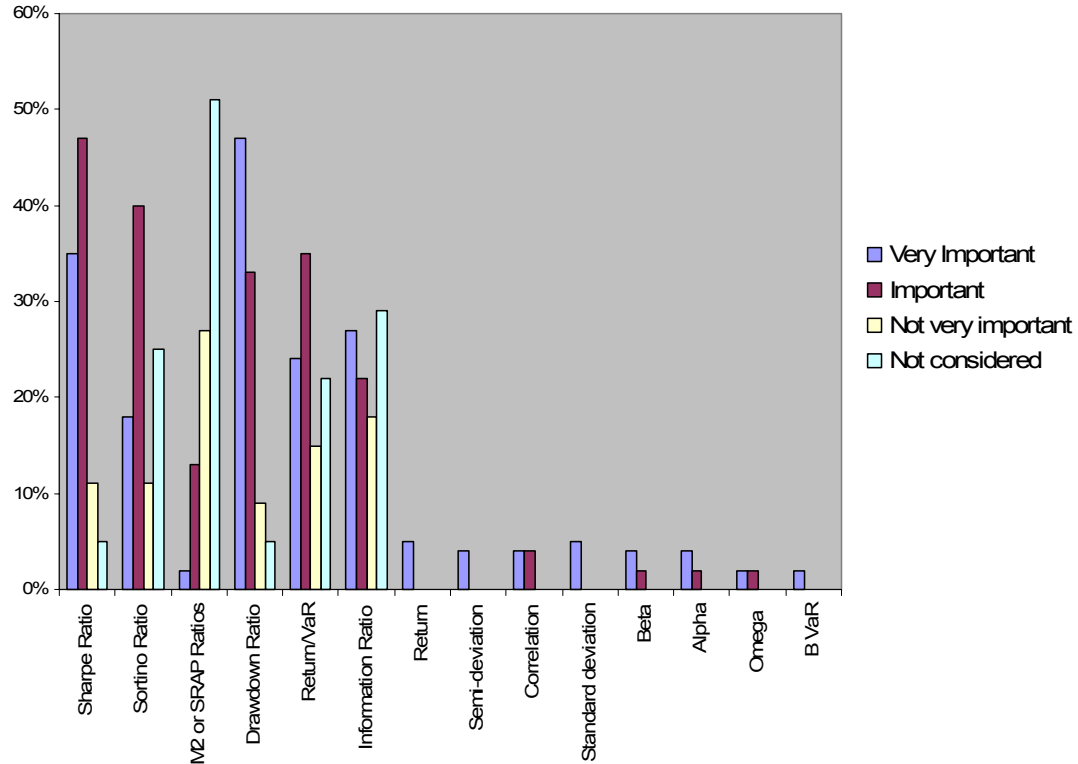
# The Current Practices of Market Participants



Source: Edhec European Alternative Multimangement Practices Survey, 2003

# The Current Practices of Market Participants

Which Quantitative Indicators do you use when monitoring manager performance?



Source: Edhec European Alternative Multimangement Practices Survey, 2003

# Edhec Recommendations for Fund of Hedge Fund Reporting

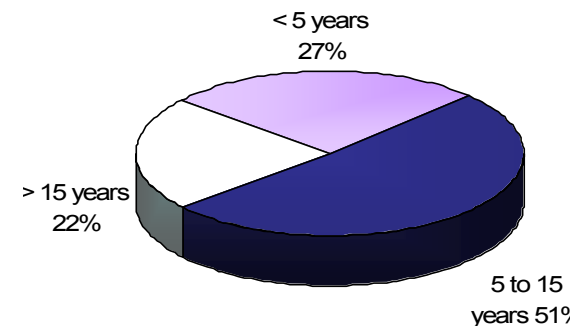
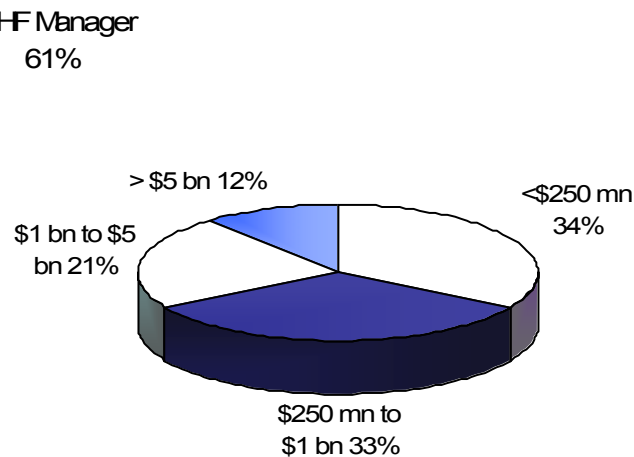
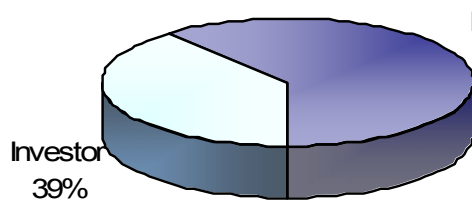
## Section 4



# Profile of the Respondents

98 professionals spontaneously decided to take part in our examination of FoHF reporting.

These professionals work for major traditional and alternative institutions, representing over \$1.1 trillion in assets under management.

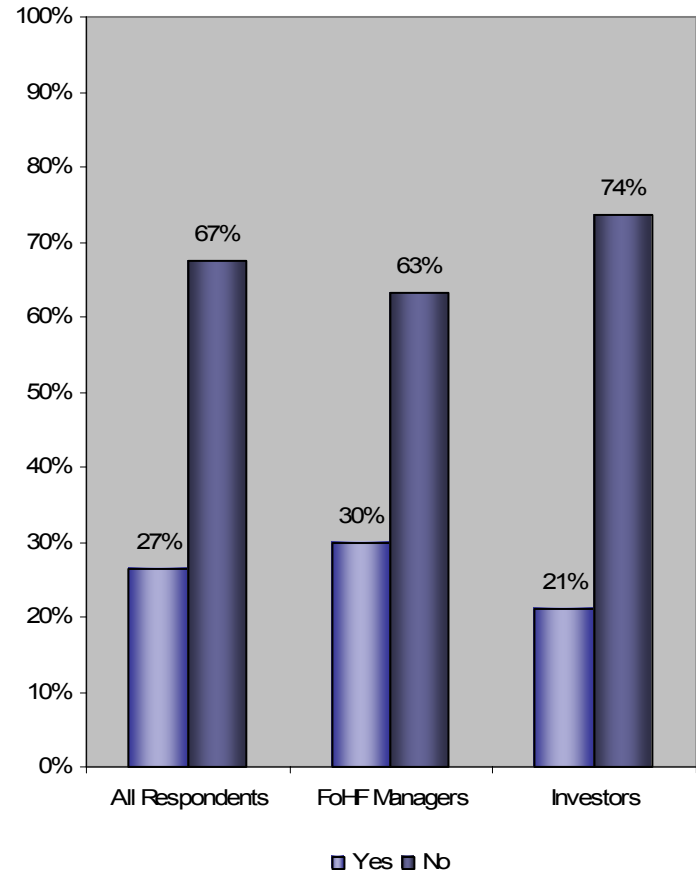


# Granularity and *Frequency*

◆ **EDHEC Position:** Monthly frequency is appropriate for FoHF reporting

◆ Fund managers (especially those managing small funds) are more demanding than investors as regards reporting frequency

Do you see any acute issue as regards both the risk and return dimensions that could not be accounted for in a monthly activity report?



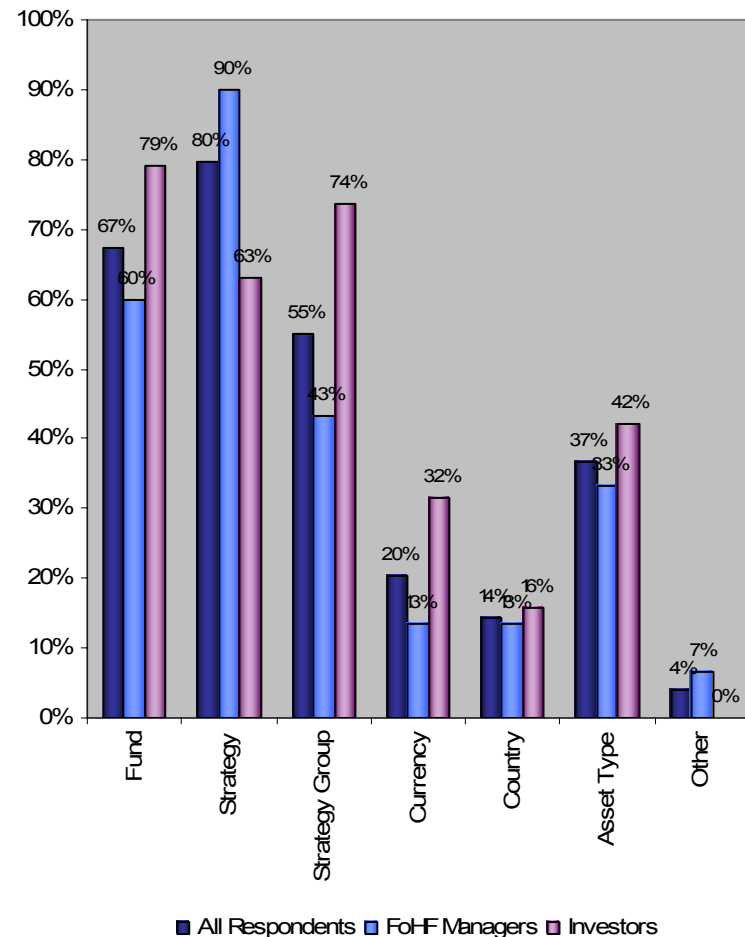
# Granularity and Frequency

◆ **EDHEC Position:** there should be three aggregation levels, namely Strategy Group, Strategy and Fund. The degree of information granularity should be suited to the aggregation level. We also suggest that the breakdown by asset type and level of liquidity should be given at the strategy group level.

◆ **Caveat:** beware of the data overkill effect !

◆ Investors are more demanding than fund managers (especially those managing small funds) as regards reporting granularity

How should information ideally be aggregated in the monthly activity report?

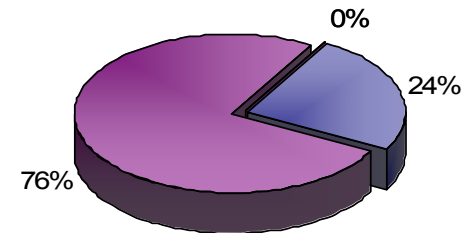


# Return Analysis

◆ **EDHEC Position:** Monthly *and* annual returns should be given at all aggregation levels. Historical returns, YTD or cumulative returns since inception should be reserved for strategy group and strategy levels.

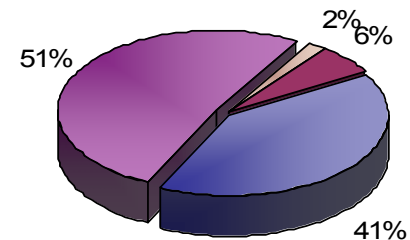
◆ Fund managers put much more emphasis on YTD than investors (i.e. important to very important for 97% vs 79%) and cumulative returns (i.e. important to very important for 80% vs 58%).

How important, in your opinion, is the history of monthly returns?



■ Irrelevant ■ Not Important ■ Important ■ Very Important

How important, in your opinion, is the history of annual returns?



■ Irrelevant ■ Not Important ■ Important ■ Very Important

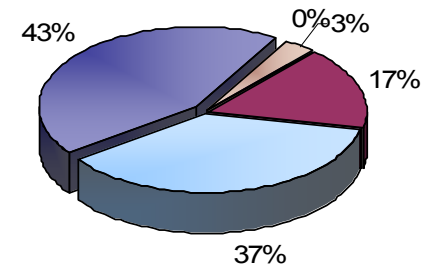
# Return Analysis

◆ **EDHEC Position:** Performance relative to an (appropriate) benchmark as well as performance conditional on equity and bond market conditions should be disclosed at strategy group and strategy levels.

◆ Performance at FoHF level should be disclosed over 12/24/36/48/60 trailing months to ease the screening process for investors

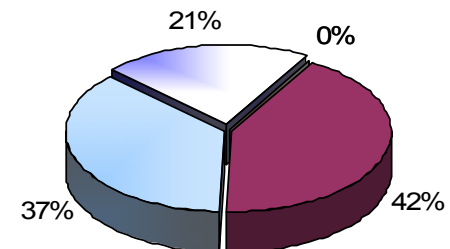
◆ Fund managers put much more emphasis on relative returns than investors (i.e. important to very important for 80% vs 58%)

How important, in your opinion, are relative returns? (Managers)



■ Irrelevant ■ Not Important ■ Important ■ Very Important ■ No Answer

How important, in your opinion, are relative returns? (Investors)



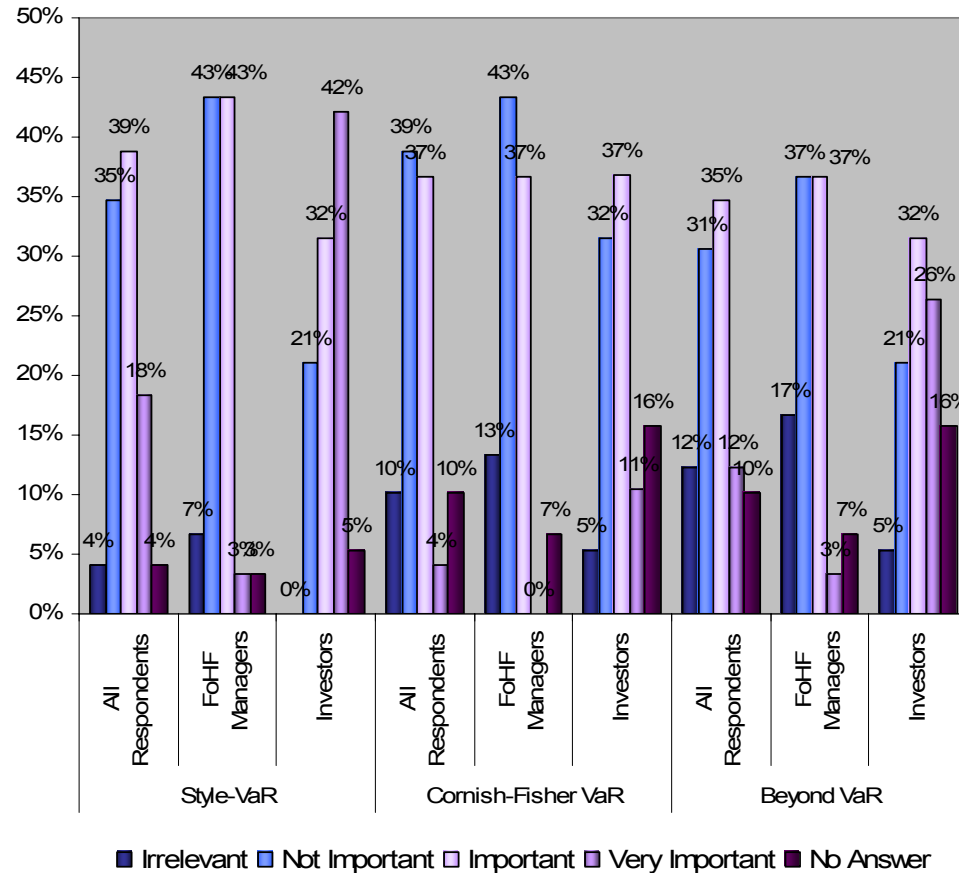
■ Irrelevant ■ Not Important ■ Important ■ Very Important ■ No Answer

# Risk Analysis

◆ **EDHEC Position:** risk indicators should span the whole spectrum of risk (i.e. normal, loss, extreme risks). This information should be disclosed at the strategy group and strategy levels.

◆ Investors are more concerned by risk than fund managers, especially as regards extreme risks (e.g. very important for 42% vs 3% as regards Style VaR or for 25% vs 3% for B-VaR)

How important, in your opinion, are the following extreme risk indicators?



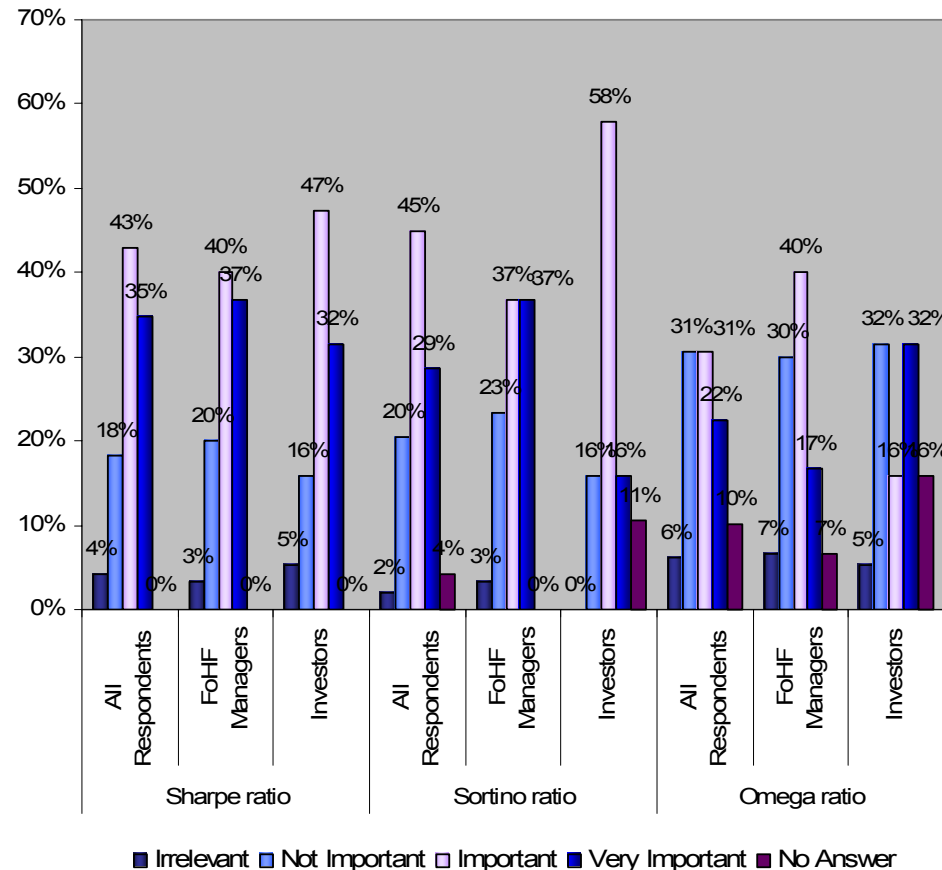
# Risk-adjusted Return Analysis

◆ **EDHEC Position:** Risk-adjusted performance indicators should account for the different definitions of risk (e.g. Sharpe, Sortino, Calmar, Omega ratios) and be disclosed at the Strategy Group and Strategy levels.

◆ Results of the performance attribution process should be integrated in the reporting

◆ Investors are more interested in alternative ratios (i.e. very important for 32% vs 17%) and the results of the performance attribution process (i.e. very important for 63% vs 43%) than fund managers

How important, in your opinion, are the following risk-adjusted performance indicators?



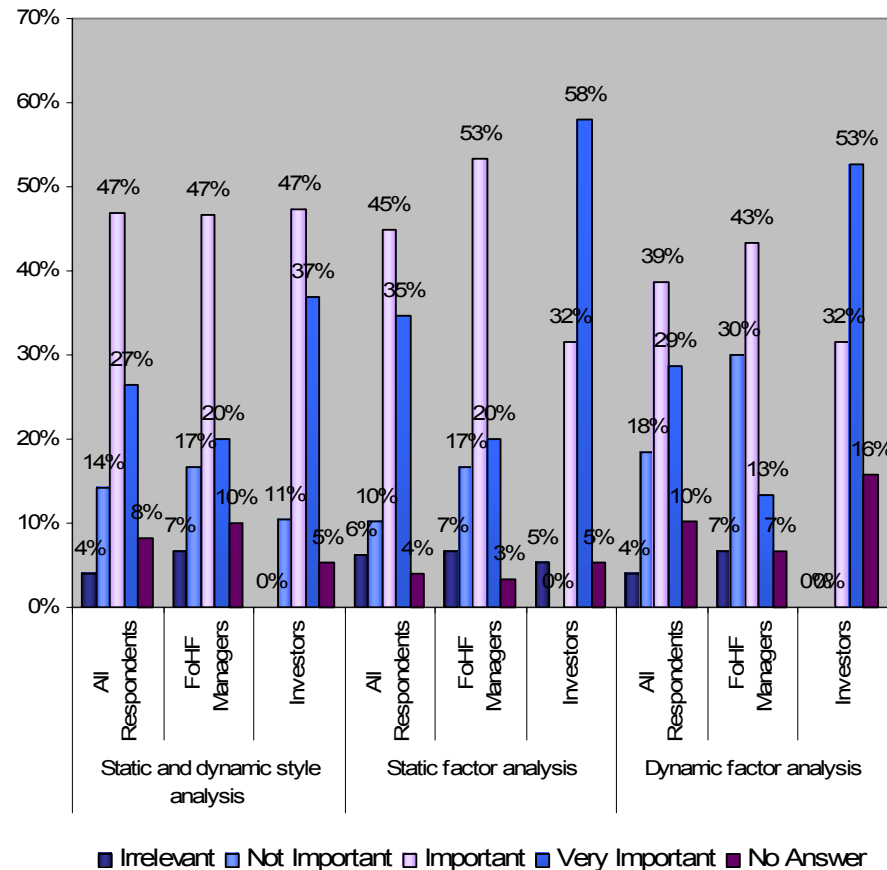
# Beta and Correlation Analysis

◆ **EDHEC Position:** static/dynamic style as well as unconditional /conditional factor analysis should be disclosed at the FoHF level

◆ Factor analysis at Strategy Group and Strategy levels should also be performed to integrate a risk attribution process into the reporting

◆ Investors are more interested in style analysis (e.g. very important for 37% vs 20%), factor analysis (e.g. important to very important for 85% vs 56%), and conditional exposures to risk factors (e.g. very important for 58% vs 20%) than fund managers (especially those running small funds)

How important, in your opinion, are static and dynamic style/factor analysis



# Conclusion

## Section 5



# Conclusion: Light at the End of the Tunnel?

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- ◆ Market participants' practices are still strongly influenced by those observed in the traditional world
  
- ◆ However:
  - On the one hand, there is a broad consensus among investors and fund managers on the definition of **relevant information**
  - On the other hand, market participants' practices are evolving and converging towards academic recommendations
  
- ◆ FoHF should inform investors on:
  - The level of return and risk
  - The nature of risk
  
- The results are encouraging, but good intentions now have to be followed by concrete changes in practices!

# References

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- Edhec, 2003, Edhec European Alternative Multimangement Practices Survey
- Edhec, 2005, Edhec Funds of Hedge Funds Reporting Survey

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