

MFA Reporter

March 2004

Reporting on issues for investment professionals in futures, hedge funds and other alternative investments

Inside This Issue

MFA in Washington.....	3
<i>By John G. Gaine, MFA President, and Stephanie Miranda Pries, MFA Vice President and Senior Legal Counsel</i>	
Absolute Return Money Management: A Future Perspective.....	5
<i>By Timothy Straus, CEO, StoneHedge Partners, Inc.</i>	
Risk Management Lessons in Leveraged Futures Trading	7
<i>By Hilary Till, Portfolio Manager and Co-Founder, Premia Capital Management, LLC</i>	
Are Hedge Funds Secure?.....	9
<i>By Bob Pollock, CEO, & Sean Chumura, CTO, CoSolutions Systems, Inc.</i>	
NASD Issues Interpretive Guidance On Hedge Fund Sales Materials	10
<i>By Michael P. Malloy, Partner, Drinker Biddle & Reath LLP</i>	
MFA on Accounting: A New Way to Save for Health Care	16
<i>By Margaret Sheridan and Scott S. Anderson, CPA, Arthur F. Bell, Jr. & Associates, L.L.C.</i>	
PR News and Reviews	17
<i>By Meg Bode, MFA PR Consultant</i>	
MFA Member News	20
Press Check.....	21



MANAGED FUNDS ASSOCIATION

Summary of Remarks at MFA Seminar, "Valuation Challenges for Hedge Funds"

By Timothy P. Selby and Manuela A. Cattaneo, Cadwalader, Wickersham & Taft LLP

MFA successfully hosted the second educational seminar of its current series in the wake of a snowstorm that nearly crippled New York City on January 28th. Despite the weather, MFA saw high attendance at the seminar on "Valuation Challenges for Hedge Funds", where three panels of industry experts discussed issues associated with valuation policies and procedures for hedge fund managers. The panelists covered three topics: (i) sound valuation policies and procedures and how they are implemented in practice, (ii) the challenges faced with valuing difficult-to-value investments, and (iii) the accounting principles that should be observed in connection with portfolio valuation and the hedge fund manager's disclosure obligations with respect to its valuation practices. Below is a summary of the more pertinent issues discussed during each panel session.



The panelists asserted that hedge fund managers should clearly establish consistent, reproducible, simple, transparent and verifiable valuation methods to be used for portfolio positions that are difficult-to-value, or illiquid.

Session 1: Sound Valuation Practices

Sandy Fleischman, Lehman Brothers; Kenneth Grant, EXIS Capital Management; Kenneth Raisler, Sullivan & Cromwell

The first panel discussed the role of prime brokers, auditors and pricing services in

continued on page 2

Risk Management Lessons in Leveraged Futures Trading

By Hilary Till, Portfolio Manager and Co-Founder, Premia Capital Management, LLC

Author's Note: This is an updated version of an article which was originally published in the September 2002 issue of Commodities Now.

This article will briefly discuss the practical issues involved in applying a disciplined risk-management methodology to leveraged futures trading. If a portfolio of instruments is normally distributed, one can come up with a 95% confidence interval for the portfolio's change in monthly value by multiplying the portfolio's recent monthly volatility by two (or 1.96, to be exact.)

The measure is useful because one wants to ensure that under normal conditions, a futures position has not been sized too large that one cannot sustain the random fluctuations in profits and losses that would be expected to occur, even without a dramatic event occurring.

While Value-at-Risk is indeed useful, it still has to be used jointly with other measures and actions. Using long-term data, one should also directly examine the worst performance of a commodity trade under similar circumstances in the past. In practice, we have found that such a measure will sometimes be larger than a Value-at-Risk measure based on recent volatility.

A commodity investment manager can potentially set up dampened risk portfolios of commodity

investments, which are very nearly uncorrelated with each other. But we have also found that seemingly unrelated commodity markets can become temporarily, highly correlated. This becomes problematic if a commodity manager is designing a portfolio so that only a certain amount of risk is allocated per strategy. The portfolio manager may be inadvertently doubling up on risk if two strategies become unexpectedly correlated.

The antidote for this problem is two-fold. One is to understand what key factors drive a strategy's performance, and the other is to use short-term, recent data in calculating cor-

relations. If two trades have common drivers, then it can be assumed that their respective performances will be similar. Recent data can frequently capture the time-varying nature of correlations that long-term data average out.

In addition to understanding the statistical characteristics of an investment, risk-management policies frequently flow from product design decisions. Futures products are typically marketed as equity investment diversifiers. Therefore, one job of risk management is to attempt to ensure that a futures investment will not be correlated to the equity market during periods of dramatic equity losses.

If a portfolio shows sensitivity to certain extreme events when the stock market has declined, this does not necessarily mean that the portfolio should be sized differently or constructed differently. It may mean that a macro portfolio hedge would be in order, such as purchasing out-of-the-money fixed-income call options when the portfolio has a sensitivity to a liquidity shock or purchasing out-of-the-money gasoline call options when the portfolio has a sensitivity to a sharp shock to business confidence.



Futures products are typically marketed as equity investment diversifiers. Therefore, one job of risk management is to attempt to ensure that a futures investment will not be correlated to the equity market during periods of dramatic equity losses.

On a per-strategy basis, it is useful to examine each strategy's:

- Value-at-Risk based on recent volatilities and correlations;
- Worst-case loss during normal times;
- Worst-case loss during well-defined eventful periods;
- Incremental contribution to Portfolio Value-at-Risk; and
- Incremental contribution to Worst-Case Portfolio Event Risk.

On a portfolio-wide basis, it is useful to examine the portfolio's:

continued on page 8



Risk Management Lessons

continued from page 7

- Value-at-Risk based on recent volatilities and correlations;
- Worst-case loss during normal times; and
- Worst-case loss during well-defined eventful periods.

Each measure should be compared to some limit, which has been determined based on the design of the futures product. For example, if clients expect the program to lose no more than say 7% from peak-to-trough, then the three portfolio measures should be constrained to not exceed 7%. If the product should not perform too poorly during financial shocks, then the worst-case loss during well-defined eventful periods should be constrained to a relatively small number. If that worst-case loss exceeds the limit, then one can devise macro portfolio hedges accordingly.

One illustrative example concerns two financial futures spread trades. This example portfolio consists of a long Russell 2000 vs. short S&P 500 futures trade and a long Municipal Bond vs. short Long Bond futures trade. These trades are normally unrelated. But during a scenario test of the portfolio's sensitivity to event risk, we note that the combination of the two trades results in an exposure to a liquidity shock, as shown in the figure below.

The short legs of each spread are the more liquid of the pair. This means that both of these trades are at risk for a flight-to-quality event, as happened in the fall of 1998. The

scenario tests confirm that the fall of 1998 scenario is the worst case scenario.

As mentioned above, one risk management response to a concentrated risk to a liquidity shock is to purchase out-of-the-money fixed-income calls, which would be expected to do well during such a shock.

We conclude by noting that our view is that there are a number of derivatives strategies, which earn returns due to assuming risk positions in a risk-adverse financial world. The returns are not necessarily due to inefficiencies in the marketplace.

There is a very important active component to an investment program that earns a return due to bearing risk. It is the investment program's risk management methodology and policy. An investment manager must decide how much to leverage the strategy and whether to give up any returns by hedging out some of the strategy's extreme risks. That investment manager must also continually monitor the risk exposures in his or her portfolio and make sure that those exposures adhere to pre-defined limits.

How one designs and carries out a risk management policy is key to an investment program's viability, especially in leveraged futures trading. ■

Evaluation of Portfolio Event Risk

<u>Event</u>	<u>Maximum Loss</u>
October 1987 stock market crash	-4.11%
Gulf War in 1990	-4.12%
Fall 1998 bond market debacle	-6.42%
Aftermath of 9/11/01 attacks	-3.95%
<u>Worst-Case Event</u>	<u>Maximum Loss</u>
Fall 1998 bond market debacle	-6.42%
Value-at-Risk based on recent volatility and correlations	3.67%

Source: Till, Hilary and Joseph Eagleeye, "Traditional Investment Versus Absolute Return Programmes," Quantitative Finance, June 2003, Table 5.

Hilary Till co-founded Chicago-based Premia Capital Management, of which she is a portfolio manager, with Joseph Eagleeye. Premia Capital specializes in detecting pockets of predictability using statistical techniques. Till is also a principal of Premia Risk Consultancy, which advises investment firms on derivatives strategies and risk management policy. E-mail: till@premiacap.com <http://www.premiacap.com>