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Hedge Fund Investor's Annual Review Checklist: Evaluating Liquidity and Market Risk Management Practices

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As 2018 progresses, market volatility has returned to US equity markets. The list of market risks are circulating daily amid an increasingly destabilized geopolitical environment. Potential trade wars with China and the extraction of QE during a rising interest rate environment are only a few of the issues which have the potential to derail markets.

This is a good reminder for investors to stay ahead of the curve by conducting an annual review of their hedge fund manager's liquidity and market risk management procedures. Market dislocations can wreak havoc on asset prices due to both a flight from securities and the disruption of liquidity conditions in markets. This issue was apparent in the early days of the financial crisis when the Bear Stearns High Grade Structured Credit funds experienced a liquidity crunch as their repo haircuts widened before they had a chance to adjust their investment portfolio and reduce the funds' leverage.

Vigilance: Then and Now

Liquidity risk management is a fluid concept (pun intended!). An important responsibility of a hedge fund manager's Treasury function is to constantly stay vigilant of market instrument innovations which can transform the liquidity of a typically functioning market in a dislocated environment. During the 2007 period, it was critical for managers of mortgage-backed securities employing repo to realize the significant impact the ABX and CMBX indices could have if used by dealers as a pricing gauge when market conditions seized. Due to the speculative activity and volatile price action in those instruments, repo haircuts increased tremendously and disrupted managers' assumptions of the leverage their strategy could support. Managers who did not get ahead of this issue were subject to significantly higher haircuts and experienced an unexpected liquidity squeeze.

In modern markets, leveraged ETFs and ETFs referencing less liquid securities have the potential to disrupt market conditions in a more unprecedented way than we have experienced before. A severe flight from these products has yet to be tested and could disrupt normal market conditions. Another risk factor is the issue where a deterioration in credit markets could knock into equities since credit and equity are financing instruments for companies and have a natural linkage.

Risk Considerations: Checklist

At a minimum, the following practices should be evaluated when conducting a review of a manager's liquidity and market risk management procedures:

1. To what extent does the firm's Treasury department integrate the portfolio stress testing work conducted by the firm's market risk management team into their assessment of how much liquidity is required by their investment portfolio in a stressed market?

2. What are the terms associated with the firm's financing agreements and how easily could liquidity be accessed, if needed, to post margin to dealers in a stressed market? This assessment should include an evaluation of the terms included in the fund's trading documentation with their dealers, including the terms associated with any prime broker lock up agreements and committed lines of credit. It's also important to understand the termination events associated with the manager's derivative documentation (ISDA agreements), futures agreements, etc.

3. Since the market risk assessment of an investment portfolio is largely a theoretical exercise, how realistic are the assumptions used in the manager's market risk models? For example, does the manager incorporate a long enough lookback period in their test data to incorporate a stressed period for the key market(s) to which they are exposed?

4. To what degree has the manager extended more lenient redemption terms to their investors than the investment portfolio can actually support? This is considered an asset / liability mismatch. It's also important to get a good understanding of any preferential liquidity terms offered via side letters or to senior management.

5. How frequently does the back office independently test the liquidity of the instruments in the investment portfolio which are leveraged and subject to margin conditions? A commonplace practice is for this assessment to come from the firm's senior portfolio managers or traders. A preferred approach is for the back office to periodically test these assumptions through their relationships with their administrators and prime brokers as a crosscheck to the front office.

Lessons Learned: Going Forward

The financial crisis was a very instructive time for hedge fund managers and many firms have since incorporated strong internal procedures that address the issues highlighted in this article. However, investors continue to be timid in insisting that managers disclose the terms in their counterparty trading documentation — despite the fact that, as investors, they are equity-like investors and junior to those terms. It's time that the industry becomes more transparent on this topic in the interest of full disclosure and fairness.

Contact Us

For more information about conducting a review of your hedge fund's internal procedures to assess liquidity and risk, please contact:

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