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CFA Society Toronto

June 2013

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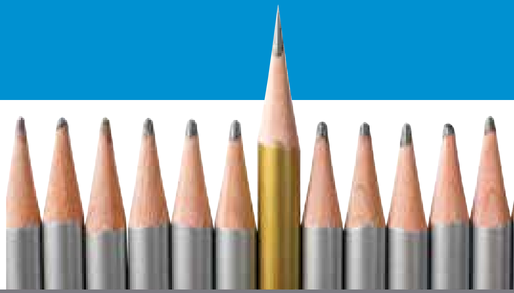

Setting a higher standard for the Toronto investment community

June 2013
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IT'S HARD TO BELIEVE that my tenure as President of CFA Society Toronto is coming to an end as we move forward into summer and our fiscal 2014 year. It has been my distinct privilege to work with an extraordinary board, and I would like to thank everyone for their dedication to CFA Society Toronto.

I would also like to thank everyone who threw their hats in the ring as this year's board of director nominees, and I encourage all members to exercise their member rights by voting their proxy, commencing 28 May.

In late March, we held a board strategy session where we focused on new sponsorship initiatives to enhance revenue and allow us to increase membership value and introduce exciting member benefits, such as the launch of CFA Society Toronto's own Toastmaster's Group.

As many of you may be aware, we will begin our search for a new CEO as Peter Jarvis transitions to retirement. Peter's dedicated service to CFA Society Toronto will be a tough act to follow. We are thrilled that he is playing an integral part in the recruitment process for his successor.

This year, we continue to increase the range of our programming and speakers with the Annual Wealth and Pension Conference this spring. The 2013 Annual Pension Conference featured John Coates, author of *The Hour between Dog and Wolf*, who discussed the biology of risk taking and the hormonal basis for financial decision making. In June 2013, we will host Timothy Lane, Deputy Governor of the Bank of Canada, a fitting follow-up to December's luncheon with Governor Mark Carney.

CFA Society Toronto continues to foster our strong relationship with CFA Institute by acting as host society for this year's CFA Institute Research Challenge Americas Regional Finals, bringing together students from all across North and South America. Building our ties with the next generation of financial professionals allows us to boost the fundamentals of CFA Institute's Future of Finance Project. The project supplies a Statement of Investor Rights and focuses on restoring trust within the financial industry. This is one of the many ways that we strive to enhance the CFA brand with stakeholders.

I have been honoured to serve as your President this year, and I look forward to continuing my role on the board as Past President this fall. As always, we value your feedback. If you have any suggestions or ideas to assist us, please do not hesitate to reach out to anyone at our Management Office or on our Board of Directors.

OPENING UP

Philippe Jorion on the benefits of giving hedge fund clients more transparency

Victoria Barclay, CFA

A year ago, the *Wall Street Journal* estimated that the size of the global hedge fund industry was US$2.13 trillion—an all-time high. Yet it also noted that "private disclosure to investors has been woefully inadequate," citing the opinion of Philippe Jorion, a professor at University of California at Irvine and author of the classic texts, Value at Risk and the Financial Risk Manager Handbook. Jorion has won awards for papers on tracking error, the global stock market, and the LTCM fiasco, and through his work, he seeks to gain insight into the interwoven topics of portfolio construction, risk management, and hedge funds.

"I can't think of many industries where the client gives a blank check to his or her agent, essentially giving up the right to have any information about what they are buying," says Jorion, who has recently set his sights on hedge funds. Specifically, he wanted to understand hedge funds' legendary aversion to transparency and co-authored a paper on the topic with Rajesh K. Aggarwal. The paper, "Is There a Cost to Transparency?" won the 2012 Graham & Dodd Scroll Award.

Jorion and Aggarwal point out that public disclosure by a hedge fund manager may lead other investors to reverse engineer the investment strategy used by the hedge fund manager. Secrecy "is a rational decision if [hedge funds] do not reap any benefit from transparency but might incur some costs, such as others free riding and front running," said Jorion when contacted by The Analyst in early 2013.

The research

To estimate the cost of private transparency, Aggarwal and Jorion examined hedge fund managers providing a managed account (MAC) that replicates a commingled fund. A MAC is typically held by a firm that is independent of the hedge fund manager. The positions of the main commingled fund are thus indirectly revealed to the client that owns the MAC. However, since disclosure is limited to clients only, it should be much less detrimental than public disclosures.

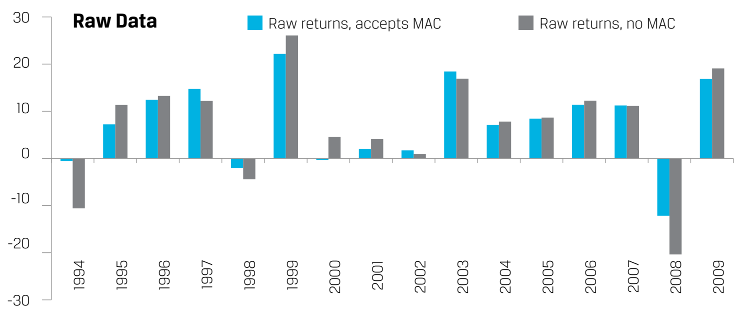
"A recurring question is whether requiring private transparency could impose a cost to the investor," said Jorion, explaining the rationale behind his and Aggarwal's study. Here, "cost" does not mean an explicit price; it refers to disadvantage, such as a lower rate of return on the fund. "The argument is that this creates a selection bias in which only poorly performing funds are desperate enough to offer transparency. This is an interesting story, but like many well-known urban legends, [it] has no foundation," said Jorion.

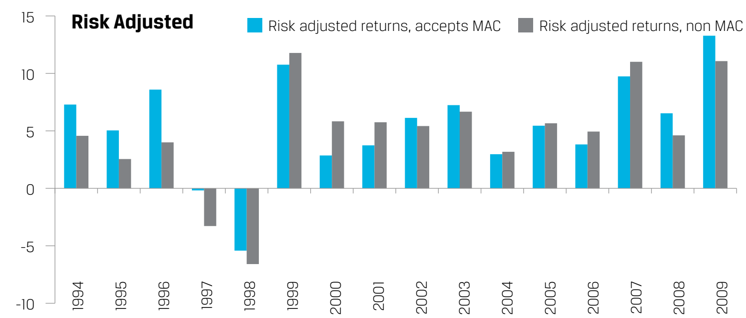
The research paper concluded that funds offering MACs have "somewhat higher returns, albeit not statistically significantly so." Aggarwal and Jorion also found that MAC-offering funds had fewer SEC investigations, fewer instances of fraud, and shorter durations of investigations on average.

Interest in MACs has been increasing, says Jorion, because "managed accounts offer complete control over the investment to the investor or a third party. In addition, they can be designed to suit investor preferences. Finally, they offer complete portfolio transparency."

Anecdotally, clients—especially large institutional investors—appear to be turning to such funds more often, according to Jorion. "In my experience, many [hedge funds] would be willing to offer managed accounts, given appropriate terms. Running a MAC pari passu to a commingled fund does add a bit of extra overhead. Trades have to be split between the different funds, for example. But this really should be a rational cost/benefit decision for the hedge fund manager. I would be willing to venture that very few managers would resist opening a MAC for a client willing to invest at least a few hundred million dollars."

Jorion contrasted MACs with commingled funds, many of which nosedived during the 2008 financial crisis. Some hedge fund redemptions were suspended, and others bore the brunt of "co-investor risk," said Jorion. "Investors in commingled accounts were subject to the behavior of other investors in the same funds, some of whom panicked and redeemed at the worst possible time. In many cases, this led to forced selling of positions, which hurt the remaining investors in the fund."





Performance of hedge funds with and without managed accounts (MACs) show that there is no cost to private transparency. Both raw data and risk-adjusted returns are shown for 1994 to 2009, inclusive. Data from R. K. Aggarwal and P. Jorion, FAJ 68, p. 108 (2012).

Jorion believes the hedge fund industry on the whole is taking a bad rap. He compared the highly dispersed "multitude of hedge funds that take a variety of positions" with the banking industry, "which is highly concentrated and where broad exposures are similar. Leverage for banks is also much higher than for nearly all hedge funds." A survey of hedge funds in the U.K. reported by the Financial Services Authority (FSA) in August 2012 found that hedge funds in general "continue to report a strong ability to manage the liquidity of their assets and liabilities in aggregate." Jorion agrees, but adds the caveat: "where a forced liquidation could have an impact on financial markets" for very large hedge funds "some additional private disclosures to regulators may be justified."

Jorion is careful to distinguish between public and private disclosure. The paper is only about private transparency. In his view, U.S. levels of public disclosure, such as the SEC's 13F form, are "more than adequate." Greater regulated public disclosure, such as the Alternative Investment Fund Managers Directive in the European Union (soon to be finalized), could, according to Jorion, "harm the hedge fund investors themselves, which often include participants in pension funds."

Jorion says that this award-winning paper is "part of a quest to improve our understanding of hedge funds and the many issues related to optimally structuring, investing, and monitoring hedge fund investments.

Victoria Barclay, CFA, is a Toronto-based risk manager and has been a CFA charterholder since 2006.