



“We are committed to providing information and solutions that can help our clients succeed.”

GERALD HASSELL,
PRESIDENT,
THE BANK OF
NEW YORK MELLON

Achieving Alpha through Operations

360° View of Hedge Fund Operational Risk

Volatile credit markets have made generating alpha a much more complex proposition. With market risks uncertain, hedge funds are now turning to their operations for improved efficiency, increased transparency and greater accuracy to manage risk and enhance performance.

As one of the world’s premier provider of hedge fund services, The Bank of New York Mellon is distinctly familiar with the operational risks being faced by our clients. In an effort to shed light on these risks, the company recently held a panel discussion entitled 360° View of Hedge Fund Operational Risk as part of our ongoing Thought Leadership Series.



We brought together industry experts from Aksia LLC, Citadel Investment Group, Deloitte & Touche and Moody’s Investors Service, as well as The Bank of New York Mellon, for a panel discussion

before an audience of 200 hedge fund professionals and industry experts. Bank of New York Mellon President Gerald Hassell opened the panel discussion by affirming the Bank’s leadership role in servicing hedge funds, “We are committed to providing information and solutions that can help our clients succeed,” he said.

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BRIAN RUANE,
EXECUTIVE VICE PRESIDENT,
THE BANK OF
NEW YORK MELLON

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JOYCELYN CUNNINGHAM,
PARTNER, FINANCIAL SERVICES
INFORMATION TECHNOLOGY,
DELOITTE & TOUCHE.

The Need for a New Approach to Operations

The *360° View of Hedge Fund Operational Risk* panel was moderated by award-winning Bloomberg News journalist Eric Schatzker, who has reported extensively on the securities and banking industries. He told the audience that over half of all hedge fund failures can be traced to operational risk and he emphasized the necessity of utilizing a more complete risk methodology. “Operational risk can be a time bomb,” said Mr. Schatzker, “and even the world’s most sophisticated investors can be in the line of fire.” The panelists agreed and discussed how operational breakdowns such as illiquidity, misreporting and excessive leverage all played a role in some of the biggest hedge fund failures of the past year.



Operational risk management refers to the processes, controls and back-up facilities necessary for hedge funds to ensure accurate pricing, efficient transaction processing and timely reporting. As alpha becomes more of a challenge to generate, increasing operational efficiency becomes even more critical. Newly developed derivative

instruments, increased investment in illiquid securities, and evolving investment strategies all point to operational risks that are likely to intensify. Thus the search for new solutions at The Bank of New York Mellon. “We want to create a forum for ongoing industry discussions that address current trends, challenges and opportunities,” according to Brian Ruane, Executive Vice President, The Bank of New York Mellon.

Hedge Funds are Becoming More Like Broker-Dealers

Panelist Jocelyn Cunningham, a Partner in Financial Services Information Technology at Deloitte & Touche, told the audience that many portfolio managers underestimated the operational capacity needed to run a hedge fund and must now



revamp their operations. “Hedge funds are looking more and more like broker-dealers as they recognize that more resources need to be devoted to operational risk,” she said. “The big back offices of broker-dealers provide a lot of support to hedge fund managers who started their business with nothing more than a spreadsheet.”

Many hedge funds were founded by traders skilled at money management, but not necessarily focused on being business managers. Despite the size of their balance sheets and complexity of their operations, most hedge funds are relatively small businesses that employ less than 50 people. Even those that are larger institutions may have grown so quickly that operations became a secondary consideration. Many of them lack the operational infrastructure to execute their investment strategy to its fullest potential. “The ability to invest in instruments such as derivatives far outweighs the operational ability to handle them,” according to Ms. Cunningham.

Panelist Daniel Dufresne, Director and Head of US Treasury at Citadel Investment, cautioned the audience not to skimp on sufficient personnel and technical resources in managing a hedge fund. "The right technology and the right people to operate that technology are absolute requirements to price, settle and trade accurately," he said. Panelist James Leahy, Senior Credit Officer at Moody's Investors Service, agreed. "A lot of operational infrastructure is needed to keep up with all these new investment dollars," he said.

Valuation Risk: For What it's Worth...

"Valuation risk is the key risk that institutional investors consider when they evaluate a hedge fund," according to Simon Fludgate, Head of Operational Due Diligence



at Aksia LLC. He explained that issues related to valuation, such as the determination of fair-market-value for each of the investment positions that make up a fund, are at the root cause of many operational failures.

Many of the instances of misrepresentation over the past year

involved some form of valuation risk, ranging from the inability to accurately price positions to outright deception on behalf of the fund manager.

Much of the trouble facing hedge funds is the difficulty in pricing derivatives. During the subprime meltdown, existing pricing methodologies of derivatives came under intense pressure and the need for more efficient pricing became apparent. The expanding universe of complex securities, based upon less liquid and esoteric asset types, has turned the once-simple task of getting a price quote into a confounding chore.

Liquidity Risk: From Torrent to Transparency

The torrents of liquidity that flowed through global credit markets earlier in 2007 have all but slowed to a trickle as we head into a new year. Rising defaults in subprime mortgages fanned credit fears that reached the highest quality tiers of the bond market. Credit concerns during the third quarter caused financing counterparties to sharply curtail their appetite for risk. Credit concerns during the third quarter caused financing counterparties to sharply curtail their appetite for risk and brought calls for greater transparency. "An increased level of transparency benefits everyone - investors, counterparties and even hedge funds themselves," according to panelist Mr. Dufresne.

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DANIEL DUFRESNE,
DIRECTOR AND HEAD OF
US TREASURY AT CITADEL
INVESTMENT

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MARINA LEWIN,
MANAGING DIRECTOR,
THE BANK OF NEW YORK MELLON

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JAMES LEAHY,
SENIOR CREDIT OFFICER,
MOODY'S INVESTORS SERVICE

Demands for independent pricing and greater transparency are prompting managers to seek out third party administrators. “As institutional investors demand more reporting, the responsibility eventually falls on the administrator,” according to Marina Lewin, Managing Director at The Bank of New York Mellon. “Better reporting



is the start to making your clients, their investors and financing counterparties more comfortable with their portfolio,” she said.

Mr. Dufresne said the issue of liquidity extends past individual investment instruments to include the overall liquidity position of the fund. If operations break down, the fund manager may be forced to liquidate positions at a loss, before maturity or in unfavorable market conditions, according to Mr. Dufresne.

Meeting Operational Challenges Going Forward

As we head into 2008, the volatility that characterized capital markets recently is likely to continue over the months ahead. How hedge funds manage their operations and related risk during these times of volatility and growth will be a major determinate of their success.



Operations management has to keep pace with the rapid growth of derivative instruments that is impacting the hedge fund industry. Hedge Fund managers must be prepared to implement new operational risk procedures to safeguard their businesses. As always, The Bank of New York Mellon is playing an active role. “As the hedge fund industry changes,

we are prepared to support our clients and meet new responsibilities,” according to Ms. Lewin.



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