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D. E. Shaw's Max Stone takes on "risk"

If risk management has become more exacting in recent years, why is it that a number of hedge funds have failed to manage the current crisis? Max Stone, a member of D. E. Shaw's six-person executive committee, says risk management comes down to a simple question: "Does the human mind have the imagination to guess how bad it can get?"

Hedge fund managers sometimes approach risk too specifically, Stone says. "A hedge fund can put on seemingly perfect hedges for the many specific scenarios it envisions. But the world can unfold in unpredictable ways, and this can mean that sometimes broader protections are in order. Hedging is often better when it is more general."

Stone explains this view by citing Rick Bookstaber, Morgan Stanley's first market risk manager, who has noted that the most successful, long-lasting species don't overly adapt to their environment, while species that adapt too specifically to their exact environment can be wiped out when conditions change. Similarly, hedge funds attempting to manage risk in changing market environments are often well served by not hedging the currently prevailing market conditions too precisely.

Portfolio managers and other investors sometimes size a position too big because they discount the possible downside of the trade, Stone says. They assume that if the trade moves against them, all else being equal, the position will be even more attractive, a chance of a lifetime. "We call this the 'just buy more' phenomenon," Stone says. "But, in fact, it is sometimes the case that 'all else' isn't equal. Maybe the position moved against you for reasons not previously considered, or the world changed in such a way that the new pricing is correct. It may even be the case that the new information should cause you to liquidate the trade. It's a mental struggle to not assign too high a belief in your initial trade concept."

Another mistake hedge funds – and investors more generally – can make is to confuse low observed volatility with low actual volatility, Stone says. Prices of certain illiquid assets – be they distressed debt, private equity, or collateralized debt obligations – that can't be observed daily are not necessarily stable. One simply can't observe the volatility. CDOs and other highly complex structured products did not appear to have high volatility on a daily basis because they weren't traded regularly. Some investors who bought them, Stone says, "may have been lulled into a false sense of security."

Having said all this, Stone points out that the D. E. Shaw group, which manages $33 billion in hedge fund assets, is not immune to these errors, but tries to counteract them through the awareness it has developed over its 20 years in the business. Shaw's guiding principle when approaching risk management is that it cannot truly be separated from portfolio management. "Risk management is a deep focus of each strategy group, not just the risk department," Stone says. "If it only matters to some risk group down the hall, then traders might be implicitly getting the message that if a risk isn't picked up by the risk system, it doesn't count, whereas in fact those are some of the risks that may count the most."

While recently failed funds have received much attention, Stone points out that the crisis this year is bank-centric, not hedge fund-centric. Stone says hedge funds have come out of this year's credit crisis better than banks so far, at least, perhaps as a result of agency issues. At banks, the people putting on the trades are usually far removed from the people bearing the risk. At hedge funds, that relationship tends to be much more direct. In other words, hedge fund managers have a lot more skin in the game. CS