

How can risk within alternative funds be assessed?

Risk management is of paramount importance within any investment fund structure. It is a critical regulatory requirement and is also directly or indirectly demanded by investors themselves. Choice of system, data sources and reporting have each become an important consideration by management and boards of directors.

Risk management frameworks for alternative funds are complex. How should the framework be devised? With many official guidelines and the experience from both the investment management community and system vendors, one can be tempted to transcribe the UCITS principles in designing a risk framework for alternative funds. Unfortunately, this doesn't work, for many reasons.

Practical considerations in risk monitoring alternative funds

For an alternatives risk manager, there are several practical challenges:

- Alternative investments are typically illiquid in nature, so standardised risk horizons make little sense.
- Strategy-based hedge funds typically follow trigger-based strategies. Therefore, the assumption of unchanged positions during the chosen risk horizon does not hold.
- Market values are usually not easily observed in the market; thus there is often no reliable time series to measure volatilities and dependencies, even current values should be questioned as to their accuracy.
- In most alternative cases there is limited availability of raw information, for example cash flows and low-level contract details for real estate investments, difficulty to measure default probability on non-listed private equity investments, difficulty to apply a "look-through approach" in case of investments to other hedge funds.
- In most cases, we cannot borrow methods used for the modelling of traditional risk factors based on covariance historical analysis even if we try to account for skewness and fat tails.

Can these difficulties be addressed?

Some funds limit risk reporting to the qualitative statistics demanded by the AIFMD reporting requirements, such as "top X exposures" and the like. Unfortunately, such an approach offers very limited insights to the actual level of risks faced by an alternative fund.

On the other hand, Annex IV of the AIFMD directive includes a "Stress testing" free-text section. In our opinion, this is the most critical section to expose and understand the true nature of risks facing an alternative fund. It must be noted, however, that in order to apply a meaningful stress test, one needs to be creative, think out of the box, fully understand the low level characteristics of each investment and each alternative market. This is by no means a straightforward task.

Why Luxembourg?

We decided to add the Luxembourg-based SYSTEMIC Solutions S.A. to our existing group of companies following the strong demand we have experienced over the last couple of years from service providers such as management companies and fund administrators, as well as several alternative and UCITS funds that have a presence in Luxembourg. In addition we have found that the regulatory environment in Luxembourg to be robust and demanding, therefore creating an additional need for risk management services compared to other jurisdictions.



Finally, we have found that there are limited specialised risk management resources in Luxembourg to address the currently increasing needs, therefore our existing vast network of risk management resources in several countries is ever-more relevant to our Luxembourg-based clients.

What SYSTEMIC can offer

SYSTEMIC provides both software systems and services allowing funds of all types to improve their portfolio management and risk management operations in a risk-compliant and cost-efficient fashion. The mix of software systems vs. services can be tailored to fit the profile and existing resources of each fund (or service provider) i.e. existence and capacity of an internal risk management unit, IT systems & personnel etc.

- The software system is based on the award-winning RiskValue platform, which can accommodate virtually any type of asset and produce a vast amount of portfolio management and risk management related metrics. It is typically provided as a cloud service, although it can also be installed within our clients' data centres.
- Services are provided by our team of experienced risk managers who have a strong academic background and who have first-hand experience working with financial institutions and regulators.

As a result, our solutions include the initial elaboration and subsequent monitoring of a Risk Management Process (RMP), on-going compliance checking, regulatory reporting (including UCITS and AIFMD reporting), performance metrics and performance attribution reports, risk analysis and reporting for any type of fund, as well as regular presentations to the Board.

What makes SYSTEMIC different?

System vendors typically cover standardised situations such as investments in financial securities and derivatives. At SYSTEMIC, for the last 15 years we have addressed the needs of very diverse financial institutions including Basel II and III capital adequacy for banks, Solvency II compliance for insurance companies, and of course various types of funds and brokers. To this effect, we have built a flexible and broad platform capable of accommodating all types of assets, liabilities, and contingent items found in their balance sheets, as well as various computation modules to measure different types of risks, stress tests and regulatory reports.

On the other hand, independent risk services providers typically rely on third party systems and so from the outset they suffer from all the above limitations in the systems that they use. In addition, these are typically specialised in either RE or PE or specific hedge fund strategies which they understand best, but they can rarely offer in-depth understanding in all of these areas at the same time.

At SYSTEMIC, we have built a strong team of risk consultants who have significant expertise in all investment types and areas of risk. In addition, they have first-hand access to our system developers allowing them to take full advantage of the system's capabilities and to request additional capabilities and customisations.

