SPOTLIGHT

Ross Ellis, who focuses on institutional demands for hedge fund managers as part of **SEI**'s investment manager services division spoke with Bloomberg's Nathaniel Baker on what investors mean when they raise the issue of transparency.

Q: How should we even define "transparency?"

A: Transparency is one of those tricky industry words that everyone uses, but no one really wants to define. One investor's good transparency frequently has been another's poison and no one has ever quite defined how much transparency is enough. You can give an investor a list of the trades you make every single day and call it transparency, but if they aren't equipped to understand the data, there's nothing transparent about it.

Q: Why bother trying? Is there some kind of benchmark?

A: In the "Era of the Investor" white paper we created with Greenwich Associates earlier this year, investors stated that the desire for transparency is to obtain "adequate information to fully understand the fund's strategy" and gain "a deep understanding of the underlying positions" for risk management purposes.

Q: Sounds simple enough. So what's the problem?

A: What is missing is a practical list of what investors are asking for and how to meet these demands. This list of desired information will change over time. Understanding who is asking, for what reason, and under what circumstance, is imperative to providing meaningful and insightful information.

Q: Other than strategy, what else are investors after?

A: At its core, transparency is about integrity. Personal, investment management, investor relations & communications and operations processing integrity are all vital parts. So is process; the process to determine a price of a complex security is typically more important than the actual resulting security price, for example. If a manager or its service providers can demonstrate a logical, consistent approach and a replicable process, with controls and checks in place, investors are likely to develop a comfort that a manager's actions won't be swayed according to market movements, an individual's stress level, etc.

Q: What else are investors interested in that might be a surprise to our readers?

A: According to Ernst & Young's 2010 Global Hedge Fund Survey, "clarity and consistency of investment philosophy" is investors' second-most important criteria when selecting a hedge fund manager, after long-term investment performance. By contrast, hedge fund managers ranked this of much lower importance—at number six. Certainly a striking gap, and one that must close as time goes on.

Q: That certainly sounds like a disconnect. How do managers go about closing the gap?

A: Partly through investor reporting and communications. In one of our recent surveys on client service, investors complained that in their attempts to provide insight managers often failed to provide examples and data to back up their claims.

Q: Isn't that garden-variety marketing?

A: Investors are asking that managers provide insight and understanding about why trades were put on and what the rationale was, not just that they were made. Once position-level or portfolio information is provided, investors can match what they heard from the manager about portfolio construction and compare that with the actual portfolio. They will look for proof that what they heard is happening.

Q: At what point do investors decide it's not worth their trouble and stop allocating to hedge funds because of these issues?

A: Investors' appetites for hedge funds are high and expected to remain so going forward. The most successful managers will meet the transparency challenge head on, understanding that this is not just another buzzword thrown around but rather, a core, ongoing part of running a legitimate asset management company for the long-term.

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