



## Can Style Analysis Act as Early Warning System for Hedge Funds?

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NEW YORK (HedgeWorld.com)—Advisers and consultants have long used returns-based style analysis to assess long-only managers. Now a new tool applies this approach to hedge funds, promising greater transparency and better due diligence.

Markov Processes International LLC of Summit, New Jersey, has adopted the method to take account of short selling, leverage and derivatives, so that it gives an accurate view of hedge fund portfolios.

This version also has an enhanced ability to track changes over time. It shows whether the returns reported are in line with the strategy the manager claims to be using, alerting investors if there is an inconsistency.

Using appropriate indexes as measures of underlying markets, the analysis breaks down the sources of performance. Investors get an early warning when there is a change in this performance attribution in a direction not indicated by the manager's style.

The analysis indicates whether returns are behaving the way one would expect from the strategy as events affect the market, said Michael Markov. Red flags are raised if the performance pattern does not match the style, for example if the manager is smoothing returns.

Investors are flying blind when returns are manipulated, Mr. Markov said. There may be an acceptable explanation for the discrepancy. Then again, the investor may be better off getting out of the fund.

Besides returns data, the tool requires only a description of the manager's style. The more detailed this description, the better. No portfolio holdings information is necessary.

Well established as returns-based style analysis is for mutual funds, its application to hedge funds does stretch its limits. For instance, daily data gives more reliable results, but since few hedge funds report daily, the Markov tool can use monthly returns.

It performed well in tests. Mr. Markov applied the model to Bridgewater Associates' Pure Alpha Fund, a global macro vehicle. He shows that returns analysis picks up the fund's long and short positions correctly, judging by a published description of the portfolio by the fund's chief investment officer.

The method can be used as a fraud alert. Applied to Manhattan Investment Fund, the analysis indicates mysterious excessive returns every month—the manager, Michael Berger, fabricated returns in the late 1990s to cover up losses.

Mr. Markov argues that even if a fund's positions are available, returns-based style analysis provides useful confirmation. It can be applied to relatively new funds, as it gives meaningful results with as few as 12 months of data points.

If you are mathematically inclined, you must now be wondering about Michael Markov's last name. No, he is not related to Andrei A. Markov, who invented Markov chains and related mathematical constructs in the early 20th century.

While not a descendent of the historical figure, Michael is a mathematician (like the illustrious Andrei) and he made use of the name connection when deciding what to call his firm.

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