

Software helps detect good and bad managers

Risk tools

Investors can now check up on hedge fund strategies and detect fraud, finds **Chris Flood**

How can investors know that their chosen hedge fund manager is not a gambler or a crook?

Well, they could talk to Michael Markov, chief executive of Markov Processes International.

Mr Markov's company MPI has developed software that allows investors to check whether managers are sticking to their investment strategies and to detect potential fraud.

The company met significant interest at an investor presentation in Japan when Mr Markov demonstrated how it provided red warning flags for AIJ Investment Advisors, which admitted earlier this year that it could not account for nearly \$2.5bn in assets.

In the case of Galleon hedge fund, whose cofounder Raj Rajaratnam was convicted of insider trading, MPI was able to detect the "alpha outliers" hidden in published monthly



Insider trading: Galleon's Raj Rajaratnam

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returns. These unexpected gains were later shown to have coincided with the months when Galleon was benefiting from insider trading.

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Mr Markov declines to comment on the extent of fraudulent activities in the hedge fund industry.

MPI's software is primarily designed to help select good managers rather than detect fraud, he says.

To demonstrate the software's effectiveness, MPI recently analysed the trading strategies of Bridgewater Associates, the world's largest hedge fund house.

MPI does not know Bridgewater's holdings, positions or strategies. But using its quantitative tools and monthly returns data, Mr Markov says it has been possible to track the returns delivered by the Bridgewater Pure Alpha II fund over the past three years.

Pure Alpha II is unconstrained so it can use leverage and derivatives in

long, short or spread positions in equity, fixed income, commodities and currency markets.

But investors have confirmed that MPI's analysis has correctly identified the various sources of Bridgewater's returns.

The need for independent verification of hedge funds behaviour was underlined by a study published last year by the Oxford-Man Institute of Quantitative Finance.

It showed nearly 40 per cent of hedge funds provided investors with incorrect information about investment performance.

MPI's ability to reverse engineer fund returns is of interest to sovereign wealth funds and other institutional investors.

A risk officer at a sovereign wealth fund said: "No single tool can tell you everything but MPI's software provides valuable insights into how a hedge fund delivers returns. It can help an investor understand whether a manager is adding value. If some parts of returns are left unexplained, it can be a way to raise warning flags, especially when combined with other sources of information."

