

HEDGEWORLD SPRING EXPO AND CONFERENCE

June 3, 2008

Panel: DO YOU REALLY UNDERSTAND THE TRUE RISK IN YOUR HEDGE FUND PORTFOLIO?

COUNTERPARTY RISK—A HIDDEN RISK

Hedge funds are exposed to counterparty risk with their banks and broker/dealers in order to carry out their investment activities:

- Prime brokerage
- Repo financing
- Stock loan/borrow
- OTC derivatives
- Futures clearing
- Cash deposits

Counterparty risk is the risk of loss due to the default or downgrade of a trading counterparty, including banks, prime brokers, futures brokers.

- Refco caused hedge funds and others to lose millions of dollars
- Bear Stearns liquidity crisis highlighted this risk

What should hedge fund managers do to minimize their counterparty risk?

- Assess the credit quality of their counterparties
- Diversify sources of financing: prime brokers, repo providers, OTC derivative counterparties
- Maintain excess cash in a strong, regulated entity
- Identify all events of default and termination events in legal agreements (prime brokerage agreement, ISDA Master) and track compliance with each
- Maintain strong relationships and ongoing dialogue with all financing providers
- Ensure access to financing by negotiating committed financing, particularly for illiquid assets

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