MODULE 5 UNIT 3
Video Set Video 3 Transcript

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NIR VULKAN: So, in this video, I want to talk to you about the kind of due diligence or questions that you could expect after you've started trading, okay. So, you have, as in the previous video, either your investors, or if you are working as part of the fund, your boss in the fund who is, sort of, in charge of you. So, your model – you were lucky enough, you convinced them, you got money, you're working. What to expect now? And in particular, what to avoid?

And I'm mentioning this because if we look at the "hedge fund" as an industry, the quant side is the area where we had the most start-ups and the most blow-ups. Okay, maybe it goes hand in hand, but we had the most blow-ups, and I have seen some of them, and I tell you, that could be very ugly. When you have this amazing, you know, physicist or machine learning people come in, and a fund started, and all the goodwill, and then it goes really bad after a while, and everybody just blames each other. So, let's see the kind of things that they would be looking for and what you can do about it.

So, the first thing is what we call a style drift, okay. So, they have hired you for the model that you have promised. And that model has some kind of strategy behind it. Maybe, you know, it comes from behavioural finance, comes from some knowledge that you have about how markets work and some inefficiencies in this market, but it takes advantage of a specific thing. And that thing either they don't have, or, you know, it's sufficiently uncorrelated and better than what they have. And that's why they've allocated to you. Remember what I said earlier: different and good is better than correlated and very good. So, remember that.

And so, you must continue to deliver on that same style, the same strategy that you have promised. And they would look for it. Now, what happened is you go in, and performance isn't so good in reality as it was on paper. It's happened to me. It probably will happen to you. It happens all the time, and they will know it. So, you know, if you're working with experienced people, you know, hopefully, they're not going to kick you out just because you had a few flat months in the beginning. But what they will not like is then you start changing things. So, for example, you start doing completely different things than what you promised them that you will do. And the reason they may not like it is because of these correlations we talked about. They have allocated money to you because they expect you in a particular asset class, in a particular strategy.

And so, once you move away from that, that's a little bit like cheating, and cheating is the one thing nobody likes. When I say cheating, I'm not meaning necessarily, kind of, evil lying. But I mean, for yourself, you have to really be careful. And if you are going to make any of these changes, you have to, in my view, discuss it with them first and be very, very clear why you are doing it.

And as I said, I sat on the other side many times, and I tell you investors don't like it, even if it's successful, if the fund goes in and says, "Oh, we now move, and we're starting to do this kind of things. And it's going well for us." I'll tell you, the investors will sit together and they'll say, "That's not why we paid them. Are they panicking? Are they kind of doing something different?" That's not going to help you. So, think carefully before you change your strategy and make sure that you discuss it – before you change it – with your investors.

A related point, slightly different, is the level of risk. And I'm doing a dial in my head because I always think about, kind of, dialling up risks or dialling down risk. And something I've seen over the years is that markets always seems to get more volatile and more difficult, unfortunately. Never the other way around. And so, you go in and, you know, the ride can be pretty rough. But let's say you're doing okay, you're still in the ride, but you really don't like the, kind of, peaks and troughs of this. And so, the temptation is to actually dial down a little bit. You know, "I'm getting the management fees. I'm okay if my performance fee will a little bit be lower, as long as I reduced the risk." This is something that you might be thinking of doing.

But this is something that they would be looking for. So, they expect a certain level of risk. And that level of risk is an important feature of your model that they expect you to maintain. And similar to the comment about style drift, if you want to change that, you have to have a good reason. "Yeah, I'm content with management fees" is not a good reason, yeah? So, you have to have a good reason and to discuss it with them.

Now, having said that, there are periods, for example, at Christmas, a lot of funds kind of shut down or reduce down positions just towards the Christmas period because whatever they do, the liquidity is lower and so on. That's okay. Again, as long as you discuss this in advance with them and as long as it's consistent with your simulation for the model, yeah.

But I think that's about it. Anything above that they'll be watching for, yes? And they're experienced, they worked with more funds than you. This is the kind of thing. So, style drift and change in the level of overall risk of the strategy. You can change. Don't change them too quickly at the beginning. Make sure they understand why you do that and that you don't panic, that you have a good reason. And you build that relationship as you go on.

And what you will find is if you've done it for seven or eight years, it will become much easier to agree a change with them, because they learn to trust you. So, it's almost like in their mind they're trying to separate, you know, the hypothesis that "this person is inexperienced and a panicky person" from the hypothesis "this person is very good and knows how to make the changes if and when necessary". So, make sure you discuss it with them, and you establish that trust

But these are the two dimensions that they'll be looking for. So, I hope you find these tips useful.

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getsmarter.com | info@getsmarter.com
+44 203 457 5774 (UK) | +1 224 249 3522 (US) | +27 21 447 7565 (SA)