



Hedge Funds Remodelled

An opportunity for new best practices

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However we describe the transformation – a paradigm shift, a sea change, a quantum leap, a perfect storm – all of us in the hedge fund marketplace know that our industry has irretrievably and irreversibly changed. At Citi, our view, substantiated by definitive market intelligence, is that the recent market dislocation has led to one overriding effect: hedge funds are redefining their previous protocols and, in their place, adopting a more mature, highly efficient, best-practices operating model.

In a post-Lehman, post-Madoff world, hedge funds are under intense scrutiny to meet market, statutory and regulatory demands while remaining focused on their investment strategy. They are attempting to generate alpha and control fees and expenses while ensuring proper risk management and transparency demanded by their investor base. In this economic environment, performance is no longer the primary investment criterion. Reports PriceWaterhouseCoopers: “the widely accepted premise that performance is the key driver behind most decisions to invest in alternative funds is, remarkably, not the case. Investors consider risk management, compliance and transparency to be as important, if not more important, than returns” (see Fig.1).

Fig.1 What do you consider to be the main criteria for considering a third-party provider of alternative investments?

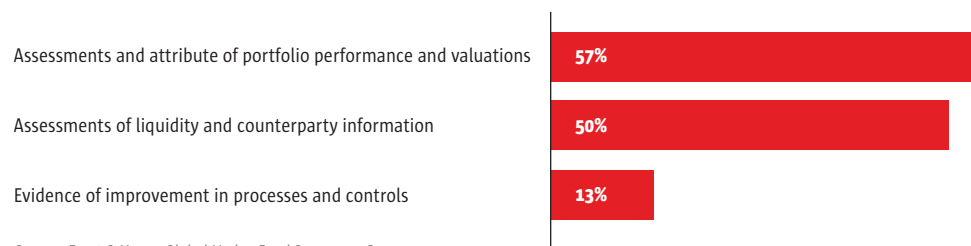
Performance	72%
Quality of compliance and risk management process	49%
Transparency	46%
Quality of reporting	33%
Product innovation	27%
Independence from large financial services institutions	18%
Size	14%

Source: PricewaterhouseCoopers/EIU survey, Jan 08

As likewise cited in Ernst &Young’s Hedge Fund Survey 2008, the pressures for transparency, greater disclosure and a greater scrutiny of risk management processes are mounting and will continue. Not surprisingly, says E&Y, 50% of firms say they have been asked to provide greater transparency on liquidity and counterparty information to their investors (see Fig.2).

To succeed in this transformed marketplace, hedge funds need to focus on investor needs in addition to alpha generation and take full advantage of a new class of capabilities – emphasizing transparency, safety and soundness and rigorous risk management practices – being developed and delivered by third-party fund administrators and custodians.

Fig.2 What specific information have you been asked to provide to your investors to demonstrate greater transparency on liquidity and credit risk?



Current market dynamics

The era when hedge funds employed self-administration and self-custody operating models is rapidly waning, replaced by a higher degree level of outsourcing of custodial, multi-prime and related services to a third-party specialist provider with the expertise to allow them to concentrate on what they do best – manage money and deliver superior client service. As consultant Celent notes in its “Trends in Hedge Fund Administration 2008” report, the majority of hedge funds have opted to unload the burden of maintaining a back office in order to free resources to allocate to their core activity – trading and generating alpha (see Fig.3).

Importantly, the outsourcing decision is not motivated by cost savings alone. The growth in assets from institutional investors comes with requirements that hedge fund managers must fulfill if they are to capture and grow institutional assets. Chief among those is the requirement that funds are administered by an independent third-party provider.

New class of capabilities

Beyond question, recent market conditions have imposed enormous pressure on the hedge fund industry. As hedge fund managers take on more complex structures and instruments in an effort to generate alpha, there is more strain on the funds’ middle and back office functions.

For support, funds are looking to third-party administrators for expanded valuation and reporting capabilities and more middle office functionality, including collateral management, risk reporting and compliance services specifically tailored for hedge funds.

- *Blended prime brokerage/custody model*
A new offering that prime brokers and custodian banks are developing to support hedge funds is a blended prime broker/custody model. This innovative capability enables a hedge fund to keep

margin investments with a prime broker and all long and unencumbered assets in a custodial bank relationship. Operating models for this will be varied given a hedge funds’ experiences dealing with multiple service providers so a flexible service offering is key to ensure the least strain on the hedge funds’ operational infrastructure. Citi is working on developing a seamless prime brokerage/custody model with an open architecture framework to allow our clients to plug and play as they see fit.

- *Collateral administration/collateral optimization*
In today’s economic environment, robust solutions are needed to satisfy the demands of global collateral managers across an ever-broadening range of products, markets and margining methods.

Although hedge fund trade strategies have become more sophisticated, the infrastructure to manage operational risk in the back office has not kept pace. Many of the operations linked to collateral management are still conducted on a manual basis and, therefore, result in increased risks with greater relevance in a blended prime broker-custodian model.

For those hedge funds that are either entering this area for the first time or have previously managed their activity through the use of spreadsheets, the volume and complexity of today’s collateral management market means that manual processes are no longer sufficient and new systems are needed.

Service providers are launching collateral administration offerings that deliver both operational solutions to mitigate risk and value-added services to improve the fund managers’ return on assets and their ability to manage client relationships. These new services provide operational support to clients specifically for collateral management and optimization.

• *Hedge fund-specific middle office services*

Service providers are introducing a comprehensive suite of middle office services that help hedge fund managers diversify counterparty risk, gain more frequent independent reconciliation of their holdings and valuations, and ultimately focus more of their professional, financial and technological resources on making investment decisions.

Typically, these middle office capabilities include a portfolio of post-trade and pre-settlement offerings, including daily trade processing, reconciliation and daily P&L reporting, in addition to OTC services, collateral management, corporate actions, cash management and risk reporting.

• *Managed account operating platform*

Hedge funds are increasingly establishing managed account structures for their underlying investors rather than creating legal vehicles like limited liabilities companies or limited partnerships. To support this structural shift, third-party administrators, as part of their middle office services capabilities, are offering managed account operating platforms that provide the robust technology these accounts require.

These solutions – which deliver end-to-end operations support from account management and imbedded compliance and audit control to paperless work flow management and performance reporting – promote efficiencies and reduce operating costs, ultimately improving productivity and enhancing profitability.

What the future holds

Just as our hedge fund industry is effectively adapting to the recent harsh market conditions, so too will we succeed in the future for the benefit of our firms and our clients.

Going forward, we believe that the global financial markets will not all recover at the same pace and

the diversification of investment strategies into the economies that recover first will give the truly global players a marked advantage. Service providers with a global reach service will allow hedge funds to benefit greatly from this opportunity. As the global economy rebounds, hedge fund managers can gain extensive operating efficiencies by engaging a single service provider, with the scale, scope and flexibility to offer individual capabilities or an integrated end-to-end package tailored to specific client needs.

In addition, we see a convergence of the hedge fund operating model and the registered 40 Act funds operating model, with the adoption of best practices being the common denominator. Hedge funds will need to meet investor demands and potential regulatory changes while still being focused on strategy. Ultimately, the key will be for the hedge funds to maintain their identity and the distinctive competencies that they possess.

Finally, we believe that despite the current market compression and pressures of investor redemptions, hedge funds will always provide an investment alternative to the sophisticated investor. The recovery of our industry will coincide with the recovery of the financial markets and the return of investor confidence, but operating models will change dramatically. A transparent and efficient operating model will become a critical differentiator for hedge funds. **THFJ**

“The era when hedge funds employed self-administration and self-custody operating models is rapidly waning”

ABOUT THE AUTHOR

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Kevin Lui is a Director in the Global Transaction Services division of Citigroup. He is responsible for hedge fund product strategy and development for Custody and Investment Services at Citi and has been with the firm for over 15 years.

Fig.3 In-House vs. Outsourced Hedge Fund Firms (Q1 2008)

Source: HFR, Celent Estimates

