The Role of Fund Administration and Technology in a Maturing Alternative Investment Market

William Keunen, Citco Fund Services, Miami

This article looks at the maturing profile of the hedge fund industry — an industry currently in the regulatory spotlight — and asks what this means in practical terms for the hedge fund manager and sponsor.

In the last two years, the hedge fund industry has begun to exhibit the classic signs of a maturing market and as such has every right to expect its participants to behave in a mature fashion. If this is really happening, what are the main indicators?

First is the performance of the markets. Following years of spectacular returns, the majority of hedge funds posted modest returns during 2001 and have continued to do so in 2002. In fact, observers argue that many hedge fund portfolios have begun to resemble the portfolios of traditional money managers. All of this is, of course, a double-edged sword. If the bear market in equities continues for several more years, investors will have little option but to make their move into hedge funds. While hedge funds were a tough sell to institutions during the seemingly endless bull market, and in particular during the tech craze that ended two years ago, the lack of correlation with major markets and the absolute returns offered by hedge funds, however modest, now seem rather attractive. Ironically, the hedge fund industry is now competing for the attention of these types of investors with fixed income investments.

Second is the appeal of hedge funds to a wider audience. The very fact that hedge funds now appeal to a wider audience has caused the creation of a variety of strategies and structures to meet the needs of the investment community. Whereas hedge funds at their outset were primarily defined by their macro approach to investing, they now come in all shapes and sizes and include categories such as long/short equity, arbitrage, emerging markets, distressed securities and market neutral, and can be packaged as structured, leveraged or guaranteed products. In fact, it could be argued that because of the plethora of options available among so-called hedge funds, it is no longer valid to describe these funds as a separate investment type, but rather as a requisite part of any diversified portfolio.

In addition to the institutional investment community, hedge funds are now increasingly being offered to retail investors. The scope for new sources of investment continues to expand, and we continue to anticipate a growth rate of 25% per annum from the current estimated $550 billion in total net assets.

What does all of this mean for the hedge fund manager and sponsor? To begin with, it is paramount that events such as the Manhattan Investment Fund fraud of 1999 are not repeated. Hedge funds are burdened with the task of convincing the entire investment community that they can run their operations properly and responsibly. As if the market itself was not applying enough pressure, recent comments from Paul Roye, the SEC's director of investment management, indicate that the regulators are keeping a close eye on the industry.

'Unlike mutual funds, hedge funds don't have to register with the Securities and Exchange Commission. While they are unregistered, hedge funds are subject to anti-fraud laws and have a duty to put clients' interests first. I can assure you that the SEC is watching to ensure hedge fund managers fulfil their fiduciary duty to clients', he said. Mr. Roye also promised that the SEC would monitor the situation closely.

With the increased profile of the hedge fund as a viable investment alternative, investors are higher up the learning curve in terms of understanding the product and are consequently more demanding. If a hedge fund wants to attract institutional money, it will be expected to deliver accurate, timely reporting, transparency and robust technology. It is no longer acceptable to protect proprietary secrets without being prepared to allow for independent scrutiny. For many funds, this may seem like a long way from how they operated a few years ago, but this is the reality of a more mature marketplace.

An added factor is that reporting and administration are not necessarily core fund manager skills, and it is this, combined with growing regulatory and market pressures, that has seen many funds outsource more of the administration functions within their funds.

Fund administration outsourcing can provide benefits for fund managers other than the straightforward removal of an administrative burden. Many of the institutions whose interest is now being courted place a high value on independent administration and valuations, as well as the specialist expertise of administrators. Investors are able to play a far more interactive role in the management of their assets, a development which may or may not excite many fund managers, but which will certainly give comfort to prospective investors. The result is an environment in which it is now commonplace to expect investors to perform detailed due diligence exercises on all of a fund's service providers before contemplating investing in that fund.

And with funds now placing as much importance on their choice of administrator as that of their prime broker, administrators are seeking to differentiate themselves and enhance their offerings through value-added services and technological developments. Whereas previously an administrator provided merely a retrospective reporting function, now they look to deliver not just a back office role calculating daily P&L and NAV results, but even a full front-to-back office function. Increasingly, in addition to the improved reporting capabilities, they are offering technology solutions with multi-currency and multi-security functionality.

For those funds that wish to concentrate on what they do best, namely the active management of investors' money, this offering provides increased capability and scalability. It enables fund managers to outsource not just the implementation of their operational and technological requirements, but also their identification, so reducing spending on these aspects of the business as their fund grows.

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It is into this environment of heightened expectations and scrutiny that Citco has entered the fray with the launch in March of its new suite of technology-based front-to-back hedge fund support services. Driven by the exclusive use of a proprietary software platform developed by Tudor Investment Corporation, the new solution is designed to deliver complete technological and operational support in a seamless, single database front-to-back environment. Other administrators are offering similar services and the prime brokers are also seeking to supply increased support to this area of the business. In any event, with the increased level of investment in technology and expertise that these initiatives will command, it is likely that the fund administration sector will continue to consolidate, with the smaller participants becoming increasingly niche players.

Having determined that, from an operational standpoint, one of the key drivers of the future growth of the hedge fund industry will be its reliance upon the added-value independent support provided by reliable experts, what are the key factors in the success of any outsourcing initiative?

The first aspect is the acceptance by the fund manager that they cannot be good at everything and that, given the state of the world's financial markets, it is even more important that they concentrate on their core competence. There may be the fear of the loss of a certain amount of control on the part of the fund manager, and this will need to be overcome at management level. In fact, it could be argued that the successful implementation of an outsourcing initiative will lead to a higher level of control, as a result of the reduced drain on management time spent on non-core functions.

Outsourcing typically involves not only a change in an existing business model, but also a change in mindset, and the scope of the solution needs to be completely understood by both the fund manager and the provider. It is a marriage of objectives that can result in optimised management of capital or acrimonious divorce.

The second aspect is the potential for cost savings generated over time by economies of scale, cutting edge technology and experienced personnel. The level of investment required to identify systems and maintain a fully operational back-office environment within a fund should not be underestimated. While no two funds are exactly alike, consolidation of these utilities diminishes the need for gathering fresh knowledge at the individual fund manager level. In other words, where the requisite set of skills is available, it makes sense for fund managers to review the options open to them.

Finally, where a systems solution is available that covers order entry and management, risk management tools and real-time reporting, and where this is linked seamlessly to an independent middle and back-office function, the chances of marrying the objectives of all of a fund's participants, namely the manager, the investors and the service providers, are much more likely to coincide fruitfully.

The nature of hedge funds ensures that their administration will always remain a bespoke activity, with solutions tailored to each fund's idiosyncrasies. Personal chemistry and, indeed, geographical location will continue to play an important role in the success of the relationship between fund manager and administrator.

The hedge fund industry has gone through a period of dramatic growth and change in recent years. The fact that the industry is maturing at a time when it is also under increased scrutiny should come as no surprise. Hedge fund managers and their administrators will need to continue to raise their game to meet the challenges of an investor community that demands transparency and accountability, together with absolute returns.

William Keunen

Citco Fund Services

Tel: 1 305 577 0233

wkeunen@citco.com