

Ireland must meet outsourcing needs

Meeting the outsourcing requirements of hedge funds is something the Irish industry needs to grasp writes Kieran Conroy as he looks back on a tumultuous 18 months.

Quite apart from the life threatening terrorist attacks, no one could have remotely predicted what has happened within the period. Throughout the last 18 months, we have lived through:

- world equity markets that have been in free-fall with no end in sight;
- one corporate scandal after another;
- a public perception that hedge funds are a risk to capital markets being roundly blamed for volatility even though short selling represents less than 1% of the volume of trading on any given day;
- the absolute returns generated by hedge funds have for the most part been meager, by their own standards;
- the publication of the USA PATRIOT Act, which at the date of writing has not yet been finalized, and in which there does not appear to be any acknowledgement that most OECD countries have been operating a largely successful set of anti-money laundering requirements for a long period of time.

The Securities and Exchange Commission (SEC) in the US and the Financial Services Authority (FSA) in the UK, are both taking a closer look at hedge funds. It appears that the SEC is apprehensive about the possibility of increased fraud. It seems to be considering whether to increase regulation of the hedge fund itself or to impose the requirement to report more information. This has led to an enquiry into the practices of hedge funds that was initially targeted at registered investment advisors, then prime brokers, and has now extended to the unregistered community, by way of subpoena (the SEC lacks the authority to demand information from unregistered hedge funds without a subpoena).

The FSA has taken a different approach, ensuring that each investment manager requires approval by the FSA prior to commencing operations of a fund while the vehicles themselves are not restricted, nor are their activities. While it appears that the FSA is under pressure from various sources (including Brussels where Europe-wide initiatives are being hatched), for the moment, it is resisting imposing restrictions on activities such as shorting, but acknowledges there may be scope for more transparency. For now, this is a positive result for London's survival as the European financial centre. What can Dublin learn from this and what can it do to leverage off the FSA approval procedures. How can we fast track managers, who have already completed their FSA application. Is there anyway that the Irish Fund application process can move in tandem with the FSA approval process to ensure a swifter start-up for funds. Why is it that Cayman is still the domicile of choice for the 180 funds that were launched in Europe last year, the vast majority of which are being managed out of EU financial environments where the manager is regulated. Why are more of these not being set-up in Ireland.

So what impact has all of this had on hedge funds and the role of the administrator?

Hedge funds come in all shapes and sizes

Although absolute returns have been meager, by their own standards, they have been providing absolute returns while the markets have been so volatile. It has led the investment community to look for other alternative asset strategies. Hedge funds now appear in a variety of investment philosophies and structures, which now include products that until recently were considered alien, such as collateralized fund obligations (CFOs), that seek to securitize hedge funds as an asset class. For administrators, the challenge is to keep up with these developments and to prove that they can add value in handling them.

The appetite for hedge funds spreads

Much has already been said about the onset of the institutional investor and their need for an organised environment in which to operate. Hence the detailed due diligence process (that encompasses all counterparties) and the demand for transparency.

In addition to institutions, it is logical that retail investors, many of whom have become disillusioned with the performance of their traditional investments in the equity markets, will seek alternatives, and access to alternative investment vehicles. The question for those in the industry is how to accommodate these investors, and for regulators, how to protect them. Retail investors have typically been granted restricted access to hedge funds through convoluted structures that seek to limit their exposure to downside risk, but that also succeed in limiting out-performance. Ireland has reacted positively by following Hong Kong's lead by facilitating a Retail Fund of Funds. The proof of whether or not this has a future will be when we start seeing Retail Fund of Funds included in individual PSRA's – Personal Savings Retirement Accounts.

Managing hedge fund risk and the administrator's role

The growing interest in hedge fund investing, together with a profile that generates daily media exposure, has made measuring and managing risk a hot topic within the sector. Investors, in performing their own due diligence process, are focusing more on how hedge funds manage risk.

So how can the administrator help? The independence of the administrator is of critical importance. They aggregate data from all prime brokers and counter parties. They price the fund in accordance with the prospectus in which the pricing policy is disclosed. Probing the administrator to verify their approach reinforces the overall perception as to whether the administrator is genuinely adding value to measuring risk or whether they are just taking the prices from the fund manager. Finally, the administrator should be in a position to supply information about the fund's activities, if not about individual positions. This could include both sector exposure and attribution, as well as benchmark reporting.

The fully-fledged “front-to-back” solution

As administrators seek to add value to the services they offer, and the demand for increased transparency and timeliness of reporting grows, it makes sense for administrators to ramp up their capabilities to meet the challenge of daily reporting and reconciliation. Certain administrators now supply fund managers with order and risk management software that is installed on their desktop, and is supported by the administrator’s middle and back-office expertise. It is a comprehensive solution that is automated, scalable, and fully reconciled to all counter parties in the market place.

This approach requires a change in mindset on the part of both fund managers and administrators. While it may not suit all hedge funds, the successful implementation of an outsourcing initiative does lead to better control of the core function of the fund manager – the management of performance and risk. Meeting these outsourcing requirements is something that Ireland needs to grasp as it puts the administrators in a position of providing daily operational support to the trading manager. These are some of the skills that we as an industry require if we are serious about our desire to further expand the investment management industry in Ireland.

Conclusion

The past 18 months has brought a profound gloom to the financial services community, with both lives and jobs lost. Today, we may be standing on the threshold of war. Markets have continued to decline, eroding performance. Meanwhile, the full impact of various ongoing regulatory initiatives remains unclear. Given these uncertain times, we can be grateful that the hedge fund industry continues to grow, albeit at a more modest rate.

It is to be hoped that the attraction of the hedge fund as an investment alternative is not stifled. To avoid the added burden of regulation, or worse, loss of investor confidence, those who understand and benefit from hedge funds should continue to invest time educating new entrants into the sector along with other participants who need to understand the process better, including regulators. Capital must be dedicated to risk measurement systems and tools to reassure investors that their needs are being met. For now, we are at a delicate stage in the evolution of the hedge fund industry.

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