Pushing the right buttons

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Winning hedge funds' business has become trickier than ever for the major **prime brokers** as IT providers, as well as other banks, look to increase their market share. **Rachael Horsewood** finds that technology is the central issue in this changing market

Information technology is only one of many things that hedge fund clients look for in a prime brokerage. But even large hedge funds with proprietary systems would agree that information technology is an integral part of prime brokers' products and services.

Philippe Carrel, head of business development for Europe at Thomson Reuters, says many hedge funds look at technology as a form of risk management. "Hedge funds generally have been good at calculating and reporting market risks since they are natural risk takers and because their shareholders and investors ask for it," he explains. The Cayman Islands Monetary Authority (CIMA) recently estimated the hedge fund industry to have somewhere around $2,300bn in assets under management.

Carrel says a lot of Thomson Reuters' hedge fund clients have taken on a more proactive approach to risk management given the added volatility and liquidity concerns caused by the ongoing credit crisis. Given the current market environment, he says a lot of hedge funds are playing it safe with more risk-averse trading strategies, such as FX, equity cash and long/short. Industry observers also stress how much counterparty risk has become a big focus for both hedge funds and prime brokerages.

William Lavelle, chief operating officer at Credaris, a credit hedge fund in London, says: "If you asked me a few years ago whether I was concerned about counterparty risk of the top prime brokers, I would have said 'no'. Were the prime brokers thinking about me and what would happen if I fell due to market pressures? Yes. That was how counterparty risk was thought about when it came to the relationship between hedge funds and prime brokerages. But the speedy demise of Bear Stearns has changed a lot of people's thinking about counterparty risk. Hedge fund managers and their boards of directors want more diversification now."

Consequently, an increasing number of hedge fund managers around the world are talking about the importance of using multiple prime brokerages. The multiple prime brokerage concept is about spreading risk and gaining liquidity. But it also is driving most of the IT products and services in the hedge fund industry today.

"My view on how many prime brokers we should use has changed over the past couple of years," confirms Lavelle. "Historically, there were two defined business models. It was common for equity hedge funds to have multiple prime brokers. The fixed-income space has never been as diverse so funds in this area tended to have one prime broker and then multiple trading counterparties for cash or International Swaps and Derivatives Association master agreements."

Sol Zlotchenko, chief technology officer at Paladyne Systems in New York, says the multi-prime brokerage concept has accentuated the need for good data management. "When you use multiple prime brokerages, your technology demands grow. You have data coming in from different sources, so reconciling and managing it becomes very important. Prime brokerages have different ways of formatting and feeding data, whether it is financing details, securities prices or trading positions, so you must have a robust platform in place in order to manage it all," he explains.

Philippe Carrel, head of business development Europe, Thomson Reuters

Middle office solutions

Middle office solutions are also popular pitches for prime brokerages and other service providers. "As hedge funds add prime brokers, the cost and effort to consolidate data across the various systems increases," observes Peter Donovan, head of financing client management at Merrill Lynch, which claims to serve more than one-third of US hedge funds with assets over $1bn.

"Both start-up and established hedge funds are increasingly outsourcing their middle and back office functions to multiple service providers in order to focus on what matters most to them – performance," adds Donovan's colleague Jeff Penney, co-head of global markets financing and services at Merrill Lynch in New York. "While other prime brokers may lock in their clients with a front-end system, our strategy is to facilitate the flexible, independent multi-prime broker environment most hedge funds prefer, giving them access to competitive pricing for financing and stock loan."

Carrel says there is also a growing focus on connectivity. "If you want to have quick mark-to-market, margin calls and responsive assessments of counterparty risk, then you need to make sure that the hedge fund, the prime broker and the custodian all speak the same language. You need to align your databases, making sure that things like securities prices, static data and corporate actions are streamlined," he explains.

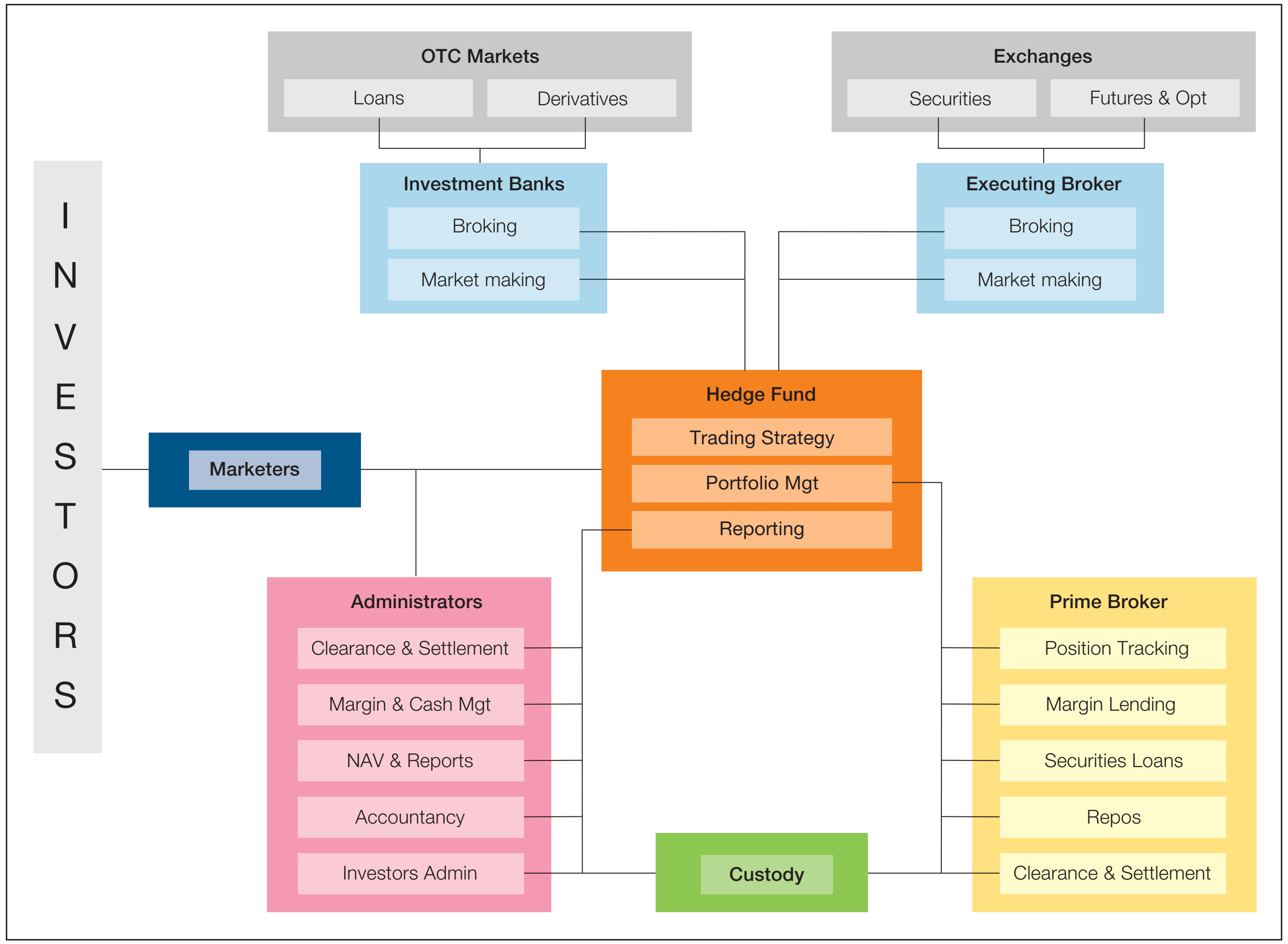
Prime brokerages and other service providers are obsessed with the importance of data management. "Every time a financial instrument is developed a new system is created to match its cash flow description. But the data management stays the same – as long as the data is clean and reliable," Carrel adds. He agrees that a lot more types of service providers are working on solutions to this.

Belinda Keheyan, head of international marketing at Investment Technology Group (ITG) in London, is quick to mention Triton, the company's execution management system (EMS) platform. "In general, most hedge funds do not have proprietary systems, so they look for brokers like us that can offer everything from auto-execution and algorithms to direct market access (DMA) and smart order routers. Hedge funds that do not have an EMS or order management system (OMS) also come to us for systems technology and analytics."

ITG purchased Macgregor, one of the original OMS-developers, in 2006 and has since worked to integrate Macgregor's XIP OMS with Triton. The integration is ongoing and eventually the firm plans to have a single customisable offering that allows customers to choose whether they want to use a standalone OMS, a standalone EMS or a one-stop trading system.

According to TABB Group, a research and advisory firm in the US, Triton is

Traditional Industry Workflow



Source: Thomson Reuters

the second most widely used EMS. The most widely used EMS is Goldman Sachs' RediPlus, which is used by 46 per cent of US-based buy-side trading firms. TABB says that about 95 per cent of US-based trading firms on the buy-side currently use an OMS. It said 70 per cent of them are using an EMS.

Most of ITG's hedge fund customers trade equities. "Connectivity is one of our EMS product's biggest selling points. Because it is broker-neutral, it allows customers to trade with any broker they like, even while they use our algos," Keheyan says.

"Hedge funds are generally pretty tight-shipped and are not massively resourced from the systems technology point of view, so many of them are looking for a broker that gives them these kinds of offerings." She describes ITG as a hybrid between technology provider and prime brokerage.

Transparency focus

Transparency is another thing the industry is focusing on, especially when it comes to leverage and credit. "I expect more service providers will take note of this focus too. Northern Trust recently launched a new platform that provides increased transparency to hedge funds of funds," remarks Ezra Zask, ceo and founder of Lakeville Capital Management, a hedge fund consultancy in Connecticut.

There also appears to be a natural convergence taking place between prime brokering and custodial services. "They will work together on one-stop solutions for hedge funds and hedge funds will become less reluctant to use them for that. Hedge funds will see the advantages of sharing more information with their prime brokers," Carrel explains.

Other banks are working out ways to target the hedge fund industry. Citi recently entered the prime brokerage business, following its $800m acquisition of Bisys, a fund administrator, at the end of 2007. One inside source says that Citi is building 'modular' technology so that hedge funds can pick and choose what service suits them. He says it is hardly surprising to see Citi take up this strategy given that the net margin for prime brokers was 100 basis points compared with four or five basis points for custody.

Even big hedge funds are eyeing up opportunities in this evolving space. Chicago-based Citadel Investment Group, one the world's largest hedge funds with over $20bn under management, has launched what it calls the first integrated hedge fund platform. Citadel Solutions, the name for this new hedge fund administration business, was created for customers of Bloomberg AIM, the buy-side OMS. The streamlined platform includes OMS, EMS, risk management, compliance, data, security valuation, trade break management and fund administration. Sources say it is being used by a growing number of hedge fund of funds.

Some hedge fund managers in London report that the strain being felt by Wall Street banks more broadly is creating interesting opportunities for European prime brokerages. BNP Paribas, France's largest bank, recently bought Bank of America's equity prime brokerage business, which is known for servicing over 500 US hedge fund clients. The deal is supposed to be finalised sometime during the second half of 2008.

"Increased competition between execution venues and vendors has brought on more market fragmentation. But the benefits of competition outweigh the consequential fragmentation, particularly if the trader uses technology with good connectivity," remarks Keheyan.

"Before all of this competition you would measure your performance against a benchmark, which ended up being an index on an exchange. Now we have data from numerous sources, which is good as long as it is clean and reliable. Data collection and cleansing is critical in making sure that the transaction cost analysis (TCA) is valid and accurate," she adds.

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Asian market access

Outsourcing for hedge fund technology is gaining new momentum in Asia too, especially as more markets open up. India and Malaysia, for example, have recently implemented direct market access. A study conducted by TABB Group earlier this year showed that an increasing amount of hedge funds are using prime brokerages for execution services and administrative functions when opening up new offices outside of their home market. It said that many of the global investment banks have been rejigging their businesses to meet the growing electronic trading and research and portfolio management needs that hedge funds require as they expand their offices internationally.

According to the report – 'Hedge Funds 2008: Perspectives on Prime Brokerage, Volatility and Expansion' – US hedge funds were increasingly expanding beyond their home market. It says that one out of every four hedge funds plans to open an office outside the US in the next two years. Many of them are expanding in Asia – some 68 per cent of the respondents to TABB Group's survey said they were planning to invest in Asia outside Japan.

The report adds that because of the limited capabilities of the hedge funds' new satellite offices, prime brokers will be integral to providing them with back-office, market access, marketing and sales services. Most sources "guesstimate" the number of hedge funds around the world to be at least 10,000. It is worth noting that many new funds – some on emerging markets and a lot on equities – have been set up to benefit from the good buys in the market.

Still, there is a minority group of larger, specialised hedge funds that expect nothing more than liquidity and leverage from their prime brokerages. "We do not necessarily demand more data from prime brokers. Because of the specialised nature of the structured assets we deal in we tend to use more third-party providers when it comes to data. Irrespective of the Chinese wall they sit behind, prime brokers are likely to be using data from their own trading desks. Therefore, if you are mark-to-marking your portfolio using their data, you are marking your portfolio to theirs," explains Credaris' Lavelle. Sources say that most of the hedge

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funds in this camp see their prime brokerages as trading partners, not service providers.

Another manager at a large London-based hedge fund says: "We do not choose our prime brokerages because of their technology offerings, and we do not have an EMS or OMS. This market is too bespoke and about 98 per cent of the trades are still done over the telephone." He adds: "But it is a totally different story for those funds trading equities. Prime brokerages are offering a lot of systems that make sense for that type of business."

Derivatives trading

However, larger hedge funds that have their own in-house systems take great interest in what prime brokerages are doing to help make derivatives trading more efficient. This is regardless of whether they invest in equity, debt or structured products. "Hedge funds seem less concerned about technology or not being given enough credit from their prime brokerages. The larger issue for most hedge funds is making sure their assets are safe and liquid," Zask explains.

One hedge fund manager with over $2bn under management says: "A lot has been done to standardise the process and documentation of credit derivatives, but breakdowns in the processing of these trades still exists. We can end up with some significant basis risk in terms of what you think you've done and what you've actually done. This happens sometimes, but people are a lot more responsive than they were a few years ago, especially when it comes to margin calls."

Hedge funds, traditionally, have been reluctant to give much away about the investment approach or pricing model they use. They do not want to divulge what could be their edge in the marketplace. Hedge funds also do not want to expose their positions because it means other players could react in a way that would make the hedge fund's strategies less favourable. But this seems to be changing too, especially as investors ask more questions.

"Investors are asking a lot more questions and the questions are definitely risk-focused," Lavelle says. "Historically, the first line of questioning would be more about track record and performance whereas now there is a lot on risk management too. They want to make sure you have the right sort of risk infrastructure needed to maintain your track record and they are very interested in the technology you use to monitor risk and produce daily reports on it. When investors come to our offices, one of the first things we do is bring up the reports on our screens and show them how our risk management platform works," he explains. All of Credaris' systems technology was built in-house.

"In 2005, when we set up, we looked at what was available and felt we weren't going to find an IT provider that could give us everything we wanted. We built what we wanted from the operational, risk and portfolio management perspectives and it has worked well for us. We could scale the assets we have under management without having to scale our operations," he explains.

Thomson Reuters' Carrel also refers to the clearing and settlement of credit default swaps. "Hedge funds have learned that a credit event can impact their spreads and funding terms immediately. The market needs to be responsive in case something like a claim for cash payment comes about. But you need more than good systems technology to manage this type of risk. You need better alignment of data management and processing. This will require a fair amount of standardisation and standardisation can be offputting if it limits the flexibility of the financial instruments," he explains.

As Zask points out, banks and hedge funds also have been reviewing the assumptions that they put into their risk management models. He says the general consensus is that models need to adapt better to crisis situations.

"Hedge funds have been pretty good at analytical models for some time now. But there is a new emphasis on stress management and how to model unusual situations. That is one area that I expect service providers will focus on," he says.

Zask agrees with other sources who suggest that hedge funds are picking up a lot of ex-investment bank staff. These hires do not only come from trading or structuring but also risk management and analytics. Some are aggressively looking for IT specialists in the risk management area.

"We have seen versions of this every time there has been upheaval in the market," remarks Zask in connection with the tequila crisis in 1994 and the Russian default in 1998. "But this one is more widespread and systemic than previous crises and I think it will lead to more changes in risk management over time," he concludes. ■