Chapter One:

A Year of Turmoil: Impact on Hedge Fund Operations

William Keunen, Citco Fund Services

Writing this at the time of the one-year anniversary of 11 September, it is difficult not to look back on what has been a tumultuous year, not least for those in financial services. Many who perished that day worked in this sector. All of us have been impacted in some way.

Quite apart from the life-threatening terrorist attacks, no one could have remotely predicted what has happened within the last year. Take a look at some of the following events and their very real impact on hedge funds.

The markets: world equity markets have been in free-fall with no end in sight.

Returns: while relative performance has exceeded that of traditional money management, the absolute returns generated by hedge funds have for the most part been meagre.

Capital flows: as a result of their poor showing, certain asset classes have experienced diminished net inflows.

The public's perception that hedge funds are a risk to capital markets: hedge funds have been roundly blamed for increasing market volatility largely because of their ability to short sell, even though short selling represents less than 1% of the volume of trading on any given day. This perception prevails despite the fact that mutual funds helped drive prices down as they were forced to sell their holdings to meet the daily withdrawals of investors disillusioned by poor returns.

A year of corporate scandals and accounting irregularities: the revelations of corporate malfeasance have resulted in several pieces of legislation that are designed to restore confidence in the financial reporting system, including the Sarbanes-Oxley Act that was signed into law in July 2002. While it is clear that these scandals have, to date, not implicated hedge funds, it could be argued that the lack of transparency in financial accounting can be applied to a debate about hedge fund transparency.

The PATRIOT Act: the Act was signed into law in the US in October 2001. However, the requirements for unregistered investment companies, which include many hedge funds, have not yet been finalised. The deadline was set as 24 October 2002. At the time of writing, it appears that the Treasury is recommending that all hedge funds, whether registered or unregistered, should be required to adopt anti-money laundering programmes, designed to lead to increased scrutiny of investors.

As advocated in the guidelines set out by the Managed Funds Association, the act recognises that hedge funds may typically conduct their operations through administrators and, as such, provides for the ability of a hedge fund to delegate the anti-money laundering process to its administrator. However, the hedge fund will still be held responsible for the effectiveness of the programme and federal examiners should be able to inspect the third party and obtain any information relating to the programme. How Treasury anticipates enforcing these principles, in particular for funds administered outside the US, remains uncertain. The other issue relates to the nature of the investor, and the process appears to impose an evaluation of each investor based on the money laundering risks they pose. As the consultation process reaches its conclusion, we watch this space with interest.

Regulation: regulators in the two main centres for hedge funds, 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. The SEC also wants to assess whether there is an increased retail appetite for hedge funds and, if so, how to protect this category of investors. 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 inquiry into the practices of hedge funds that was initially targeted at registered investment advisers, 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 SEC is still in information-gathering mode and plans to conclude its inquiry by November.

The FSA takes a slightly different approach. While each investment manager requires approval by the FSA prior to commencing the operations of a fund, 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.

Guide to Sound Practices for European Hedge Funds: recently finalised and published, this document is the result of a detailed consultative process between the main players in the UK hedge fund market, investment managers, sponsors, lawyers, prime brokers, administrators, investors and the Alternative Investment Management Association. Its intention is to provide guidance on the key areas of a hedge fund business to new entrants. Although it does not purport to cover every scenario, it effectively raises the bar for the whole industry by setting standards and acting as a useful reference point.

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

With some notable exceptions, the largest asset class among hedge funds, long/short equity, has experienced its worst performance period while the markets have been so volatile. Anecdotally, this itself implies that most managers have remained net long. In any event, it has led the investment community to look for alternative asset classes. Hedge funds now appear in a variety of investment philosophies and structures, which now include products that until recently were considered alien, such as collateralised fund obligations, that seek to securitise 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 (which encompasses all counterparties) and the demand for transparency. Institutions also generate their own asset classes that are often some variant of the fund of funds structure. In fact, growth in assets invested in funds of funds currently outstrips that of direct investment hedge funds.

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. Again, funds of funds are often the vehicle of choice.

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 due diligence process, are focusing more on how hedge funds manage risk. They want to know whether fund managers have risk management systems, how many people within the organisation focus on risk management, and what type of risk management information they provide investors, and how frequently. Investors indicate that their main concerns are liquidity and market risk. The majority have experienced a negative surprise regarding a hedge fund manager; the result being that the demand for transparency takes on added urgency.

Risk generally relates to performance, and poor performance can result from two major areas — market risk and operational risk. While market risk can be caused either by the performance of the market as a whole or by a specific position in a portfolio, operational risk is typically considered to be non-market related. This is the area that is affected most by the quality of a fund's counterparties, the prime brokers and the administrator. For example, pricing the portfolio can be problematic, especially in the case of illiquid securities or for portfolios with complex derivatives. Pricing models may be invalid and even listed securities are often thinly traded. In reality, the only time a price can truly be verified is when it is traded.

So, how can the administrator help? The independence of the administrator is of critical importance. The fund's prospectus discloses its pricing policy, and scrutiny of the administration agreement provides insight into the administrator's role in the pricing process. Probing the administrator to verify their approach reinforces the overall perception as to whether the administrator is genuinely adding value to risk measurement. After all, the administrator could just be taking the prices from the fund manager. Finally, if the administrator is able to satisfy the investor's need for transparency, then they should be in a position to supply information about the fund's activities, if not about individual positions. This could include sector exposure, attribution and the proportion that big bets represent to the overall portfolio.

Increased Interest in Outsourcing

Despite the fact that assets are not growing as in previous years, and that there is more competition now than ever before, fund administrators report that business has held up well. The principal reason is that there are an increasing number of outsourcing enquiries. Why is this? Because investors are now increasingly sophisticated. They insist that funds are properly managed and that their operations are transparent — and no longer remain the sole domain of the secretive fund manager. Also, for the most part, fund managers recognise the advantages of delegating those areas of the business about which they know least, and which can be time-consuming — especially if the service provider is familiar with the product and can, through its independence, add credibility with investors.

Finally, as administrators strive to develop systems and processes that support the industry's requirements, the notion that an outsourced agent can meet the expectations of both managers and investors takes on greater credence. It is self-fulfilling.

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 the marketplace. It is automated because the systems flow front to back from trader to back-office seamlessly, with electronic prime broker feeds received overnight. It is scalable because it allows the hedge fund to grow without growing its operations, (allowing the fund manager to dedicate resources to managing the fund). It is fully reconciled because the daily three-way reconciliation between fund manager, administrator and prime brokers remains intact.

This product is typically most attractive to medium-sized hedge funds and start-ups where there is little or no infrastructure in place to manage a hedge fund's operations. It may be an attractive solution for hedge funds that are more complex, trade a variety of securities, use multiple counterparties to execute and clear trades, and need an expert aggregator of data — a service provider with the ability to reconcile information relating to positions and cash on a daily basis.

Furthermore, by reconciling trades and cash positions with each prime broker daily, and ensuring that accounting records match the fund manager's view of the world, the administrator becomes familiar with the fund's activities. Consequently, the administrator is better equipped to provide investors with what they need — transparency and risk information from an independent source. By supplying the information investors want and by demonstrating that the proper process is in place, the hedge fund is favourably positioned to raise additional capital.

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.

Specific Post-9/11 Concerns

The critical importance of securing data was emphasised on 11 September. The result has been the creation of business continuity environments in separate geographic locations that enable hedge funds to rely on high system availability at all times.

Conclusion

The past year 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 hedge fund 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 in 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. We are at a delicate stage in the evolution of the hedge fund industry.