

August 23, 2005

The Hedge Fund and the Welcome Wagon

Relocating from the Bahamas to Park Avenue tests hospitality of onshore service providers

By Chris Kentouris Senior International Editor



August 22, 2005 – When Joe Bucci joined hedge fund Lyford Group as chief operating officer a year ago, his first task wasn't to set trading strategy or bring in new clients. It was to find enough office space in New York City to comfortably fit a staff of five without breaking the bank.

Lyford's global macro-strategy fund, started in 2002 by former trader Samer Nsouli in the Bahamas, had a modest \$10 million in assets under management. "We didn't want to spend exorbitant sums of money and then hope the assets would grow," recalls Bucci, former manager of Credit Suisse First Boston's prime brokerage operation.

Bucci scoured the Big Apple on his own and, despite his training as an accountant, found the task of renting office space too daunting. "It wasn't just finding the space that was a problem," he says. "It was also determining whether there was sufficient room for a secure and climate-controlled computer room for our servers and other technical needs." Bucci anticipated that the firm would eventually grow from four traders to eight.

Bucci's balancing act is common among start-up hedge funds. Typically run by former wirehouse executives, they must ensure that their operations are cost-efficient. The funds earn a piece of the action through management and performance fees and, as in Lyford's case, readily outsource operations and processing work that doesn't fall under trading strategy. Only the largest of the thousands of U.S. hedge funds have the staff know-how or experience to run these tasks in-house.

"We realized that we could spend ourselves out of the market quickly--the way many of our peers have," says Bucci. Instead, Lyford is still in business--and growing--three years after it started in a family office in the Bahamas. The firm's principals had big plans but put them into effect deliberately and incrementally. They turned, for example, to Eze Castle Integration (ECI), one of three industry leaders--the others are Richard Fleishman & Associates and Gravitas Technology--that usher newcomers along in their role as outsourced IT providers. These outfits bring to bear, on behalf of their clients, relationships

with service providers in such specialties as trade order management systems (OMS) and fund administration providers, which they help their clients manage. ECI, which calls itself a "virtual CTO," says that many of its 400 clients are managing under \$100 million of assets.

Bucci and Nsouli moved from temporary quarters at 300 Park Avenue to its current New York office at 375 Park Avenue within three months, after over 50 visits to various locations in Midtown Manhattan. In Nsouli's case, the relocation involved packing up his family in the sunny Bahamas and moving over a weekend. Joining Bucci and Nsouli were a chief strategist, a trading assistant and a secretary.

A three-month transition might seem of little consequence in the traditional world of portfolio management, but to a hedge fund manager who profits from short-term market inconsistencies it can seem like an eternity of lost opportunities. Even with ECI's considerable help, not everything went according to plan.

The Dell personal computers--a common choice in the hedge fund industry because they are flexible and economical--got up and running smoothly, along with data feeds from Bloomberg and Reuters. Only the door to the air-conditioned computer room couldn't be shut. It had been installed backwards, requiring a day to fix.

Then came the bigger decision: just how much to spend on trading and back-office technology and what to select. "Software is the lifeblood of what we do, but we needed to maintain cost controls," says Bucci.

While other hedge fund integration providers--Bucci won't name them--were recommending that Lyford spend megabucks on the latest high-tech gadgetry, ECI took a conservative tack that cost Lyford 25 percent less.

Executing less than a dozen trades a day, Lyford does some of its work manually. The firm places orders over the phone and does not use a full-blown OMS. After confirmation that the trades have been executed by floor brokers at any of a dozen exchanges around the world, trade details are sent to Lyford's prime broker--Bear Stearns--and to fund administrator Citco, which reconcile their books the following day. The hedge fund relies on the RiskManager product from RiskMetrics, using the application service provider model of outsourcing, for daily value-at-risk calculations and portfolio stress-testing.

Lyford also relies on ECI to be its facilities manager. That means that it can call on ECI staffers to fix anything from a computer system glitch to a phone problem. Bucci declines to specify how much Lyford pays ECI but acknowledges it is "far less" than having two full-time IT staffers on call around the clock.

ECI officials say that Lyford's smooth IT growth is typical of the start-up hedge funds with which they work. And ECI doesn't have to fear becoming a victim of its own success--some clients may expand their relationship with the firm while others downsize. "We understand how to grow and change with our clients'

businesses and make it the most effective solution for managing their IT and infrastructure," says managing director Chris Grandi. Industry sources, however, say that ECI has lost two large accounts to Gravitas despite higher fees.

Although Lyford didn't lose even an hour of trading time in its first year of full-scale operation, it must, like any financial institution, take precautions for potential disasters from an IT and infrastructure perspective.

All information on Lyford's daily trading activity is stored electronically by its prime broker and fund administrator, meaning the data can be retrieved within minutes from either third-party source. That trading volume is scant further simplifies things. Should Nsouli or his colleagues lose access to Lyford's office, they can always work from their laptops at home or at other remote locations.

Anecdotal evidence indicates that one-time costs of registration could exceed \$100,000. Recurring annual costs could be even higher.

Such arrangements may not, however, pass muster under the Securities and Exchange Commission's requirement, effective February 2006, that hedge fund managers register as investment advisers. Lyford could easily stay off the regulatory radar screen--it has fewer than 25 investors--but it plans to register as a step toward boosting its client base and assets beyond the current \$50 million. Lyford also wants to create a new, higher-risk hedge fund, but Bucci would not elaborate further except to say that Lyford will hire a trading strategist to assist Nsouli.

In addition to an undisclosed European family that provided Nsouli with Lyford's seed money, JP Morgan Incubator Strategies, a hedge fund investment arm of JP Morgan & Co., owns a minority stake in the global macro hedge fund. JP Morgan also serves as Lyford's placement agent.

Along with registering with the SEC, Lyford must also select a chief compliance officer--a role Bucci is willing to undertake--and meet exacting reporting and documentation requirements. It must prove that it has a solid methodology for pricing its portfolio and sound operational procedures including business continuity plans.

Pricing its portfolio is easy enough--all of Lyford's holdings are in exchange-traded securities, unlike other hedge funds with difficult-to-price exotic or illiquid holdings. The fund is 60 percent invested in equity and fixed-income indices, with currencies and commodities making up the remainder.

"Writing the documentation will be the most expensive and difficult exercise," predicts Bucci. His stance is shared by many hedge fund managers who must or want to register. Anecdotal evidence indicates that one-time costs alone could exceed \$100,000. Recurring annual costs could be even higher depending on whether a dedicated CCO is hired and how many other changes are required to comply.

Under SEC oversight, Lyford would have to electronically archive all of its e-mails and instant messages. In keeping with its relationship with ECI, Lyford will count on the integrator to install an e-mail archiving system.

"We're not looking to be audited by the SEC," says Bucci, a former auditor. "But we intend to be prepared if that should happen."

*(c) 2005 Securities Industry News. All rights reserved.
www.securitiesindustry.com www.sourcemia.com*