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OPEN PLATFORM: EZE CASTLE INTEGRATION

Jack of all trades

The marked increase in institutional capital flowing into the hedge fund market in the past 12 to 18 months has brought with it some stiff challenges, as funds are forced to comply with regulatory and institutional investor requirements, while trying to concentrate on their core competence and preserve their 'lean and mean' status. It's a big challenge, writes Chris Grandi

The past few years have found the hedge fund industry at the epicentre of unprecedented growth and attention. The once-rebellious outliers of the financial services industry are now its darlings. Individual investors, institutions and the vendor community are all clamouring to be a part of this ever-expanding bubble.

However, with this growth has come significant change – some of which has called into question how hedge funds can continue to do what they do best – manage money – while at the same time meet new regulatory and investor requirements. Institutional investors bringing increased stringency, imminent SEC regulations and connection with a greater number of players in the financial services universe mean hedge funds must adapt to these changes without dropping the ball of profitability – and adapt quickly.

A new hedge fund paradigm has developed – technology outsourcing is taking centre stage for hedge funds of all sizes and strategies. In particular, increasingly critical and complex IT needs have seen the rapid uptick in outsourced IT services – allowing hedge funds to use IT as a leverage point from which to meet new demands and grow their businesses.

Hedge funds have long been known for running lean and mean – often comprising small staffs managing enormous quantities of money. Any excess staff were the bare essentials – administrative support and limited, if any, IT support staff. IT was a necessity kept to its most critical components. However, the arrival of the hedge-fund boom called into question traditional operating models – would they be able to meet increasing investor demands, and would they be adequate to support growth and profit making?

New money and a new way of doing business

This growth has found sources of new capital shifting rapidly and unexpectedly. Institutions – pension funds, endowments and foundations as opposed to wealthy individuals – are becoming the primary source of investment capital for hedge funds. With this shift has come an increased need on the part of hedge funds to do business in a different way, no longer as the rebels of the financial services world, but as firms employing industry-standard best practices. Hedge funds have been called upon to professionalise and 'operationalise' their businesses – management excellence, strong operational controls and top-notch client response and service are all de rigueur. And, at the cornerstone of this, is the IT to back it up and make it run.

The most pertinent questions are: How do we meet these new levels of stringency, while still doing what we do best – invest money while maintaining profit margins at the highest rate possible? And how do we scale the notoriously lean-and-mean hedge-fund world to meet these demands?

Institutional investors – new demands

Institutional investors are specific about the attributes that hedge funds need to display to win their business. While the primary driver of hedge-fund success remains the investment professionals' ability to deliver investment returns, past performance and innovative investment strategies will no longer be enough to win investors' confidence. Institutional investors are demanding that hedge funds display solid and robust operational capabilities that meet a number of due diligence requirements – standardised compliance reporting, transparency in performance measurement and operational risk monitoring are but a few.

To satisfy these demands, hedge funds need to develop a more mature business model than was previously expected by individual investors. Institutional investors need to feel confident that their hedge fund adviser is a viable long-term business, that the investment professionals are focused on their core competency, and that the business is supported by robust infrastructure with well-defined procedures and processes. Additionally, given the rate of growth in hedge-fund business, institutional investors will closely study hedge funds' ability to scale and grow, while mitigating operational and business risks.

Lean-and-mean meets outsourcing

One of the most successful ways in which hedge funds have been able to meet the institutional investors' demands for operational excellence is by working with best-of-breed outsourced technology providers – allowing hedge funds to stay focused on their investment-management core competencies, while at the same time providing institutional quality infrastructure, compliance and client service.

Hedge funds have traditionally outsourced clearing to prime-brokers and record-keeping to fund administrators. As hedge funds continue to take on institutional assets and comply with additional SEC rules, they have increased their need for more robust business and technology solutions in areas such as compliance, disaster recovery, data back-up, e-mail archiving, client reporting and the often overlooked area of voice systems.

Additionally, the rapid advance of technology in areas such as direct market access and algorithmic trading have caused hedge funds to look to outsourcing providers to meet their needs. Further, many hedge funds have structured relationships with outsourced providers to work as virtual extensions of their hedge fund – allowing them to get the best talent in technology, compliance and client service. This lets the hedge fund provide the best services on all fronts and provide institutional quality services that institutional investors are looking for.

The key components

Increased investor demands and desire for growth should not cause hedge funds to over-complicate their operations or over-invest in them. With regard to IT infrastructure, systems should be kept to core, essential functions: communications (e-mail and instant messaging, telephony), compliance (regulatory and investor), disaster recovery and business continuity, networking, CRM, third-party data providers and trading and accounting systems. They should be reasonable and rational – the right scale for where the hedge funds are now – and be able to flex to where they might be in one, two, or more years down the line.

Realising the benefits

If outsourced IT spending trends are accurate, then hedge funds are finding clear and increasing value from outsourcing. So what are the real, essential benefits to outsourcing IT?

- More is better – put simply, there is no way even the largest of hedge funds can or would develop the IT infrastructure – both in terms of human and non-human resources – that is available through using a top-notch outsourced IT partner.
- Stay safe – an outsourced IT firm can implement a greater number of safeguards and protections than a typical hedge fund could develop internally – at a lower cost and at a quicker time to market. Business continuity and disaster recovery solutions are a critical concern, given that even a few hours of down-time can mean millions of lost dollars. Outsourcing this function not only gives hedge funds access to better technology, but an army of people monitoring it and ensuring as close to 100% up-time as is possible.
- 20/20 foresight – firms need IT today; they need systems and services implemented for the near-term. But they also need to plan for the future. By leaning on the outsourced IT partner, hedge funds not only have day-to-day, near-term support, but can leverage a ‘virtual CTO’ (chief technology officer) model through which their IT partner provides long-term technical strategy and infrastructure planning.
- A dirty three-letter word – it’s there, hedge funds aren’t anxious to talk about it, but they’re getting ready. In just a matter of months the SEC will levy its new regulations, and funds will have to register and be ready for an entirely new type of monitoring. IT is the tool for successful SEC compliance – it’s also the key to ensuring this mandatory process costs as little, both in terms of dollars and human resource, as possible.
- On the edge – finally, with innovation sweeping the industry, hedge funds can stay on the cutting edge by keeping track of the latest technologies by leveraging the reach and breadth of their outsourcing firms.

Confidently turning to the future

Institutional investors answer to many parties and have many challenging fiduciary responsibilities. Their robust due diligence raises the bar for hedge funds that want to win their business. The SEC isn't going away, and has the final word: firms must register and must comply.

The requirements for operational excellence are present in every aspect of hedge-fund management. While the challenge is steep, the potential rewards are great, and fierce competition will strengthen the hedge-fund industry. As the most successful firms will demonstrate, operational excellence achieved through successful outsourced relationships with best-of-breed providers will position these firms for huge growth with long-lasting client relationships.

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ECI is a provider of IT services to hedge funds, asset managers, broker-dealers and private equity firms, and includes startup and relocation services; outsourced technology support; voice systems installation and support; business continuity planning; archiving; and internet services.