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US funds flee sub-prime woes for global opportunities

Investors step up pressure on admin quality

Institutional investors keep hedge fund faith

In this issue…

03 Institutional faith keeps managers buoyant
By Suchita Nayar

05 Building a strong capability for US clients
By Jacques Bofferding, Fortis Prime Fund Solutions

08 Credit woes highlight new demands on service providers
By Suchita Nayar

11 Sub-prime woes pose questions for managers
By Joe Seet, Sigma Partnership

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Institutional faith keeps managers buoyant

By Suchita Nayar

Most hedge funds may have weathered so far the gales blowing through the financial markets following last summer's implosion of the US sub-prime mortgage sector, but the crisis is far from over.

The sub-prime meltdown has since upended credit markets across the globe and jolted equities as well. Add leverage, and you have all the ingredients for worldwide financial contagion, one that has sounded the death knell for hedge funds big and small. Notable casualties include funds run by high-fliers such as Bear Stearns, Citigroup, Focus Capital, Peloton Partners and Sailfish Capital Partners.

Is there a wider shakeout coming? With serious macroeconomic problems looming, investors surely have reason to pause. Hedge funds rang up an average loss of nearly 3 per cent in January, their worst-ever monthly decline since 2000, according to index providers, and after a mixed February, managers are reporting a fresh round of losses for March.

A lingering problem is that the underlying real estate linked to troubled paper remains in the doldrums, which means that deflation of the credit bubble still has some way to go. Asset valuations, meanwhile, remain hard to determine in a market that has to a large p6

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Building a strong capability for US clients

By Jacques Bofferding

Endowments and institutions in the US have become the dominant investors in the hedge fund industry, drawn by the potential of generating returns that are uncorrelated with traditional equity and bond markets. With the increase in their hedge fund allocations, they are in a position to demand that managers seek higher levels of fund administration service as an additional assurance to investors.

Jacques Bofferding is regional managing director, Western Hemisphere at Fortis Prime Fund Solutions

Third-party fund administrators are increasingly becoming managers' chosen source for independent net asset values, which can be cross-checked against the numbers tallied internally by the managers. They expect fund administrators to produce NAVs in an error-free and timely manner, and looking forward, they expect administrators to provide detailed information on how performance is calculated.

At the same time, the complexity of investment strategies being pursued by managers is increasing. The clients of Fortis Prime Fund Solutions are not only trading complicated instruments but are diversifying into private equity and real estate investments. The boundaries that previously separated alternative investments into various asset classes are rapidly becoming blurred. That is giving rise to accounting, legal and tax complications, which makes for an even more challenging task for the fund administrator.

Fortis Prime Fund Solutions has adapted quickly to keep pace with these changes, adding specialists to handle administration tasks associated with complex derivatives and other esoteric strategies along with associated accounting and tax matters. The firm's specialised desks are equipped with complete expertise in these complex areas while many competitors still cater mainly to long/short equity, which are the easiest funds to handle.

Fortis Prime Fund Solutions established a presence in the US two years ago. The firm has serviced offshore funds for US managers for a long time, but took the decision to create the business in order to be geographically closer to its clients. The 15-strong sales and client relationship management team services a wide range of clients, most of them located in the hedge fund hothouses of New York and Connecticut.

Considering the dominance of US managers in the global hedge fund market, Fortis has decided to expand its business offerings in the country further, establishing an operational hub in the US that will offer local fund accounting, share registry and banking services to national clients. This is important because Fortis wants its touch and feel to be like a US company, so that local clients are more comfortable in their dealings with the company.

Unlike other banking houses that have acquired fund administration operations, such as Citigroup's acquisition of Bisys in 2007 and Deutsche Bank's purchase of HedgeWorks in February this year, Fortis's strategy is to expand its offerings organically. The Prime Fund Solutions business is not short of skills or technology, capable of relying on its strong global systems and knowledge to propel the US expansion. The firm is adapting its systems to US standards and plans to take this initiative live over the next few months.

The latest offering will round out what's already a robust service, including fund administration, tax support, custody, and bridge and leverage financing. Fortis has built outstanding expertise in servicing blue-chip funds of hedge funds, which comprise more than half of its total US business, while in single-manager funds its strength lies in the ability to handle clients that are active in more complex and high-volume trading strategies, such as multistrategy products. ■

p3 ◗ extent seized up, resulting in longer redemption terms. Finally, equity markets are also weakening, despite the US Federal Reserve's attempts to revive the economy by repeatedly slashing interest rates.

"There'll be more hedge fund blow-ups this year than ever," says Michael Hennessy, managing director of investments at Morgan Creek Capital Management, which was established in 2004 by Paul Yusko, former investment chief and a colleague of Hennessy at the endowment of the University of North Carolina at Chapel Hill.

"Price discovery, when it occurs, will likely threaten if not devastate hedge funds and even financial institutions. There'll be month-to-month hits and then, in the case of hedge funds, redemptions which, combined with tighter lending, will cause the classic death spiral."

That makes the job of managing money that much harder. Recent losses are creating real liquidity problems at some funds of funds, according to Virginia Parker, founder and chief investment officer of USD600m Stamford, Connecticut-based fund of hedge funds manager Parker Global Strategies.

Hedge funds are imposing longer lock-ups and gates, Parker says, and there is nothing a fund of funds manager can do other than hope to have redeemed before the underlying manager triggers this move. This means manager due diligence has to be rigorous in order to "pick managers that know how to keep their powder dry", she says.

The bar for due diligence and risk management is being raised, industry participants say. An effort is being made to improve disclosure and transparency via initiatives such as the President's Working Group on Financial Markets, which has nearly completed drafting a report designed to address key investor concerns.

Separately, two industry bodies, the Alternative Investment Management Association and the Chartered Alternative Investment Analysts' Association, are co-operating on a guide for hedge fund investors, written by Alexander Ineichen, senior investment officer at UBS Asset Management, with help from California Public Employees' Retirement System portfolio manager Kurt Silberstein. The guide is due to be published during the second quarter of this year.

Among the issues that are expected to be addressed by the various reports and publications are the overuse of long lock-ups, side-pockets and illiquid investments, over which experts have already raised red flags.

Current market conditions call for even greater manager scrutiny, according to Gary Witt, a managing director of ratings agency Moody's in New York. Ensuring the manager has sound funding is more important today than it was a year ago, says Witt, who leads the agency's unit that gives ratings to hedge funds.

In turbulent times, funds should not have a single source of funding, and operational risks need to be vetted. "Hedge funds are usually started by traders coming out of large institutions and haven't run businesses before," he says. "They are focused on generating returns, not taking care of mundane business issues."

One likely result will be a slowdown in new entrants coming in to the market. Institutions now want to see longer performance records and larger volumes of assets under management, criteria that have become particularly difficult to meet in current market conditions.

Industry data on new launches is starting to indicate a slowdown from the record pace of recent years. According to a survey by Absolute Return, 30 funds were launched in the second half of 2007, compared with 51 in

the six months to June. In total, USD31.5bn was raised last year, compared with USD40bn in 2004 and USD35bn the following year, albeit slightly ahead of the USD30bn total in 2006.

According to BarclayHedge and TrimTabs, investors added USD2.5bn in net new capital to hedge funds in January, which was USD200m more than in December but far short of the USD21.8bn figure for November.

"As the market matures, you're going to see fewer wannabes joining the market," says Michael Caccese, head of the financial services practice at law firm Kirkpatrick & Lockhart Preston Gates. "Those who are having difficulties surviving will exit. The successful ones will expand and will find it easier and cheaper to acquire new strategies through acquisitions rather than training talent."

Cases in point are the acquisition of London-based Castlegrove Capital by Israel Englander's Millennium Capital, and Blackstone Group's purchase of GSO Capital in New York. There have been plenty of similar deals and more are on the way, according to Karim Leguel, investment chief at New York-based financial advisory firm Rasini & Co.

"I expect more M&A in the industry as bigger hedge fund managers acquire smaller ones, given the increased costs of running a hedge fund and the economies of scale and the reach and talent of bigger managers," Leguel says. "I also believe that institutional investors will be buying more stakes in hedge fund managers, allowing them more sustainability and potential access to capital in tough times."

The good news is that hedge funds still enjoy institutional support. Darien, Connecticut-based consultancy Casey, Quirk & Associates forecasts that institutional capital invested in hedge funds will rise to USD1trn by 2010, almost triple the USD360bn the firm recorded in 2006.

Inflows might not pour in as a straight upward line on a graph, but they will continue to grow, according to Casey Quirk chairman John Casey. All told, institutions allocated a record USD66bn to hedge funds in 2007, of which an estimated USD52bn is still waiting to be deployed.

Hedge fund investment is now a normal part of the institutional allocation process, according to Patrick Keane, a managing director in New York with third-party placement agent Liability Solutions.

"Despite spectacular headlines of some hedge fund disasters, institutional investors are increasing their use of hedge funds as part of their portfolio diversification strategy," Keane says. "They are no longer considered an exotic part of a typical, diversified institutional portfolio."

Where's the new money going? Managers say the possibility of bargain-hunting has drawn investors to credit strategies, while managed futures, global macro and selective commodities have drawn strong investor interest since late last year. By contrast, equity long/short, certain emerging markets, event-driven and merger arbitrage in general have lost some lustre.

The temporarily debilitating forces notwithstanding, Hennessy says, hedge funds as a whole will again prove their worth this year in terms of portfolio diversification, defensiveness and superior risk-adjusted returns. ■

Credit woes highlight new demands on service providers

By Suchita Nayar

Firms that provide services to hedge funds are changing the way they do business, and the reason is institutional investors. As these investors allocate increasingly large sums to hedge funds, they view the quality of service provision as an important aspect of risk management.

These investors come with a high level of requirements, according to Fortis Prime Services' Western Hemisphere head Jacques Bofferding. They want net asset values determined more frequently, without delays and errors, and to have a clear view of all that follows once a trade is placed at the manager's end. Says Bofferding: "They are raising the bar – they want to make sure their money is in a safe place and will return."

While the instinct for preserving capital is nothing new, it is particularly crucial right now. Investment banks have already suffered USD190bn in losses linked to the sub-prime meltdown and are far from done yet, with some forecasters suggesting that total write-downs could escalate to as much as USD600bn. Global markets, meanwhile, have seen significant falls, claiming many hedge funds as casualties.

Practitioners say the problems are intensifying. Amid the unfolding credit crisis, leverage is adding to industry woes. While the going was good, prime brokers and other lenders were quick to offer credit to funds to enable them to juice up returns, especially in strategies where profit margins are wafer-thin.

With asset values falling, leverage has amplified losses, pushing investors to the exit in droves. Banks are making new lines of credit scarcer and pricier and are calling back outstanding loans or raising margin requirements. This credit squeeze is forcing managers to sell assets in order to raise cash, but buyers are scarce even for what are still deemed good quality assets, sending prices still lower.

“The liquidity crisis is one of the biggest we’ve seen in a long time,” says Karim Leguel, investment chief of asset advisory firm Rasini & Co in New York. “Banks and brokers are in distress due to regulatory arbitrage involving structured products, and this affects everyone,” he says, referring to their use of off-balance sheet vehicles to avoid having to set aside capital to meet adequacy requirements. There is zero tolerance for error in current markets, he argues.

On the accounting front, valuation of assets is also proving difficult. Hedge fund investments have increasingly branched out into exotic securities, which are complicated to value at the best of times. Compounding these problems, the future still looks murky for US real estate, which is at the core of many of the structured products that are under water.

“On the fixed income and asset-based lending side, lack of transparency is a concern,” says Campbell Harvey, professor of finance at Duke University’s Fuqua School of Business. “Investors are wondering how much more bad news is yet to come.”

In this fraught economic landscape, investors are bracing for the worst and hoping that at least their funds’ service providers are on the ball.

Merrill Lynch’s prime brokerage business, which ranks third behind Goldman Sachs and Morgan Stanley in industry rankings, is well prepared to handle current challenges, according to Jeff Penney, co-head of Merrill’s global markets financing and services business.

“The current market adversity is playing to our advantage,” he says, claiming that Merrill has picked up a number of new clients in recent months as hedge funds move away from the traditional model of having just one prime broker to a multi-prime system.

“Global prime brokers like ourselves are being added to hedge funds’ prime broker lists, because they are seeking to diversify their investments both geographically and by asset class. Hedge funds see the benefits of having a diversified portfolio of global assets.”

Merrill Lynch has hired selectively this year, a period during which some of its biggest rivals, like Morgan Stanley, have lost senior prime broker bankers.

Penney says Merrill has expanded its infrastructure and offerings to meet the growing needs of the market. For example, it launched the Merrill Middle Office Solution with hedge fund administrator GlobeOp late last year for hedge fund managers with more than USD1bn in assets, touting benefits that include efficient data aggregation and trade reconciliation along with compatibility with other prime brokerages.

Merrill also sees interesting growth opportunities in electronic access to markets along with prime brokerage custody and finance, and is focusing on Asia and Eastern Europe as key regions for expansion, Penney adds.

Some of Merrill’s rivals, including Citigroup and Credit Suisse, have also invested heavily to build technology that can host multiple primes. This trend is expected to continue despite a recent US General Accountability Office report finding that the increasing use

p12

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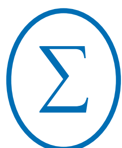

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Sub-prime woes pose questions for managers

By Joe Seet

To date some 287 federal cases related to the sub-prime crisis have been filed by unhappy investors in the US. While there is no doubt that some hedge funds will be ensnared and implicated in some of these lawsuits, it's a fallacy to hold hedge funds wholly responsible for this crisis.

Responsibility for securitising and rating mortgage-backed transactions lies with the investment banks and rating agencies, and most hedge funds are only investors in these securitised transactions. Some of the lawsuits seek to implicate hedge funds, but the problems lie clearly on the origination side of the mortgages and with the poor due diligence by the rating agencies and investment banks.

Valuation is another important issue facing all hedge funds, and mortgage-backed and other illiquid assets, such as small-cap equities, can be very hard to value. Model-based valuations are no substitute for market-led 'willing buyer, willing seller' priced transactions. Hedge funds are finding it increasingly difficult to value problematic assets, and when faced with significant redemptions, the only viable option is to liquidate the fund and close the business.

There is also the matter of governance and the role played by fund directors. Many 'career' directors have had it too easy for too long, and it is questionable whether they truly understand the new and complex accounting rules coming into play. In today's litigation climate, disgruntled investors are likely to sue fund directors as well as the managers themselves.

Career directors who are simultaneously overseeing tens of funds while spending much of the week on the golf course are especially at risk. Managers need to rethink seriously the key role of fund directors and adopt best practice to appoint truly professional and knowledgeable directors with no conflicts of interest.

Joe Seet is the senior partner of Sigma Partnership

The credit crisis is a very serious problem for hedge funds and funds of funds. With investment banks sitting on hundreds of billions of dollars of write-downs in their own trading and non-trading books, the natural thorough reassessment of credit lines to funds is having a contagion effect on the industry.

The US Federal Reserve's recent rate cuts were designed to boost the economy, but Japan's experience in the 1990s suggests that control of the money supply through lower interest rates might not be the only stimulus needed. Many banks and funds are tapping sovereign funds for a bailout.

Meanwhile, many managers with funds that have so far focused purely on the US are already in London or considering setting up offices there to access UK, European and Asian market opportunities.

Sigma Partnership is well placed in London to offer comprehensive specialist advice to inbound managers seeking to build their UK and European businesses. The firm's partners have solid investment banking backgrounds and eschew the checklist-based methodology of other boutique consulting firms. Drawing on its professional knowledge and understanding of the needs of hedge funds, Sigma Partnership assists its clients in the areas of regulatory compliance, accounting, taxation and governance.

Sigma pioneered a series of monthly briefing notes in 2006 on issues of topical interest to managers, investors, participants and other service providers. The current distribution figure is over 1,000 and many notes are subsequently redistributed by recipients such as law firms. Topics have ranged from the need to change limited partnership agreements under new accounting guidelines and MiFID regulation to taxation and governance issues. ■

p9 of multiple prime brokers was fraught with risk, since no one institution had the full picture of a fund's risk exposure.

Industry participants, however, take issue with the report's conclusion. Multi-prime is a necessity and not a matter of choice, according to Stuart Feffer, who with Christopher Kundro heads Cargill subsidiary LaCrosse Global Fund Services, which administers USD14bn in assets.

"Most people I speak with in the market are very concerned that balance-sheet issues and credit exposure concerns at the banks could lead them to change the availability of collateral and lending terms on short notice," Feffer says. "Therefore many fund managers are making sure they have several different prime broking and financing relationships."

While the GAO's report purely highlighted concerns and did not make any recommendations, it might feed into a separate report being prepared by the President's Working Group on Financial Markets.

Even so, the report crystallises the idea that counterparty risk should be a primary area of focus, according to Judith Gross, principal at compliance consultancy JG Advisory Services in New York. "Market players as well as regulators will certainly use this report as a roadmap for planning their future programmes," she says.

"The report was also significant because it mentioned the importance of proper disclosure in risk reduction – that is, potential investors should be aware of risks associated with a hedge fund investment, but often they do not understand those risks." Gross expects hedge funds and their counterparty risk to come under greater scrutiny.

Administrators are also increasingly in the spotlight. Both managers and investors demand predictability of good service and scalability of operations from their providers, according to Akshaya Bhargava, who heads Bermuda-based fund administrator Fulcrum. Due diligence processes are becoming much more rigorous, says Bhargava, who took the helm at Fulcrum after his former employer 3i invested USD57 million in Fulcrum last June.

An administrator not only has to demonstrate competence in its work, but must show strength in its own operational management, he says. Fulcrum, which serves its clients around the clock from offices in India, Ireland and Canada, is focusing on building out its middle office offerings and has automated procedures so that the same work can be done seamlessly from anywhere in the world.

Sigma Partnership's managing partner Joe Seet expects institutions to demand higher governance standards from managers, with the role as gatekeepers carried out by independent fund directors. As a result, administrators are not putting their executives up to be board members due to the obvious potential for conflicts of interest.

"The competition for funds is so intense that both prime brokers and fund administrators are looking for more value-added services to differentiate themselves from the competition and to provide a one-stop shop for the customer," says Scott Alderson, president of New York-based Paladyne Systems, which sells front-to-back technology offerings to hedge funds and administrators. Some of the additional services include daily reconciliations, technology offerings, risk management and aggregated reporting, he says.

These factors are contributing to the rise of specialist service vendors such as CorrectNet, which offers services that aggregate data from different sources and provides data management and reporting applications to hedge fund managers. There's a growing need for sophisticated client reporting and transparency, according to chief executive Robert Miller. ■