Lessons Learned from 2008: Hedge Funds Need to Diversify Custodial, Operational Risk

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There is little doubt that the events of 2008 will have long lasting effects on the asset management industry. Additional oversight and regulatory statutes are a given as a result of this tumultuous year and asset managers around the globe have had to reassess their investment and operational strategies.

Some changes will be brought about by forces from outside the industry as Congress debates the financial risks inherent in investing. On 13 November 2008, 110th Congress held a hearing, Hedge Funds and the Financial Market, the purpose of which was to examine risks to the financial markets posed by hedge funds. These hearings will no doubt lead to proposals for regulatory and tax reforms. Financial experts and investors alike will have to wait and see the extent to which these hearings will affect the industry.

While Congress may take months or years to enact reform, asset managers reacted almost immediately to the unforeseen events and began implementing operational, tactical and strategic changes to their investment plans. These changes from within the industry will likely not only carry over into 2009, but become a permanent shift in investment and asset management strategies.

Volatility in 2008 Moved Multi-Prime Brokerage to the Forefront

Asset managers have always known the importance of diversifying investments to mitigate risk within their portfolios. But many had not considered diversifying custodial risk as well, since it seemed so unlikely that an entire bulge bracket prime broker would falter. Prior to 2008, employing a multiple prime brokerage strategy was left to asset managers with AUM's over US$1 billion who had the investment clout and means to handle the increased operational costs of dealing with multiple prime brokers. But as the events of 2008 unfolded, many asset managers, regardless of their AUM, realised that a multiple prime brokerage strategy meant diversifying not only custodial risk but operational risk as well. The number of asset managers incorporating a multiple prime brokerage strategy began to increase.

The advantages of multiple prime brokerage are now clear since it spreads the risk of having assets in jeopardy if another crisis unfolds. It becomes not only possible, but relatively easy, to rapidly transfer assets if one broker shows signs of distress. Additionally, investors may begin to seek out funds that utilise a multiple prime brokerage approach since it demonstrates a willingness to use operational tactics to mitigate investment risk. As a result, many asset managers who at the start of 2008 had not considered multiple prime brokerage are now actively weighing the operational challenges and benefits associated with it.

The Challenges of Multiple Prime Brokerage

The operational challenges in utilising multiple prime brokerage are real but not so large that they cannot be overcome. Traditionally, funds needed to have AUMs large enough to maintain accounts with multiple prime brokers. That hurdle can easily be surmounted by utilising the services of an introducing prime broker with custody and clearing arrangements at multiple prime brokerage firms. With this arrangement, a fund can have the benefits of multiple prime relationships regardless of their AUM.

The main operational challenge is the level of reliance the fund has on the initial prime broker for tools such as reporting systems, intra-day P&L and daily data-aggregation. These challenges can best be met by either maintaining more systems in-house or by hiring the services of a neutral third-party provider. For most funds with assets of less than US$1 billion, maintaining additional systems in-house with the capability of aggregating reports across multiple prime brokers is cost prohibitive and requires an enormous dedication to technological support. As such, it is not really a feasible option.

For most mid-size funds there are two more cost effective options. The first is utilising the services of a prime brokerage firm that not only provides the custody and clearing services of multiple prime brokers, but also has the capability of providing aggregated reporting. That solution simplifies the process by allowing the asset manager to have one point of contact that both represents them to the firms that clear and custody, and also can deliver on the front end to provide the detailed daily reports needed.

The second option is using the services of a fund administrator. Fund administrators exist to consolidate data from multiple sources and provide reporting that independently values a fund's entire portfolio. They can provide consolidated versions of the reports that are commonly provided by prime brokers such as position, risk reports, cash balance and the like. It is a solution to the data aggregation problem that also has additional benefits since many fund administrators also offer middle office services, such as P&L calculation and reconciliation.

The Benefits Outweigh the Challenges, Industry Shifts Accordingly

Regardless of which option is used, one thing is clear: the industry is shifting from a single prime to a multiple prime brokerage model. Asset managers may choose to maintain multiple accounts directly, or bring on an introducing multiple prime broker with multiple custody and clearing arrangements. Either way, the definition of mitigating investment risk has changed. It now means not only diversifying within an investment portfolio but also through operational tactics as well. That is a shift in the industry – a direct result of the historic events of 2008 – which will carry-over into 2009 and likely become a permanent change in the way portfolios are managed.

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