



Quality is Key for Hedge Fund Operations

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The past year has been a difficult one for hedge funds. Market conditions, regulatory emergency orders and volatility all affected the ability of funds to develop and maintain strategies that made for consistent performance. Even in that context, funds tended to perform “better” (meaning performing less worse) than traditional asset managers.

Raising assets in a declining asset environment also proved difficult. Combined with a move to cash, a call for redemptions, a consolidation of funds, and unfortunately, liquidation of others, hedge funds were faced with a series of unprecedented challenges.

If the market of 2008 taught us anything, it is that there is no easy way to riches. Since Adam Smith wrote the *“Wealth of Nations”*, astute investors and competitors have understood that the market is merciless – especially when it tries to right itself.

Market confidence has been shaken globally. And overall market conditions were not and will not be helped by the Bernard Madoff Ponzi scandal. In terms of raising assets, there will be a legitimate focus on scrutiny and due diligence. Hedge fund transparency, disclosure and regulation will become huge issues for debate among regulators and legislators. The real issue for hedge funds is when their information appropriately becomes market information – certainly not at the level of style and strategy, but perhaps post-trade.

This Madoff scandal also means that firms with external rather than internal processing of critical tasks will be able to provide their end investors with a high level of confidence.

What the market is currently telling managers is that quality might not be enough, but that a lack of quality will certainly not be. Quality extends to all aspects of the fund – its asset model, trading capability, clients and cost structure. Many costs, currently seen as fixed, can in fact be converted to a variable cost model.

Such a conversion gives managers the ability to expand or compress costs, given the conditions the fund is experiencing at any point in time. Considering quality in the cost equation and given the scrutiny firms will be under, middle office operations might best be considered an area where deployment to external experts is the best alternative.

Cost Management and Fund Performance

That funds will continue to be beset with challenges in regulation, raising assets, eking out performance and extracting value from costs goes without question. As previously mentioned, end investors will look to funds that have outsourced some operations so that both operational, as well as investment risk, are being managed and controlled.

The larger question that fund managers must address is whether they are operating their funds as firms, as opposed to trading operations. Management of funds as a firm means looking at all aspects of the operation – not least of which is how much of the performance has been diverted into cost – and what a firm can do about the cost equation.

The facts are that some costs, such as overhead, are truly fixed; whereas others are currently fixed but may be converted to a variable cost model, with an attendant reduction in overall costs and a spike in performance. In addition, a properly structured variable cost model will give managers greater control.

Of particular focus are the middle office operations of the firm. Middle office tasks (such as reconciliation and resolution processing, cash and collateral management, accounting, security master and static data maintenance, global settlement and confirm processing, swaps processing and settlement and other reports) are seen as necessary, but costly. While they are often taken care of in-house as a fixed cost, they absorb both money and time.



What Does It Cost?

Costs can be seen in terms of dollar amounts translated to performance and profitability. And if they cannot vary with fund expansion and contraction, managers are stuck.

Costs are also intangible: Is there resident expertise; does the time expended matches the benefit gained; is there flexibility to adapt to market conditions, new trading strategies, new asset classes; is all the frustration of internal management worth it?

These tangible and intangible questions are as important as the primary questions of fixed and variable costs when managers are looking at their operations.

A more sophisticated look at the seemingly necessary but mundane middle office takes the operation as an opportunity to extract value for the firm. What is required in this scenario is partnership with a strategic vendor that has domain and global expertise, combined with leading-edge technology and a large service capability, all of which can be customised to each fund. In sum, what is needed is a bespoke approach that can simultaneously reduce costs.

Converting middle office process to an outsourced model frees the fund not only from fixed costs of internal middle office operations, but gives flexibility. In an outsourced model, middle office costs vary with the growth or contraction of the fund itself. The shift from a fixed to variable cost model means that the middle office operation and costs become scalable, extendable and compressible – tacking to the fund itself.

Such an alternative allows fund managers to focus on their core competency, while trusting the complex middle office operation to a firm whose sole focus is providing these services. In addition to the processing and systems costs, by securing outside expertise, the fund no longer bears the cost of additional headcount to run the middle office internally.

Such a “rental” model has already proven effective in transition and new launch situations. Given current conditions, it is increasingly viewed as an attractive alternative for established funds.

As fund managers look to the future, survival will largely depend upon making the right choices at the right time. All of these choices need to be set against the defining category of quality. Increasingly, managers are seeing that the right choice is the conversion of the middle office to a variable cost structure, and outsourcing these critical operations to dedicated experts.

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¹ <http://www.viteos.com>