New opportunities for third-party administrators

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Created *13/12/2009 - 14:36*

The improved economic outlook has encouraged managers to launch a raft of new funds. In fact, the creation of new funds has nearly matched the number of liquidations over the last year, meaning the total number of funds in the Caymans is barely down from its 2007 high. The difference is that the average fund size is now reduced. While smaller funds can be nimbler and create value more easily, setting them up in an era of drastically increased demands by investors and regulators can be expensive. John McCann, managing director of Trinity Fund Administration, says forward-thinking administrators can save on these costs. “We can effectively be project managers, co-ordinating all parties and providing para-legal services that reduce the overall set-up to the fund. We want to partner with the fund rather than offer a service at an hourly rate.” Once set up, smaller funds are also subject to the same rigours of their larger cousins and require the ability to produce daily NAVs, monitor valuation policies, keep track of their counterparties, measure their end of day leverage and keep abreast of the regular changes in accounting standards. Few can do this on their own, and many will outsource these activities, creating enhanced opportunities for third-party administrators. On the other hand, with the creation of smaller funds, there are less assets to compete for. Does this mean more competition and a possible shake-out among hedge fund service providers? “There is certainly more competition,” says McCann, “but the long-promised shake-out is not likely to take place now. The Madoff fraud, if there are any positives to be taken from it, has put the focus firmly on operational risk, which is something that we have been preaching about for years. He has become the poster-child for independent fund administration.” Mr McCann points to a Tabb Group report showing that fund administrators are now considered the most important counterparty to hedge funds after the prime broker. “Of the last 100 hedge fund failures, nearly 70% were due to operational risk rather than performance risk. These were primarily failures of safe custody and failure to obtain independent verification of valuations.” Even the “elephants” of the hedge fund industry have now appointed independent administrators, he says. “It has been a natural evolution that has been talked about for years, but it has taken a single big blow-up to make it actually happen.” Risk management from administrators is in particular demand, at both the operational and management level. Says McCann: “It is within the remit of the manager to ensure that policies are implemented, but the administrator can act as an early warning signal should any faults appear.” While the emphasis on risk management is grounded in good sense, McCann believes other shifts within the industry in the post-Madoff era are less wise. For instance, while managed accounts are in vogue, they can actually lead to greater risk than investing directly with the manager. McCann warns: “You are responsible for your own money, so if the manager leverages a strategy ten times and the trade goes against him, you could lose more than your original investment.”

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