Investors drive boom in fund services outsourcing

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What a difference a year has made. In 2009, hedge funds posted record gains, reversing steep declines from the year prior, and capital, coveting those impressive returns, is returning. While this has comforted hedge fund service providers, the conundrum they face is: How to improve their revenues and margins in today's "new normal" business environment.

From fund-administrators and prime brokerages to auditors and technology vendors, service providers aren't exactly suffering, but after a period of steep asset-erosion at their clients, most speak about doing more for at best flat fees.

Yet in many ways the global financial storm brought more business to some. Partly thanks to investors' push toward greater transparency, managers have tapped independent firms to chalk up monthly net asset values, periodic valuations of toxic securities, and the like. And as regulations take shape, administration, compliance, custody and reporting specialists are expecting better days ahead.

Such growth is likely to translate into higher revenues at vendors but expect margins to stay compressed in the near term. The major reason for is that while numerous factors have pushed their business costs higher, their clients, who have emerged from the financial crisis a lot more cost-conscious, are driving harder bargains. "It'll take years for vendors to recover to pre-crisis profitability levels," says a source.

The last 15 months had many mangers fretting about counterparty arrangements, following the Lehman Brothers collapse. Now, the panic has mostly abated. "The switching of primes and moving of balances has slowed down," says Jeff Lowe, a managing director at BNP Paribas in New York.

Prime broking units of European universal banks Credit Suisse and Deutsche Bank have gained market share since late 2008, catapulting their market-rankings. The duopoly of Goldman Sachs and Morgan Stanley, which has historically controlled the lion's share of the business, was dismantled as managers redistributed their assets among a wider group of primes. "Business is much more spread out than what it was two years ago," says Glen Dailey, the prime brokerage chief at Jefferies.

JPMorgan, which absorbed the sprawling fixed income powerhouse Bear Stearns in mid-2008 and is credited for navigating the financial turmoil better than some of its peers, is seen as another beneficiary of the upheaval. "We won a lot of business during the flight to quality last year. We continue to grow it and are spending our time on a holistic offering to the meet the global needs of our clients, across asset classes," says Lou Lebedin, co-head of prime brokerage.

The crisis may be over but don't expect the multi-prime trend to disappear, market participants say. Even as Credit Suisse and Deutsche Bank have made significant inroads in the U.S. and globally, US players -- Goldman Sachs and Morgan Stanley, having worked through some of their balance sheet problems, are rebuilding their franchises and are using multi-prime to their advantage as they strive to regain some of the lost ground. Indeed, firms with over USD3b of assets now work with 4.8 primes each, compared with 3.7 in 2008, according to the TABB Group.

Nonetheless, in the current low interest rate environment, prime brokerage is no longer the profit engine it once was. The cost of running prime brokerage could rise even higher if Congress were to approve President Barack Obama proposed "Financial Crisis Responsibility Fee."

On January 15, the Obama administration proposed a 15bps tax on banks with over USD50b of assets. It also applies to U.S. broker-dealer units of foreign players. It seeks to recoup USD90b of losses related to the Troubled Asset Relief Program (TARP) that was a lifeline for financial firms during the throes of the market meltdown.

In its current form, this fee would be based on the entity's assets minus certain items. And since certain prime brokerage and broker-dealer activities such as margin lending, securities lending, and repurchase (repo) agreements are asset-heavy, their profitability would be dented.

Brad Hintz of Bernstein Research noted: "We expect some of the tax costs to be passed on to hedge fund clients in the form of higher domestic margin loan rates." While that'd have been a cinch during the go-go years of hedge funds, it's difficult now. Moreover, if they attempt passing on costs to their non-US hedge fund clients, they'd give foreign competitors a leg up.

"For now, everyone's keeping an eye on government and regulatory changes," says Gregory Voetsch, executive vice president at broker-dealer Knight Equity Markets, which sells sales/trading, foreign exchange, algorithms and other electronic trading services to hedge funds.

Even so, there's plenty business to keep prime brokerages busy. Managers are employing leverage once again to amp performance. Philip Vasan, prime brokerage head of Credit Suisse, recently told clients that at year-end, funds had 2.5 times gross average leverage while excess cash was down to 22% from 38% a year ago. The early word on new fund-launches was pretty good, too. "There're a number of second-generation managers that we've our eyes on," he said. Funds are starting out with smaller purses, though, and "USD300-500m is the new USD1b."

So, what's clicking? Pershing's director Jeremy Todd says during the last six months, there's been a "significant uptick" in investors, notably institutional ones, combining tri-party arrangements with managed accounts. Under a traditional tri-party arrangement, which gained popularity following the Lehman situation, an investor entered into a three-way relationship with the manager, prime broker and custodian. In the tri-party and managed account tie-up, the account would still link up the manager, brokerage and custodian but with "the critical difference that the account is in the investor's name," says Todd.

Notes Stephen Keller, Bank of America Merrill Lynch's managing director and head of Americas Financing Sales: "Of late, we've seen more interest in commodity funds as relevant hedges against inflation." On the other hand, the credit trade, which was very powerful in 2009, has begun to feel somewhat crowded. Adds Keller: "Some funds that were very heavily tilted toward credit are beginning to swing into equities."

Larger fund-administrators are pulling farther ahead. Witness the growth of BNY Mellon, which in early February announced its acquisition of PNC's Global Investment Servicing. "This catapults us from the fourth or fifth position to a strong No. 3 overall," says Brian Ruane, the chief of BNY Alternative Investment Services. The deal takes its assets under administration to USD300b from USD188b a year ago. "The drive toward fund-administration outsourcing has been investor-driven and is ongoing," notes BNY's Marina Lewin.

Investors will keep up their demands for greater overall transparency, particularly concerning independent valuation and risk reporting, says GlobeOp chief executive Hans Hufschmid. "Both fund managers and their investors want to be closer to their data – more frequently, in greater details and in specific configurations," he says.

In 2010, look for growth in: Independent valuation services from hedge fund, pension fund and other institutional clients; greater loan servicing requirements from banks and hedge funds; and finally, additional risk metrics and reporting requirements from all clients, Hufschmid says. GlobeOp's assets have risen to USD106b from USD88b in June 2009.

Dylan Curley, a sales executive with JPMorgan Worldwide Securities Services, also highlights the expanded role of fund-administrators following the financial crisis. The demand for middle office services -- daily profit and loss, trade settlement, performance and risk -- are rising. Sophisticated investors are making sure that fund-administrators are pricing securities independently and substantiating custody-assets. The USD70b unit is "doing more than NAV calculations. We're creating more value add in the middle-office with managers," Curley says.

Additionally, the emerging manager business is expanding. “Decent numbers of funds are launching once again although it isn’t clear how many of them have staying power,” says Stuart Feffer, who helms LaCrosse Global Fund Services. “Anybody serious about collecting third-party money is now using outside administrators. That’s not a law everywhere but it may as well be,” he adds.

For auditors, too, these are busy times. In addition to year-end audits, they are being called in to work the numbers on side-pockets says Michael Patanella, an audit partner in the financial services practice of Grant Thornton. “A great deal of funds that restructured 3-6 months ago and put their illiquid assets into side-pockets. Until they’re sold, they require valuations just as the liquid side of the portfolio.”

Ray Iler, who oversees Deloitte’s hedge fund audit and tax practice, observes that given the greater due diligence investors are exercising, hedge funds are shifting their accounting work to firms that are well-known industry players. “There’s been a flight to quality,” he says.

Technology vendors are also betting on demand. For instance, outsourcing of compliance administration and remote hosting for systems such as those used for trading, which managers historically housed internally, is “trending up,” says Rick Enfield, director of product management at Asset Control. With the recent shakeout among prime brokers, “managers realized the systems they came to rely on aren’t available for “free” any more or will come at cost,” he says.

Risk is garnering vendors’ attention, too. “It used to be that risk was an after the trade check on a T+1 basis and that having a risk system was a check-the-box requirement to satisfy investors,” says Marshall Saffer of MIK Systems. “We’re seeing a dramatic shift in what the ‘front-office’ hedge funds want in almost real time.”

All told, the future success of service providers will hinge upon managers’ capital-raising. According to Howard Eisen and Andrew Dabinett, co-founders of third-party marketing firm FletcherBennett, managers require a sound marketing plan. “Because virtually every fund is now open and competing for capital, “build it and they will come” is no longer an effective marketing strategy.” Attorney Kim Budinger, founder of KTB Counsel, agrees. “The top issues for established and emerging money mangers for 2010 are capital-raising and capital-retention.” Greater attention is being paid to investor reach-out, details of marketing materials, and alternate investment management options, such as separate accounts.

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