

TABB Group: "Hedge Funds Now Spend USD 10 Billion on Prime Brokerage, USD 1 Billion on Data and USD 500 Million on SEC Registration"

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While seeking sources of capital, dealing with increased regulation and market expansion, US hedge funds' search for alpha now carries a heftier price tag.

According to TABB Group's second annual study on hedge funds, 'Hedge Funds 2006: The Quest for Alpha in a Competitive World,' released today, spending on prime brokerage has risen to USD 10 billion while investments in market data and technology exceed USD 1 billion. In addition, to register with the Securities and Exchange Commission and meet new regulatory requirements, funds have spent more than USD 500 million over the past five years, far exceeding the USD113 million the SEC estimated it would cost the industry.

The search for alpha, explains Adam Sussman, senior consultant at TABB Group, who with research analyst Matt Simon co-authored the report, drives funds' increased expenditures on highly specialized forms of data, independent research and access to company management and expert networks.

As the US markets become overcrowded and the global economy continues to glow, hedge funds are showering investments around the globe. 'The bigger driver is the notion that complexity creates inefficiency,' writes Sussman, 'and within inefficiency lies alpha. The manager who can cut through language and cultural barriers, local regulations and disparate accounting conventions will be able to locate good ideas on a global basis.'

Meanwhile, notes Simon, two-thirds of the funds are planning to expand into other areas over the next two years, up from 41% that broadened their exposure over the last two years.

'Driving the exploration into new markets are changes in the macroeconomic picture, including the rapid growth of Asian economies and the tightening of interest rates,' he says. 'The perception is that the U.S. markets are overcrowded, with too much cash and not enough opportunities.' This expansion increases reliance on prime brokers for instruments such as margin, security lending and OTC derivatives, technology - trading platforms, reporting packages and basic risk management software - and back office-related services, including custody, clearing and settlement. As a result, the average US hedge fund, including offshore clones, will spend USD 4 million in 2006 (USD 10 billion industry-wide), with a huge portion of spending coming from funds with over USD 1 billion AuM

Additional findings include:

- TABB Group estimates total spending in the US by hedge funds on data at an average of USD 432,000 per annum per fund, allocating as well significant amounts to market data terminals, historical databases, low-latency, real-time data feeds and national and industry publication subscriptions.
- Nearly 30% of funds are planning improvements in front-office technology by 2007.
- Hedge funds with six or more relationships are consolidating most of their business with fewer prime brokers while nearly half are considering adding or switching to a new broker.
- While nearly 50% were not concerned with SEC registration, those that were spent between USD 64,000 and USD 374,000 on the registration process, largely dependent on the size of the fund, well above the SEC estimate of USD 45,000.
- Hedge funds expect overall assets from pension plans to climb from 15% in 2006 to 19% in 2008.
- TABB Group also expects advanced electronic trading to pick up in other liquid issues, such as

exchange-traded equity derivatives, US Treasuries, certain corporate bonds and major foreign exchange pairs.

The 2006 report analyzes data drawn from in-depth conversations from January to March 2006 with managers and traders at 81 US-based hedge funds, with a combined USD 89 billion AuM, representing 15% of the total US-based hedge fund assets. Funds were segmented by AuM under USD 100 million, between USD 100 million and USD 1 billion and more than USD 1 billion. Compared to TABB Group's 2005 report surveying 63 funds, the 2006 report is more comprehensive, covering sources of inflows, asset allocation, trading and trading technology, prime broker services, idea generation, data and research usage and broker relationships.

Background Note: TABB Group is a Financial Markets advisory and thought leadership firm. Focusing on the intersection of the financial markets and technology, TABB Group has produced major studies on the future of trading technologies, the impact of the market structure changes on the use of real-time technologies.

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