Institutional attitudes to the fore in the post-crisis world

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Created *22/04/2010 - 15:54*

In the space of less than three years, the landscape of the hedge fund industry has changed fundamentally. While the basic investment skills that propelled managers to the fore and lured investors seeking higher risk-adjusted returns remain critical to success (and some of the props used by the less skilled, notably high levels of leverage, have been kicked away), the crisis has changed the basis of the relationship between managers and investors.

Over the past couple of years there has been extensive discussion of the new importance of transparency and liquidity, but the word that seems to be on most lips throughout all facets of the hedge fund industry is institutionalisation. It is a term that applies equally to investors, managers and service providers, and it appears to foreshadow increasing consolidation around the largest players in the sector, albeit with important qualifications and hedges.

In some respects the institutionalisation of the industry is not new at all but a process that has been underway for much of the past decade. The share of investment by institutional investors has been gradually overtaking that of wealthy individuals and families over the past few years, but the transition has undoubtedly been accelerated by the crisis as institutions (in the main) proved more patient during the 2008 downturn and have been quicker to allocate capital to hedge funds again over the past six months or so.

“Different types of investor behaved very differently during the crisis,” says Max Gottschalk, senior managing director and head of European business at fund of hedge funds manager Gottex Fund Management. “Institutional investors proved very stable and in general remained confident. We started to see institutions making investments again toward the end of 2009, a trend that has gathered momentum in 2010. The institutions typically work with consultants, who have been proactive in promoting hedge funds and fund of funds products to their clients as a way to diversify away from their equity and fixed-income exposure.

“Overall investor confidence on the institutional side has remained steady through the crisis, and we are seeing renewed interest in our products and in the hedge fund industry overall. But individuals seem to have suffered more in terms of performance. Typically their hedge fund investments were more geared and they invested in more directional products, so we expect them to take a bit longer to come back to the market.”

Kier Boley, who is responsible for emerging markets and Asian multi-manager investments at GAM as well as manager of a commodities-focused fund of hedge funds, agrees: “The type of investor is the major difference. In the mid-2000s, the market was dominated by private banks, wealth managers and their clients, but coming out of the crisis it’s much more institutional. The mandates will be much larger, from pension funds and funds of funds, but they will be fewer and farther between.”

Institutional investors are increasingly demanding that the managers they deal with adopt the same standards. “Managers are having to start thinking more about how they position themselves in dealing with investors,” says Steve Kass, co-managing principal of New York-based accounting firm Rothstein Kass. “There is more concern about transparency, having the right service providers, having the right administrators and building more of an institutional-type structure internally.”

During much of the early and mid-2000s some managers of hedge funds and funds of funds had a more relaxed approach to operational issues and selection of counterparties, but Kass says that as the industry matures, managers are focusing on improving professionalism throughout their activities. He says: “We see our fund of funds clients building a more robust infrastructure, in some cases involving general counsel in the organisation, appointing chief operating officers and selecting more professional service providers."

That means new challenges for hedge fund administrators, too. One that has probably had more than its fair share already is Fortis Prime Fund Solutions, which had to battle to maintain its position as a global leader in hedge fund administration during a severe downturn for its clients at the same time that its parent group was having to be helped out of its financial difficulties by the governments of the Netherlands, Belgium and Luxembourg.

Ironically, the fact that Prime Fund Solutions' parent company ended up as a state-owned entity turned out to be a major benefit, according to European regional director Charlie Woolnough. "During the time of greatest fear in the markets, we benefited from being able to tell our clients and their investors that we were ultimately owned by a very strong and stable government entity," he says. "We were able to distance ourselves from some of the other large administrators whose financial stability has been brought into question and returned to our usual role of giving comfort to fund investors rather than being a source of worry."

The parent group, Fortis Bank Netherlands, announced in March that it was close to an agreement to sell the Prime Fund Solutions business to Credit Suisse, although completion of the deal could take a few more months. Although unwilling to comment on the proposed sale, Woolnough acknowledges that to be part of a large and solid financial group is becoming increasingly important to service providers' clients.

"Counterparty risk was a buzzword during the crisis and it's not going away," he says. "There is now a much greater emphasis on who your counterparties are. Clients are looking behind brand names because some of them have failed over the past couple of years, but they do want administrators who are owned by large entities.

"Many hedge fund managers have become so big, with USD20bn in assets under management or more, that in many cases they have outgrown their administrators. In the past many service providers were privately owned, but now that's definitely changing. The trend toward institutionalisation applies not just to asset management firms but administrators as well, and consolidation in the sector is taking place right now."

Investors are already flexing their new muscle in relationships with managers to obtain more beneficial terms, according to Woolnough, but they are also insisting on vetting their service providers too. "Managers were traditionally in a position of power in relationships with their investor base," he says. "Many larger funds were closed to new subscription because they'd reached critical mass and didn't need new money. But things have changed, and the balance of power has shifted back somewhat.

"Investors are less passive now and have a lot more say in how the industry is developing, whether it be in fee structures and levels, fund governance or governance of the asset managers. Funds are now open because they need investment, and they have to listen more closely to the people that are providing that money."

Administrators are now seeing a sharp upsurge in due diligence visits by larger investors. "Whereas before 2008 we'd perhaps have five or six visits a year to our operational offices in Europe, there are now almost two or three a month," Woolnough says. "Not just pension funds but funds of funds doing due diligence on underlying hedge funds, endowments and high net worth investors are taking the time to come to Dublin, the Isle of Man or Luxembourg.

"They are going through the processes we use to calculate the NAV, in particular how much input the manager has in production of the NAV and whether they are providing prices – which they are certainly not doing with us. There are instances, with NAV-lite for example, where the exact demarcation of roles in the process between administrator and manager isn't clear. In these situations investors are asking, rightly, who does what and how the number is produced. We encourage that – we believe our processes are industry-leading and we're happy to be transparent. And indeed, that's the way the industry is going."

Woolnough expects the number of investor visits only to increase further in the future – and he also believes a shake-up could be in prospect as managers start to look again at their choice of service provider. “The landscape froze somewhat in 2008, because many fund managers weren’t in the best shape to move service providers, but I see this thawing now. Some managers believe, rightly or wrongly, that they have been treated unfairly by an administrator or prime broker, and they are starting to look round and consider their options again.”

As this process plays out, he expects larger service providers with institutional owners to benefit. “This isn’t to say that large administrators or prime brokers necessarily do things better than smaller players, but it’s a fact of life that institutional investors want institutional counterparties to service their funds. So anyone who is institutionally owned has something of an advantage going forward.”

Investors are also paying greater attention to the quality and capability of the IT tools used by managers and administrators. “Investors are putting more pressure on the managers themselves to provide more granular exposure reporting – not only counterparty but true cash exposures of the underlying instruments – on a variety of different exposures and are demanding faster service turnaround times,” says Chris Cattermole, Geneva sales manager for Advent Software in Europe, the Middle East and Africa. “That also means a lot more demands on service providers to deliver the granularity that investors are looking for.

“From a due diligence standpoint, institutional investors are looking at managers in more detail than they used to. One of our manager clients told me that investors are not just asking how they do things but they’re asking to see them in actual practice. If pension funds or other institutions saw offline processes or Excel spreadsheets being used to value their funds, they would become a bit uncomfortable about their investments. Managers are now having to prove to investors that their money is being managed on pedigree technology.”

In the aftermath of the crisis, this particularly applies to risk management systems, according to Paul Compton, head of product management at SunGard’s alternative investments business. “The way hedge funds approach risk has had to change,” he says. “In years gone by risk numbers weren’t always an integral part of the fund manager’s own investment process. Now investors are not just asking for metrics but are asking questions about how risk enters into the manager’s investment process in terms of idea generation and risk management.”

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