

Paradigm shift sees middle-office growth

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A year or two on from the onset of the financial crisis the ramifications for the hedge fund industry are still being felt. While the headlines talked of hedge fund failures and investors losing their capital, this actually applied to a relatively small portion of the universe of funds: the vast majority of managers and their clients entered a period of reflection and re-examination rather than entertaining thoughts of Armageddon. For managers, the key question was to maintain the viability of their businesses. "Hedge fund fees were largely based on an absolute return model, so the losses they incurred fed directly to the bottom line," says Tom Zdon, vice president of global accounts at Advent Software.

For some funds, this marked the beginning of a shift towards the benchmark approach employed by traditional fund managers, and a consequent widening of the investor base to create greater fee stability. "Our experience is that separately managed accounts (SMA) and Ucits funds are certainly in vogue at the moment as they each reduce investor risk in different ways and are in demand as investors seek lower risk alternatives," says Zdon. For hedge funds accustomed to dealing with a handful of clients or platforms, this shift towards the mass distribution markets meant some were poorly equipped to deal with the greater volumes of clients, transactions, transfers and communication.

This shift is one of the reasons that demand for middle-office solutions is growing. "The costs of supporting trading and distribution have gone up just as fees have gone down," says Zdon. "More firms are deciding to outsource the middle-office." Workflow tools are particularly in demand, as they help to manage the proliferating relationships, not just with customers but also with trading partners and other counterparties. Zdon adds: "Frequency of reporting, valuation timing, trade accuracy, and estimated NAV production is occurring in quicker cycles, requiring systems that can work within a daily reporting model."

Advent Software has responded to the increased demand by broadening the scope of its middle-office suite. Customers can perform post-trade reconciliations across the range of assets and strategies, and can slice and dice by performance, trade and strategy. "It is not enough to have a portfolio management system any more - you need workflow solutions that are connected to counter-parties in real-time," Zdon says.

Counterparty risk has changed since the dire days of late 2008 when it was far from clear which banks would survive and which would succumb amid panicky markets. Zdon says: "It is not about the fear of people going out of business now, but about investors saying 'how is the business being managed; and the bank being able to show them and provide reassurances in real time. The same holds true for hedge funds with their new client bases."

Nevertheless, there is a continuing shift to diversify the prime broker base and this has engendered greater complexity and more effort in the middle-office to tackle critical activities such as reconciliations and cash management. "Many funds now want full cash reconciliation with their prime brokers at the end of the day, rather than a model," says Zdon.

Valuations are subject to similar levels of scrutiny and more work is now needed to prove and communicate prices to funds and their investors. The task is made harder by the rising number of multi-asset funds. Zdon says: "Single asset strategies have lost a lot of cashflow following the liquidity crisis so, from our point of view, the ability to service cross-asset classes is critical."

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