Paradigm shift boosts fortunes of independent providers

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Created *08/06/2010 - 07:57*

The hedge fund industry has emerged in a stable condition after a few volatile months, but there now exists a new paradigm: fewer funds with more assets under management, but the same number of service providers.

The intensification of rivalry in every jurisdiction is not lost on the majority of providers. T. Andrew Smith, global business development head at Butterfield Fulcrum, says: “There is little topline growth, so there is a lot more competition now. You can see it with hedge funds themselves as the 2+20 fee structure is now often discounted. For us as administrators, it is a question of operating as efficiently as possible – shrinking expenses and redeploying technology and resources.”

It is also a question of maintaining client levels by providing funds with a service that will reassure investors and regulators. “We have to be that much sharper when it comes to pricing,” says Smith, “But the critical issue is transparency and that revolves around people, processes and technology. You are not necessarily going to win the business by undercutting your rival by a basis point. The fund is just going to go back to the administrator it likes best and ask for a comparable price.”

Equally, while many funds demand online tools, administrators that offer a full and reliable service with total transparency are unlikely to lose business, Smith believes. “The fund is probably going to be content to receive an email rather than logging in to get the same data. But what clients really want – and this is non-negotiable - is a transparent process, on a daily basis, and in their own time zone.”

Transparency is now an industry watchword, but it means very different things to different funds and investor types. However, valuation, risk and verification are the cornerstones of transparency for many funds, and vendors have added functionality to existing services and filled out their suites to address these key areas. Marina Lewin, managing director of BNY Mellon Alternative Investment Services, says: “We have developed new products and services such as Price Verification and Asset Validation, which helps managers to verify prices independently of the core administration service and value assets against the records of custodians and counterparties.” Through an alliance, BNY Mellon Alternative Investment Services also offers Investor Analytics to investors and managers, which measures risk and diversification within portfolios. It believes custodian services are also a key differentiator for funds looking for service providers. Lewin says: “A lot of managers are looking for custodial services to diversify their unencumbered assets. Funds are looking for solid financial services firms that can offer cash management services.”

Administrators that can prove they have internal controls that ensure continuity and consistent quality are equally likely to gain an edge. Sometimes this means having the right certificates on the website or on the office walls. “It is important that we can show that each office follows the standards and implements the same controls,” says Peter Hughes, group managing director of Apex Fund Services. Apex is one of a growing number of administrators that have devoted resources to obtaining the SAS 70 standard, which demonstrates - for instance - that each price is reviewed and each portfolio is scrutinised by two senior staff members. Allocators, concerned by high-profile hedge fund failures linked to administration failings, see SAS 70 compliance as essential. “If it is important for the allocator, it is also critical for the client,” says Hughes.

Getting the service proposition right is clearly a priority in a tougher operating environment. But these are uncertain times and focusing too heavily on one jurisdiction represents a risk that many administrators are coming to realise needs to be mitigated to safeguard the business model. The primary source of risk mitigation is through geographical diversification. Hughes notes that markets wax and wane quicker than people can imagine, so it is helpful to have multiple revenue streams from multiple locations. “At the start of 2008 we decided to open six new offices,” says Hughes. “Even though that was not looking a good idea by the end of the year, we went ahead and launched them and they are already profitable.” In Asia, one of Apex’s principal areas of focus, the recession ended earlier than elsewhere (indeed, it barely touched some parts of Asia at all) and Apex attracted a number of new funds to its platform. “In tough times, you take all the clients you can at low assets then pick up the basis points later when liquidity returns,” Hughes says.

Wherever the service, it has to be provided at the lowest margins possible to attract new business. Hughes says: “Funds are looking for a high-touch service without having to pay through the nose for it. Even the big names have felt the pain so they don’t want to pay the huge fees that are levied by the large administrators any more. They don’t feel they are getting value from them.”

One way for the administrator to reduce its own costs and the fees it charges clients is by outsourcing some of its activities to cheaper locations. Smith says Butterfield Fulcrum has reduced its staff in high-cost locations. “We still have the same business volumes, but we have moved the core operations to centres of excellence,” says Smith. “We do business in nine different countries but most of our core operations people are based in Canada and India. India and Canada are the engine rooms for core administration services such as reconciliations and data management.”

Butterfield Fulcrum is not alone in withdrawing back-office services from Bermuda: Citigroup, JPMorgan and SEI all pulled back some time ago, leaving a hard core of smaller administrators in Bermuda that are solely focused on servicing funds on the island.

Butterfield Fulcrum still has a significant client base that is serviced from the island. It has ten additional offices after opening a new office in Dublin last year. A number of other administrators have also created bases in Ireland after it became clear that the island would be one of the main beneficiaries of funds migrating from Cayman and Bermuda. Butterfield Fulcrum will also open an office later this year in Luxembourg, which has been another significant beneficiary of the post-crisis era. “There has undoubtedly been a migration of volumes from Bermuda to Luxembourg and Dublin and we always aim to follow our clients,” says Smith. “We aim to be frontiersmen, getting there before our clients do. We spend a lot of time talking to our clients and asking them where they are likely to go next.” This mirrors the situation of a couple of years ago when there was a big push by hedge funds into South America and administrators had to decide whether they could service funds out of Cayman and Bermuda or whether they needed to be present on the ground.

Some administrators – such as Apex - insist that all activities should be performed in the same jurisdiction as the funds that are being serviced. Hughes claims: “People are increasingly turning to our high-touch model.” Apex’s growth from launch six and a half years ago has indeed been rapid and while it is headquartered in Bermuda, it now has 13 offices around the world. The growth is predicated on a belief that tailor-made solutions will predominate in the future. It has a “one point of contact” philosophy and tough self-imposed service standards.

Its model provides hope to all niche providers that the might of the large, captive administrators can be challenged. As Hughes says: “Three years ago, we were purely a niche administrator. Now we are a global brand.”

Independent administrators have been able to steal a march on banks in the last 18 months, according to Butterfield Fulcrum. “The big banks were unable to replace the employees they had to let go during the crisis and were focused on getting their balance sheets back on track,” says Smith. “They have a lot of power, but they cannot turn on a dime like smaller, more flexible firms. If we need to hire to service a demand in any of our locations, we just go out and hire the people we need.”

At the same time, the best captive administrators are also playing to their strengths. Lewin at BNY Mellon Alternative Investment Services says: “Our competitors are wide awake. But the financial strength of our institutions has allowed us to grow our assets – we are one of the few top administrators to have done so in the past year or two.”

It would appear then that two types of firm are starting to dominate the industry: innovative and dynamic independent service providers with global ambitions, and powerful captive administrators that have protected and enhanced their reputations in the wake of the crisis. It is not impossible that these two groupings will tighten their grip for years to come.

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