Technological innovations for hedge fund managers

TCA tools strengthen power of the buy-side

Providing managers with insight into daily exposure

Waking up to the impact of MiFID
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Brokers have always held the balance of power in the markets. Investors, the buy-side, have had no option but to conduct their business through brokers, since they have no direct access to the big pools of liquidity - generally stock exchanges.

But in the past 12 months, the buy-side has started to bite back with a force that has shocked many on the other side of the divide. Led by innovative and aggressive hedge funds, investors have demanded cheaper trading, greater choice of brokers, direct access to exchanges and new venues to trade in.

Increasingly they are dissatisfied with trading through one or two chosen brokers and are demanding access to a much wider universe. Many even want to see a significant increase in transparency, a notion that frightens many on the sell-side who have benefited from having a monopoly over information.

The shift in the balance of power is aptly demonstrated in the swift rise in the use of transaction cost analysis tools over the past year or so. TCA is a harmless-sounding concept, but it confers great strength to the buy-side.

By measuring the effectiveness of brokers, it is helping to end the era of cosy relationships predicated on long lunches and plain inertia. Through the use of TCA, the buy-side has hard evidence of the usefulness of a particular broker that can be acted upon directly or used as a way of gaining more favourable trading terms.

Transaction cost analysis tools have strengthened the power of the buy-side.
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Growing complexity within the strategies of hedge funds means it is harder for managers to keep track of the portfolio and of their total exposure to securities and asset classes. When the hedge fund manager runs more than one fund, as is usually the case, tracking exposure becomes even harder. But it is essential, for the health of the firm and the confidence of investors, that their exposure is monitored and acted upon.

“Firms are developing expertise in areas such as bank debt, loans, derivatives that they did not have before,” says Chris Cattermole, Advent Software’s sales manager for Europe, the Middle East and Africa for the firm’s Geneva investment management, reporting and accounting platform. “They are looking to spread risk and open up new avenues in terms of markets and clients. But this creates a dilemma because cross-asset class cash flows are not easy to track.”

Whereas once the model was one of various silos with different asset classes in each, the requirement for rapid views on cross-asset exposure of shares, futures, options and other securities issued by the same company is driving funds to consolidate their books onto a single platform.

For the hedge fund manager, the chief investment officer and the prime broker, having access to an intra-day P&L is essential to manage the risks inherent in volatile markets. The trouble is, some funds have outsourced all their back and middle office functions to administrators.

Says Cattermole: “The fund manager may get daily reports on his desk first thing in the morning, but that reflects what has happened yesterday.” If an event takes place in the morning, the manager may find it difficult and time consuming to get an accurate valuation of his latest exposure. “In that case, the manager will lack visibility and could be adversely affected,” he adds.

In the US, much hedge fund accounting is done in-house, but in Europe outsourcing as a model has taken off. This has cost benefits but does not allow the manager to have a full, detailed report exactly when it is required to facilitate risk-adjusted portfolio decisions.

Systems such as Advent Geneva can run reports showing a consolidated view of a firm’s positions within seconds. In effect, such systems are handing back middle office functionality to hedge funds, but with a reduced staff requirement.

Cattermole believes this capability, along with a pedigree name, is attractive to institutional investors, which provide the bulk of new assets to funds these days. “It shows that you have tight control, can react in a timely manner and have a high level of compliance with the contracted investment strategy,” he says.

But doesn’t this fly in the face of conventional wisdom that says the more elements of the business that can be outsourced, the more reliable and cost-effective the business model? Cattermole believes conventional wisdom has to be selectively applied.

“It is a case of combining in-house and outsourced capabilities,” he says. “One provides a tradeable NAV while the other provides an indicative NAV. Paying the administrator for intraday reports can be very expensive so this model works well.” In addition, investors are happier. “Transparency is reduced if everything is outsourced, so institutional investors could be turned off,” Cattermole adds.
become must-have technology for the buy-side in a remarkably short space of time. The long-term driver is the advent of electronic platforms that have shifted the focus of trading to short-term price volatility, meaning that trading performance has become a crucial factor in portfolio returns.

Adding to that are recent unbundling rules, which have concentrated buy-side minds on the quality of TCA tools they are using, since they are no longer free. Then there is the European Union's Markets in Financial Instruments Directive, which requires all buy-side firms not only to achieve best execution in trading but also to prove they have done so.

This three-pronged thrust has shone the spotlight firmly on brokers and technology providers and raised the question of whether their offerings can rise to the challenge. The buy-side too is under pressure; it must decide what it wants to achieve through TCA.

Brian Mitchell, head of trading and portfolio control at Baring Asset Management, is clear it is not purely about cost. "I'd suggest that for most on the buy-side the quality of prices received and the reduction of market impact are the two most important criteria, closely followed by explicit costs," he says.

An important purpose of TCA is to offset purely subjective views of the various brokers buy-side firm deals with. "Broker scoring can be very subjective, so quantitative data such as TCA can be useful to either validate a view or contradict it," Mitchell says.

Asset management companies must also decide whether to use pre-trade tools as well as post-trade ones. ITG, a technology and data provider, believes the trading landscape has become too complicated to navigate without automation.

"The market structure is so different from just a few years ago," says Alasdair Haynes, chief executive of ITG International. "You have the choice of crossing networks, direct market access, algorithms – and choosing which algorithm to use – agencies, and so on. The technology acts much as a SatNav in a car – it tells you how to get somewhere, which roads to pick, and how long it takes to get there."

Finding the right route can have significant benefits. "There is potential for an uplift in trading performance of 50 to 60 basis points," Haynes says. "For a fund, that is the difference between being top or bottom quartile, given the narrow range of performance."

But many asset managers choose not to use pre-trade analytics, says Clare Vincent-Silk, a consultant at Investit. "Pre-trade tools can certainly help decide how to trade, but they are only really useful if you do a lot of block trading or large volume trading," she says. "And the systems can be hard to integrate if you are trying to bolt them on to an existing infrastructure."

The emphasis is firmly on post-trade TCA, given the relative ease in carrying it out and the desire by the buy-side to comply with the new rules on unbundling and best execution.

Many clients of fund management companies expect to see a monthly or quarterly post-trade report that details commission costs. However, buy-side firms say these numbers are a red herring. "Commission costs only really tell part of the story," says Tarne Bevan, head of trading at HSBC Halbis, the bank's active strategy and hedge fund arm. The firm has developed an in-house TCA system because it felt that third-party providers did not provide data timely enough to be useful in improving order management. "The reports could include trades from three months ago, and a busy dealer is unlikely to be able to remember the circumstances of the particular trades," she says.
Mitchell agrees that commission costs are only part of the overall picture of trade costs. The Barings system looks firstly at implementation shortfall analysis, examining the overall quality of the trading decisions and the implementation performance. Secondly, time series analysis reviews all time-stamped orders and executions to identify where, and under what circumstances, performance is gained or lost. Finally, it undertakes peer analysis by market conditions, order size and security type. “This allows us to review related diagnostics to help identify any potential systematic inefficiencies,” he says.

Importantly, Barings is able to separate the trading data by variable, otherwise its TCA reports would be meaningless. ITG, the main technology provider used by Barings, says it is vital to have a sophisticated handicapping system when evaluating traders. “A trader may look like he is high-cost, but if he is trading for a momentum fund, for instance, he may actually be under benchmark,” Haynes says.

These distinctions are increasingly important to clients. As Mitchell says: “Clients ask increasingly in-depth questions. For example, they may want to know style biases or the average cost of trading in Japan or in UK small-cap. Of course, we aim to achieve lower than benchmark transaction costs, but we review this in the context of the returns generated from the decisions of our investment teams. If higher than benchmark transaction costs were paid, we would expect higher returns from investment decisions.”

If the tools for evaluating equity trading costs are broadly satisfactory for fund managers, the same cannot be said of technology to analyse trading in less liquid instruments. “Since commissions are not paid for OTC, fixed income or foreign exchange trades, their transaction cost analysis tends to focuses on bid-ask spreads and other implicit costs of trading,” Mitchell says. “Determining benchmark costs is more difficult for institutional investors due to the limited access to market price quotes and volumes.”

With fixed income and foreign exchange trading, some solutions are looking promising. “On the forex side we’ve recently been looking at an RBS product that we believe has some useful analytics for pre-trade decision-making in terms of the most ‘active’ times of the day or week to trade to minimise any price impact,” Mitchell says.

RBS is also working on generating ‘trade-weighted average price’, which may help on post-trade analysis. “We also welcome the International Capital Market Association’s proposal to run a pilot scheme to test the impact of the introduction of post-trade transparency to the investment grade corporate bond market.”

If TCA is likely to get under the skin of brokers, other technologies may have them pulling their hair out. One of these is provided by BidRoute, a UK-based company founded at the start of this year whose first product went live in November and which is attempting to revolutionise portfolio trading with an eBay-style auction service.

BidRoute chief executive Barry Marshall says the scale of portfolio trades means a better way of fulfilling them could have wide-ranging repercussions. “A third of all equity trading worldwide is programmed,” he says. Of course, programme trading is a nebulous concept with many possible definitions. Perhaps the most widely used is that of the New York Stock Exchange, which defines programme trades as at least 15 shares traded at the same time with a total value of more than USD1m.

BidRoute argues that the current process for portfolio trades is so clunky that even large buy-side firms will only set them up once or twice a day. At the moment, a spreadsheet or OMS report has to be
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Many small and, even medium-sized, institutional investors are uncomfortable with investing directly in single-strategy hedge funds, for a variety of reasons. These include that they do not always have the investment and due diligence expertise in-house, and the cost of acquiring or developing that expertise would be uneconomic. In addition, their internal rules prevent them from making large allocations to any single fund. They typically prefer to rely on the expertise of funds of funds or multi-manager funds to enter the market.

Yet large amounts of money flowing to hedge fund allocators bring problems of their own. Up until recently, there was no structure that ticked all of the end-investor's boxes. The classic fund of funds route avoids capacity constraints, offers diversification and outsources research, due diligence and fund selection. But the flipside is that funds of funds are expensive and also lack full liquidity and transparency.

Multistrategy funds have lower fees but suffer from limited liquidity and choice in the underlying managers and strategies. In addition, changing or liquidating a manager in a multistrategy fund can pose problems for the management of the firm, and significantly, there is also the potential for cross-collateral drawdown.

The managed account platform, which has grown in popularity, has its own advantages. There is full transparency in the underlying portfolios, daily liquidity for the manager, and flexibility in choosing and replacing managers. But fees are high, there is unlimited risk and there is also the potential of cross-collateral risk.

Custom House has developed a structure it believes is a step forward by comparison with existing offerings. It has designed a managed account platform that provides daily liquidity, transparency, flexibility and limited liability, and at the same time eliminates cross-collateral risk between portfolios.

In essence, the platform consists of a master fund with a series of managed accounts structured as segregated sub-funds that can be tailored to the particular investment demands of the fund manager's clients.

According to Custom House chairman Dermot Butler, the driver for the concept was a client request. “Over two years ago, we were approached by a large Canadian bank that was running a multi-manager managed account programme in-house,” he says. “They wanted to reorganise it and create a fund structure, both to create a marketable product and to get the platform off their balance sheet.”

Launched in December 2005, the master fund linked to 28 authorised segregated cells. “Each cell contained a specific managed account, organised as a sub-fund,” Butler says. “They are ring-fenced by the segregated cell structure, so that no one sub-fund of the master can contaminate any other sub-fund, should it lose more money than it has in assets.”

With its network of offices in Dublin, Chicago and Singapore, Custom House is able to provide a daily tradeable NAV for investors in any region of the world. The Singapore office was originally set up in January this year with the intention of servicing the fast-expanding Asian hedge fund sector, but that original aim was soon superseded. Butler says: “Because of the demand for daily dealing, capacity in our office was quickly taken up.”

He says potential clients and competitors are sometimes surprised that such an offering exists. “It is very innovative. People ask us if we are providing indicative NAVs. We have to inform them they are tradeable.”

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**CUSTOM HOUSE INNOVATIONS**

**Structuring accounts to meet needs**

Interview with Dermot Butler

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created from which the main characteristics of the trade are distilled and shown to a broker for pricing purposes. The number of stocks is revealed and their approximate size, but many other relevant characteristics may be omitted from the information given to the broker.

Says Marshall: “The buy-side trader demonstrates his skill in getting the best deal by thinking how he should characterise the trade by region, sector, beta and tracking error.” The process is clearly subjective and can lead to misunderstandings between the two parties. “It’s like putting a photo of a car on eBay, but only showing one side of it,” he adds. “The other side will be the one with the dent in it. Clearly, if a fund manager gives the equivalent of a photo without a dent, the trade is likely to be priced more favourably.”

The solution to this unreliable process, BidRoute believes, is to create auctions for portfolio trades. It has created a system where, instead of carrying out one or two programme trades a day, fund managers could do 100. Marshall says: “At the moment, you phone, say, Goldman Sachs and Morgan Stanley. Goldman Sachs might say it will charge 10bps and Morgan Stanley might say 8bps. But other brokers’ prices are not taken into consideration because there is just not the time and resources to call them all up.”

Auctions can be divided into asset classes, under which, for example, all the specialist small-cap brokers would be invited to bid for a portfolio of small-caps. Marshall says the system addresses an issue that clearly disadvantages the underlying investors of buy-side firms.

“Greenwich says that 73 per cent of programmed trades go through three brokers,” he says, “but there are a lot more than three brokers in the world.” BidRoute’s system could potentially bring dozens of specialist brokers in from the cold, to the benefit of fund managers.

Marshall says the tool was built predominantly for the benefit of the buy-side to redress an imbalance that has gone too far. “The buy-side doesn’t want to just rely on brokers,” he says. “If it is an algorithm, the fund manager is not in control because he has not made the algo but rented it, and probably only the broker knows how the thing works. The buy-side needs a tool that is easy to use and doesn’t need someone else to service it.”

There is even flexibility within the product for the fund manager to decide whether the auction is sealed or open. While most auctions are likely to be sealed, index-type trades could be opened up to the entire broker spectrum to encourage stronger bidding patterns. “You won’t necessarily move the market by letting people know you are inviting bids for even a very large index trade, so you may as well have an open price,” Marshall says.

And BidRoute’s idea could have the side-effect of helping the buy-side to expand its asset base. Whereas many funds have to soft-close because they are investing in strategies with limited capacity, the auction approach to trading could help to increase exposure to the desired assets. “Sometimes the dealing footprint left by hedge funds and other investors is too large,” Marshall says. “By splitting a programme trade into smaller parts, the impact can be lessened.”

A 50-stock trade can be split, for example, into five lots of ten. This would be difficult under the current system because of the sheer effort involved. “The result could be that funds could grow bigger than they are able to at the moment,” says Marshall. “And this, of course, means higher fees.”
The most anticipated financial event since the birth of the euro has finally come to pass. The European Union’s Markets in Financial Instruments Directive came into force on November 1, signalling the end of years of preparation and kick-starting a new era of capital flows around and between EU member countries.

Many financial market participants have no doubt of the benefits MiFID will confer. “The European market is really opening up and becoming a single economic area for financial services,” says Paul Beach, head of corporate and investment banking at Atos Consulting. “That will continue and has to be good for investors across Europe.”

The core principle of MiFID, he says, is to increase the transparency and awareness of cost and prices. But Beach believes MiFID is not necessarily driving these changes, and is actually a reflection of what the market had started to do on its own. “Although MiFID is driven by regulation, it is actually a market change,” he says. “Hedge funds and other professional investors are driving it, by increasing competition and demanding that brokers pursue best execution strategies.”

Best execution is the one part of MiFID that everyone agrees will have a major impact on the marketplace. Atos principal consultant David Smith says: “As the market unfolds, firms will move away from a one-size-fits-all execution policy. Innovating brokers will start to specialise, so order routing capabilities that are attractive to hedge funds will take up the flow. There will be many more venues and more, smaller-sized, trades.”

In the US, there has been rapid take-up of best execution practice to the extent that brokerage is now less to do with personal relationships and more to do with sales based on price. “We are heading the same way in Europe,” Smith says. “There will be less need for voice broking as hedge funds look for the most efficient mechanism.”

In fact, the EU legislation has not actually stipulated that brokers find the best price for their clients, but instead prescribed transparency of execution within the agreed
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Dealing with new MiFID rules

Interview with Richard Jones

For many buy-side institutions, the focus of the European Union's Markets in Financial Instruments Directive has been primarily in a single area. Their overwhelming concern over the past couple of years has been to ensure they are able to match up to the best execution requirements of the directive.

However, MiFID is not one-dimensional, and some firms may be focusing too much of their energy on a single issue. "Best execution has probably been over-weighted, while possibly there has not been enough focus on other regulatory areas impacted," says Richard Jones, chief executive of Fidessa LatentZero.

Jones points to client order handling and the requirement to treat all clients equally, handling orders fairly – especially where client and in-house funds are concerned. He gives an example of an aggregated buy order of 200,000 shares, within which one is an order for 190,000 shares and another for just 10,000. "Under a standard pro-rate allocation, the smaller order doesn’t get filled until after the 190,000 is done, which is clearly unfair to the smaller fund," Jones says.

Protection against front-running, which involves a conflict of interest between in-house trading and third-party orders, is similar. "Buying first for an in-house fund before a large client block order is traded is specifically prohibited under MiFID," Jones says. This rule will have greater ramifications in some countries than in others. "Most asset managers in the UK, France and other well established jurisdictions already have policies on front-running, but is it the case in other European markets?"

Client order handling can be dealt with by effective order management systems that are configured to control when orders are kept separate and when they should be merged, and how partial fills are allocated. Some buy-side firms have high standards in this respect, never merging orders and always executing client orders before those of in-house funds. "If you configure the order management system to control merging and allocation, you are adhering to your own policy by definition," Jones says. "An OMS is not compliance in itself, but it is a strong supporting tool."

Those fixated on best execution may also have missed rules on trade and transaction reporting. "There has always been reporting of trades via exchanges, but now off-market trades also have to be reported," Jones says. Asset managers cannot assume that brokers will do this automatically. "There now has to be a contract between the asset manager and the broker," he adds. "For off-market trades executed through non-EU brokers, asset managers will have to report trades themselves in real time."

The requirement for next-day transaction reporting relates to requirements under MiFID to monitor and prevent market abuse and insider trading. Trades must be reported to local regulators the following day so the regulator can examine transaction history in the case of market events such as mergers and acquisitions. Says Jones: "They might look at all trades in the weeks running up to the event to see if there is large or unusual activity by people who are likely to have relevant information."

Where trades are carried out by EU brokers, the asset manager can rely on the latter to report the transactions as MiFID requires. An issue for EU asset managers arises where a trade for an EU security (including dual-listed securities) is executed by a non-EU broker, which is not obliged to report the transaction. "Some asset managers are reporting to regulators all trades done through non-EU brokers, just to be sure."
service standards. But inevitably, price is what both buy-side and sell-side are focusing on and over which the coming battles are likely to be fought.

However, some brokers have viewed the letter of the law and the slightly hazy stipulation of transparency within service standards as meaning they do not need to make any changes at all. Beach says: “Banks are effectively allowed to set their own standard, so many have not changed radically. They are compliant but they have not radically improved their best execution.”

Atos believes they are missing an opportunity to benefit from the changes that MiFID implies. “We are seeing more advanced banks moving on from compliance and providing a differential in terms of the levels of speed and execution,” Beach says. To achieve that, they need to adopt new technology approaches such as smart order routing (SOR) to take advantage of the new venues that MiFID permits. In effect, MiFID allows a whole new range of markets to be created, and it is up to the buy-side to choose the right brokers and the appropriate technology to access the full range of new trading venues.

In this new and more diverse environment, SOR mechanisms are indispensable for speedily checking all the venues that are relevant to the underlying customer and the type of trade. Smith says: “Smart order routing allows you to apply all the rules you want to according to client and transaction type.”

The new venues, including systematic internalisers, have existed in the UK for years as London’s position as a major trading centre has provided huge amounts of liquidity for the bulge bracket banks that do business there, but for much of continental Europe, the advent of systematic internalisers will represent a significant cultural shift.

“The commission wanted to break the monopoly that local exchanges enjoyed in countries such as Italy, Spain and France, and provide pre-trade price transparency,” Beach says. “By law, before November 1, if you wanted to buy local shares you had to trade through the local exchange.”

Estimates for the numbers of systematic internalisers that will be created in the wake of MiFID’s implementation range from four to 400. Beach says: “All the institution has to be able to do is to make prices available on an automated basis. They could be on a website or carried by data vendors. That makes for a very open playing field.”

The challenge to the incumbent markets is clear from the intent of a group of the world’s largest investment banks to set up a viable alternative. Turquoise, a consortium comprising Citigroup, Credit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS, announced at the end of 2006 that it would set up a rival to Europe’s established exchanges, and BNP Paribas and Société Générale joined the group early this year. It is one of several new liquidity providers that are expected to launch in the next six to 12 months.

At the time of Turquoise’s initial announcement, the thought of a serious rival...
to the European stock exchanges was genuinely shocking. At the launch announcement, shares in the London Stock Exchange fell sharply on concerns that the new platform would divert trading away from it. After all, Turquoise promised to cut trading fees in half.

The rationale for Turquoise is fairly simple: the investment banks that conduct the lion’s share of trading either directly or on behalf of clients were fed up with being forced to pay the tariffs set by Europe’s exchanges and with the refusal of those exchanges to reduce fees. “There is a real need for competition in the marketplace for equity execution and venues,” says Eli Lederman, who was appointed chief executive of Turquoise in October.

The model that Turquoise and others are based on is tried and tested in the US, where trading systems known as electronic communication networks have proliferated since they were authorised by the Securities and Exchange Commission in 1998. “ECNs have undoubtedly taken market share away from the incumbents,” says Eli Lederman says. The success of the US ECNs is predicated on the ‘taker-maker’ model, which Turquoise will also adopt. The model rewards those who make prices to buy or to sell, while levying higher charges on those who take those quoted prices, either by ‘hitting the bid’ to sell or ‘lifting the offer’ to buy.

Providers of liquidity will receive a rebate on their fees as a kind of loyalty bonus for using the platform. Lederman believes this rebate model will be a key weapon in the battle to attract liquidity in a marketplace that could soon include a host of new players.

Another weapon, he believes, will be Turquoise’s use of innovative technology, which he thinks will put the incumbent exchanges’ systems in the shade. “There is a question mark over the quality of technology that the incumbent exchanges possess,” Lederman says. He says Turquoise’s systems will be able to handle greater volumes and provide speedier trading than currently exists.

“Our latency will be very low – we are talking about small numbers of milliseconds,” he says. Low latency is particularly important to attract investment bank proprietary trading desks and those hedge funds that use quantitative methods to trade very small market anomalies using large amounts of leverage.

Turquoise will also attempt to meet growing demand for access to shares that are traded between banks in large blocks away from the main exchanges. In the US, ‘dark liquidity pools’ now account for about 10 per cent of equity market trading.

Lederman says: “There is demand for a link-up between the transparent order book and the dark order books behind it. Our technology will look for matching between these two venues. That is truly innovative. It means our system works well for small orders, but also for large orders when there is the need for more obscurity.”

Turquoise argues that the combination of cheaper trading, speedy execution and access to previously invisible liquidity will allow it to quickly gather momentum. “We think 10 per cent of European volumes is quite feasible and our aspirations are much higher than that,” Lederman says.

He believes Turquoise will offer the best pricing so, under MiFID’s best execution principles, which compel brokers to offer the best deal to their clients, liquidity will automatically flow to it. “Brokers must look for the best price and smart order routing technology means they will scan all venues to find it,” Lederman says.

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And now we’ve added PerTrac Portfolio Manager, an entirely new application that will change the way you manage your funds of funds and other multi-manager portfolios. From due diligence to trade entry and cash management to risk assessment, PerTrac Portfolio Manager will help you better organize and understand the array of information relevant to your portfolio, allowing you to save time, make better decisions, and produce stronger returns. Advanced features like the Monthly Liquidity Schedule and FX Hedging put you in control of the entire portfolio management process. And because PerTrac Portfolio Manager shares information with PerTrac Analytical Platform and PerTrac CMS, it integrates into a seamless firm-wide solution.

Learn more about unlocking the power of information with the PerTrac Suite, including PerTrac Portfolio Manager, at www.pertrac.com.
The fund of hedge funds sector is still growing strongly despite intermittent predictions of its demise. In fact, as more institutions enter the hedge fund market, fund of funds managers are continuing to see strong capital inflows.

But, despite the growth in assets under management, many rely on outdated internal systems, and those that have tried to modernise have often been stymied by a lack of robust technology offerings. “From a technology perspective, funds of hedge funds are a very under-served and under-automated market,” says Meredith Jones, managing director of PerTrac Financial Solutions. “Many firms have rudimentary systems, whether they manage USD50m, USD500m or USD5bn.”

These systems often consist of a series of linked Excel spreadsheets, with separate workbooks for subscriptions and withdrawals, investor balances, performance and NAVs and foreign exchange hedging. “The fact that some of the best minds in the financial industry must rely on technology that cannot keep pace is almost mind-blowing,” Jones says.

The lack of a cohesive and comprehensive portfolio management system can negatively affect returns and damage overall profitability. It is essential, for instance, to know where to find liquidity in the event of unexpected or large redemptions. With anything between a handful and 100 managers in a portfolio, all with varying redemption terms, finding liquidity is easier said than done. And that’s just one component of the overall portfolio.

PerTrac, working with London-based fund of hedge funds firm Caliburn Capital, has developed a dedicated solution, Pertrac Portfolio Manager, which it believes will end manual inputs and sluggish outputs. According to Jones, the new workflow system adds value in a number of ways.

To start with, it improves performance by giving high-level visibility over all aspects of the fund. “Viewing only one of the moving parts in a portfolio is not optimal,” she says. “To maximise returns, it is crucial to understand the details and how those details work together to create the total return.”

The system also helps ensure that fund of funds managers do not take greater risk than they intend. They can check at a glance with customisable charts, set risk limits and risk flags, and keep checks on portfolio, geographic and strategy limitations.

The system aims to save managers time to focus on fund selection, due diligence and monitoring. Time-saving tools include cash management capabilities that allow managers to easily enter inflows and outflows, account for operational costs, handle series rollups and hedge currency exposure.

Jones says Pertrac Portfolio Manager allows a fund of funds business to scale more effectively, reducing the need for new hires. In addition, she says, having a robust, comprehensive portfolio management system can be a competitive advantage and attract additional assets under management. It can also increase client satisfaction through the ability to respond quickly to queries. Finally, it reduces errors since the fund of funds is freed from manual calculations.

PerTrac Portfolio Manager has just gone live after testing with a number of funds of funds since June. As a result of tester feedback, PerTrac has added new features such as a leverage model, and has future functionality in development.

Jones believes it is genuinely pioneering. “Our largest competitor in this space is Microsoft Excel,” she says. “Bill Gates is a worthy opponent, but we believe that most people managing multi-manager portfolios will find PerTrac Portfolio Manager the better solution.”

Keeping pace with the fund of funds industry

Interview with Meredith Jones

Meredith Jones, managing director, PerTrac Financial Solutions

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speedier trading and reduced fees, many buy-side firms do not seem to have come to terms with MiFID at all, despite the long lead-in period. “Some seem to be taking a wait-and-see approach,” says Richard Jones, chief executive of Fidessa LatentZero.

“People are waiting to see who will be the first to be caught for non-compliance and then address the areas their rivals were caught for. A number on the buy-side have taken that view. Some of our customers have been very proactive and have dedicated time and detailed thought to the process. Other people have rung us up in the last couple of weeks and asked what impact MiFID is likely to have on them.”

One of the reasons that some on the buy-side have ignored MiFID is that best execution – the central plank of the directive – is not actually mandatory. As Jones says: “Best execution is only a requirement when clients require it to be a requirement! If you are a pension fund you will certainly demand best execution, but a hedge fund and its clients may not necessarily require best execution. MiFID does provide more flexibility within the boundaries of best execution than previous regulation by recognising factors other than price, such as speed and certainty of execution.”

In the case of certain hedge funds, however, best execution even under the new wider definition may be a hindrance to the investment strategy. For example, filling an order at the best price over, say, three days may be far less attractive than trading immediately and having the option to sell the position shortly after.

Nevertheless, around Europe there appears to have been a disconcerting lack of preparation by buy-side firms. According to Celent, a Paris-based consultancy, this could be a big mistake. “The buy-side are saying they will believe MiFID enforcement when they see it,” says Celent chief executive Octavio Marenzi. “This is extremely brave, because the regulators are serious about this. They may have to string up a few firms to make an example.”

Some buy-side firms do not believe MiFID applies to them at all, he says. “MiFID in fact makes no distinction between the buy-side and the sell-side. It sees them all as investment firms and treats them all the same. It was argued that portfolio management should not be regulated in this way because it is not transactional, but this argument was rejected by the European Commission and the Committee of European Securities Regulators. I think this is right – it is very hard in some cases to make the distinction.”

The buy-side has a number of key areas it cannot afford to ignore in the wake of MiFID. They are compliance-type issues but nonetheless should not be taken lightly. They include client classification: explaining to the different types of clients about execution policy and agreeing the policy with the relevant investor.

In addition, MiFID prohibits the bundling of execution and research in all its many guises. While unbundling is standard practice in some countries – in the UK, the Myners report at the start of this century was forceful in its condemnation of bundled services – in other jurisdictions the practice still exists. Marenzi says: “Let’s be clear – soft commissions are going the way of the dodo.”

If buy-side firms cannot bring themselves to take a proper look at the provisions within MiFID, they could also face extinction. After all, if the regulators really want to make an example of directive-dodgers, the fines and penalties imposed could be the difference between making a small profit or a heavy loss in any one year.