STATE STREET

# VISIONFOCUS

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# Hedge Funds: Rebuilding on a New Foundation

The hedge fund industry is reinventing business models and best practices to address sweeping regulatory changes and investor demands for enhanced fund transparency, liquidity and efficiency. Investors, fund managers and regulators alike are looking to third-party fund administrators to provide objective risk assessment and reporting.


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# Hedge Fund Recovery

The expansion of hedge fund assets under management to more than $2 trillion for the first time, in the first quarter of 2011, represents the endorsement by institutional investors of a more transparent and rational hedge fund industry. These asset levels, surpassing the previous industry record of $1.93 trillion established in the second quarter of 2008[1], together with evolving practices and market reconfiguration, suggest that the hedge fund industry is moving beyond the financial crisis and rethinking its future.

Perhaps most noteworthy in this changing environment is the new dynamic emerging between fund managers and investors as a result of growing concerns over liquidity, transparency, terms for fees and lockups, and risk management approaches. This development is fostering a keener focus among investors and fund managers alike on operational excellence, third-party administration and risk management, transforming these considerations from "nice to haves" into critical market differentiators.

The return of hedge fund assets under management to record levels suggests financial recovery and renewed stability among the world's high-net-worth and institutional investors, but it represents only part of the picture. While the total number of hedge funds worldwide grew from 9,045 in Q4 2009 to 9,418 in Q1 2011[2], many individual funds and funds of hedge funds (FoHFs) continue to close their doors. While market appreciation, rather than inflows, have historically accounted for most growth in hedge fund assets under management,[3] and while inflows notably slipped during the 2008-2009 crisis, new investment flows are once again returning. See Figure 1.

According to recent polls, investors continue to express support for alternatives as a whole and for hedge funds in particular. For example, one survey found that fully two-thirds of investors polled intend to increase their allocations to alternative assets — including hedge funds, private equity and commodities — over the next 12 to 24 months.[4]

1 Hedge Fund Research, "Hedge Fund Industry Surpasses $2 Trillion Milestone," April 19, 2011.

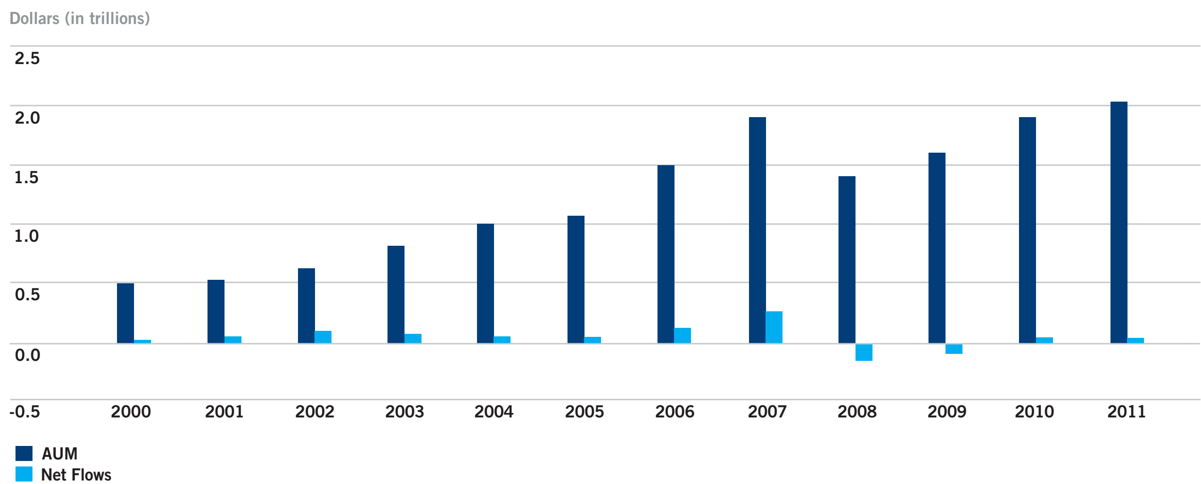
2 Hedge Fund Research, Global Hedge Fund Industry Report, Q1 2011.

3 Hedge Fund Research, Hedge Fund Industry Estimated Assets, Q4 2010.

4 Poll by Quinnipiac University, Connecticut Hedge Fund Association and Bank of America, cited in Dan McCrum, "Greater Hedge Fund Exposure Forecast," *Financial Times*, December 14, 2010.

Elsewhere, in a survey of pension fund, endowment, foundation and insurance investors in North America, Europe, Japan and Australia, participants reported that they planned to boost their allocation to alternative investments proportionately by more than a third by 2012, from 14 percent of their total portfolios to 19 percent.[5] Certainly, underlying trends such as aging populations and chronic pension underfunding, which drive the need for absolute returns, suggest huge opportunities for the hedge fund industry to play a larger role.

**Figure 1: Hedge Fund Industry: Estimated Assets and Net Flows**




Source: HFR Industry Reports© HFR, Inc. 2011, www.hedgefundresearch.com

[5] Russell Investments 2010 Global Alternative Investment Survey, cited in "Alternative Investments Gain Ground Among Institutional Investors," ai5000, June 21, 2010.

### Investors' new role

The downturn left its mark on more than balance sheets; it also set in motion a wholesale reshaping of the industry. In the wake of the crisis, hedge fund investors have come to recognize the critical importance of operational, administrative and risk management issues that they had once left to their fund managers.

As hedge funds increased this focus on operational efficiency and risk management, market differentiators have emerged, including safekeeping and the provision of third-party collateral management, quality client service, transparency, liquidity, credible valuation policies and independent third-party administration. These criteria — and not solely absolute returns — are today increasingly defining the competitive advantage of hedge funds for institutional investors who have come to expect that their priorities and concerns should move to the center of fund decision-making.

This dynamic, back-and-forth balancing of initiatives between managers, investors and their service providers will likely define the industry going forward. In the aftermath of the downturn, the hedge fund industry has undergone a definite paradigm shift. As it becomes more institutionalized, it will by definition grow steadily more oriented toward addressing the concerns of institutional investors.

Hedge funds have evolved beyond their traditional markets among high-net-worth investors, foundations, endowments and the largest pension funds, to the mid-sized pension funds that make up the vast center of the asset management marketplace. Institutional investors' new focus on hedge funds' risk management capabilities should place funds in good stead for asset owners increasingly attuned to macro investment trends and systemic risk.

As pension assets shift from traditional asset management firms to hedge funds, many industry analysts anticipate convergence between both types of fund management. But thus far, convergence has primarily been evident in the distribution of investment products. For example, some hedge funds have created UCITs in Europe, or in the US, offered funds of hedge funds in a "wrapper" compliant with the Investment Company Act of 1940 (40 Act), which governs mutual funds. But these products do not precisely replicate the performance of hedge funds on which they are based. Institutional investors migrating to hedge funds would therefore seem to be pursuing a unique set of investment techniques in the belief that hedge funds can produce differentiated alpha.

# The New Yardstick for Hedge Funds

Post-crisis fund selection will emphasize five critical operational and risk management elements: investment strategy and performance, portfolio liquidity, transparency, a reconsideration of pricing and lockup periods, and operational due diligence.

In addition to these five criteria for measuring a fund's overall suitability, and to ensure better accountability, institutional investors are insisting that managers are supported by third-party custodians and administrators. Taken together, these evolving standards are expected to set the operational and investment standards that will define the hedge fund industry for years to come.

### Investment strategy and performance

While operational excellence, third-party administration and greater transparency may have broadened the definition of successful fund management, robust risk-adjusted investment returns are still a central pillar of performance. But even this is evolving. The days of no-questions-asked performance are gone and unlikely to return. Asset owners today want to know how returns were achieved, the strategies that drive them and the risks encountered at every stage of the investment process.

Third-party administrators can play a critical role in the provision of this enhanced performance attribution by articulating what proportion of investments have been priced independently, the percentage of portfolio holdings that the administrator has reconciled with external parties, certain characteristics of counterparty exposure and the complexity of portfolio valuations.

### Liquidity management

To mitigate the likelihood of the costly liquidity mismatches that were observed during the crisis, investors are more deliberately modeling their own liquidity profiles, and disaggregating the liquid from the less liquid components of their portfolios in line with their long-term and shorter-term liabilities. Following suit, hedge fund managers are similarly dividing their portfolio strategies, for example, between liquid equity investments and less-liquid structured credit strategies.

Managers can then work with their clients to ensure they direct them toward investment strategies that are appropriately aligned along a liquidity spectrum, or seek out credit services that meet their requirements for liquidity financing, investor redemptions, portfolio reallocations, and currency hedging and capital calls, effectively bridging their cash needs pending receipt of investment redemption proceeds. Leading administrators are also being called upon to provide bridge financing as part of their comprehensive mix of services.

### Portfolio transparency

Despite fund managers' reluctance to share information about their strategies and investment positions, investors are increasingly demanding more detailed insight into fund activities. Specifically, they want timely information about strategy, sector and geographic exposure, and leverage ratios. In addition, investors want this information aggregated and organized in a way that better helps them understand portfolio risk.

To address this need and compete for investor flows, fund managers are offering clients more comprehensive data on their investments, including better risk analysis, timelier reporting and indicative perspectives on investment positions. Increasingly, managers are providing all of this through the reporting infrastructure of third-party administrators that can manage these expanding volumes of data.

### Pricing and lockups

The financial crisis was a difficult experience for many hedge funds and their investors. In many instances, short-term liquidity events drove institutional investors to redeem investments in high-performing funds and hold onto others from which they otherwise would have wanted to disinvest. These decisions were made in accordance with the lock-up provisions of management contracts rather than in response to performance. In the months after the crisis, several hedge funds revised their fees in an effort to retain market share.

Today, with the critical months of crisis receding, top-performing funds are once again commanding high fees in response to investor demand. At the same time, newer funds eager to establish themselves with investors are offering more flexible pricing and lock-up arrangements and allowances for more frequent redemptions. Funds may even adopt time-spans exceeding the traditional year for calculating performance fees or claw-back provisions. The question today would seem to be whether competitive market forces are driving a long-term divergence in fees and terms between different types of hedge funds, resulting in more varied terms and compensation structures across the industry. Suffice it to say, investors seem likely to insist on more balanced incentives that deliver improved alignment between risk-adjusted fund performance and manager compensation.

### Operational due diligence

Investors and fund managers alike have come to recognize the benefits of a holistic approach to risk management that takes into account both portfolio and operational risk, and embraces third-party assessment and monitoring of counterparty and partner processes. Fund managers have also come to recognize the unique benefit of large third-party administrators with substantial technology platforms that are able to aggregate risk data and analysis and provide a single dashboard of information for funds that have been placed with multiple administrators.

Independently administered and objectively measured risk assessment will also provide critical infrastructure for the new regulatory requirements coming into effect around the world. This will most notably be required in the United States, where the Dodd-Frank Wall Street Reform and Consumer Protection Act will require all hedge fund investment advisors with more than $150 million in assets under management to register either with their state or with the Securities and Exchange Commission (SEC).[6]

With the need to register comes a whole layer of obligatory compliance infrastructure such as lawyers, accountants, compliance officers and regulator liaison staff. Though still evolving, Dodd-Frank will likely require that funds test compliance programs once implemented, and that they report information on risk exposures to the SEC on an annual or quarterly basis (depending on their size) as part of regulators' new systemic risk assessment efforts. These new requirements may create no additional burden for the five percent of largest hedge funds that manage 70 percent of hedge fund assets under management, because most of these funds had already registered and developed these compliance functions before the financial crisis.[7]

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[6] Azam Ahmed, "For Small Hedge Funds, Success Brings New Headaches," *New York Times*, January 20, 2011.

[7] Ibid.

But it is expected to be particularly burdensome for startup and smaller hedge funds that must hire these executives and establish their functions. What's more, the new Financial Stability Oversight Council (FSOC), created under the auspices of Dodd-Frank, will give regulators substantial latitude in designating certain nonbank firms and niche hedge funds as Systemically Important Financial Institutions (SIFIs), and therefore subject to expanded regulatory coverage and information reporting requirements[8] such as Form PF. This proposal seeks a broad range of disclosures from hedge fund managers regarding their investment strategy, assets under management, counterparty exposures and operational risk controls. For large and small firms alike, third-party administrators with substantial technology, information-gathering and reporting infrastructure in place will be the best way to make this compliance reporting feasible.

In Europe, the Alternative Investment Fund Managers Directive (AIFMD) will, in 2014, introduce a harmonized European regulatory regime and a "passport" enabling alternative investment funds to market and manage investments throughout the European Union under one single authorization.[9] To take advantage of these opportunities, authorized fund managers will have to comply with a range of provisions regarding governance, organizational structure, monitoring and safeguards, and oversight. The Directive will also require significant reporting enhancements to investors and regulators across a wide range of business areas, and calls for alternative investment managers to appoint independent custodians and demonstrate greater control over risk management processes.[10]

On a more immediate time-frame, the European Undertakings for Collective Investments in Transferable Securities (UCITS IV) directive, which will build on the existing UCITS III, introduces a management company passport that will enable companies established in one EU member state to market UCITS freely across the 27-member European Union and centralize their asset management, administration and risk management processes. Both small and large funds will need to manage the complexities of UCITS compliance to take full advantage of the marketing and distribution opportunities created by the Directive.

As investors and fund managers — in both the US and Europe — adjust to the changing hedge fund marketplace, risk management and operational due diligence will play a much larger role in attracting investor allocations. Third-party administrators will play an essential role in facilitating compliance with the evolving supervisory and regulatory landscape.

[8] Testimony on the Financial Stability Oversight Council, SEC.gov, January 25, 2011.

[9] "Alternative Investment Fund Managers Directive: Some Practical Considerations for the Hedge Fund Industry," Ernst & Young, January 2011.

[10] European Alternative Investment Industry Gearing up for Regulatory Challenges," hedgefundsreview.com, April 4, 2011.

# Risk Aggregation and Transparency

Across the alternative investment industry, institutional investors are driving the evolution of all investment channels — direct hedge fund investment, funds of funds, managed accounts and other structures. Improved investor sentiment and positive inflows suggest reviving confidence across the board. Perhaps equally important is the choice and proportion of assets investors deploy to specific hedge fund investment channels.

### Funds of hedge funds — evolution at work

The fact that FoHFs accounted for fully 60 percent of world hedge fund investment pre-crisis[11] can be attributed to the critical service they were seen to provide. But FoHFs experienced a disproportionate share of investor redemptions during the crisis and have been slower to recover. While the industry as a whole is back in record territory, FoHFs stood at $673 billion at the end of Q1 2011, down from their peak of $826 billion in 2008.[12] In an effort to regain their former preeminence, FOHFs are undertaking their own fast-forward evolution.

By helping institutional investors choose funds best suited to their liability profile and tolerance for lockups, FoHFs served to introduce many institutional investors to hedge funds for the first time and came to play a critical role in investor risk strategies. While the crisis seriously impacted this sizable market segment, the dynamic shifts occurring throughout the industry — particularly in Europe where high-net-worth investors fled market reversals and asset gathering scandals — may help FoHFs regain their role as some investors' preferred conduit for hedge fund investment.

As the crisis rose, industry analysts noted that more institutional investors had chosen to bypass FoHFs in favor of direct hedge fund investments. But those foreseeing the demise of FoHFs will likely be disappointed. While single-manager funds did attract more investment flows in recent quarters, a recent survey[13] found that fully half of respondents intend to gain exposure to hedge funds exclusively through FoHF vehicles.

In a complex market, FoHFs retain a critical utility for institutional investors, helping them to navigate among thousands of hedge funds, and to undertake due diligence and ongoing management of direct fund exposures. But institutional investors are demonstrating notable selectivity, looking for FOHFs with solid performance and unimpeachable operations, administration and governance.

In the next phase of hedge fund evolution, successful FoHFs will be those that develop an innovative, more flexible business model geared to providing client-focused portfolio solutions. Such solutions can comprise a wide spectrum of customizable services that investors need not replicate in-house, including more flexible asset allocation strategies that enable investors to optimally combine their hedge fund exposures with other kinds of asset allocations such as private equity or hedging overlay.

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[11] Estimate of Per Trac Financial Solutions survey, cited in Joseph Checkler, "Fewer Hedge Funds, but with More Assets in '09," *The Wall Street Journal*, March 30, 2011.

[12] Hedge Fund Research Q1 2011 and Q2 2008.

[13] SEI/Greenwich Associates, "Institutional Hedge Fund Investing Comes of Age: A New Perspective on the Road Ahead," January 18, 2011.

FoHFs should also be prepared to offer their insights and expertise without necessarily serving as the physical conduit of fund investment. Sophisticated investors are today seeking customized, bespoke advisory services from FoHFs and then undertaking their own direct fund investment. According to a recent survey, more than 63 percent of FoHFs — generally speaking those with considerable size and scale — are offering these bespoke solutions.[14]

FoHFs are well positioned to support critical issues facing investors today, such as liquidity, transparency and fees. Ironically, these are precisely the concerns that most preoccupied FoHF clients before the financial crisis. Bearing this in mind, FoHFs that are attracting the most investment flows post-crisis appear to be those that internalized the lessons of the crisis, offer enhanced services and exercise their substantial buying power to coax improved transparency and fee structures from underlying funds, and facilitate liquidity management — both in terms of investments and of client tolerance for illiquidity.

### FoHFs and third-party administrators

Third-party administrators play a catalytic role in mitigating investment and operational risk for FoHFs. They enhance the transparency of investment valuations, deliver insight into investment operations workflow and provide a lengthening menu of other value-added services, such as investment exposure transparency and fund liquidity reporting.

At a deeper level, third-party administrators are creating infrastructure that will significantly improve the speed and availability of critical information to FoHF managers. No longer must investors or managers wait weeks to learn the status of trades or redemptions, or net asset value prices. By means of real-time, proprietary dashboard technologies, fund clients can gain direct Web-based access to the universe of information related to their fund holdings and generate real-time, customizable reports. As FoHFs evolve, they are increasingly turning to third-party administrators for reporting that would assist the manager in addressing the priorities and concerns of their investors, such as liquidity and transparency.

### Managed accounts — new models

Throughout the financial crisis and its immediate aftermath, investors sought out managed accounts to avoid the liquidity and transparency issues prevalent in commingled investments. While constituting only two to four percent of total hedge fund assets under management,[15] managed accounts saw a surge of investment flows during the crisis as high-net-worth investors fled hedge funds and FoHFs in pursuit of liquid and transparent investment structures.

Some industry observers interpreted this precipitous shift in allocation as an inflection point that would permanently alter the nature of investor engagement with the hedge fund industry. But as markets stabilized the surge of assets to managed accounts leveled off. In contrast to their specific advantages — transparency, liquidity, the ability of investors to terminate trading authority at will — managed accounts present unique challenges. Often, their increased cost and technical and operational complexity dissuades fund managers from offering them to clients. Nevertheless, given the impact of the crisis and current trends in the industry, many leading funds have signaled their willingness to accommodate client requests for managed accounts.

FoHFs have assumed a role in developing and marketing managed accounts, using their sophisticated infrastructure to establish managed accounts with individual hedge funds for their clients. These provide investors with funds of managed accounts (FOMAs) that deliver advanced FoHFs processes, with the transparency and protection of managed accounts. Investors who want exposure to managed accounts without the complex due diligence and operational responsibilities that come with them are using third-party managed accounts platforms that aggregate funds and provide controls, transparency and liquidity for managed accounts.

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[14] Global FoHF Forum Survey, cited in Niki Natarajan, "The New Face of Hedge Funds," InvestHedge, April 20, 2011.

[15] Estimate of Invovest21, cited in Carol E. Curtis, "Managed Account Platforms Growing Rapidly at Hedge Funds," *Securities Technology Monitor*, November 2, 2009.

In the wake of the financial crisis, some industry observers believed that investors would face a choice between FoHFs and managed accounts. Instead, managers and investors alike appear willing to mix and match the best elements of both investment structures, together with those of other hedge fund options in a convergence play, as old models give way to service-oriented flexibility.

### Funds of one

For large investors concerned about the proximity risk (which arises when investors with varying tolerance for risk are co-investing in a single hedge fund vehicle) entailed in FoHFs, managed accounts may not be a viable option, given their inherent complexity. In some cases, these investors have collaborated with hedge fund managers to develop a new structure, known as the "fund of one," essentially comprising a separate share class for a single investor.

Funds of one represent another useful example of the innovative solutions that can emerge when investor concerns come first. No matter how the ownership of the fund happens to be structured, a fund of one is segregated from the hedge fund's commingled accounts. Since responsibility for operations lies with the manager, investors' operational requirements are greatly simplified. FoHFs have also explored this structure, driving hedge funds to establish funds of one to obtain full transparency on behalf of their clients. This approach also reduces impediments to liquidity.

### UCITS and hedged mutual funds: blurring the boundaries?

With one eye on investor appetite for less-correlated, risk managed hedge fund investment styles, traditional asset managers are devising strategies that mimic those of hedge funds. Moving in the opposite direction, hedge funds are calculating how they might enter the vast market of smaller institutional and retail investors that they do not yet serve.

In Europe, new fund structures that arose in accordance with provisions of the UCITS III Directive allow funds to make use of financial derivatives, opening the door to the deployment of hedge fund-like strategies for the benefit of a wide range of investors, including retail investors. At the same time, investors in UCITS enjoy more flexible liquidity terms, restrictions on leverage and transparent pricing. Between 2009 and 2010, this class of fund doubled in size to $90 billion.[16] Industry observers estimate that some $400 billion will be invested in UCITS III compliant funds over the next two years.[17]

In the United States, hedged mutual funds (HMFs) offer market exposure, protection from volatility through leverage, and the ability to short sell. Moreover, HMFs afford greater transparency and liquidity, in keeping with the new paradigm emerging across the hedge fund industry. Registered under the Investment Company Act of 1940, they also spare investors the burden and cost of performing due diligence, a feature enhanced by their lack of performance fees. Perhaps most significantly, HMFs outsource many operations to independent custodians and administrators that provide daily pricing and valuations and enhanced custody solutions. Despite the advantages of HMFs, market analysts caution that HMF limits on leverage and other regulatory restrictions may hamper their ability to undertake strategic niche investments (a hallmark of hedge fund investing). These same restrictions also raise the possibility of tracking error issues.

The willingness of institutional investors to direct new flows to hedge funds, and to pay full fees for superior performance, seem to suggest that they believe hedge funds offer a unique and differentiated investment opportunity. Retail investors seem eager to pursue investment structures that mimic hedge fund-like strategies, with the liquidity advantages of the UCIT and mutual fund formats. But while institutional investors may use new more liquid structures in various situations, they are not foregoing hedge fund allocation in favor of flows to these other offerings. As the total investment pool expands around the world, hedge fund managers, traditional asset managers, small and large fund structures alike seem intent on developing new products that meet investors' varying needs, with risk adjusted performance and customer service defining the marketplace.

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[16] Marte de Sa'Pinto, "Funds of Hedge Funds Seen Fending off Newcits," Reuters, October 22, 2010.

[17] "Deutsche Bank Survey Finds the Entrepreneurial Sprit is Back," InvestHedge, April 4, 2011.

# Hedge Fund Operations and Administration

Institutional investors, once preoccupied largely with fund performance, now take great interest in the manner by which hedge funds manage operational infrastructure, choose administrators and provide for governance and best practices. A growing number of investors, when considering a hedge fund manager, seek detailed information on fund operations and administration practices as part of the RFP process. In this flight to quality, investors have made it clear that front-to-back-office integration and the administrators' reputation, capabilities and service orientation carry substantial weight in their consideration of any new fund manager.

In addition to the requirement for operational excellence imposed by investors, financial regulators, now empowered with oversight responsibility for large hedge funds, are creating new reporting requirements. Increasing numbers of funds will likely review their operating models in light of this increased reporting burden to determine whether or not they have the staff capacity, reporting infrastructure and requisite investments in IT to meet the demands of this enhanced transparency cost-effectively.

In line with this expanding investor focus and new regulatory demands, third-party administration, hand in hand with the prudent management of counterparty risk, has come to be seen as an essential element of good governance. Funds have accelerated long-term trends in the direction of diversifying operational risk such as working with multiple prime brokers. As the majority of large hedge funds have shifted to a multi-prime model to diversify counterparty exposure, leading administrators stand as the consolidated book of record for the fund that will facilitate reporting to regulators and auditors.

Escalating client demand for operational control and transparency is driving funds to outsource many responsibilities to administrators experienced in a wide range of asset types. By shouldering a range of front-office process functions, such as data management, asset class coverage and portfolio risk analysis, third-party administrators enable fund managers to concentrate on what they do best: generating alpha and distributing investment products.

Third-party administrators will play a growing role in collecting, organizing and distributing the volumes of data generated by escalating demands for transparency. They can report on how much of the portfolio is independently priced, the percentage of holdings reconciled with third parties, and the overall liquidity of the portfolio. They provide investors with risk and analytics reporting — including transparency into the holdings of underlying funds and FoHF portfolios —sector/benchmark analysis, stress test results, and a full suite of Greeks (risk measures and hedge parameters) to help the investment managers and investors manage portfolio risk. Administrators can also provide aggregation services that allow asset owners to receive a consolidated view of all of their portfolio holdings across their various service providers.

Leading fund administrators that are also global custodians are offering enhanced custody (EC) services as an alternative to the traditional prime brokerage and stock borrowing model. The traditional prime brokerage financing models center on the concept of rehypothecation, by which prime brokers use collateral posted by hedge funds to back the prime broker's own trades and borrowings. Rehypothecation introduces a secondary level of counterparty risk to the hedge fund.

By contrast, enhanced custody allows clients to borrow and finance through a custody account with no rehypothecation of assets. The program eases credit and operational risk for investment managers while giving them access to borrowable securities through the custodian's securities lending program. It also allows self-financing of assets from the custody account.

In all of these tasks, technology will continue to play an ever larger role as fund managers and their clients look to global-scale custodians and administrators with proven technological expertise and capabilities. This trend will be particularly instrumental in supporting a 24-hour trading clock in response to global trading activity, along with data centers and proprietary cloud computing applications that can integrate information across front-, middle- and back-office systems and deliver it through Web-based portals.

Administrators will be crucial in developing and supporting technology "bridges" that facilitate collaborative transactional activities between fund managers and their investors, allowing investors to review and alter their investment allocations. They will also be required to service demand for hybrid vehicles investing in combinations of FoHFs, direct investments, private equity and real estate. The outsourcing of middle-office functions to third-party administrators makes clear that administrators are evolving into critical intermediaries between hedge fund managers, investors, prime brokers, investment banks, trading venues and clearing entities.

As the role of third-party administration expands in the hedge fund industry, it is likely to accelerate innovative trends already under way. This should be good news for managers and investors focused on liquidity, transparency and risk management. For fund managers, it may also help pave the way for new classes of investors, notably small and mid-size pension funds, to consider hedge fund investment for the first time.

### Third-party Services

**Hedge fund administrators are increasingly being contracted for a wide range of third-party services, including the ones listed below. As was the case with traditional asset management and mutual funds a generation ago, the outsourcing of these services is expected to establish a substantial foundation for expansion as hedge fund managers concentrate less of their energy on operations and more on investing and distributing products.**

- **Real-time portfolio trade capture**
- **Cross-asset and multicurrency reporting**
- **Fund-of-fund analytics**
- **Trade processing**
- **Securities pricing**
- **Derivatives processing**
- **Collateral management**
- **Tri-party collateral agreements**
- **Fund accounting**
- **Reconciliation of cash positions and cash balances**
- **Net asset value calculation**
- **Daily information delivery**
- **Client reporting**
- **P&L calculation**
- **Custody**
- **Foreign exchange**
- **Cash management**
- **Securities finance**
- **Liquidity lending**

# Charting the Future in a Changing Landscape

The hedge fund industry is in the midst of one of the most dramatic reinventions ever experienced in financial markets. Responding to the impact of the global crisis, it is experiencing the acceleration of earlier trends and, through evolutionary shifts in product development, reshaping itself in response to new ones.

Already, the hedge fund industry has seen its center of gravity shift from providing investment services for high-net-worth investors to establishing a more comprehensive infrastructure of services for institutional investors. Funds are redefining the terms on which they operate, creating new investor-responsive vehicles and offering new approaches to service delivery.

New regulatory requirements rising in the United States and Europe, even as they seek to build a more sustainable foundation for future growth, will likely constitute a drag on short and medium-term hedge fund profitability.

As investor flows to the hedge fund industry gain speed and financial markets recover, observers wonder what direction institutional investors may choose to take. Will they focus their strategies on balancing asset allocations, or simply concentrate on achieving a predetermined objective? If the latter, which alternative investment category will they favor, and why? Many foresee the advent of an investment era that is largely instrument-neutral and focused instead on achieving uncorrelated alpha, regardless of the source. Indeed, some even speculate as to how much longer alternative investments will be considered outside the mainstream, as hedge fund managers begin to compete with long-only managers for every part of institutional portfolios with a focus on risk-adjusted returns.

As for the hedge fund industry itself, it will continue to evolve. While the number of funds may fluctuate, assets under management are likely to grow much larger. Beyond any question of size, however, the industry can anticipate becoming more complex, as regulatory scrutiny expands, investment vehicles proliferate, investment targets multiply and systemic risk analysis improves.

A foreseeable constant will be the changing dynamic affecting investors, fund managers, prime brokers, administrators and custodians. Investors will likely maintain their push for greater transparency, liquidity options and regulatory oversight. Fund managers will continue to offer new products and services in response to the evolving environment. Heightened concern over counterparty risk has already cast doubt on the legacy model by which prime brokers assumed custody for all of a manager's assets.

Meanwhile, third-party administrators and global custodians will play a significant role in setting the standards for services that investors will increasingly expect. Their ability to combine traditional custody, cash management, foreign exchange and credit services with leading-edge, technology-rich fund administration will help them provide seamless and continuously improving service delivery as full-service, end-to-end partners.

Many believe that large institutional investors will play a substantial role in forging this path as they rethink their portfolio allocations. Over the long term, expanded hedge fund allocations might presage a more balanced market overall — one less dependent on traditional strategies and presumptions of normal returns. Whatever the future course, the hedge fund industry is actively expanding while simultaneously redefining the role that absolute return strategies can play in supporting the sustainable growth of asset pools around the world.

The migration of many middle-sized institutional and retail investors toward alternative strategies will serve as a strong incentive for hedge funds to enhance client service. As more investors articulate their needs, the industry can expect to see more collaborative efforts between investors and fund managers to create new fund vehicles that continue to closely align the interests of investors and their managers.

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