the | hedgefund | journal

INFORMING THE HEDGE FUND COMMUNITY

ISSUE 115

Brexit

What could it mean for hedge funds?

115 | JULY | AUGUST 2016

Brexit: A Case Study in Event Risk Management
Blu Putnam, Chief Economist, CME Group

Brexit: What Asset Managers Can Expect
Schulte Roth & Zabel

Voce Turns Five
A Voice for Value

Broadridge's Buy Side Gambit

The evolving buy side operating model

HAMLIN LOVELL

"Running a large hedge fund or asset management company is a lot of work, and thanks to regulators, the increasing sophistication of investors, complexity of products, technology and information security requirements, it is not getting easier," says Bennett Egeth, President of Broadridge Investment Management, Reference Data and Risk Solutions. "Many of the large funds are victims of their success, 60 to 70% of the people working in large funds are working in operational, accounting and technology with little direct involvement in generating alpha or raising capital."

According to Egeth, it has been very hard for these complicated, sometimes secretive organisations to ask themselves not just what is differentiating, but whether perhaps a third party could run the operations any better. Egeth points to a series of questions firms should take the time to answer:

- Are our operational requirements materially different from our peers?
- Are we experts at delivering services under SLAs and do we have a mature operational governance model?
- Do we have the capabilities to manage our technology in a scalable and secure manner?
- How much are we spending on non-differentiating activities?
- How much of our management team cycles are spent in supervising non-differentiating activities?
- How can we better align our cost drivers and fixed expenses to the drivers of the profitability?
- Would our investors feel better if we had a specialist handling these capabilities?

"Bridgewater's appointment of BNY Mellon to provide middle office services in 2013, was a seminal moment that allowed funds to have honest conversations internally and with investors about what is differentiating, whether their expense structures were reasonable, what were contributors and mitigators of operational risk, and what options exist," Egeth recalls.

Indeed, 30% of hedge fund managers have switched at least one service provider over the past 12 months, of which 34% switched administrators, according to Preqin's May 2016 Special Report on Hedge Fund Service Providers. The report found that quality and cost are both important considerations. On the product side, for the last decade, a popular approach has been to use eight to 10 'best of breed' service providers. Examples include: portfolio accounting, order management, compliance, risk, data warehouse, reconciliation, regulatory reporting, and data management systems. Egeth argues that managing many vendor relationships can be costly and cumbersome, and increases operational and vendor risk, forcing large hedge fund complexes to build large system integration and development infrastructure.

Escalating costs and complexity are encouraging asset managers and hedge fund managers to explore other models. Having acquired Paladyne Systems in 2011, Broadridge is a relatively new entrant on the buy side block, and yet it already services more than 250 global hedge funds, hedge fund administrators, asset managers, family offices and prime brokers.

Broadridge's potentially disruptive offering – a modular suite of investment management solutions that combines portfolio, order, risk and reference data management with data warehouse reporting and reconciliation functionality in a single, multi asset and integrated application – allows managers to consolidate and streamline their infrastructure.

Proliferation of hedge fund manager operational models

In the post-crisis years, virtually all funds use an administrator, responsible for producing their books and records, but their operating models have been slow to evolve. Many centred their infrastructure around large accounting systems, feeling that this clearly signals to institutional investors that they are investing in infrastructure, and expediting the operational due diligence process. "Unfortunately the operational risk, total cost of ownership, vendor risk and opportunity cost of senior management time is extreme, and most firms have found it to be unsustainable in the long-term," according to Egeth.

Over 80% of hedge fund assets are administered by a third party, according to PWC's 2014 survey. Many administrators offer some middle-office services, with 60% of hedge fund managers currently or considering middle office outsourcing, so says the 2015 EY Hedge Fund Survey. Beyond the alternative space, IMP Consulting and TSAM found 48% of asset managers outsource back office services and many have done so for five or more years.

Today, companies in the buy side ecosystem can buy products, solutions, managed services, data cleansing, hosting, IT accounting and administrative services as components or bundled together. Egeth enumerates some important criteria to consider as including:

- *Completeness:* the broader the offering, the broader the benefit.
- *The service value chain:* moving from individual products to integrated solutions to managed services increases the benefits across multiple dimensions, including economics and operational risk.
- *Alignment:* for a managed service, seek expertise in the managed service space rather than from firms trying to increase margins on other businesses.
- *Control infrastructure:* institutional investors are not looking at an individual product as evidence of institutional infrastructure but rather are seeking a demonstrable control infrastructure.

Some funds are using a variety of administrators for different funds, asset classes and even levels of service quality. For instance, only two of the top five hedge fund administrators overall make it into the top five list for CTAs: SS&C Globe Op and Citco Fund Services (with NAV Consulting number one, and CACEIS and Northern Trust also top five for CTAs), according to Preqin.

Other asset managers stress the need for more separation between service providers. Broadridge does not provide execution, custody, administration or financing services. Other third-party operational middle office providers that also emphasise their independence from administrators, are sought after by some asset managers. Still other administrators will stress how their outsourced middle-office services unit is internally segregated from other units, such as administration.

Yet, despite the wave of outsourcing, Egeth says that resources devoted to operations, technology, reconciliation, data management and so forth, keep on growing with the complexity of funds. So much so that 60% or more of the staff in large funds are employed in these functions, rather than in alpha-generating or asset raising capacities. Technology spending is also growing at an accelerating rate: by 9.6% in 2013, 10.2% in 2014, 11.8% in 2015, and is forecast to increase by 12.4% over the next three to five years, according to the 2015 EY Hedge Fund Survey.

But this inflation need not be inevitable. Egeth contends that the popular model of buying a big name portfolio accounting system and adding six to nine other technology solutions often results in asset managers "becoming technology firms managing money" rather than the reverse. Egeth sees many hedge funds as part of much larger complexes, within bigger financial organisations with multiple sleeves. They may have five sets of infrastructure for their hedge fund, mutual fund and other offerings – sometimes with separate portfolio and general ledger systems – but this is "labour intensive, diverse and difficult to roll together," says Egeth.

He adds: "Managing multiple platforms entails a high cost of ownership and operational risk, with vendor risk now in focus," and asks "If one vendor fails, is there redundancy?"

In response to these challenges, Broadridge aspires to provide "convergence in technology solutions and operational solutions for asset management complexes and individual managers." Managers might benefit from a consolidated platform solution that rolls these functions together.

The benefits of scale and scope are clearly being recognised by the industry. Administrators have been consolidating for years, with at least 30 deals since 2006. Now consolidation is gathering pace between and within administration and technology provision spaces as well. "Things are changing faster than anyone realises with three huge acquisitions involving SS&C/Advent, FIS/Sungard and IHS/Markit," observes Egeth, who has never before seen such disruption.

Five administrators (SS&C GlobeOp, Citco Fund Services, HedgeServ, Morgan Stanley Fund Services and IFS State Street) account for roughly half of hedge fund industry assets, according to Preqin.

Broadridge's business model can be seen as another dimension of the drive for consolidation. "Consolidating technology platforms can take out 50% of the technology spend on non-alpha generating parts of a business, and deliver 30-40% saving on operational costs," claims Egeth who adds that "funds are now looking for efficiencies in places that they previously did not consider."

These efficiencies flow to both the fund's management company and investors. Historically, for many administrators, services such as simply being able to process derivatives, handle high frequency trading, manage collateral, or crank out reconciliations were a competitive advantage, but Egeth argues that these capabilities are becoming commoditised. It may, therefore, be better to scale up and benefit from operational leverage to save on costs. "If conversations start with hosting technology, they may progress onto outsourcing the day-to-day running of back office and middle office operations," he explains.

Investors generally welcome outsourcing. Between 70% and 90% of them will accept outsourcing of services ranging from pricing and valuation, confirmations/affirmations and settlement, OTC services (ISDA details/confirms, OTC reconciliation and bank debt processing), corporate actions processing, daily P&L, margin calculations and collateral management/optimisation, according to the EY 2015 Hedge Fund Survey. Thus the field is wide open for Broadridge and others.

The journey from sell side to buy side

Broadridge has been servicing banks and brokers since 1962 and five years ago the firm began servicing asset managers and hedge fund managers. A significant growth engine for Broadridge has been expanding beyond selling technology solutions to banks and broker dealers, to selling operational capabilities as managed services. This is based on expertise, neutrality and the ability to deliver scale to clients. "We believe the speed that the buy-side has moved from products to solutions will be even faster for solutions to services," says Egeth.

Paladyne was an attractive acquisition partly because it also services administrators and prime brokers, many owned by the sell side firms Broadridge has serviced for two decades. Broadridge's GTO (Global Technology and Operations) business unit has been providing back office technology for banks and broker dealers for some time, including the clearing and settlement of more than $5 trillion in US equity and fixed income trades per day. Client demands and acquisitions with additional capabilities have moved Broadridge into the middle and front offices. Clearly, Broadridge has substantial credibility among sell side banks, providing managed services to almost 30 of them globally. "We are fortunate to have a mature managed service governance model to draw upon as we extend these capabilities into the buy side," says Egeth.

Broadridge has a distinct managed service differentiator. "We are the only FINRA regulated Managed Service Provider," says Egeth, who thinks this additional oversight enhances credibility with the financial community. Broadridge will sometimes service all three entities in a relationship – managers, prime brokers and administrators – and this wider involvement with the industry brings synergies and enhances trust, according to Egeth.

Indeed, Broadridge has routinely obtained some fund clients via referrals from PBs and administrators. "We work with virtually every PB out there and some PBs actively refer clients to us, particularly for more complex funds," he says.

Growing menu of internally and externally integrated services

Broadridge does not yet fit the marketing cliché of a complete 'one stop shop' but is steadily expanding the breadth of its offering. "When we started, our value proposition was augmenting Geneva or Sungard with five or six solutions. Now we can offer eight out of the 10 capabilities that a fund needs – as an integrated solution," Egeth finds. "There is a clear trend of migrating up the value chain in our clients from buying individual products, to seeking more integrated solutions."

"The current solutions for hedge fund managers cover: order management, portfolio management, compliance, reference data management, pricing and valuation, risk management, data warehousing, reconciliations, accounting, fee management, reporting and hosting. We have started to offer many of these capabilities as managed services already. We do this globally across virtually all asset classes."

These systems integrate with each other - and with external vendor packages. For instance, Broadridge claims to have been one of the first to bundle order management systems (OMS) with portfolio accounting, at a time when other providers were more focused on fusing execution management systems (EMS) with OMS.

Real time, intraday, risk reporting is sought after because end-of-day reporting is just not good enough anymore and institutional investors are focussing on this in their operational due diligence for PMS and OMS, Egeth finds.

Broadridge Risk Master is a multi-asset class solution, integrated with Numerix Cross Asset Library for data and pricing solutions. Broadridge's strategic partnership with the Numerix Cross Asset Library offers credit risk analytics including an end of day package for reporting and transparency. "We are also 'model agnostic' in that other libraries can be fed in," Egeth explains. Risk Master allows for sensitivity analysis, stress testing, various VaR metrics, CVE, PFE and back testing. Compliance Master assists with pre and post trade compliance.

There are some gaps in coverage, but they are routinely being closed based on the feedback from clients. Broadridge says it will continue to make acquisitions and enhance current capabilities to fill out its offering. Long term, "The holy grail is to have the highest level of completeness, delivered in a hosted way, with managed services on top," Egeth foresees.

The investor communications business that Broadridge has developed since the 1980s is still the company's largest business. Broadridge leverages its expertise and solutions from this unit and its GTO business, to manage large volumes of confidential and sensitive information that must be kept secure. Broadridge has earned the trust of "the toughest banks with the toughest processes servicing eight of the largest 10 banks," states Egeth.

But in throwing down the gauntlet to the buy side, Egeth feels confident that Broadridge offers "a robust solution, a commitment to the market, a $7 billion balance sheet, a stable and a well-run firm with huge expertise on the managed services side to the fund community." **THFJ**