Shining a Bright Light

Trends from the turbulence

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Three trends stand out in the many and ongoing debates spawned by the market turbulence of summer 2007:

1. An intensified focus on fund infrastructure
2. Valuation
3. Increased competition between hedge funds and regulated funds

Focus on fund infrastructure

Issues surrounding the OTC derivatives confirmations backlog following the July-August volume surge are forcing both dealers and hedge fund managers to re-examine alternatives for improving contract settlement. Today, a majority of credit default swaps are settled electronically through DTCC, and the Swapswire platform settles a significant part of interest rate swap transactions. These changes were already underway before the volatile summer months and had pushed many hedge fund managers and their administrators to move swiftly to adapt their technology to this OTC processing revolution. But the summer crisis clearly demonstrated that progress to date has been insufficient. When volumes escalated rapidly, particularly in the credit derivative market, a number of dealer systems failed to keep pace. A recent dealer survey indicated that aged outstanding confirms in OTC derivatives roughly doubled in volume during the crisis.

At GlobeOp we saw a very significant surge in daily OTC processing figures during the summer, growing from 1,300 transactions per day to over 2,000 at the height of the crisis. Because we already frequently handle opportunistic hedge fund trading activity that can ebb and flow dramatically with market opportunities, we were in the fortunate position of being prepared for the surge.

Valuation

In parallel to the trading volume surge, investors increased their demands for more transparency and faster information. Investors were requesting faster NAV confirmation, flash intra-month P&L estimates, and current views on portfolio risk exposures. Reassurance about portfolio risk exposure, loss limitation and investor liquidity became a priority, especially as markets continued to move quickly. Investors are now focussing more on the way hedge funds value positions and portfolios. Investors battered by the drop in value of illiquid investments, and institutional investors reviewing 2008 allocations, are now having a second look at the fund prospectus.

Greater investor attention will be paid during new fund due diligence to fund prospectus pricing policies. In the interest of transparency and risk management, investors will demand best practice that echoes those dictated by UCITS III:

- all pricing/portfolio valuation to be provided by an independent 3rd party
- fund managers should not price portfolios, to avoid conflict of interest
- fund managers should not override pricing received from independent 3rd parties

Fund managers, and fund boards, can expect to be more frequently asked: How much input does or can the manager have in finalising the monthly NAV? Are manager marks, if any, systematically compared for consistency with counterparty marks, or with independent valuations from a third party? What is the range, independence and flexibility of your risk analytics? As a result, service providers specialising in independent OTC instrument valuation, risk analytics and reporting are responding to a noticeable increase in calls from fund managers and institutional investors alike – an upward trend in due diligence questionnaires from institutional investors was already underway in November.

Increased competition

The third trend developed independently from the July and August market turmoil, but is being reinforced by the transparency issues that turbulence created for many hedge fund investors: increased competition in OTC investment opportunities between hedge funds and the new breed of regulated funds. European mutual funds operating under UCITS lll guidelines and US counterparts such as 130/30 funds are ramping up OTC derivative trade volume alongside that of hedge funds and pension funds. The line between classic, regulated asset management firms and unregulated hedge funds will continue to blur.

Regulated funds are limited by law in terms of risk concentration, risk management processes, the type of assets that can be held and the frequency of valuation. Additionally, all OTC derivatives held in a UCITS lll-compliant fund are subject to reliable and verifiable daily valuations and the manager must be in a position to trade those positions at any time.

After the experiences of the past summer, these requirements and controls will encourage institutional investors to give greater consideration to such regulated funds as an alternative to hedge funds.

Interestingly, a number of high profile hedge fund managers are now also entering the UCITS lll space. A prominent example is that of JPMorgan Highbridge. Its Statistical Market Neutral fund, a Luxembourg-domiciled Sicav with minimum investment of $25,000, raised $10.5billion this year. Having caught the eye of other major hedge fund managers, additional similar products are in development.

Looking ahead - ingenuity plus infrastructure

However, all participants will remain challenged by the demands of OTC trade processing. While hedge funds, and some institutional investors, may have more OTC derivative experience, their ingenuity in creating new instruments is matched by the challenge of maintaining an infrastructure capable of handling the number and diversity of instruments, increasing trade volumes and requirements for faster valuation.

Mutual funds eager to take advantage of the OTC derivative opportunities afforded by UCITS lll are finding their time-to-market ambitions challenged by the directive's requirements for independent, daily valuation & risk reporting.

Many are now discovering that being UCITS lll-compliant requires a robust, scalable, high-quality middle and back office infrastructure that is costly and cumbersome to develop in-house. Their traditional service providers - custodian banks - face significant IT and resource investment to automate spreadsheet-based systems if asked by mutual fund clients to provide sophisticated OTC processing and risk reporting services. It is a new, complex and rapidly expanding territory in which few custodians have extensive experience. Thus both mutual funds and custodian banks share the challenge of in-house accounting engines ill-equipped to deal with the new and/or different types of positions coming on stream, ie. derivatives, leverage and the borrowing of both cash and securities.

Outsourcing will increasingly provide a competitive edge. More complex middle-back office and administration (MBA) and OTC processing support will be required by larger hedge funds continuing to grow their trading volume and strategic diversity, as well as by institutions, mutual and 130/30 funds as new entrants to an increasingly competitive market.

To remain competitive, traders demanding greater fund focus on core strategy and a faster time to market will argue for reduced technology buildout times and investment. They will push for better access to advanced OTC valuation engines to optimise data available from inter dealer brokers, prime brokers, or specialist data providers as well as access to comprehensive libraries of pricing models.

Fund risk managers will require professional, scalable, independent infrastructures that use automation to minimise error-prone manual data entry and overall operational risk. Sophisticated risk models will have a stronger priority, in order to more accurately assess the consistency of model marks and counterparty marks, and factor in market risk volatility factors.

Regulatory, investor and fund risk manager demands for independence and transparency will increase the need for service providers to demonstrate institutional-strength controls and independent review procedures such as SAS70 type audits.

The summer's volatility generated dramatic headlines, and swings of fortune for many funds and investors. As investors and fund strategists review year-end results, leading edge funds that have identified new market opportunities are already implementing the lessons learned. **THFJ**