Administrators Build on 2010's Gains

by Paula Schaap, Editor, February 28, 2011

Gone are the heady days of 2007 when every Tom, Dick and Harry with a trading algorithm and a dream was starting up a hedge fund firm.

Yet the bursting of the finance bubble in 2008, with all its attendant pain, wasn't without its silver lining, especially for hedge fund administration firms.

Those who once toiled in financial services backrooms have found themselves promoted to the front of the line as regulation and investor oversight became industry watchwords following the Madoff scandal and other, lesser frauds.

Plus, the industry itself has recovered as institutional investors are, once again, turning to hedge funds for the returns and diversification needed in today's asset manager portfolios.

With 62 administrators reporting, the 2010 Q4 HFN Hedge Fund Administrator Survey put hedge fund assets under administration at about $2.796 trillion. That represented a 6.6% increase over the 2010 Q2 survey.

Funds-of-funds assets under administration were about $934 billion, a 3.86% decrease over the 2010 Q2 survey.

Elliott Brown, managing director and product executive at JPMorgan Fund Services says the survey results bears out his firm's experience regarding new fund launches.

"We're seeing a little more, both by new firms and existing clients that run multiple hedge funds," Brown says.

The size of firms that have attracted investor inflow has been mixed, Brown says.

"Certainly you've seen some of the larger, more franchise names attracting asset flow," he says. "But we are also seeing more specialized launches managing to be quite successful. This was a trend six months ago and it's

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continuing, especially in the bank loan and distressed debt space."

Tom Davis, the chief executive officer of Meridian Global Fund Services, says in the second half of 2010 the majority of investor funds went into larger firms.

"A lot of the established funds are still accepting new money, although we have seen some closes, both hard and soft," Davis says. "But I think before the capacity dries up, they are looking at some of the successes of the smaller managers and are beginning to allocate funds."

Long-short and emerging markets are some of the sectors Davis says attracted investor interest in 2010.

"All the indications we're seeing is that emerging markets will become even more popular," he says.

"The biochemical sector is still popular," Davis says. "And then distressed debt and distressed equity are also still popular; not to the same extent as in 2009 and the beginning of 2010, but there is still interest in that sector."

Toni Pinkerton, who is the global head of fund services at Maples Fund Services, says compared to a year ago, fund launches are up with a higher proportion of more liquid strategies such as long-short and CTA platforms.

"That's as compared to six to 12 months ago where we saw less liquid, more distressed-type securities," she says. "Most of the less liquid funds that ran into trouble in the financial crisis have now completed the final stages of wind-up."

Pinkerton says what she has seen is that "some [funds] are still slow to launch; the fundraising is still challenging, although getting better."

While Frank Franiak, the president and chief executive officer of Woodfield Fund Administration, says investor flow has been loosening up, the fundraising environment is still tough.

"One of the things I tell new managers is to expect it to be twice as hard to raise money," Franiak says.

Andre Le Roux, who is head of business development at South Africa-headquartered Maitland Group, has a somewhat different take on the question of investor flows.

One of the issues was what would happen to South African pension fund allocations to the country's still small hedge fund market -- Le Roux estimated it at about $8 billion to $9 billion in assets.

"There was some legislation being promulgated which suggested that there wasn't going to be a lot of allocations to hedge funds from pension funds," Le Roux says.

However, the proposed legislation wasn't enacted, in fact, South African pension funds can allocate up to 10% to the asset class.

"So that suggests a tenfold increase, which is positive news for the hedge fund industry in South Africa," Le Roux says.

Over in the funds-of-funds space, Vastardis Capital Services founder and Chief Executive Officer William Vastardis says the traditional hedge funds-of-funds are still experiencing hard times because of Bernard Madoff's Ponzi scam (in which billions of investor money was funneled through those vehicles) and the general market collapse in 2008.

Still, Vastardis says, things in the funds-of-funds sector are picking up along with the economy.

"The bigger part that we see is funds that don't only invest in underlying hedge funds, but also other asset classes," Vastardis says. "That started about two to three years ago. Some of the chief investment officers who came out of the big endowments are investing client assets in an endowment-like structure."

The big deal in the hedge fund industry in 2010 was regulation. Although regulation of the asset class had been discussed for several years, passage of the Dodd-Frank financial reform bill in July confirmed what everyone knew already: hedge funds and private equity firms with assets of more than $150 million would have to register.

What's more, securities regulators are working on rules that will mean increased reporting from hedge fund firms and their concomitant higher costs.

While Franiak says that increased regulation could cause some not to launch funds, he also says he hasn't seen anyone closing a fund because of more regulation.

"If it doesn't go too far," Franiak says, "it helps us because then hedge funds need an administrator who knows the issues."

Brown says the cost to start up a hedge fund firm has definitely increased, "therefore, the minimum assets to be successful has risen with that."

Yet, Franiak believes the industry has largely self-regulated, primarily because investors have demanded it.

"The major investors have basically said to the funds, 'if you don't do things in certain ways, if you don't engage certain advisors and administrators we feel comfortable with, we won't give you money,'" he says.

Although increased due diligence demands from regulators, investors and firms will present an opportunity for fund administrators, it also presents challenges, Davis says.

"The challenges for administrators will be to anticipate what the ever-changing needs of the investor base are," he says.

Davis notes that while everyone talks about transparency, few define exactly what they mean by the phrase.

"Full transparency would be every trade that has been made, but is that helpful to them? Probably not," he says. "People talk about risk analysis, but even with risk analysis, some of the measurements are a little difficult to interpret to make them meaningful to different investors."

Le Roux also says another aspect to increased regulation is often an enhanced relationship between an administrator and their hedge fund clients.

"As a result of all this increased compliance costs, our clients are engaging with us more regularly; they're looking for leadership from us," Le Roux says.

"Hedge fund managers, in the end, want to trade, so they're looking to us as partners now, rather than just service providers," he says.

In 2010, there were also a number of fairly high profile mergers and acquisitions in the administration industry.

In February 2010, Bank of New York Mellon acquired PNC Global Investment Servicing for $2.3 billion, raising it to third at the time in assets under administration behind Citco and State Street Alternative Investment Solutions.

This month, administrator Butterfield Fulcrum was acquired and combined with administrator FORS from private equity firm 3i Group and The Bank of N. T. Butterfield & Son.

That is a trend which many in the business expect to continue.

"Will there be more industry consolidation around the middle of the pack?" says Brown. "There probably needs to be."

Vastardis agrees that smaller administrators won't survive or will be bought by larger firms.

"Technology demands, which are costly, will be a barrier to entry," Vastardis says.

There could also be more merger activity for administrator's clients, the hedge funds themselves, Davis says.

"The cost of doing business has gone up, so in order to get the scale of business to generate the fees needed to provide services, there is a need for critical mass," he says.

Davis also says a trend to watch out for over the next few years is the globalization of the administration industry.

Administrators "are trying to have a global footprint to meet the demands of managers who are trying to serve various investors from different parts of the world," he says.

The next few years, Davis says, will determine what global side of the administration business will look like.

"Because I don't think we know that yet," he says.

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