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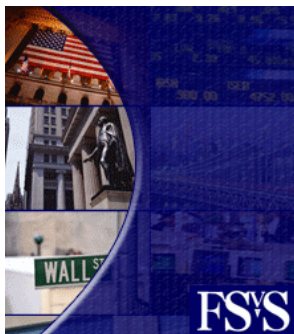
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#### Guest Article: Changing Models in Hedge Fund Consultancy

by Jayesh Punater, Gravitas Technology, May 12, 2008

Over the past five years, the private funds marketplace has evolved and changed significantly. Funds are investing in more complex instruments with global scope, and the industry is experiencing greater regulatory scrutiny than ever before. Institutional and individual investors are demanding more transparency and accountability, putting pressure on hedge funds to establish high-quality operations as well as delivering absolute returns. At the same time, the industry is in flux; smaller, weaker funds are closing while some multi-billion-dollar funds are poised for even greater growth. For many managers, the focus now is firmly on "big": big investors and more assets under management (AUM). Even many startup funds are setting up shop with large asset bases, with an eye toward attracting institutional investors.



Hedge funds are clearly veering towards the more traditional asset management firms in their outlook and client bases. Yet from an operational perspective, they are very different: what may be a cost-effective IT and operations infrastructure for a traditional asset manager is not necessarily a workable business model for a hedge fund.

No two hedge funds are alike in strategy or product mix, and as funds grow increasingly complex in structure and approach, the best path for IT and operations is not always clear cut. Is outsourcing the most comprehensive and cost-effective solution? Is internalizing operations the best approach? The answer may lie somewhere in between.

#### A Dynamic Industry

Unlike many of the more traditional asset management firms, hedge funds and the hedge fund industry are always in a state of change. Some years will be immensely profitable, while alpha will be elusive in other years. Funds will come and go; positions will be placed and then unwound. A hedge fund is a classic example of a business that needs flexibility to expand and contract its operations depending on its needs and circumstances.

Take a hedge fund with 25-40 employees. In a profitable year, when the fund has more investment ideas and capital to put to work, having full in-house operations staff and technology may be wholly justifiable. But in a down year with less activity and returns, an entire staff of technologists may simply not be practical or prudent from an economic standpoint. Identifying the right number of resources to service the fund is a balancing act that is strongly influenced by the fund's performance.

#### Outsource or In-Source?

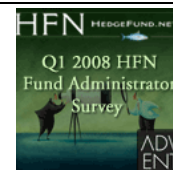
As has now become common knowledge, outsourcing takes certain business processes or functions and has these performed by an outside firm. Conversely, in-sourcing takes the same processes or functions and has them performed internally by full-time employees. Within the hedge fund sector, service providers – prime brokers, fund administrators and IT consultants – provide the opportunity for fund management firms to outsource some of their operational activities to avoid the costs and logistical challenges of bringing the work in house. The advantage to outsourcing is that a hedge fund can acquire a team of domain experts that are highly specialized and experienced across a range of strategies and product mixes. The main possible disadvantage to outsourcing is that service providers can hold managers hostage to costly and rigid contracts.

A hedge fund has several choices to manage its IT and operational infrastructure:

- Outsource all operational infrastructure to prime brokers and fund administrators
- Outsource some of the back office functions while keeping some of them in-house
- Conduct all operations in-house, i.e., a "self-administration" approach
- Establish complete shadow operations: outsource as well as maintain certain key elements of operational infrastructure in-house

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Hedge fund managers may choose to outsource because of skill-set limitations. By outsourcing, they find they can often achieve better quality work at a lower cost. Outsourcing also gives them an opportunity to process more work and scale their operations.

Smaller funds are often more likely to outsource everything while larger funds will either do self-administration (especially if they are trading very complex and diverse products) or they will establish a shadow accounting environment. With shadow accounting, a fund maintains a complete duplicate set of accounting books and records, and does not rely on its administrator completely.

As funds get larger and more complex, they will tend to bring more operational activities in-house and rely on their administrator for only a few functions. This creates more intense demands on IT resources and capabilities. In an ideal world, the fund and its administrator will share a "common platform" where certain functions are done in-house by the fund, while others are done by the administrator. Achieving a state of having common data, and a shared technology platform, can go a long way in reducing redundant work, as well as reducing reconciliation efforts.

For any fund, finding the right operational business model is a process that takes into consideration the fund's strategy, global reach, product mix and client base. Every firm has its own needs and culture, there is no one-size-fits-all solution. Establishing a blueprint is essential to avoiding costly internal investments that may not be appropriate for the firm's needs.

#### Variable Cost Model

Just as each hedge fund requires a tailored approach to planning and executing an appropriate IT and operational strategy, managers should also be able to scale their operations up or down, depending on their circumstances and performance.

Given the trend toward multi-billion-dollar funds and institutionalization, the new paradigm for hedge funds is to hire a core team of IT professionals who are skilled at working with service providers, and then outsource a certain percentage of their administration and IT work to outside providers. This variable cost model approach enables funds to pay only for the very specific services they need and use, offering the ability to negotiate the level of service provision depending on those identified needs.

Done properly, this variable cost form of outsourcing is completely scalable and flexible, and is wholly consistent with the basic business model of producing maximum alpha (inherently variable) in an always changing environment.

#### Partnering to Scale

A decade ago, hedge funds were relatively simple businesses and the vast majority of funds were directed to long-short equity strategies. Today's funds are global, multi-strategy and are processing large volumes of trades across widely differing strategies and geographies. As funds reach a critical mass and seek to institutionalize their platforms, they will increasingly look to partner with service providers who can help them scale their IT and operations to meet the needs of all important constituencies.

In many ways, the changes the sell side firms experienced over the last decade or so are now affecting the alternative investments space. It is no longer effective to solve scale issues by just assigning more bodies to achieve desired actions. Funds need an organized approach and a blueprint which is a mixture of people, processes and technology. This is achieved by introducing relevant, expert business consulting assistance – including operations, IT and accounting – to review and assess current state environments in order to help define the most appropriate road map to design, remediate and/or implement the most suitable processes and systems.

As the largest hedge funds continue to grow

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