Operational risk, IT and outsourcing

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By Paul Compton - *The traumatic crisis that engulfed the industry two years ago prompted a renewed concern among many hedge fund managers to gain control over their positions and exposures. Traumatised investors started asking managers many more questions about how positions were being valued, and even, in the wake of Madoff, whether the assets the fund claimed actually existed. This greater activism on the part of investors has turned out to be a lasting phenomenon, with managers under pressure to answer questions continually about their investment exposures and operational risk.*

Meanwhile, hedge fund managers also have to deal with the lasting financial consequences of the crisis. Many faced extensive redemptions from investors who were disenchanted with performance or needed to realise assets. In the industry as a whole, assets under management have only just recovered the level of November 2008, still some way below their peak, and many funds remain below their high water marks.

So although fund inflows are recovering, many incumbent hedge fund managers now have to run more robust and transparent operations on reduced fee income. For start-ups the situation is worse. Most fund inflows lately have gone to the largest incumbent managers. Wannabe start-ups struggle to attain critical mass, and investors are reluctant to commit money on the traditional model whereby a 2 per cent management fee was intended to fund the bulk of operating expenses.

It's now common to see start-ups launch with only USD25m-USD50m of committed capital, often with only a 1.5 per cent management fee. That doesn't leave much of a budget, putting funds in the risky position of funding their operations from expected performance fees.

All this means the hedge fund COO has to do more, with less. Technology is the key to managing operational risk and delivering transparency to management and investors.

Traditionally, a hedge fund manager would build its own operational infrastructure in-house, implementing third-party software as part of the solution but also building their own applications and integrating it all into coherent workflows. The manager's own IT group would have responsibility for running and developing the in-house platform, involving ongoing costs of headcount and infrastructure maintenance.

Today hedge fund managers are increasingly outsourcing more of these operational requirements to specialist vendors such as SunGard. Our business is increasingly about hosting and maintaining systems on behalf of our clients. Managers still have full access to and control over their operational processes, but can significantly reduce the 'total cost of ownership' of the systems they need to have in place.

This new model requires long-term partnerships between hedge fund manager and vendor; no longer is software deployed and then managed by the client with arms-length support from the vendor. From the manager's point of view, selecting a strong vendor with a good understanding of the challenges facing its clients can offer a number of benefits. This can include the ability to go to market quickly with a ready-made technology solution, and to leverage the expertise of a vendor which specialises in technology design, quality assurance and scalability.

But ultimately it is investors who are the principal driver for change, by turning the spotlight on issues of operational risk. They are demanding more information on internal systems, and a strong vendor partnership can provide added assurance to investors that the fund's systems are robust and based on reliable technology.

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