

# SECURITIES INDUSTRY | NEWS

## Smaller Hedge Funds Seek "Industrial-Strength Technology"

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**Carol E. Curtis**

With some form of hedge fund adviser regulation a virtual certainty, the consequences for hedge funds in terms of risk management are clear. Part of any broad-based registration requirement is the need for hedge fund managers to show that they have the proper risk management infrastructure in place, including systems to measure risk, enforce risk policies and procedures, and support a chief compliance officer.

But no matter what happens with regulation, investors are already demanding that hedge funds show they have robust risk management tools in place in areas like portfolio pricing, valuation and counterparty risk. They are understandably anxious to avoid a repeat of 2008, when investors on average lost almost 20% of their investments in hedge funds.

"Regulation [of hedge funds] has been talked about for two years," says Paul Compton, head of product management for alternative investments at Wayne, PA-based SunGard Data Systems. "What has happened post-crisis is that a lot of hedge fund advisers have been under pressure from investors-particularly institutional ones-to do more [about risk management]. That is setting the agenda."

It is not totally investor-driven, he says: "On the part of the hedge fund industry, there is also a general desire to make risk a more important part of everything."

Risk measurement analytic tools are what hedge funds are looking for now, he says. SunGard Data Systems' answer for this is software called APT.

APT, which was acquired by SunGard in 2008, allows users to avoid static combinations of pre-packaged risk factors and instead gives them the ability to select from hundreds of possible factors that might explain the risks a given portfolio is exposed to, facilitating a clearer understanding of the dynamics of risk and allowing for asset allocation, analyzing performance and breaking down risk for a broad array of asset classes.

"It gives hedge funds the ability to look at portfolio exposures and do scenario analysis, which has gotten more emphasis," Compton says.

When it comes to a more broadly defined view of risk, experts agree fund valuations and operating processes are coming under scrutiny. "The pressure on firms to accurately measure portfolio prices, fair values and risk exposures has never been greater," says Boston research firm Aite Group in a recent study titled, "What is the Risk or Value of Your Portfolio? Industry Challenges for the Pricing and Valuations Process."

The reason for the pressure, Aite says, is that "events of the last 18 months have shown that the once-straightforward pricing and valuation process is fraught with hard challenges brought on by market volatility and dislocations."

Aite adds that "systemic illiquidity, enormous write-downs, increased counterparty risk and margin calls" were part of a "check-list" of reporting activities whose underlying data and pricing methodologies were not well understood.

The meltdown served as a wake-up call to IT executives, who are increasingly emphasizing risk-related functions, Aite said. One result is increased IT spending on risk management technology.

According to Aite, in just one area, counterparty risk management, a survey of senior IT executives found they expect to spend \$253 million this year, twice the \$127 million spent in 2009.

## **OUTSOURCING GROWS**

In an interview, senior Aite analyst John Jay says that smaller hedge funds in particular are increasing their reliance on independent suppliers for risk management tools.

"For smaller hedge funds, there has been a large reliance on custodians and prime brokers," he says. "To the extent that can be eased, the outsourcing of risk management-applications and risk management reports-so it is out of your hands, is a way for smaller hedge funds to be more transparent without the internal cost."

Among the competing vendors, Jay likes Black Rock Solutions, RiskMetrics Group and SunGard. "A firm gains market power in direct proportion to its acceptance by the buy side," he says. "The reason XYZ firm might be capturing the biggest market share is that it is able to recognize that for most firms there are 12 to 15 they most need, and they service these things."

SunGard's APT package, employed at many large hedge funds, is a favorite of Jay's. One reason: APT is available as a service hosted on remote computers.

"This is industrial-strength technology," Compton says. "These are solutions that have been in place at \$1 billion dollar hedge funds, the biggest players in the world. We are making industrial-strength systems available on a hosted basis for the first time, to make them a practical proposition for smaller hedge funds."

Other SunGard hosted products for hedge funds include Front Arena for the buy side, a comprehensive suite of functions for studying worst-case scenarios, handling cross-asset validation and creating client and investment classifications.

SunGard also offers VPM, a multi-currency, customizable investment management solution connecting front and back-office operations from general ledger transactions to reconciliation. VPM stores a complete audit trail for auditing and reporting.

The hosted approach is driven by cost considerations. Post-crisis, many hedge funds have with fewer assets under management, creating cost pressures. "This can be a hard combination, but hosted solutions can help square that circle," says Compton. "Quite a few hedge funds are talking about going down this road."

For large hedge funds, risk management is somewhat different. Many of these hedge funds are advised by firms that have voluntarily registered with the Securities and Exchange Commission (SEC), so a newly mandated registration requirement will not affect them.

Many are already equipped with cutting edge risk technology and internal risk infrastructure, Jay says, including a chief compliance officer, a risk manager, and technology that gives them the direct ability to measure risk, such as VAR (Value-at-Risk).

"The top dozen [hedge funds] are equally if not more sophisticated than sell-side firms," says Jay. "They see these issues way in advance, and so are not the ones to have a lot of gargantuan changes. They will be incremental."