

This industry report discusses a number of issues surrounding the operational environments of hedge funds, a topic little explored by the world's financial press to date. It follows a roundtable event, hosted by Omgeo in July 2004, which examined the hedge fund industry's growing interest in increasing transparency and efficiency to prepare for future growth. For a copy of the transcript, which was produced after the event and formed the basis of this report, please contact Kim Davies at Omgeo: kim.davies@omgeo.com

Hedge Funds in the Mainstream: Addressing Cost, Risk and Compliance through Technology

Executive Summary

At a recent roundtable organised by Omgeo in London, senior industry figures in the hedge fund industry gathered to discuss the impact of institutional investment on the future of the hedge fund market. The continued growth in allocations to hedge funds from large investment houses seeking to diversify their portfolios is ultimately expected to supersede the proportion of investment received from hedge funds' traditional client base – high net worth individuals. The roundtable participants were invited to debate the importance of operational issues to hedge funds in both meeting the strict due diligence requirements of institutional investors and achieving sustainable growth, as the number of managers pursuing hedging strategies in the market augments.

Participants were in agreement that, if the hedge fund market is to continue to increase capacity to accommodate institutional inflows, then it will need to ensure that its investment strategies are supported by a robust operational infrastructure that tackles trade failure, instrument complexity and risk control. However, this is often easier said than done – with the market evolving so rapidly with new instrument types and strategies emerging each day, technology providers need to constantly evolve their offerings in order to meet the rigorous demands of this alternative investment industry.

Contents

<i>Hedge fund investor base is changing</i>	2
<i>Sophisticated technology is key in meeting institutional demands</i>	2
<i>Survival Techniques – Risk mitigation and increased transparency critical to hedge fund success</i>	3
<i>Keeping Pace – Solutions providers face challenges</i>	3
<i>Straight Through Processing pays off for hedge funds</i>	4
<i>Appendix A: Participants</i>	5

Key Findings

- Sophisticated technology is required to meet institutional demands. Many independent hedge funds will have to change the way they operate in order to secure institutional investment.
- Investment strategy innovation alone cannot guarantee the growth of the hedge fund market. Hedge funds need to demonstrate transparency and operational risk control to attract institutional funds.
- Operational inefficiency can undermine fund performance and in some cases wipe out positive returns altogether.
- Adoption of straight through processing (STP) technologies is becoming increasingly important to hedge funds and the risks of not automating are high.
- Automation allows managers to focus on core competencies.



Hedge Funds in the Mainstream

Hedge fund investor base is changing

With the combined impact of inflation and the volatility in equity markets, institutional investors are focusing on new ways to achieve absolute rather than relative returns. Six years ago it was estimated that institutional investors made up just 18% of investors in hedge funds – the remaining 82% being private investors. Today that proportion has shifted considerably – the latest report shows that institutional investors now make up 40% of the market with high net-worth individuals and private banks accounting for 60% (KPMG).

This influx of institutional investment shows little sign of slowing down and has led many to speculate on the potential impact of this shift in the hedge fund market's investor base. This institutionalisation could be a healthy development if it leads to transparency, accountability and professionalism; however, some have raised concerns that a sudden surge in popularity could result in a dilution of quality of investment strategy.

Overall, the outlook for the hedge fund industry remains very favourable. Despite recent performance challenges, institutional investment in independent hedge funds is set to continue to grow rapidly. This will be balanced by competition from the institutions themselves, who will

increasingly set up their own hedge funds. This presents many opportunities for the hedge fund market, but also some challenges. In a crowded market, returns may become more modest than has traditionally been expected of hedge funds. In such an environment, it will be critical that hedge funds tackle the operational inefficiencies that can knock off crucial basis points from a fund's performance.

Sophisticated technology is key to meeting institutional demands

Michael Azlen, Managing Director of hedge fund of funds, Asset Alliance International, believes that hedge funds which are offshoots from institutions give clients a great level of comfort, as they are able to draw on an existing infrastructure to deliver the required transparency and due diligence. Therefore, to continue to attract institutions, independent hedge funds will have to change the way they operate to reflect the competition. He says:

"Two traders in a room with a Bloomberg [terminal] will not attract institutional-quality capital. Institutions need to see more than one person managing the money, a dedicated person in risk management and transparency from top to bottom."



The 'Hedge Funds in the Mainstream: Addressing Cost, Risk and Compliance through Technology' roundtable, 7th July 2004.

Hedge Funds in the Mainstream

Hedge fund managers will also develop new investment strategies in order to accommodate institutional investment and they will need sophisticated technology to support the execution of those strategies.

Richard Hughes, Managing Director EMEA at Omgeo, observed:

“Historically the demand for technology such as trade management systems has come from the larger, traditional fund managers. Today however, the hedge fund and prime broker industries increasingly see these types of systems as fundamental to the validity of their business models.”

Survival Techniques – Risk mitigation and increased transparency critical to hedge fund success

The importance of transparency is a recurring theme in the institutionalisation debate and quite often it can be a deal-breaker for hedge fund clients. In order to ensure the desired visibility into the entire trade flow, many institutions now employ operational specialists to assess hedge funds' operating environments. In fact, the need for transparency is increasingly driven by regulatory, as well as client, demands – hedge funds need to show that they are “watertight”.

The risks of not having streamlined processes in place, like straight through processing, are high, as institutional investors are reluctant to invest their money in hedge funds that cannot meet strict due diligence requirements.

Operational risk is also a serious threat to trading activity. Gary Plummer describes his experience of a hedge fund that started up without trade management systems:

“After two weeks of trading, it was discovered that nearly every trade had failed to settle. Good performance on paper had been completely wiped out by lack of automation. You could show the paper profit being 2% up on the market, but the actual costs of trade failure took them into negative territory. Traders need trust in the process; they want to know if you book a trade it feeds through automatically, is matched to the external market, fed to the prime broker and settled on a timely process. Moreover, it’s got to be cost efficient.”

A lack of operational control and repeated manual errors could be very damaging to a hedge fund's reputation.

Despite these risks, many start-up hedge funds are not particularly aware of the significance of technology in delivering increased transparency and risk reduction.

Neville Atha, Executive Director, Morgan Stanley Prime Brokerage agrees:

“We spend a lot of time talking through the necessity of automation with new funds, and trying to get the number of failed trades down because that is exactly the sort of thing which can undermine the efficiency and returns of the fund.”

Keeping Pace – Solutions providers face challenges

When it comes to investing in technology, hedge funds are extremely demanding but they tend to have small budgets. Technology vendors find it difficult to keep up with hedge fund demands for new functionality that supports the complex instruments they need to trade to stay ahead of the pack. Many of the more traditional buy side vendors are entering this market and are developing the scope of their products in response to hedge fund demands. However, many find it hard to do this cost-effectively given hedge funds' low budgets and the scale of their requirements.

Jonathan Clark, Executive Director of Citisoft, believes

“The hedge fund market is similar to the rest of the buy side in that pioneering developments in technology have been made on a proprietary basis, and the change to using third-party systems can be a difficult one.”

There is a constant search for open managers, as high-quality hedge funds attract funds and close to new investment very quickly. In that environment hedge fund managers will be focused on developing new strategies to meet demand. However, this begs the question of whether hedge funds will be able to execute those strategies, unless the technology is available to support new instruments. The continuing development of hedge fund technology is fundamental to its ability to grow and meet demand.

Hedge Funds in the Mainstream

Straight Through Processing pays off for hedge funds

The introduction of a greater degree of straight through processing (STP) to the investment process can offer firms many benefits. In the main, hedge funds will concentrate on bringing front office products in-house, but will look to prime brokers to provide back office solutions such as trade matching.

Dominic Rieb-Smith, Business Development Manager, EMEA, at Omgeo maintains

“STP is critical for firms’ competitive edge – when margins are tight and the market is competitive, you can actually lower your overall costs and increase your profits through operational efficiency. The value of automation is magnified in the hedge fund industry, particularly with start-up operations, where there is a need for scalability from day one in order to cope with volatility in trading volumes without incurring increased cost and headcount requirements.”

Hedge funds are better placed than most financial institutions to take advantage of the latest technology, as they are not held back by legacy systems. Trade matching and confirmation systems are essential to increase efficiency, so that operations managers can just focus on exceptions. Gary Plummer notes:

“Having come from a bank where in 3 years of using Omgeo’s services we had had no failed trades, when it came to starting Callidus it wasn’t a question of ‘Can we afford to have Omgeo CTM¹?’ but ‘Can we afford not to have it?’”

Sven Jones, of hedge fund Marshall Wace concurs:

“Because we have a very automated environment, we have been able to increase our trading activity. We can focus staff onto other activities to develop the business and improve profit by looking at other avenues of revenue generation rather than just normal trading. The benefits of automation are significant.”

STP also allows hedge funds to keep staffing levels at a manageable point. It is inefficient to have only a handful of fund managers with a very large support staff focused only on the operational side of the business. With STP in place, firms are able to keep operations lean and focus on their trading activity – increasingly important in today’s marketplace. A few years ago when hedge funds were smaller and making huge returns, they were less concerned about making another half per cent performance based on operational efficiency. Now in today’s more competitive market and tougher economic climate, there is a much greater focus on how funds can save money by being operationally efficient.

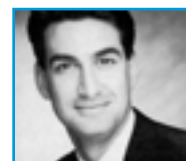
Although a single, integrated platform for hedge funds to process all instruments is the nirvana, given the growth in investment strategies employed by hedge funds and their reluctance to operate on similar platforms to their rivals, the likelihood of a single platform being developed in the near future is remote. It is however encouraging to see that the amazing growth of the hedge fund market has gone hand in hand with increased interest in operational technologies to mitigate risk and reduce costs.

¹ Omgeo Central Trade Manager is the global solution for central trade matching, offering real-time settlement instruction enrichment and settlement notification messaging, all in a secure and stable environment

Hedge Funds in the Mainstream

Appendix A: Participants

- **MICHAEL AZLEN**
MANAGING DIRECTOR, ASSET ALLIANCE INTERNATIONAL



- **RICHARD HUGHES**
MANAGING DIRECTOR EMEA, OMGEO



- **DOMINIC RIEB-SMITH**
BUSINESS DEVELOPMENT EMEA, OMGEO



- **JONATHAN CLARK,**
EXECUTIVE DIRECTOR, CITISOFT



- **PRADEEP MENON**
FOUNDING MEMBER & HEAD OF SALES EMEA, RISKMETRICS



- **GARY PLUMMER**
HEAD OF OPERATIONS, CALLIDUS CAPITAL PARTNERS LLP



- **SVEN JONES**
MARSHALL WACE LLP



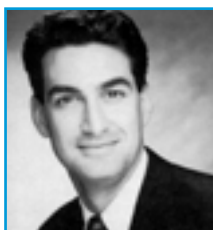
- **NEVILLE ATHA**
MORGAN STANLEY



- **MELISSA ROWLING (CHAIRPERSON)**
MANAGING DIRECTOR, FINANCIAL SERVICES AND MARKETS
WEBER SHANDWICK SQUARE MILE



Hedge Funds in the Mainstream



MICHAEL AZLEN

MANAGING DIRECTOR, ASSET ALLIANCE INTERNATIONAL

Michael Azlen has a total of 17 years experience in asset management, proprietary trading, structured products, equity derivatives and hedge fund management and is a member of the Asset Alliance Investment Committee. From 1995 to 1999, Michael was a Senior Fund Manager for the Quality Arbitrage U.S. Fund, a quantitative long/short equity hedge fund. Prior to this, he was Vice President and head trader in the Equity Derivative Products groups at CIBC World Markets and previously Scotia McLeod both of Toronto, Canada. Michael holds a Sloan Masters Degree in Business from the London Business School as well as a BA in Management Economics from the University of Guelph, Canada. Michael serves on the Board of Directors of Asset Alliance International.



RICHARD HUGHES

MANAGING DIRECTOR EMEA, OMGEO

Richard Hughes has held the position of managing director at Omgeo for Europe, Middle East and Africa (EMEA) since 2001. As the principal driver of the EMEA business' strategic direction and growth, Richard has been credited with leading Omgeo's expansion into a number of new markets and building Omgeo's critical mass of European clients.

Richard joined Omgeo, formerly known as Thomson Financial ESG, in 1992, when his responsibilities included developing the electronic trade confirmation community (ETC) within Europe. During this time, he has held positions overseas and successfully established a client base in Hong Kong. Prior to joining Omgeo, Richard spent three years as the publisher of 'Professional Investor', the official journal for the Institute of Investment Management and Research (IIMR).

Richard holds a bachelors degree in history and politics and makes a lasting, knowledgeable addition to conferences on the issues affecting the global securities industry and the evolution of operational efficiency in emerging markets.



DOMINIC RIEB-SMITH

BUSINESS DEVELOPMENT EMEA, OMGEO

Dominic Rieb-Smith joined Omgeo in June 2002 and is responsible for developing Omgeo's business within the UK and other parts of Europe. Dominic's main role is to expand Omgeo's business in the alternative investment management community, developing the position of Omgeo as both a strategic partner and solutions provider primarily to hedge fund managers and prime brokers.

Prior to Omgeo, Dominic worked as a Sales Specialist in the Financial Markets division of Global Crossing, a global network solutions provider. His main responsibility was to provide global network solutions to the investment banking community throughout EMEA (Europe, Middle East & Africa). Dominic also spent time as a Strategic Account Manager driving significant increase in both revenues from existing clients and the number of buy and sell side clients utilising Global Crossing's network services.

Hedge Funds in the Mainstream



JONATHAN CLARK,
EXECUTIVE DIRECTOR, CITISOFT

Jonathan Clark is a founder partner of Citisoft. Having studied Accounting and Finance at Bristol, he moved into the investment management sector in the early 1980's and has since undertaken consultancy assignments for many of the most respected City and global institutions. Jonathan has extensive financial business knowledge with direct experience of most areas of investment management, having worked on multiple projects throughout the full investment process. Jonathan is regularly quoted in the press and is responsible for the Sales and Marketing of Citisoft.



PRADEEP MENON
RISKMETRICS

Pradeep Menon is a founding member of the RiskMetrics Group, and the Head of Sales for Europe Middle East & Africa. Prior to joining RiskMetrics, Pradeep was part of the Equity Derivatives Group in JP Morgan focusing on Index Arbitrage & Index Option strategies, working in New York, London and Hong Kong. Pradeep joined JP Morgan & Co in New York in 1994 after a graduate degree in Electrical Engineering.



GARY PLUMMER
HEAD OF OPERATIONS, CALLIDUS CAPITAL PARTNERS LLP

Gary has over 10 years experience in settlements and operations within the Hedge Fund/Investment banking industry. He is responsible for Trade Support and liaising with Bank of Bermuda, the Administrator to the Callidus Funds. Gary joined the firm at inception from UBS. Previously, Gary was Head of Trade Support for UBS O'Connor Limited, a wholly owned subsidiary of UBS AG. A member of UBS O'Connor Limited from initial launch June 2000, Gary was responsible for many of the control, reconciliation and reporting procedures and systems currently utilised by the Investment Manager.

His career began with SG Warburg & Co responsible for Nostro reconciliation and broker confirmation of foreign exchange trading, 'small deals' service for Mercury Asset Management, cash management of currency positions and finally Money Market Operations. Following the merger of SG Warburg & Co with Swiss Bank Corporation, Gary was employed within a split role providing operations support for the Continental Options Sales Desk (Vanilla and Exotic trading) and working within Chinese Wall environment for the Alternative Asset Management Currency and Rates team. In 1997, Gary joined the AAM Currency and Rates team in a full time capacity providing trading desk support, monitoring and reporting risk and stop loss limits and reconciling/reporting daily trading P&L in fixed income, ETD and foreign exchange products. His coverage of the Currency and Rates Global Macro team continued into his employment within UBS O'Connor Limited.

Hedge Funds in the Mainstream



SVEN JONES
MARSHALL WACE LLP

Sven Jones joined Marshall Wace in December 2000 where he has responsibility for investment operations and technological development. Prior to this he worked for 5 years at Coutts & Co where he was manager of the Client Reporting team in the Investment Middle Office. Sven studied at ENPC, Paris and Imperial College, London, where he gained a Bachelor of Engineering degree in 1993 and a Master of Science degree in 1994.

CHAIRPERSON



MELISSA ROWLING
MANAGING DIRECTOR, FINANCIAL SERVICES AND MARKETS
WEBER SHANDWICK SQUARE MILE

Melissa Rowling has extensive experience in financial services communication. After beginning her PR career in the communications department of Unilever, Melissa joined Weber Shandwick Square Mile in 1994, managing corporate and financial accounts for a number of financial services clients. In 1998, Melissa left to run the marketing and communications programmes for two hedge fund firms, Yetman Asset Management and IKOS, which trade foreign exchange and interest rates. Yetman was a start-up and Melissa's role there included the whole breadth of corporate communications, including investor relations, media relations, corporate literature and conferences. In addition, there was a certain amount of middle office work carried out to support the traders.

Melissa returned to Weber Shandwick Square Mile at the beginning of 2000, to apply her in-house and technical financial markets/services knowledge to a number of accounts and to use her extensive experience in financial markets communication. Since returning, Melissa has run a number of financial markets and services accounts, including Integrated Asset Management, Fabien Pictet & Partners, Eriswell Capital, GHK Asset Management, Trafalgar Capital, Hedge Fund Review, Currenex, Instinet, GFInet Fenics, Prebon Yamane, FTSE, Euronext, SVG Capital, Merrill Lynch and CLS Bank. Melissa is qualified as a registered Representative of the FSA.