

**Peter Hill** of **Citi Hedge Fund Services** shows how the hedge fund space in Canada and around the world is recovering from the recent economical turmoil

# A market in transformation

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**A**s the hedge fund market – in Canada, throughout North America and around the world – is recovering from the most brutal market conditions in decades, the industry is poised for profitable growth. Evidence of the market's slow-but-steady rebound is widespread. Beginning last May, net fund contributions exceeded redemptions, reversing a months-long trend; overall, the industry achieved a 17% return in the first eight months of this year – even higher in Canada because of the energy-sector strategies some funds employ; and we are seeing an uptick in the number of funds being launched.

Among these signs of resurgence, one thing is certain: today's hedge fund market is facing an entirely new economic climate, with conditions far different than those that prevailed before the credit crisis. And to achieve their previous levels of success, managers are having to adapt to a transformation of the space – a market-wide makeover that is being driven by two overriding forces: mounting pressure from investors demanding greater transparency and independent valuation; and additional regulatory and reporting requirements that will inevitably be implemented.

#### **Investor-led demands: independence and transparency**

The era when hedge funds employed self-administration and self-custody operating models is rapidly waning, replaced by a higher degree of outsourcing of custodial, multi-prime and related services to a third-party specialist provider with the expertise to allow fund managers to concentrate on what they do best: develop their business, manage their investment portfolios and deliver superior client service.

The events of the past year – the global credit meltdown, the Madoff scandal, the collapse of Lehman Brothers and Bear Stearns – have brought about a seismic shift in investors' priorities. Today, as never before, investors are demanding independence and separation of functions related to valuation, pricing, compliance and custody. To an unprecedented degree, they are demanding rigorous due diligence, risk management and financial controls and are requiring proof of visibility as well as a guarantee that their money is being managed properly.

This demand for independence is being led by institutional investors and funds of hedge funds. As a re-

sult, we are seeing an 'institutionalising' of the industry and acceleration in demand for industrial-strength operational processes.

In response to these investor-led demands, funds are looking to service providers for expanded valuation, custody and reporting capabilities and more middle office functionality including risk reporting and compliance services specifically tailored for hedge funds. These key functions are under the tight scrutiny of existing and prospective investors, who are clearly concerned with the way these processes work and how they correlate to the overall risk associated with the portfolio. Hedge funds with third-party administrators can remove one potential sticking point from a prospective investor's selection criteria. Increasingly, investors are conducting due diligence themselves to confirm the independence of a fund administrator's analysis, pricing protocols, allocation processes and internal policies and procedures.

#### **Increasing oversight and regulatory requirements**

While hedge fund managers are adapting to the market-wide demands for increased transparency and independent valuation, they are also faced with the prospect of additional regulatory and reporting requirements by authorities in North America and around the world. The particulars of the new policies are still being deliberated, but stringent regulatory oversight and compliance requirements will place upward pressure on funds' operating costs. This pressure, as well as pressure on revenues, is leading to the demand for cost-effective middle office solutions in addition to more traditional fund administration services.

#### **The future: investor-first focus**

At Citi, we are optimistic about the prospects for the hedge fund industry in Canada and throughout North America as we, like our clients, strive to successfully adapt to the new market conditions. We have identified a number of trends that we believe characterise the hedge fund space now and going forward.

**Canada COE** – Canada is becoming a centre of excellence for the hedge fund space. Transfer agency services in particular are being moved from other sites to create jobs in Canada because of the market expertise and service quality that exist here, in conjunction

“We believe that the hedge fund space will continue to provide an attractive investment opportunity”



with structural costs that are lower than in many other major hedge fund centres.

**Single service provider** – In Canada, managers often employ the same investment strategies for both their onshore and offshore vehicles. We’re noticing that funds are increasingly looking to consolidate administrative services with a single third-party provider that can deliver a comprehensive portfolio of integrated capabilities to eliminate duplication and improve efficiency.

**Growth** – The growth curve, positive and negative, of the Canadian hedge fund market has closely paralleled the arc of the global hedge fund space. Although the market dynamics we are facing now – increased investor scrutiny and the prospects of additional regulation – will persist, we believe the industry will continue to grow at a rapid rate, likely outpacing the traditional fund sector.

**Hedge fund-specific middle office services** – In response to market demand, service providers are introducing a comprehensive suite of middle office services that help hedge fund managers diversify counterparty risk, gain more frequent independent verification of their holdings and valuations, and ultimately focus more of their professional, financial and technological resources on making investment decisions. Typically, these middle office capabilities include a portfolio of post-trade and pre-settlement offerings, including daily trade processing, reconciliation and daily P&L reporting, in addition to OTC services, collateral management, corporate actions, cash management and risk reporting.

**Managed account operating platforms** – Hedge funds are increasingly establishing managed account structures for their underlying investors rather than creating legal vehicles like limited liabilities compa-

nies or limited partnerships. To support this structural shift, third-party administrators, as part of their middle office services capabilities, are offering managed account operating platforms that provide the robust technology these accounts require. These solutions – which deliver end-to-end operations support from account management and imbedded compliance and audit control to paperless work flow management and performance reporting – promote efficiencies and reduce operating costs, ultimately improving productivity and enhancing profitability.

**Funds of hedge funds** – Funds of hedge funds (FoHFs) will continue to be important. From an investor’s perspective, they provide an important risk management function by diversifying exposure across multiple funds, instead of individual fund managers. From the managers’ perspective, FoHFs provide a valuable distribution capability, allowing them to efficiently distribute their offerings to a broader range of investors.

**FoHF custody** – As a key element resulting from the market demand for independence, FoHF custody from a third-party provider is becoming increasingly essential by delivering autonomous safekeeping, settlement, registration, income processing, corporate actions and reporting and reconciliation services.

Finally, we believe that the hedge fund space will continue to provide an attractive investment opportunity for sophisticated investors seeking portfolio diversification and above-market returns. We believe investors are becoming increasingly knowledgeable about the alternatives market and about the fund administrators that actively support its success. We are excited about working with our hedge fund clients as they grow their businesses in this new environment. ■