

Independents' day

What are the benefits of recent consolidation of hedge fund administrators? Dermot Butler from Custom House in Dublin investigates

I recently participated in a panel at a Dublin conference discussing long-term trends of importance to hedge fund administrators.

The panel was asked whether the industry is facing capacity problems, and to comment on the impact of recent industry consolidation.

It was interesting to note that, in the same panel, we were asked a somewhat contradictory question: "Can so many administrators survive, and what were the economics of business in a crowded market?"

I found it difficult to understand how two questions could be posed with implied contentions that seem so dramatically different. How, I wondered, could the industry be facing capacity issues if there were so many administrators that the question cast doubt on their survival? Somewhere there was a non sequitur in those questions.

I found the most interesting topic was assessing the impact of industry consolidation, of which, it is claimed, there has been a lot in the past two or three years. (It is, of course, open to question whether there has been any consolidation, as such. What has happened is that the institutions have, for the most part, played 'Pac-Man' and gobbled up the smaller hedge fund administrators). But, for the sake of argument, I will agree to use the term consolidation.

There are basically four groups that have and will be affected by the consolidation:

- firstly, there are those independent administrators that have been consolidated (the 'consolidatees') or absorbed into an institutional administrator;
- secondly, there are those institutions that have merged with, or taken over the consolidatees, which I will refer to as the 'consolidators';
- thirdly, there are those independent hedge fund administrators, like my own company, Custom House, that have not (yet?) been consolidated (the independents); and
- fourthly, the hedge funds themselves and, of these, the most affected will be the clients of the consolidatees.

When you consider the list of participants in recent consolidations, the rationale behind those transactions is easy to work out from both the consolidators' and consolidatees' perspective – taking capital out of their business and getting more "clout" in the marketplace.

I suppose the first of these consolidations was that of Mees Pierson into (and then out of) Amro and into Fortis. However, that was more the purchase and sale of a bank that had an administration arm than the purchase and sale of hedge fund administrator per se.

More recently, we have seen a plethora of mergers/takeovers or consolidations: Bank of New York and IMS; State Street and IMA; Bysis and Hemisphere; HSBC and the Bank of Bermuda. More recently Mellon and DPM; and



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Bysis (again) and RK Consulting (which, presumably, was intended to increase their hedge fund footprint in the US); JP Morgan and Trnaut; and Northern Trust and Barings.

BIG BUYERS

What is notable about all of these consolidations is that the consolidators are all very large institutions with very large traditional, predominantly US, mutual fund administration businesses.

These institutions appear to have been very concerned their 'bread-and-butter' clients had to look elsewhere for administration of their hedge funds.

The consolidator could either start up their own hedge fund administration department, taking time and a great deal of money, or buy the expertise. Almost all took the second choice, with notable exceptions being Goldman Sachs and UBS.

The reason the majority went this route was primarily because they all had major institutional clients who were themselves getting into the hedge fund market and they could not service them. It, therefore, seems to me the consolidators acquired the consolidatees because they needed to have the ability to provide a full service to their institutional clients, both in traditional and hedge funds, and needed it quickly.

So what impact will that have on the consolidatees?

Firstly, they will see a deal flow of larger hedge funds, remembering that many of the consolidators mentioned above consider a mutual fund of \$500m a small client.

Secondly, I believe the hedge fund administration departments of these institutional administrators (the former consolidatees) will start to absorb the attitude and culture of their parent – they will tailor product to institutions, or at least very large clients. Indeed, we have already seen evidence of this trend with the recent announcement by one of these institutions that, in the future, they are going to concentrate on the institutional hedge fund market. This announcement was somewhat ironic because the consolidatee, in this particular case, had, during the past two or three years, been very aggressive in acquiring market share in the hedge fund field. Now it seems likely they will not look at any fund of less than, say, \$100m, possibly \$300m.

This group is not unique, although perhaps more voluble than the other institutional administrators. It is, I believe, almost inevitable the smaller (less than \$100m) end of the hedge fund market will begin to feel vulnerable and perhaps even find themselves increasingly unwelcome

with their large institutional administrator.

This will create real opportunities for the remaining independents who are willing and capable of taking on both smaller funds and start-ups.

LANDSCAPE OF OPPORTUNITY

One other feature of recent presentations and articles has been the contention that the market is at risk of some form of manager quality famine, as the major managers close to additional investment.

There appears to be a belief that the major managers of the past two or three generations are the only people capable of running a hedge fund, and new hedge funds will not contain anyone of quality or note.

While I accept several, maybe even many, new managers may not be up to the Tudor-Jones, Steinhart or Soros standard, I also believe there will be many who could well be.

The hedge fund market has been characterised by new managers evolving from pro desks in major institutions and new trading strategies developing with each generation. Hedge funds started with AW Jones's introduction of a now classic, relatively straightforward long/short fund.

There are now numerous strategies that come under the hedge fund umbrella and that are competing in complexity.

We will continue to see start-up hedge funds and, although many of those will fail and several plod along, quite a few will also perform well and grow. This, of course, is very encouraging for the independent administrator capable of handling smaller funds and start-ups.

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Furthermore, the reluctance of institutional administrators to take on, or even continue working with, funds with perhaps less than \$300m and certainly less than \$100m, will provide a deal flow for specialist independent administrators, whose business model enables them to make a profit on these smaller funds.

Those hedge fund administrators that retain their independence will, I think, find their niche and potential for growth continues, not in spite of the consolidation, but because of it.

Indeed, it is quite feasible that we may witness a growth in smaller specialist hedge fund administrators seeking to serve the so-called smaller hedge funds.

KEY POINTS

Some administrators under consolidation are turning away from smaller funds and concentrating on institutional hedge funds.

This could create a new market for specialist administrators working with funds under \$300m, or \$100m.