

Dermot SL Butler of Custom House analyses some of the key trends and developments currently impacting the fund administration sector in Ireland

Volatility creates opportunity

As chairman of leading independent hedge fund administrator Custom House and with more than 35 years experience in the financial services industry, Dermot Butler is well placed to provide the HFM special report with an analysis of some of the key trends and developments impacting the hedge fund administration sector in Ireland at this time.

Consolidation has dramatically altered the structure and composition of the hedge fund administration sector in recent years, with the acquisition of hedge fund administrators by larger traditional administrators and by the big banks. As the hedge fund industry continues on its journey towards greater institutionalisation and the financial mainstream, what impact does Butler think this will have on the market for servicing for small to medium-sized funds, should this trend continue? “Further consolidation is beneficial from our perspective as an independent administrator looking to service start-ups and small and medium-sized funds, because the global institutional players are increasingly refusing to do so,” says Butler.

“Whereas BISYS, for example, before it was acquired by Citigroup, may have looked at servicing a US\$100m or even a US\$50m fund, on the basis it could grow, I doubt whether Citibank would look at anything that size now, as its business model does not allow it to handle an account that size. I stress this is supervision on my part, but there is a lot of anecdotal evidence that, these days, many of the large administrators won’t even consider funds below US\$200m, even US\$300m in some cases.

“Consequently, Custom House is seeing a lot of business from fund managers who are choosing to leave or being told they have to leave the large administrators. Of course, moving administrator is extremely disruptive for funds, so they tend to

resist changing even if not entirely happy or satisfied with the service they’re receiving, but we are definitely seeing the results of the imposition of big bank culture over entrepreneurial administration culture.”

Furthermore, the opportunities this trend towards consolidation presents to the market are not confined to those already established in the space, as Butler explains. “Here in Ireland, you’re seeing a lot of smaller administrators moving quickly to fill the vacuum created by the trend to scale in the institutional hedge fund administration sector. Some of these entrants had already established their business in other jurisdictions, such as Apex, whilst others have moved into the global hedge fund administration space from a third-party service background in other markets, such as, for example, domestic mutual funds in the US.”

Call for greater transparency and procedures

The growing institutionalisation of the hedge fund space is also a key driver of the next development raised with Butler, which are the increased demands of hedge fund investors for greater transparency of the operations and procedures of the vehicles in which they are investing. Administrators such as Custom House, of course, have found themselves at the forefront of these demands. So how has this changed the day-to-day work they do for the funds they administer? “Operational due diligence is being stepped up, and we are seeing more due diligence visits on behalf of investors.”

So are there any particular aspects of their operations and procedures those acting on behalf of investors are particularly concerned with? “Transparency around pricing is an increasingly important focus for hedge fund investors, particularly with regard to the pricing of hard-to-value securi-



Dermot SL Butler is chairman of Custom House Administration & Corporate Services Ltd., which offers a full hedge fund administration service through globally integrated offices in Dublin, Chicago and Singapore. He is also deputy chairman of AMIA.

ties, following the subprime debacle and its knock-on effect on the fixed income and structured products markets," says Butler. "Merrill Lynch recently posted the biggest quarterly loss in their history due to the exposure of their portfolio in that area, and they are in what once was exulted company with Citigroup, UBS, Bank of America and Societe Generale, amongst many others.

"What is perhaps most extraordinary is that Soc Gen's losses in this area (excluding the famous fraud) are almost perceived to have been a 'mere' US\$2.9bn or thereabouts, which is about the same sum as Barings lost. It's still not entirely clear to what degree they knew, or perhaps even know now, what their portfolio is really consisted of, and even if they did know, if they could value it or even whether they have been able to value it yet. They may be getting a better idea on a fairly rapid learning curve now, but my gut feeling is that an awful lot of institutions have little idea and that more losses are going to come out of the woodwork before the fat lady sings!"

Importance of independence

Given such concerns, hedge fund investors are placing increasing value on the credibility and independent verification a third-party administrator can bring to pricing, according to Butler. "We had an approach from a hedge fund manager yesterday, who said, 'I have a fund. It's US\$100m-plus. I've been running and administering it myself, and I now wish to go out and get outside investors, so I'd like to have the valuations I've done and the transactions I've reported over the past year verified, and then I would like you to take on the administration thereafter.' It's the independent verification that's important."

So how does Custom House deal with the hard-to-value prices? "You can still get independent verification for the majority of prices, whether from an exchange or from two or three brokers, or from independent pricing agents, such as Markit. However, there are situations where it's not possible to independently verify a price. In these circumstances, it is important that transparency should



be expressed, by way of a clear statement in the offering document, explaining that in certain circumstances the manager (or the counterparty) may be the last resort for valuing the portfolio. This presents an obvious conflict, which investors should consider before writing their cheques."

Another way in which the day-to-day work of administrators is being affected by the growing institutionalisation of the hedge fund space is the rapidly growing demand for daily valuations, which has provided a welcome boost to business. Initially, Butler is concerned that constraints on capacity imposed by a shortage of suitably skilled personnel in Dublin could hinder Custom House's ability to keep pace with this growing demand. "There is a lack of suitably qualified personnel in Dublin and certain other jurisdictions. You can't find staff, or they move, or you get staff and they're inadequate. Lots of Dublin administrators have tried to overcome staffing constraints by opening up in Cork, Galway and Drogheda and Nass, for example.

"We opened up in Chicago and Singapore – both of which are cheaper than Dublin – which gave us a global footprint

and a 24/7 capacity, because our systems now enable us to work around the clock. About 25% of our book is now daily-dealing hedge funds, because we are able, for example, for a North American client, to do the trade capture and reconciliation in Singapore, start the NAVs in Dublin, finish them in Chicago."

Despite the recent turmoil in the markets, Butler is defiantly optimistic regarding prospects for the year ahead. "We were about US\$21bn at the end of 2006 and broke US\$32bn by 1st January 2008. That has come from performance, organic growth of funds – they've continued to sell to more clients – and the new funds we took on last year, which was approaching 60 by the year's end, including many funds opened for existing clients.

"The hedge fund market has continued to grow strongly, as it has over the last six or seven years, and I don't see any reason for that to stop. Market conditions may mean it won't grow in the same way, but for hedge funds, the bigger the crisis, the bigger the profits. Volatility creates opportunities, and as Confucius said, 'Crisis equals opportunity.' Confucius would obviously have been a very good hedge fund manager!"