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A JUSTIFIABLE OPTIMISM?

On reflection, a review of 2009, from a hedge fund administrator's point of view has to be a 15 or 18 month review, because the seeds of today's challenging environment were sown in 2008 (indeed, some were sown in 2007). The overriding impression of the hedge fund industry right now is one of guarded optimism and that feeling seems to have broadly filtered down to the administration community. On the face of it, this may seem logical, given the stance of both the media and many governments that the West is starting to climb out of the recession. Even so, there are very few—if any—financial experts, or even just participants in our industry, who are convinced that the horrors of 2008 are over. So why the optimism? By Dermot SL Butler, chief executive of specialist fund administrator Custom House.

WHATEVER ANYONE MAY say, hedge funds, largely led by commodity trading advisers (CTAs), performed very well in 2008. Most lost money, but on average only 15% to 20% across the board. That, in turn, represents anything from between 15% and 35% generation of alpha, given that most traditional assets (such as long-only equities) lost anywhere up to 50% in value.

Of course, some hedge funds blew up, but they were, for the most part, either quasi-long-only funds or invested in sub-prime. On the other hand, many made real returns and, in some cases, huge returns, because they were famously short of sub-prime or similar. Nevertheless, on average, they produced a more than respectable level of alpha, which is one of their main objectives. Thus, if, as

some investors and institutions have advocated in the past, the managers had been paid their incentive fee on the amount of alpha they generated—*i.e.* out-performance of their chosen benchmark or beta—then many would have taken home large cheques last year, even though their funds lost money (despite the fact that the hedge fund's other main objective is to maintain capital and produce a real return). Unfortunately, they lost money, largely because one of the core components of a hedge fund, that genuinely hedges, is the requirement to leverage their portfolios.

It is a fact that the classic Arthur Winslow Jones (AWJ) hedge fund hedged the inherent market risk of a long-only portfolio; and this risk exists however good a stock-picker you might be. AWJ did this by selling short of the shares of companies that he believed would underperform in a rising market and out-perform in a falling market. It goes without saying that such a hedging strategy will not only reduce the risk, but also the profit potential in the portfolio. *Et ergo*, by leveraging the portfolio, AWJ could increase the risk by a small amount while increasing the profit potential by very much more, assuming his stock-picking was up to scratch.

Accordingly, for any hedge fund which runs an appropriately hedged portfolio, leverage is an essential component. In 2008, the banks, almost without exception, panicked and indiscriminately withdrew liquidity from the market and all their clients, including hedge funds, with the result that all assets, good or bad, were hammered regardless of quality or value. So what has this to do with current optimism?

Actually, as a group, hedge fund managers tend to be very smart and they appear learn from their own and from others' mistakes, even though that failing to anticipate the complete withdrawal of liquidity was predictable, or a mistake. It can be equated to the financial equivalent of the *Hundred Year Storm Surge*, which no one ever anticipates will be broken. Be that as it may, it is clear that hedge fund managers are managing their liquidity requirements today in a different way, perhaps supported by the imposition of the Basel Banking Supervisory Committees' *Principles of*



Dermot SL Butler, chief executive of Dublin-based fund administrator Custom House. Photograph kindly supplied by Custom House, December 2009.

Sound Liquidity Management. In fact, approaches to many aspects of the markets have changed. It is this ability to be flexible in the storm that leads me to believe that the hedge fund industry will not just survive, but will grow, regardless of any further downturns that may occur (which according to market watchers is likely to be property-led).

Since the second quarter of 2009, the global financial markets have seen not only the return of investors to existing funds, but also the establishment of several new funds. These funds have not been launched in "Gold Rush" droves. Nonetheless, new funds have appeared in a respectable, steady stream.

Optimism then and the return to what is ironically-termed 'normality', is probably the most important and most stabilising aspect of 2009. Moreover, the realisation by institutional investors that most hedge funds have actually served them well throughout the crisis, has attracted them back into this market at a steady pace. The experiences of some institutional investors over the past 18 months has undoubtedly led to greater initial and ongoing due diligence, but that is never a bad thing.

Of course, many other factors, borne by the crisis, can and will continue to affect hedge fund administrators. These include, *inter alia*:

Greater due diligence by administrators when taking on a client and ongoing due diligence, however well the relationship has developed over the years; the requirement to verify the existence of certain assets in a fund's portfolio; a more disciplined approach to pricing of complex derivatives and other illiquid assets; and new and anticipated regulation.

Due diligence—or rather a lack of it—appears to be the clear failing of not only the investors, but also the managers of those funds that invested in Madoff. As yet, there is little actual evidence of what actually happened, because of the alacrity with which Mr Madoff pleaded guilty. However, there are a lot of allegations in court papers, which if proven, could indicate that some of the auditors and administrators of those "feeder funds" appear to have failed the proper due diligence tests. As a result, many administrators have revisited and honed their due

diligence procedures, some with a hint of smugness. Even so, for those more modest administrators the phrase "There but for the grace of God..." resonates in private around their boardrooms.

The move towards administrators verifying the existence of certain types of assets came about following the Petter's scandal, which would have been the horror fraud of 2008 if Madoff had not eclipsed it at the end of the year. Whatever the actual cause, it is now incumbent upon administrators to verify the existence of virtually any asset that is not exchange traded, or where there is an unhealthy close relationship between the manager and the fund's prime broker or custodian (as with Madoff).

Ironically, the Madoff scandal has also been directly responsible for moves by international institutional investors, led by the Swiss private banks pressing US self-administered funds to appoint an independent administrator. This is a positive move, not only for administrators, but for the whole industry. It is ironic because Madoff never had a fund and, therefore, would never have had, or could have used, an administrator in the conventional sense. However, in the way of the law of unintended consequences, the demand has grown for independent administrators to 'administer' single investor managed accounts, which was hitherto virtually unknown.

Managed accounts

Moreover, the demand for managed accounts has come about with the reaction of some investors to what they deemed "opportunistic" gates (that is, not necessary except to keep assets) has resulted in a plethora of managed accounts and growth of managed account platforms. This has, in turn, provided opportunities for administrators that can handle daily dealing net asset value (NAV) calculations, both for managed account platforms and single managed accounts. Indeed, the increase in frequency of valuations is a new feature of the administration offering; with weekly and even daily valuations becoming much more common than two years ago.

It was inevitable that following the extraordinary failure of many of the world's major banks to not only mismanage the risk of their derivative portfolios or even recognise that there was such a risk, the world's governments have worked quite cooperatively together to introduce a range of new limiting regulations combined with capping compensation, including "excessive" or "abusive" bonuses. One can have sympathy for this approach and the outcome of the G20 meeting in the spring of 2009 was, on the whole, positive: severely criticising the banks on the one hand, while agreeing that hedge funds had not contributed to the debacle and had posed no systemic risk on the other. Lo and behold a mere three or so weeks later, the European Union published the first Draft EU AIFM Directive.

This was a clearly political document put together largely by the French and German EU teams, ably supported by an errant Dane, called Poul Nyrup Rasmussen. It was also cobbled together without any consultation with the hedge

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fund industry, or anyone else for that matter. At first, this draft directive came as a huge shock. However, as the storm settled, many market practitioners realised that it was so extreme that it would attract criticism from all quarters, even those who were, in fact, sympathetic to the basic intent.

No surprise then that the industry—ably led by AIMA—educated many EU politicians and decision makers to try and change the directive. Under the auspices of the Swedish Presidency of the EU a second Draft EU AIFM Directive was published. On the whole, this directive addressed many of the more contentious of the original clauses in the first directive. There was a sting in the tail however—a suggestion (some prefer requirement) that hedge funds and their managers should adhere to a similar restrictive remuneration policy as the banks. This is patently comparing apples with doughnuts and will, I assume, be changed yet again; but not for some months.

One major regulation change in Ireland was the long awaited implementation of the 3rd AML Directive. The new Irish legislation is quite lengthy, but part of that is devoted to bringing Private Gambling Clubs and Trust and Company service providers under the scope of the legislation. The main effect on the fund industry and Irish administrators is going to be the change to a risk-based assessment of potential anti-monetary laundering and terrorist financing threats. This will mean more stringent Know Your Customer (KYC) procedures which are now clearly defined as Customer Due Diligence. There are tighter requirements and identification with regard to the actual offence of money laundering, regulatory obligation, wider definitions to tipping off, the requirement to issue suspicious transaction reports as quickly as possible and, in particular, the identification and handling of Politically Exposed Persons (PEPs).

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