Hedge funds face growing risk, technology and data challenges

Hedge fund managers need to concentrate on performance. But technology requirements, particularly in a multi-asset class and highly regulated, complex environment, can prove to be a distraction. Bennett Egeth is president of Broadridge Investment Management Solutions, a provider of technology to more than 250 funds and five of the top 10 fund administrators. Having worked alongside global investment managers, asset servicing providers, banks and broker-dealers for three decades, he discusses how hedge funds and service providers are solving their issues in risk, technology and data.

Bennett Egeth, President, Investment Management Solutions, Broadridge

"Hedge funds should be focused on two activities: alpha generation and capital raising. They shouldn't have to be system integrators. They shouldn't have to worry about whether their technology – be it order management, portfolio management or risk systems – are integrated, and are going to work for them every day," says Bennett Egeth, president of the investment management solutions business at Broadridge Financial Solutions. "Every fund needs to ask itself what is differentiating to their business, and it needs to concentrate on that with a laser focus. Funds have started to realise that there are many functions they once considered differentiators, such as back-office and technology prowess, that are in fact differentiators of solutions providers, service providers or hosting services, and not differentiators of asset managers."

Instead, Egeth has found that hedge funds need an integrated and scalable solution hosted for them. Such solutions need to handle a broad array of asset classes and functions, from trading to risk management. So, as a portfolio manager moves into new strategies and asset types, the transition is seamless and integrated immediately. Hedge funds need to be able to mutualise their costs and infrastructure across these activities and support a common set of implementation tools and solutions. This will make it possible for them not only to move into new asset classes and trading strategies, but also to keep up with regulatory and compliance requirements, investor reporting and the all-important risk management and monitoring. Such solutions decrease the cost of ownership and internal staffing, but ensure continuity of trading and growth.

An integrated technology platform is critical to controlling and managing risk in today's fast-changing markets. Delays or gaps in implementing technology solutions may cause a fund to miss out on market opportunities or adversely affect a portfolio manager's ability to manage the risk of existing positions and strategies.

Therefore, Egeth suggests that both new and established funds cannot overlook the completeness of the technology solution they use. "If a fund needs to go out and buy an order management system, a portfolio management system, a risk system, a set of books and records or reconciliation tools, they've moved from what is their core business to being a technology and integration firm as well. That is an expense and, more importantly, it's a diversion of resources from things that should really matter to them," he points out.

Funds also need to consider the breadth of asset class coverage on a single platform. Many fund managers have different platforms to support different asset classes because they cannot find a solution that brings them together on a single platform. Not only is that expensive, but it also represents a huge amount of risk organisationally. To be most effective, managers need to have the ability to bring everything together and monitor it in real time, as market events change. "If they don't have such a system, it makes putting the consolidated picture together for regulators and reconciling with prime brokers and administrators much more difficult," Egeth says. "Completeness of solution is extremely important. The later the information is brought back together, the greater the impact on both compliance and risk management."

Finally, another important area for funds of any size centres on regulatory compliance. The plethora of regulations hitting the hedge fund industry means this expense is a cost factor from the start. The more complex the fund, the more geographies it trades in; similarly, the broader the asset classes traded, the more effort needs to be put into meeting regulatory requirements.

"Funds need to feel comfortable that their providers are giving them the information to do effective reporting. They now need to maintain a certain level of knowledge and expertise about regulatory infrastructure in order to make sure they are compliant and can reconfigure data correctly for the various reporting forms," says Egeth.

There are many ways solutions providers can help facilitate compliance in terms

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of collecting information, aggregating it, normalising it, attaching risk analytics to it and putting it into forms that can be submitted to regulators. For established funds that have been operating in the post-financial crisis environment, the new regulations have come as a necessary burden. For emerging managers, the cost of regulatory compliance can be prohibitive.

"From a fund's perspective, multiple individual technology solutions impose a high economic price and make it harder to stay competitive and compliant," continues Egeth. "Hiring internal expertise adds to the costs and raises the alpha requirement. Being able to be cost-efficiently compliant is a common goal in the industry."

Importance of risk

An integrated platform gathers the relevant information, and brings it together to better understand the underlying risks a fund faces.

From this perspective, Egeth believes hedge funds should be concentrating as much on data quality as on the technology used. "The biggest reason for failure in risk monitoring and the implementation of risk systems is data quality. The quality of the data underpinning the system is crucial. If the risk systems are being built on top of poor or incomplete data, they will be useless. The difference in integration in a successful project and an unsuccessful project often comes down to the quality of the data driving the analytics," he points out.

"It's all about managing risk in this business," says Egeth. "Funds need to make sure their infrastructure is capable of helping them make the best decisions, and is also capable of different functions within the company. Funds should have multiple people acting on the same information, rather than inefficiently acting on segregated data sets. Every professional needs to access and use that data for their specific function: trading; managing the portfolio; overseeing risk management and compliance functions; and reporting to investors and regulators, often across multiple jurisdictions and using multiple asset classes."

In fact, risk management is so important that some hedge funds are going to the expense of installing a second risk management system to ensure the first one is working. This is a major expense that can be avoided by a combination of better data capture and implementation of a system that can analyse that data in multiple ways.

Data, data everywhere

Now, more than ever before, data management is critical to the success of a hedge fund. Better data leads to better decisions, as well as fewer exceptions and lower operational risk. Traders and portfolio managers especially have a keen appreciation of the power of data and its ability to develop strategies with a competitive advantage. With the introduction of multi-layered regulations and an increased emphasis on risk management, other functions such as compliance and reporting now must also have access to and be able to manage data.

A March 2014 *TabbFORUM* blog post pointed out that the appetite for data will continue to expand across trading firms and the entire capital market structure, "turning up the heat on storage infrastructure. While real-time analysis remains critical, automated capacity management tools, solid-state solutions and other high-performance computing applications could help firms unlock hidden alpha in older data."

The same *TabbFORUM* post made the point that optimal management of data-demand patterns requires specific tools without which automation and capacity utilisation could become sloppy and expensive. More than other asset managers, hedge funds have been caught in an exponential increase of data input and output. As more factors need to be taken into consideration due to increased regulation, the expectations of firms' abilities to digitise, capture and store information has also risen sharply.

The possibilities of data and its wider implications for the overall asset management industry are often overlooked. For example, very few hedge fund industry participants have an accurate sense of the true cost of data management. Without understanding this, it becomes impossible to calculate revenue and mitigate risk.

Special case for start-up funds

Choosing a technology partner that can offer a hosted solution could help newly launched funds attract capital more quickly from institutions. "It becomes easy and cost-effective for a start-up fund or trader to hang its shingle and get up and running if it uses a hosted solution," says Egeth.

Additionally, while new launches may start with just one prime, they may also end up with multiple primes and even multiple administrators. That level of complexity requires a system that can cope with scale and multiple uses.

For start-ups, a 'hedge fund in a box' solution is essential. According to Egeth, it "provides a cost-effective scalable solution that is part of an enterprise-level platform into which the fund can grow as its positions increase, the jurisdictions and countries in which they do business expand, and they move from listed to over-the-counter asset classes."

An example of the additional complexity that comes with age and growth is a start-up that begins with one or two prime brokers. As its assets under management grow and product range expands, it could end up with seven or more prime brokers. "It becomes a large operational challenge for them if they're not using a multi-broker, agnostic application where it's just a matter of turning on the different interfaces," notes Egeth. "From an administrative perspective, funds may also need and want the ability to shadow their administrator and provide institutional-quality infrastructure much earlier in their life cycle. What is important is that a brand-new fund of $15 million can have infrastructure in place that institutional investors see as a requirement to invest money into that fund. In order to make the investor community comfortable giving young funds larger blocks of money to manage, they really need that institutional-quality infrastructure."

Generally, start-ups begin with capital from people they know; the traditional family-and-friends model, such people are investing based on a relationship rather than historical track record. "Start-ups need to put themselves in their investors' shoes or, more importantly, the shoes of the investors they aspire to have," says Egeth.

He advises funds to ask themselves what they need to do to pass an operational due-diligence review by an institutional investor. What features, functions and ability to scale are they going to want to see? How are the applications run? Attributes such as hosted solutions run by professional service companies are important to institutional investor due diligence.

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