

Boutiques trawl for clients in wake of consolidation

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Custodians allow smaller hedge funds to slip through their net

It has been another busy year of consolidation for hedge fund administrators, with the large banking organisations scooping up smaller rivals in an effort to increase the scale and range of their services.

The most notable deals include the Bank of New York/Mellon Financial merger, State Street's acquisition of Investors Financial Services, Citigroup netting the Bisy Group and, more recently, French administrator Caceis' deal with Olympia Capital International.

With more set to follow, some commentators are questioning whether independent administrators' days are numbered, suggesting the industry could see the same rationalisation path already experienced in the mainstream custody arena.

Ken Somerville, head of business development with Dublin-based hedge fund administrator Quintillion, thinks not. He said: "The asset classes that managers trade, the fund structures they use and the valuation mechanisms that are required are so boutique and so specialist that this kind of commoditisation will not be possible for a long time."

What's more, where consolidation has taken place and administrators have tried to commoditise processing functions, some fund managers have been disgruntled because it is "to the detriment of the service standard", according to Somerville.

So whereas a manager with \$5bn (€3.4bn) or \$6bn in assets will receive the requisite tailored solution from the administrator, those running \$1bn or \$2bn and below may not. "It has therefore created a market space for us and a number of other providers," he said.

Quintillion, which launched in November last year, has \$4.5bn in assets under administration and is attracting clients from start-up managers with between \$50m and \$1.5bn in seed capital. Somerville sees new business opportunities for independent firms such as Quintillion falling into three broad categories.

The first comes from investment managers with no existing relationship with an administrator. Such managers will consider both big institutions and independent providers, with the choice based on a combination of criteria including the administrator's technology infrastructure, the range of services, the costs, the firm's staff retention policy, how important the fund will be as a customer and the prospects for a long-term relationship, according to Somerville.

The second opportunity occurs where a fund manager already has a relationship with an administrator and it is happy to build that relationship as it adds new funds to its own business. Somerville said this has supported considerable organic growth in the sector.

A third chance for an independent administrator comes when a hedge fund manager seeks to replace its current provider because it is dissatisfied with the standard of service – whether due to slow net asset value delivery, unfavourable commercial terms or any other reason. Somerville argues that service standards often deteriorate because of the scale of the large administrators.

He said: "That doesn't apply to everybody. Managers with large sums, \$3bn and above, are inevitably the key relationships for the very big firms and to a large extent are well served. But there is a category below that; managers with less than \$2bn who potentially find that the large administrators don't have the firepower to support the relationship internally because the bigger relationships occupy the attention of senior management."

Hedge fund managers in this position could consider switching to an independent provider with which they can "build a better long-term relationship because there isn't the bureaucratic infrastructure in the background that makes your particular piece of business less visible or less significant to the provider", Somerville said, adding that about 30% of Quintillion's business this year has come from this route.

However, the impetus to change does not come solely from the managers. In some cases administrators are culling relationships with the smaller funds on their books to create spare capacity or redirect resources towards the larger and more valuable components of their business, according to Somerville. He said: "While it may not be as blatant as the administrator resigning its mandate, there have been other measures we've seen that effectively are the same thing."

One strategy is to raise fees to a level more in line with a higher asset base. "Perhaps you're running \$300m and they'll propose a fee which is equivalent to a \$1bn product," said Somerville. "As a manager you have no choice but to replace that relationship, because one of your responsibilities is to manage the expenses of the fund with a view to delivering good investor returns."

Some administrators demand minimum account sizes when taking on new managers. Dermot Butler, chairman of Dublin-based Custom House Administration & Corporate Services, said minimum account balances used to be between \$50m and \$100m; now they are between \$200m and \$300m and, in some cases, \$500m.

He said: "Between 60% and 70% of all hedge funds are less than \$100m. You're now seeing that funds of \$200m aren't particularly welcome where they thought they would be. It provides good opportunities for companies such as Custom House. This has been recognised by others, because previously unknown names are starting to come out of the woodwork, such as Channel Islands and Caribbean law firms turning into administrators."

However, thriving as an administrator is not just about the availability of clients. It also requires the functionality to support an increasingly demanding and complex market. This requires investment in sophisticated technology and quality personnel.

Some commentators have questioned whether independent administrators can compete with the deep pockets of the big

banks.

Glenn Henderson, global head of sales with Bermuda-based Fulcrum Fund Services, disagrees. He said: "I don't think there's a correlation between the big banks and their greater ability to afford technology and talent. The fund administration business is not as profitable as some of the trading environments in an investment bank or big bank. And I don't think they are the first guys on the block when it comes to allocating resources."

The recent credit crunch could also have an impact on the banks' future investment capabilities. Henderson said: "I think back-office, fee-earning businesses within the banks are going to have to tighten their belts the same as all other groups. I don't think it's going to get any easier for them."

In addition, he believes the big banks' legacy platforms will restrict the technology they use.

Henderson said Fulcrum had the flexibility to be opportunistic about hiring talented staff and the aggressive budgets and strong in-house technology talent. "We know what our clients want and we go out and build it."

"Being nimble and being a first mover is also the way a lot of hedge funds run their businesses, and we've proved that with the level of technology and quality of service we can provide."

He believes Fulcrum's technology and staffing skills give it a competitive advantage that allows the administrator to support a range of strategies, asset classes and investment vehicles.

He said: "The traders keep thinking up more exotic ways to make money and, as these get more complex, administration will get tougher. The companies that are willing to invest time and money to get the talent and technology to support those strategies will definitely win out."

In June, 3i's venture capital arm, 3i Growth Capital, invested \$57m in Fulcrum, which will use the equity infusion to expand in Europe and Asia. Henderson believes this investment should remove hedge fund managers' concerns about counterparty risk. "You have an independent administrator that has great technology and great talent, and now has FTSE 100 backing."

"That is a significant change for the better for us."

As for the overall prospects for independent administrators, it is a case of basic economics, said Quintillion's Somerville.

The continued growth of the market and launch of new funds means they need to find a home. He said: "Without new providers, or an expanse of administrators, potentially supply and demand will be mismatched."

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