

The administrator—integral player in the alternative investment industry

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With more than 10,000 hedge funds, and nearly \$2 trillion in assets¹ under management and institutional money continuing to flow in, the alternative investment industry is growing at a rapid clip. Established managers are growing existing funds and traders are leaving Wall Street firms to launch start-up funds at unprecedented rates.

Many new funds, in particular, are started by star traders who know little and care less about back-office functions such as securities valuation, custody and recordkeeping. However, they *do* care about the fund's net asset value (NAV),² which determines their asset management and performance fees. As a result, industry leaders are paying greater attention to the operational side of the house.

Some fund managers continue to perform all of their operations in-house. However, many are choosing to focus on their core competencies of asset-gathering, fund management and trading. These funds outsource some or all back-office and even middle-office (posttrade, presettlement) functions.

This is where third-party fund administrators come in, providing some of the most important of these functions on a cost-effective, outsourced basis. As a result, the fund administrator has become an integral player in the alternative investment industry.

With fund administrators' newfound prominence comes significant challenges that test their ability to maintain the highest quality service. These challenges include:

- The need to provide real-time pricing of new exotic instruments and daily profit and loss calculations;
- Increased competition from custodian banks, prime brokers and the funds themselves;

- Requirement for a scalable technology platform; and
- Increased demand for transparency and qualified staff.

Real-time pricing and increased competition

The alternative investments industry is not only continuing to increase assets under management, but also developing new trading strategies and complex new instruments designed to increase returns or mitigate risk. The fund administrator's ability to price derivatives, less-liquid instruments and private investments is critical, not only to the fund manager but also to investors who are scrutinizing NAVs to ensure that NAV-based fees are calculated accurately. Whereas monthly NAVs once were the norm, today daily profit and loss data and daily "lite" NAV are the least that is expected. This has put pressure on the administrators to keep upgrading their technology and also has resulted in the continued use of spreadsheet-based workarounds.

Many administrators are expanding their service offerings to provide middle-office and, in some cases, front-office services, such as P&L, risk reporting and more prime broker reporting. The provision of these services is changing the ballgame and attracting new entrants. For example, some hedge funds are entering the administration business as the biggest fund managers grow into full-service financial services firms. Major custodian banks have also become some of the largest administrators, and many custodians and/or prime brokers are expanding into administration via acquisitions.

Scalable technology platform

The technology used by administrators varies depending on the firm's size. Many use commercially available software packages, while many of the newer administrators have built their own. In almost all cases,

¹ Chicago-based Hedge Fund Research, Inc.

² Net asset value (NAV) is the excess of the fair value of securities owned, cash, receivables and other assets over the liabilities of the company. The valuation of the underlying investments within a fund may be determined by the fund administrator, who would use various sources to value as accurately as possible the investments in the portfolio, such as equities, debt or other securities and transaction types. One of the key issues is valuing illiquid investments, such as many private equity fund holdings.

spreadsheet-based manual processes are common in order for administrators to manage data and create statements. This is especially true when there are side-pocket deals³ and breakpoint schedules that cannot be managed within a conventional portfolio accounting system. Allocation models must be developed as end-user computing systems (frequently using spreadsheets) to perform the accounting and ensure the manager receives accurate information.

Some administrators have begun using third-party providers for fund performance reporting to investors. Information appearing on these reports is generated by the fund administrator, usually through spreadsheet-based manual workarounds. Customization and handholding is an integral component of the administrator's customer service model.

Technology platforms continue to be upgraded and/or replaced to increase scalability, provide tighter operational controls and improve capabilities to manage and track new products, such as credit derivatives. However, the need to be creative and flexible when servicing fund managers with increasing trade volumes will mean client services processes will continue to include user-based workarounds (with the use of spreadsheets) and data manipulation outside of core processing systems.

It is estimated that over 40% of financial data are currently transported, aggregated or presented via spreadsheets. Given their centrality in operations processing, spreadsheets are here to stay and administrators must put in place controls to ensure efficiency and quality.

Transparency and staffing

The influx of institutional and pension fund money into hedge funds is resulting in more regulation, increased demands for transparency and the need for faster and more frequent valuation of NAVs. Fund administrators and other independent third parties, such as valuation services, are being pressed to deliver greater transparency, more frequent valuations and increased reporting even as they face decreasing margins and staffing issues.

The third-party administrator service model is based primarily on the work of two professionals: The fund

³ Some hedge funds have investment strategies that allow the fund to invest in illiquid securities, yet investors are still allowed periodic redemption. In such cases, a common mechanism used is a "side pocket," whereby, at the time an investment is made in such an illiquid security, a proportionate share of a limited partner's capital account, relative to the entire capital balance of the fund, is assigned a separate memorandum capital account or "side pocket account." These are often referred to as "designated or special investment accounts."

accountant and the investor relationship manager. The most skilled of these professionals are always in demand and often in short supply. As a result, lengthy work cycles often require staff to work extensive overtime, resulting in high turnover and a negative impact on service.

Manual processes with spreadsheets will continue to be needed in order to meet the demand for customization. However, their use must be controlled and ultimately improved to automate and streamline processing of data and minimize the staff time focused on mechanics rather than on data.

In order to maintain high margins, many administrators already have established headquarters or operations in other venues where funds are domiciled, such as Ireland (particularly Dublin), Bermuda and the Cayman Islands. In addition, some administrators are moving processing work to lower-cost locations such as India, which may place further cost pressures on their competitors.

As the industry continues to grow, fund administrators will need to increase technology spending to remain competitive. They must build technology platforms that are scalable and integrate that service across the entire lifecycle of a trade, including capture, bookkeeping, reconciliation and reporting. This technology will not solve all problems for administrators, since many functions cannot be automated. Although standardization of data and information are needed, customization of services will continue. Thus, administrators must continue to improve manual processes, such as spreadsheets, to remain competitive in an industry under pressure to provide not only fast but also accurate service in basic tasks such as NAV calculation.

As alternative investment funds grow in importance, fund administrators will need to continue to strengthen their operations, product set and global footprint. They must strive to retain experienced staff and recruit new professionals, continue to develop advanced technology, provide robust processes and perform with a boutique mindset while supporting even the biggest of clients.

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