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Protecting Human Assets

Hedge fund experience at a premium

By Elise Coroneos

As the number of hedge funds needing third party service providers has increased over the past few years, these same service providers have found it increasingly difficult to locate skilled people with experience specific to the industry. This has resulted in what some are calling a skill gap.

The shortage of people with experience in servicing hedge funds is now being further exacerbated as the industry moves into more complex instruments and structures, of which even those with direct experience servicing hedge funds find it difficult to stay abreast.

"The difficult thing in this business is locating and training quality people," says Frank Franiak, a partner at Chicago-based Customized Accounting Solutions. "It is a problem that almost all the service providers are having."

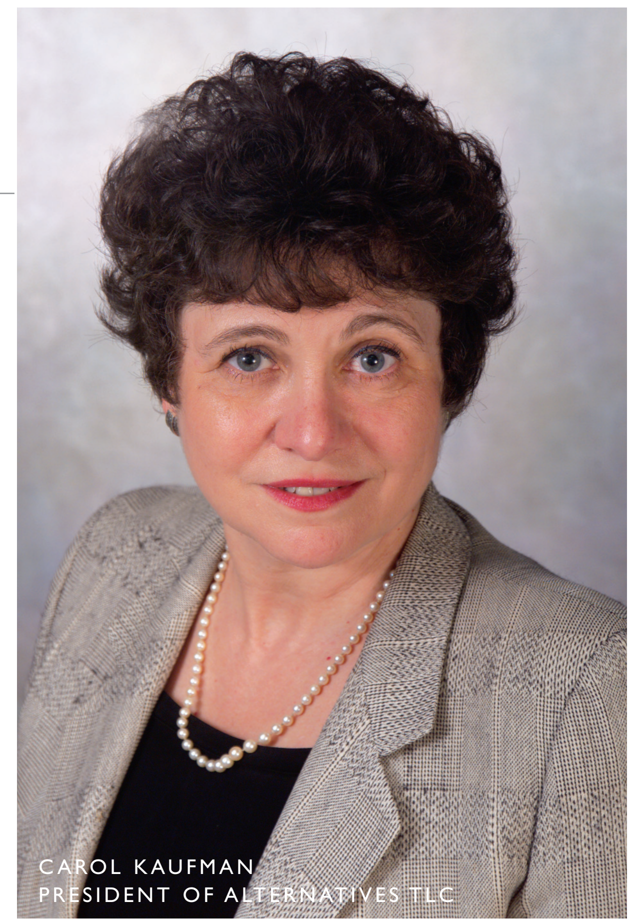
The difficulty in finding skilled people is due to the ever-changing and complex nature of hedge fund structures and increased demands from investors, says Franiak, whose firm began providing hedge fund accounting services in 1977 and now services more than 100 funds with assets upward of $9 billion.

"We are finding that funds are getting more complex in terms of the instruments they trade, the strategies and more creative structures they use such as segregated portfolio companies and side pockets, the more unusual fee structures with different kinds of hurdle rates and more exceptions to fees," says Franiak.

Hedge fund investors have also played a part in the drive by service providers to maintain a skilled workforce. This is because the increasing demands investors put on hedge funds to meet due diligence requirements find their way to the service providers' doorway.

"Even four of five years ago, we rarely heard from investors or potential investors of funds that we work for, but today it is a pretty frequent occurrence to get calls from investors asking due diligence questions," says Franiak. "Back then we got a call or two every few months, whereas now we get several calls every week."

Another factor putting pressure on service providers such as administrators is a trend toward more domestic funds seeking the services of administrators—a 34 ▶



CAROL KAUFMAN
PRESIDENT OF ALTERNATIVES TLC

Ettore Paratore, portfolio manager of Harmony Asset Management Ltd. See review of the fund-of-funds manager on page 14.

New Horizons

The ever emerging trading edge

By Patricia Ward

Seeking to hone their competitive advantage, some pioneering trading advisors are looking to markets off the radar screen of many of the more established players. São Paulo-based Orbix Global Partners, London-based Beach Horizon and Chicago-based Calyon Financial are finding opportunities in some of the world's more interesting emerging futures markets.

For a long time, Russ Rausch, Calyon Financial's head of e-brokerage sales for North America, watched equity investors capitalizing on emerging markets opportunities. Over the last three to four years, however, he has seen more and more futures traders exploiting these opportunities, especially since Asia began making its comeback.

"Emerging markets are moving and growing quickly, so getting in early can be an asset," says Rausch. "However, there are always pros and cons and fund managers have to consider their tolerance for risk and returns volatility before entering these markets."

To exploit such markets, Orbix launched its systematic trend following Orbix Emerging Trends CTA program in April 2003. This focuses solely on emerging-markets-dedicated trading advisor products.

The program can trade 15–20 positions in currencies, interest rates, sovereign debt and stock indices. At present, its focus is on Brazil, but as assets grow, the program's developer Alexandre Bourgeois is also looking to trade in Russia, India and China.

Beach Horizon's first fund is also seeking to capitalize on Asian opportunities. Launched in May, Horizon Fund Ltd is up over 11% to end-September.

"We already trade products in Japan, Singapore and Hong Kong and would potentially like to gain exposure to many more diverse markets," says Beach 34 ▶

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◀ 1 service that was previously used mainly by offshore funds.

"We are seeing a definite trend toward full administration even for domestic funds, which can only lead to even more demand for outside administrators and hedge fund accounting services than is already the case," says Franiak.

A scarce resource

With so many financial conglomerates intent on growing their hedge fund capabilities, the need to protect the capabilities they already possess has become a necessary part of the game plan.

As a result, service providers now find it necessary to protect not only their hedge fund clients, but also their workforce from potential poachers.

"There are some skills that are readily available and transferable from other areas of investment banking both front and back office, but some are unique to the prime brokerage business of servicing hedge funds," says Dick Del Bello, who heads prime brokerage in the Americas for UBS. "That is more of a scarce resource and a more competitive resource for us to go after."

According to Del Bello, accounting and relationship management are two areas in which it can be difficult to find people with experience and skills specific to hedge funds. "You typically either train folks yourself or you have to find people who are not happy where they are and bring them over."

UBS today services some 750 hedge funds, up from 210 funds in December 2003. To adequately serve this vastly increased number of funds, UBS has increased its prime brokerage workforce to more than 300 people in the US and about 435 worldwide.

Other areas of hedge fund service have experienced similar growth. For example, HSBC Alternative Fund Services has tripled its assets under management and staffing levels since its acquisition of the Bank of Bermuda in 2004. Sources at HSBC say that the firm's New York-based alternative fund servicing unit has grown from around 60 people prior to the acquisition to some 250 today.

An industry concern

An increasing demand for people with experience in servicing hedge funds is not confined to the US. A salary survey by London-based Morgan McKinley released in April this year found that the average salary for a person with zero to two years experience working in hedge fund operations to be as much as £25–32,000 ($45–57,000). Someone with eight or more years experience can except to be compensated £65–100,000 ($116–178,000).

"This is significant money for people with not a lot of experience," says Carol Kaufman, head of Alternatives TLC. "It demonstrates that skills specific to serving hedge funds are really in demand and if you want someone with experience you have to be prepared to pay a premium price."

Kaufman formed Alternatives TLC earlier this year to train and inform those wanting to enter the hedge fund industry, particularly in the area of accounting and compliance. She says she saw a skill gap in the hedge fund industry that she believes could hold back its further development.

> It often seems that there are not enough people with the correct skills and the turnover is very high.

According to Kaufman, a capacity issue in the hedge fund industry will be the result not so much of a dearth of good hedge funds, but rather a dearth of well-trained hedge fund accountants able to strike proper net asset values.

"Because there are new fund structures being invented almost every month, knowledgeable hedge fund accountants are in high demand and are being poached from firm to firm," she says.

Kaufman is not new to starting companies whose aim is to service hedge funds. Before launching Alternatives TLC, she had developed InvesTier, a hedge fund and fund-of-funds investment accounting solution, then sold it to Sungard Investment Management in November 2002.

"The ways that fees can be calculated and passed on to investors are becoming very complex," she says. "So regardless of the technology used, people need to understand the underlying methodologies or they will never know if things are being calculated properly."

To help in the process of striking correct valuations and fee calculations, Kaufman also believes it is imperative that hedge fund accountants know how to read offering memorandums and make a habit of working more closely with auditors and attorneys when funds are being formed.

"Unfortunately, many offering memorandums are not specific enough with the detail of how to calculate valuations, including the fee calculations," says Kaufman.

"The attorney and auditor must get together at the onset of the fund to discuss and agree upon valuations and fee calculation methodology so the accountants know the correct rules to apply."

An effort to improve the skills of hedge fund accountants and increase the number of skilled accountants generally is a move supported by many hedge funds.

According to one hedge fund manager contacted for this article, a real need exists for better communication between prime brokers and administrators. "It often seems that there are not enough people with the correct skills and the turnover is very high," he says.

The New York-based manager, whose hedge fund operation has been in business for about five years, invests approximately $400 million in funds and managed accounts across mortgage derivatives, market neutral and fixed income strategies.

"From our point of view, consolidation of functions would be a good thing," says the manager, who admits that the firm has at times been less than satisfied with the performance of its service providers.

"Although senior management has made an effort to improve its service, what we want to see is for them more thoroughly to train their junior people and then retain them," he says.

Elise Coroneos is a financial journalist based in Sydney.

◀ 1 Horizon's co-founder and partner Sanjeev Lakhanpal. "For example, we are watching developments in India and China."

Obstacles and opportunities

Even though Futures Commissions Merchants such as Calyon Financial can help traders in developing markets deal with evolving regulatory issues, technical system reliability and compatibility, and requirements to take on local partners, Rausch warns that these markets can still be difficult for trading advisors to access.

"For instance, you can't currently trade the Chinese futures markets from outside China," he says.

Korea, on the other hand, can be accessed by outsiders. Calyon Financial has direct electronic access to the Korean stock index futures and options markets and has customers who actively trade in these markets.

As BRIC exchanges are not electronic, traders have to be prepared for less price transparency, less anonymity, a less level playing field between the on- and off-exchange market participants and reduced possibilities for very high frequency trading.

> Brazil will get to be boring, but it is going to take another 30 years, I hope.

Nonelectronic exchanges also bring more possibilities for human error. However, Bourgeois points out that the human element can also be advantageous. "We have a guy trading for us in the Brazilian Mercantile & Futures Exchange pit," he says.

"He can give us a lot of very good information on the flow on the floor, thus allowing us to have much better execution, and add to our high level of local knowledge. This knowledge is crucial when trading less highly regulated and transparent emerging markets and gives us a tremendous edge."

By comparison, he finds that in the US and Europe, information is accessible to everybody, but that is not the case in Brazil. "In Brazil, the current trading environment is rather like that of Chicago during the 70s, when many big CTAs made a lot of money," says Bourgeois.

"Brazil will get to be boring, but it is going to take another 30 years, I hope."

A further point: While there may be a lot of money to made trading on emerging markets exchanges, trades can be relatively expensive in terms of price and time.