Risk vs. cost:
How hedge fund managers can engage the right mix of internal, outside and shadow administration
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Hedge funds are back. Total assets under management (AUM) have strongly recovered and are already higher than they were in 2007. In addition, many new funds are launching, particularly smaller managers with AUM of under $100 million. At the same time, managers are feeling pressure to cut fees, while compliance and regulatory costs continue to increase dramatically—and could rise by as much as 20% over the next three years.

**A real opportunity to manage costs**

Emerging funds are looking closely at how best to meet regulatory requirements without overspending. Top of mind: **fund administrative costs.** For efficiency, most funds engage a third-party administrator to manage and maintain all or part of their books and records, while also keeping in-house resources to shadow the outside resources. Because of the expense of duplicating these tasks, each fund must make a decision as to where they fall on the spectrum of cost versus risk when engaging the right mix of resources.

“Large multibillion-dollar hedge funds often use a different model, which includes both an outside administrator and a full in-house shadow function that completely duplicates the outside administrator’s work,” comments Michael Patanella, National Asset Management Sector Leader. “Although much costlier, the resulting risk reduction means this is a trade-off they are willing to make.”

Says Kristin Castellanos, global head of product management at Deutsche Bank Fund Services: “Fund managers who adopt a full in-house shadow approach often find that having a dedicated team under their roof helps to align fund operations and portfolio management. The downside is scalability; there is a fixed cost associated with this approach that may be problematic in periods of declining assets.”

Adds Patanella: “Funds who opt to use this model should consider that costs may be allocated to the fund group as a result, rather than the management company. Such a shift in fee structure may require a conversation with investors, depending on the fund’s governing documents.”

For the large fund, another advantage is the ability to exactly duplicate the administrator’s work, ensuring the accuracy of trading data, portfolio management, regulatory compliance and investor communications.
Emerging managers won’t have the same budget options as a larger fund, so a well-considered administrator choice is one of their most important decisions. An administrator with a flexible technology platform may allow an emerging manager to leverage external analytic tools that they might otherwise have to source themselves. There is also an opportunity to maximize the budget by selecting an administrator that can provide bundled services such as regulatory reporting and/or depositary services. Administrators that have invested in a consolidated technology platform should be able to repurpose data and provide these services at a lesser cost than an additional provider, which has to duplicate the administrator’s books and records. “Leveraging a third-party independent administrator can help emerging funds achieve economies of scale,” comments Fred Jacobs, managing director of global business development for alternative investments at SS&C GlobeOp, a fund administrator. “At the same time, third-party administrators can improve the manager’s ability to set themselves apart in an environment of stringent investor and regulatory due diligence requirements.”

Evaluating your operating model
Emerging funds have usually grown quickly, with a heavy focus on sales and marketing. When the fund gets to a large enough level, it’s a good time to take a fresh look at administrative costs, agreements and structures. To guide the evaluation process, consider the following areas:

- **Administrative costs** — List all vendors and their costs.
- **Administrative data** — Determine how much of your vendors’ data needs to be collected and collated for investors and regulators (e.g., brokers, trustees, custodians, risk data providers and market data providers).
- **Outsourcing agreements** — Collect all agreements and develop a matrix based on costs and deliverables. Once you have a matrix in place, look for redundancies and cost disparities.
- **Deadlines** — Create a matrix of regulatory and/or compliance deadlines.
- **Mix of service offerings** — Once you are aware of your regulatory deadlines, ensure your vendors can provide the services you need to meet your growing regulatory obligations in a way that is cost-effective.
- **Data access** — List the dates (or real time) that investors, internal departments and/or external vendors need access to fund data.
- **Vendor qualifications** — Examine whether vendors are up-to-date with technology, processes, and communication deadlines and protocols.

This review process should reveal some key changes that need to be made to keep costs low and risk at a level acceptable for your fund.

“This developing a cost-efficient model means determining what to keep in-house, what to outsource and what to shadow (do both). Finding the right mix for your fund reflects the needs and preferences of your leadership team, your investors and regulators — in the end, investors and regulators will examine whether the fund is maintaining the right amount of oversight to keep risks at a manageable level.”

*Michael Patanella, National Asset Management Sector Leader*
Important functions to shadow
For any fund that uses outside administrative vendors, there are important functions that should also be shadowed by internal resources. Again, every fund must find their own comfort level with shadowing outsourced tasks, but here are some that should take precedence:

- Subscriptions and redemptions
- Asset valuations
- Regulatory compliance
- Cash management
- Risk management vendor oversight
- Collateral and margin management
- Foreign exchange hedging
- Portfolio rebalancing
- Reporting for profit and loss, position and risk reporting (intraday and end of day)
- Internal analytics

Says Castellanos: “Independent verification of investor-facing processes is one of the most vital aspects of shadowing an administrator. Of all of the reasons cited for moving to a new administrator, few are as widespread as dissatisfaction with a transfer agency or investor services. When an administrator miscommunicates or mishandles communications to a fund’s investors, it sends a poor message regarding the professionalism of not only the administrator, but the investment management team as well. By shadowing investor processes (or obtaining transparency into your administrator’s transfer agency records on a dynamic basis), an investment manager can monitor this important function before an error or miscommunication creates a situation.”

Peter Sanchez, CEO of Northern Trust Hedge Fund Services, agrees: “A good way to think about what to shadow is by asking yourself, ‘What is most important to my investors?’ For example, investors increasingly demand independent valuations, which suggests outsourcing. But if you have complex or illiquid assets, you may feel a shadow or independent check is necessary because you need to make sure those valuations are right. Conversely, you wouldn’t necessarily need to shadow the compliance testing, as long as you have the right technology and can demonstrate to your investors that you have sufficient oversight with regard to monitoring of risk, investment strategy and leverage.”

“So much of financial reporting today is automated,” adds Patanella. “If you are a CFO or CCO, you can’t simply revalidate an administrator’s work in Excel. Shadowing can provide an additional level of comfort for both the C-suite and the investors.”

Choosing the right outside administrator(s) for your fund
Once you’ve taken a fresh look at your administrative cost model and evaluated the high-priority areas your fund should be shadowing, it’s time to take a look at current vendor relationships and choose the best fit. Cautions Jacobs: “Choosing the right administrator can provide the accounting, reporting and compliance support a fund needs to boost investor confidence and free the firm’s principals to focus on developing alpha-generating investment strategies. However, choosing the wrong administrator will increase strain on limited internal resources and may affect your ability to attract assets.”
Jacobs also notes: “For most funds, typically the first step when selecting an administrator is getting referrals from other managers and auditors to create an initial list of three to five strong possible matches. Next, managers set up an initial meeting to get a sense of the administrator’s approach. Following this initial evaluation, the manager typically narrows the focus on two administrators they feel are the best fit for the fund’s strategy. The final decision revolves around three key external factors: (1) the amount of technology and staff the manager has in-house and how the administrator can supplement it, (2) the type of investor the fund is seeking to attract as it grows, and (3) the complexity of the fund and the ability to manage this complexity in-house.”

Here are some important questions to consider:

- **What specific tasks will you outsource?** Each task has a cost that may differ significantly between in-house and outside vendors, which must then be weighed against any potential risks. “Anything performance-related — anything operational that touches alpha-generating decision-making — is something you are going to want to take ownership of,” says Sanchez.

- **What capabilities will work best for your fund?** Matching the administrator size with the fund size can ensure you get high-priority attention. This should be evaluated carefully, as some large administrators have services focused on emerging funds. “Generally, when a fund launches, you need an administrator that can offer an integrated front- to back-office solution plus regulatory reporting, because you’re capital limited,” explains Sanchez. “When your fund starts to grow, that is when you bring those close-to-alpha processes, such as portfolio rebalancing and rebate optimization, back in-house. A mature fund needs an administrator with strong data aggregation and data management capabilities. So it is all about the life cycle of the fund.”

- **How can you assess the administrator’s quality?** How are they ranked against their competitors? Can they provide references? Have they faced any regulatory issues or been sanctioned?

- **What technology is the administrator using to streamline operations?** Are they using the most advanced technology? Can they provide a real-time dashboard? Are vendor systems fully accessible to in-house personnel? Can fund managers access real-time information, such as analytics, system-generated portfolio stress tests and risk measures? Are their systems structured around a central data set, or are multiple data sets and internal reconciliations required?

- **What communication protocols/customer service policies are in place?** How does the administrator communicate? When and how are they available to in-house staff and customers? Who are their designated contact points? How often will you meet to evaluate performance? Does the service team really understand your business and operational needs?

- **What other criteria is important to your fund?** Evaluate your needs carefully — some examples might be: Is there a cultural fit? What resources does the administrator have to step in when there is a disruption in your staff or business? Do the administrator’s strengths fit your strategy and product set?

Once you’ve chosen an administrator that fits well, it is important to work closely to meet your needs, as well as those of your investors.
The balance between cost containment and risk reduction is a living proposition. It should be examined regularly to ensure that costs remain at an acceptable level. Investors need access, transparency and demonstrated risk levels that provide a comfort level that keeps their investment with you.

“When choosing your service partners, it is vital to consider the long-term relationships you are building,” advises Castellanos. “Partnering with vendors that have comprehensive service offerings and allow you to leverage a flexible technology platform are key. Although there is no one model that will fit every client, gaining transparency into fund books and records, both on the accounting and investor services side, is critical to deciding whether you choose to monitor your administrator or fully shadow, either internally or externally.”

Funds who are looking for an alternative to shadowing the administrative function may also want to consider engaging an outside service provider to complete a Service Organization Controls (SOC) 1 report, to evaluate the internal controls relevant to financial reporting.

Many funds don’t have the resources to evaluate the best structure and vendors. If you have questions about outside evaluations, find out what Grant Thornton LLP can do for you by contacting one of our professionals.
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