

By Deborah Brewster in New York, Financial Times
Published: Jan 14, 2008

FT REPORT - FUND MANAGEMENT: As hedge funds swell so do demands on brokers

A big factor behind the rapid growth of hedge funds has been the fundamental change in who invests in them.

Before about 2000, investors were mostly high-net-worth individuals. Since then, a big wave of institutional money - from the pension funds, endowments, sovereign wealth funds - has flowed in.

With the floods of institutional money, the sheer size and complexity of hedge fund groups is much greater than before. That has meant changes in what the hedge funds need from their prime brokers.

As the funds become larger they look to prime brokers for a lot more than just stock execution. This means the big investment banks' prime brokerage divisions are in a stronger position to claim the business of the larger funds, they believe.

Alex Ehrlich, global head of prime services for UBS, says: "If you are starting or running a hedge fund that is active globally across markets and products, you will need to work with a bank or investment bank. Global prime brokers are being forced by the institutionalisation of the hedge fund industry to be strong across asset classes, countries, and products.

"By definition, one cannot be a niche player and deliver across many different categories."

Jonathan Hitchon, co-head of global prime finance at Deutsche Bank, says: "Prime brokerage has evolved a lot over the last 10 years . . . there has been an ongoing concentration of wealth (350 funds control 85 to 90 per cent of the capital under management) and the big funds are the biggest drivers of change.

The larger funds have outgrown prime brokerage in the purest sense and look upon it as financier, providing leveraged financing.

"As funds have become more sophisticated and more institutional, they have become very demanding at the financial institutional level, they look at how you are as a bank, how sophisticated you are in equity derivatives, and geographical diversity."

Barry Bausano, co-head of global prime finance at Deutsche Bank, says: "Managers have a renewed focus on platform stability, a global universal bank with a large and robust balance sheet, high and stable credit rating with access to a deposit base as well as central bank liquidity facilities."

The hedge funds also want much more detailed information about their trading positions, along with valuation of derivatives and risk analysis.

Steve Vermut, managing partner of Merlin Securities, says: "They need the information because the investors are institutions, and institutions need answers to questions.

"For example, say the hedge fund is usually up by 1-2 per cent a month, and it is suddenly up 6 per cent in a month. Before about 2000 its high-net-worth investors wouldn't ask any questions; they would just think the fund had a good month. Now institutional investors ask: what happened? The fund needs to be able to consolidate its data and track risk and returns and source the returns much more quickly and in detail for its investors."

Many brokers are using technology as a selling point, in part to address this need.

Sal Ventura, the head of the global prime services business development group at Credit Suisse, says: "The more traditional hedge fund client has a growing appetite for transparency. This summer has shown that up. Clients were much more demanding about getting detailed information from their providers.

Credit Suisse had made a "significant investment" in its Advanced Prime Suite technology platform because of this, he says.

"Previously prime brokers used their own technology and locked the client in. We've tried to give the clients the technology to put on their desktop; it allows them to multi-prime."

The product allows the fund to see execution, order management, middle and back office functions and portfolio accounting, he says.

"The funds have many more end investors interested in risk profiles and what the underlying assets are. Risk analytics is something we do a lot more of now."

However, Mr. Ehrlich at UBS makes the point that in spite of the growth of hedge funds, the business remains driven by personal relationships and referrals.

"More and more hedge funds are becoming like institutions. They are no longer eight people in jeans in a small office. They may be a client of the investment bank in 15 different places - for fixed income products in Russia, equities in Brazil, currencies or commodities somewhere else; they expect best-in-class service across all 15 different parts of the firm.

"But they still tend to be run by one or two people at the top of the firm who are accustomed to having a relationship with senior management at the most senior level of the investment bank. So much as you need to have execution and technology, you ultimately need the relationship to work effectively at those senior levels to properly service the client.

"Prime brokers need the ability to act in a bespoke manner.

"If our goal is to be best in class, then we need to respond in a manner that reflects that, and clear the path for clients to do the more complex and sophisticated transactions that are harder to do," he says.



Most prime brokers report that during the period of the credit crisis last year they received many more calls from clients wanting reassurance about the prime brokers' balance sheet and financial security.

However, the growth in recent years of using many prime brokers rather than just one has acted to diversify the risks of hedge funds.