



## To Attract Institutional Capital, Hedge Funds Need IT Edge

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Securities Industry Blog, March 10, 2010

Today's hedge fund industry is a different animal from three years ago, before the financial crisis hit. In a *Pensions & Investments* ranking this month of hedge funds with at least \$20 billion in assets, J.P. Morgan is still at the top, with \$53.5 billion. But some familiar names have disappeared, including Goldman Sachs Asset Management, Renaissance Technologies Corp., and Citadel Investment Group.

The top firms, after JP Morgan, include Bridgewater Associates in second place (assets: \$43.6 billion) and Paulson & Co. in third (\$32 billion).

There's a reason Bridgewater ranks so high: all of its money is managed for institutions, which is where the industry is finding growth right now. Paulson has nearly \$22 billion in institutional money, right behind Bridgewater.

P & E notes that institutions have become hedge funds' most loyal investors and also that they have been adding to their hedge fund portfolios in the last year.

The report reinforces a March 9 front-page *New York Times* story which said public pension funds are shedding stocks and adding riskier investments like hedge funds to their portfolios, to make up for ground lost during the credit crisis.

That's good news for hedge funds – at least, for those able to meet the increasingly rigorous standards of institutional investors in critical areas such as risk management, transparency and operations.

“Raising and retaining institutional capital without the ability to articulate and differentiate your business makes is next to impossible -- and the barrier is only going higher,” says Ron Suber, senior partner and head of global sales and marketing at Merlin Securities, a privately-held prime-brokerage services provider.

In an interview, Suber discussed a checklist he has designed to help hedge fund managers understand and articulate their edge to desirable institutional investors.

High on the list of necessities, he says, is the need to provide institutional quality infrastructure.

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“Institutional quality means, quite simply, that regardless of the size of your fund, it is run in a manner that constantly adheres to all best practices,” he says. “This includes having an empowered compliance consultant or internal CCO, retaining reputable third-party administrator and tax/audit firm, outsourcing your [information technology] --complete with disaster recovery and multiple levels of redundancy -- as well as defining and enforcing strong trading and operational policies and protocols.”

When it comes to outsourcing IT, Suber says it is increasingly necessary for hedge funds to locate their business operations “in the cloud” – because “you need to be mobile and able to operate your business anywhere, given the circumstances of managing money today.”

The days of sitting in an office with a desktop computer and a physical hard drive backup are over, he says.

Hedge funds need to showcase their performance using the full range of quantitative measurements, according to Suber.

“Institutional investors are more advanced than ever, so be prepared to offer them the data and analysis of their choice,” he says. At a minimum, he advises, be able to provide the following:

Risk gauges (delta and beta, adjusted with implied volatilities)

Daily exposure detail, since inception

Alpha over custom-blended benchmarks on long and short positions

Asset allocation versus stock selection criteria

Concentration, liquidity and leverage statistics

Volatility

Attribution, both absolute and relative.

Hedge funds seeking institutional capital also need to operate in a multi-prime and multi-custodian environment, he says.

The days when a fund larger than \$75 million could use only one prime broker or custodian are over.

“Institutional investors require, for good reason, that managers mitigate their counterparty risk by using multiple primes and custodians. Further, some institutions

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choose the prime broker and require that a true custody bank retain at least a portion of the cash and fully-paid-for assets under management,” he says.

“If a hedge fund only uses one prime broker, they have only one source to borrow securities for securities lending,” he says. “When you want to go short, you need a second supply to borrow from.”

What is the biggest IT challenge for even the largest and most sophisticated players?

“The hardest part is aggregating all of your assets,” he says, “and having perfect information and real-time P & L to trade and understand your risk in these volatile times.”