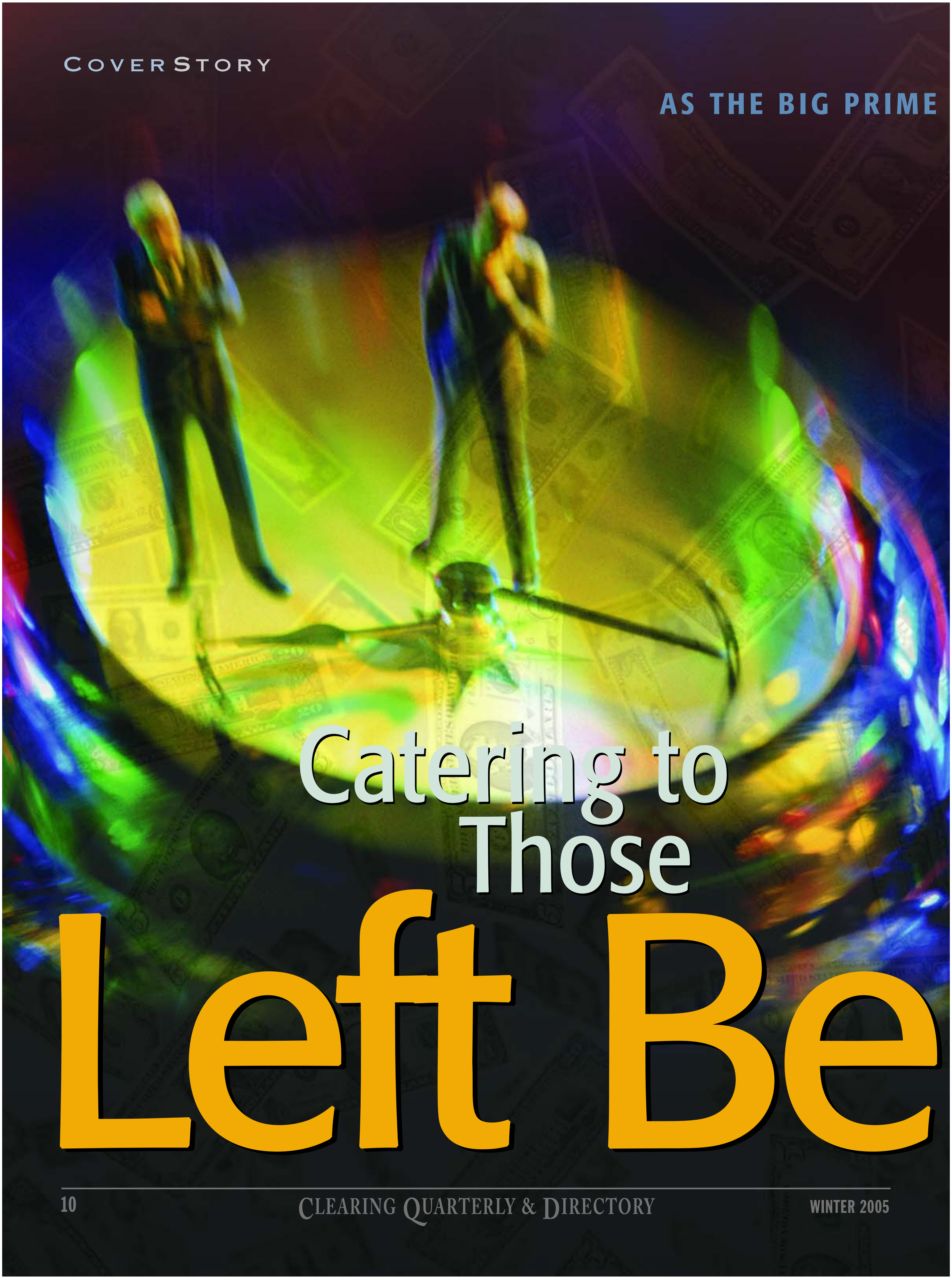
AS THE BIG PRIME



Catering to Those Left Be

hind

BROKERS FACE HEDGE FUND OVERLOAD, THE MINI PRIMES ARE STEPPING IN TO FILL THE VOID

| by John Hintze

How many mini-primes can the hedge funds take before funds are fully primed? Given the lack of hedge fund industry data, an answer to that riddle would surely win a consultant some attractive fees. Absent that data, however, hedge fund service providers are stepping into the unknown alongside their risk-seeking customers, and the mini-primes are no exception. In fact, the mini-primes–broker-dealers providing prime brokerage services to small and midsize hedge funds–are probably taking even greater risks, since their fund managers are often greener and less likely to have perfected a reliable investment strategy.

Mini-primes, however, are forging uncharted territory, and the excitement of exploring a new market is palpable. Some see a boundless supply of new customers, whether that means hedge fund managers breaking into the business or hedge fund castoffs that aren't meeting the revenue minimums of the major prime brokers.

"It's the only market with room for expansion," says Brian Villante, CEO of Grace Financial, a Long Island-based mini-prime. He adds, "Publications always talk about 7,000 or 8,000 hedge funds out there, but I think they're missing 25% to 50%. There are a lot of funds using retail stock brokers and not prime brokers because they don't think they're big enough yet."

Others are more cautious in their appraisal of the market, and they're seeking to carve out often technology-based niches that will lure hedge fund managers to their platforms for the long haul. Merlin Securities, for example, has set its sights above the small fry and is aiming its services, including a sophisticated proprietary reporting system, at midsize hedge funds that fear getting lost in the crowd at a major prime broker.

"Everybody [in the prime brokerage business] has either gone upstream to compete for the top few hundred hedge funds, or they service the low end because you don't need a big investment to do that," says Steve Vermut, who launched Merlin's services in the spring and has already aggregated more than $1.4 billion in hedge fund account assets, with the average fund size at $55 million and the largest at $450 million.

Either way, there's consensus that the hedge fund market will continue growing in terms of assets under management, and the question is how much. TowerGroup, for example, estimates hedge fund assets totaling $1.2 trillion in 2005, up 20% from last year.

"Hedge fund managers are already saying it's closer to $1.3 trillion," says Matt Nelson, an analyst at the consulting firm. "We're predicting 15% annual growth, with total assets topping $2 trillion by 2008."

Nelson forecasts, however, that much of that growth will come from institutional money, and that increasing regulation of hedge funds in the U.S. and U.K. alongside a "general distain" for hedge funds in countries such as Germany, Hong Kong and Canada will put pressure on smaller funds.

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Steve Vermut

"We'll see more concentration of assets among big players," Nelson says.

Even so, new hedge funds will inevitably emerge. The biggest prime brokers, led by Morgan Stanley, Bear Stearns and Goldman Sachs, still take on promising smaller funds, although in limited numbers since they have concerns about overextending their prime brokerage platforms, especially in terms of personnel to service customers.

Beyond staff support services, their platforms provide fundamental functions such as clearing trades, and margin and securities lending. Those functions are also offered by the major prime brokers' correspondent clearing affiliates and other clearing firms catering to the mini primes. The mini primes provide the clearers with a back door into the smaller hedge fund arena. In this model, the clearers provide most of the clearing and financing-related functions, tapping revenues stemming from the trading activities of their mini-primes' customers, while the mini-primes provide the high-touch service plus whatever other specialties they can build on top of the clearing platform.

Clearing firms unaffiliated with the major prime brokers are also opening that back door. Those clearers include Penson Financial, Wedbush Morgan and, reportedly Pershing, the largest clearer in terms of broker-dealer customers. Two other sizable clearers acknowledge, off the record, that they are eying the sector, with one adding, "We don't support this in a big way yet. Give us six months and we'll have a better story to tell."

Wedbush Morgan ventured into the space nearly three years ago, according to Harvey Cloyd, vp at the firm, by building a group of executives that focus specifically on emerging professional traders and hedge funds. "We decided we don't have to be a Goldman Sachs.

We can be experts and focus our energies both from a broker-dealer perspective and a clearing perspective on servicing emerging clients," Cloyd says.

Cloyd says Wedbush Morgan acts as a prime broker to emerging hedge funds directly, and it also clears for some mini-primes, although he did not provide any names. He describes the mini-primes' allure as providing hedge funds with support services to better take advantage of the clearers' platforms, including trading and clearing systems, online profit and loss reports, securities lending, and the ability to execute away from the broker-dealer.


David Prokupek

Penson, on the other hand, says it doesn't solicit direct prime brokerage business, although it does take referrals, so as to avoid the appearance of conflicts of interest with its mini-primes. Doug Throckmorton, a vp at the Dallas-based clearer who runs its prime brokerage business, says the firm has "seven or eight firms either involved in or intending" to pursue mini-prime brokerage business. In addition to the fundamentals, Penson provides mini-prime correspondents with its own direct-access platforms to equities, futures and options markets, or connectivity to third-party ones, as well as easily customizable access to trade-related data.

Regional clearers, however, face the challenge of less name recognition in the hedge fund community and, more importantly, among the institutional investors, which are expected to provide the bulk of hedge fund capital in the future. "If a hedge fund puts in its offering papers that its fund administrator is Citco and its prime brokers are Goldman Sachs and Morgan Stanley, then it looks a lot better. The same principle applies to clearers," Nelson says.

Some mini-primes, recognizing that advantage, have purposely sought a brand name clearer to run their back offices. Grace Financial, for example, touts Goldman Sachs Clearing & Execution. "A smaller fund manager looking through a broker is going to have a more difficult time marketing themselves as a real money manager. We feel we can offer them a clearing house that gives them an extremely reputable name," Villante says.

Others have emphasized the other great allure: rock-bottom prices. Montecito Advisors, with about a dozen registered reps, used to split its business between supporting registered investment advisors and a mini-prime brokerage. The IRA half clears through Fidelity's National Financial, while the mini-prime business cleared through Refco, until Refco imploded in October following revelations of its CEO's fraudulent activities. Elie Genadry, chairman at Montecito Advisors, said in mid-October that Refco had recently sent an abrupt email saying it was no longer accepting purchase orders, and that Montecito Advisor's prime brokerage customers had since sought other homes.

Genadry says Montecito Advisors chose Refco for its low costs–half of some competitors, he estimated–which could then be passed on to its small and midsize hedge fund customers.

Refco had started up its clearing business over a year ago, and apparently it offered low prices in a bid to attract business. That business comprised around 10 correspondents before the firm's collapse, according to the NSCC.

"A lot of people want to get into [mini-prime brokerage] because it can be good business if you already have an infrastructure in place–compliance, accounting and those things."

Penson's Throckmorton acknowledged picking up at least a few of those correspondents.

There's little consensus on the number of mini-primes plying the hedge fund market for business, in part because many of the broker-dealers are new to the business and testing the waters. Like Montecito Advisers, the prime brokerage activity may take up only a percentage of their activities. At Denver-based Geronimo Partners, prime brokerage only makes up 10% of the firm's business.

"A lot of people want to get into [mini-prime brokerage] because it can be good business if you already have an infrastructure in place–compliance, accounting and those things," says David Prokupek, principal and founder of Geronimo Partners and the former head of capital markets at Tucker Anthony Sutro before it was sold to the Royal Bank of Canada.

Geronimo Partners clears through Bear Stearns, which appears to be the most successful clearer in the mini-prime brokerage arena, with more than 10 such correspondents. Prokupek says that the firm's Denver location has offered a type of market niche since none of the major prime brokers have offices in the region. Geronimo Partners is still growing the business "opportunistically," says Prokupek, but the "bloom may be off the rose a bit" for mini-primes that still harbor high hopes.

"At the end of the day, there's a somewhat high failure rate among smaller hedge funds, so it costs you money to handle someone for a year and you may not really make any profit," Prokupek says.

He adds that Geronimo is no longer applying the same sales effort to garnering new clients that it did a year ago, partly because mini-primes face an inevitable dilemma.

"The smaller clients need to grow pretty fast, and when they do they're going to end up going to a big guy, and if they don't they may not end up being great business," Prokupek says, adding, "For us, we're seeing more growth in some other businesses, so we're shifting our resources."

Other firms must accept that dilemma and work with it, or try to minimize it. In the case of Grace Financial, which focuses on the mini-prime business, it recently lost a client managing $280 million in assets to its clearing firm's prime brokerage affiliate–painful, but also a sign that the mini-prime is doing something right. Such mini-primes tend to market themselves as a mixture of market expertise and hands-on service to support their customers' growth. They also highlight their own special strengths.

"We pride ourselves on having agency-only execution, and on the fact we have a lot of venues to get orders done," says Villante.

"We decided we don't have to be a Goldman Sachs. We can be experts and focus our energies both from a broker-dealer perspective and a clearing perspective on servicing emerging clients."


Harvey Cloyd

Villante notes the five-year-old firm's trading desk supplements a menu of direct market access systems with experienced traders that can lob phone calls to desks around the Street to complete large or complex trades in investments, ranging from securities to futures to foreign exchange.

M.S. Howells & Co., on the other hand, is well known for its research capabilities, especially in areas including energy, biotech and software. Half its business is "boutique prime brokerage," and the rest is servicing larger institutions. Scott Pollak, the firm's managing director, points to the broker-dealer's research capabilities and notes that prime brokerage customers can prompt M.S. Howells' analysts to do proprietary research for them as well as talk directly to the director of research–services that even the biggest hedge funds may not have available to them through their major prime brokers. Pollak says, however, that the firm doesn't want to be pigeon-holed as mainly a research shop.

"A lot of prime brokers view the business as a financing opportunity. We look at [prime brokerage clients] as institutional accounts, so we try to give them all the products and services an institutional fund would need," Pollak says. He adds, "We're more of an end-to-end solution provider."

That means providing trading solutions across asset classes and currencies, soft dollar accounts, and answering clients' marketing questions. M.S. Howells recently converted from Bear Stearns to Jefferies & Co., which reportedly is making forays into the mini-prime business. Pollak says Jefferies supplies Advent's portfolio accounting system, and M.S. Howells is in the process of developing proprietary technology to enhance that system, including new performance reporting and real-time portfolio management tools, "So clients can better understand where their portfolios are leveraged on an intra-day basis. "We want to be in the best of class in every solution."

That may be what it ultimately takes to hold onto clients for as long as possible. Merlin Securities' Vermut once ran the prime brokerage unit of Montgomery Securities, which, through a series of mergers, eventually wound up at Bank of America. It had a history of servicing midsize hedge funds and even large ones touching a few billion in assets that wanted strong technology without losing the personalized service. Merlin has similar aims, using Bear Stearns as its clearer and offering a sophisticated menu of services on top.

"A lot of our clients feel if they go with one of the big prime brokers, they'll get lost," Vermut says.

Vermut says Merlin aims to provide the same or better level of service than the largest prime brokers. For example, he brought the former head of Bank of America's stock loan desk over to act as an agent for clients' stock loan transactions. Merlin has an agreement to try Bear Stearns' stock-loan desk first, and if the order can't be filled it can look elsewhere, ensuring clients complete their trades.

Vermut also touts the firm's technology, which currently allows hedge fund clients to pour their portfolio data into just about any type of information bucket, enabling them to view portfolios by variables such as the fund management companies' analysts and fund managers, and the industries they are vested in. Once a client has chosen the buckets, Merlin can customize reports to meet the customer's specific needs.

"We can then provide them with alpha and beta views," says Vermut, noting, for example, that each manager can be measured by the risk in his or her portfolio and the portfolio's excess returns over the market.

Analyzing portfolios at that level of detail is a boon not only to the investment strategies of Merlin's clients, but a major plus in attracting and retaining institutional investors.

"If you're up 1% every month and one month you're up 3%, high-net-worth investors will call up and say, 'Great job.' But institutional investors will ask what happened: 'Why are you up 300 basis points instead of 100 basis points; did you take more risk?'" notes Vermut. He adds, "If you can't explain that, you're going to get fired."