As the outsourcing industry matures, a new type of relationship is emerging between hedge funds and service providers: collaboration.

“Hedge funds are looking for new models to create scale but maintain control,” says Jayesh Punater (pictured), chief executive of Gravitas, an outsourcing platform that provides cloud technology, collaborative outsourcing, risk support and research to the alternative investment industry.

“We have started working with larger clients to create a new model called co-sourcing. It will dramatically reduce the cost of technology and cut down on staff requirements, allowing hedge funds to scale their business while adhering to new regulatory and reporting requirements,” he says.

The key to co-sourcing, according to Punater, is that clients do not relinquish control of outsourced functions. Gravitas provides infrastructure, such as private cloud and data warehousing services, and staffs the operation. The client is involved in this hiring process. However, management positions, such as chief technology officer, remain in-house.

**Maintaining oversight**

This collaborative spirit allows hedge fund managers to delegate certain functions to third parties while retaining a level of oversight that will satisfy regulators and investors. For example, risk management and compliance is an area where managers are often reluctant to cede control. However, increased regulatory requirements such as Form PF in the US and the soon-to-be-imposed reporting obligations under the EU’s alternative investment fund managers (AIFM) directive have changed the game. In addition with the move to institutional investors, better risk reporting to shareholders is a necessity, not a luxury.

These developments, coupled with advances in technology to match the complexity of operations and counterparty relationships, have persuaded some managers to consider outsourcing.
“Gravitas offers risk as a service,” says Shyam Prakash (pictured), director of risk and analytical services. “It is based on a co-sourcing framework where the client and provider are involved in a much more collaborative manner than traditional outsourcing. Hedge funds want control of the delivery and services from the service provider but at the same time don’t want to sacrifice cost efficiencies or quality.”

Co-sourcing of risk provides control over the project and delivery at a competitive cost, says Prakash, as well as the ability to scale up or down depending on the business and the markets. As part of its risk reporting-plus offering, Gravitas provides customised risk reports by integrating IBM Algorithmics’ risk engine with Gravitas’s in-house risk technology.

Citi also offers risk management tools that hedge funds can adapt to suit specific needs, according to its global head of hedge fund services, Michael Sleightholme. For example, its investor transparency report provides information on risk measures including counterparty exposure and the amount of the portfolio that is independently priced and reconciled. The report can be sent directly to investors or it can be used in-house for general operational risk management.

More creative solutions

Service providers are also beginning to move beyond the back office. “Outsourcing providers have definitely become more creative [in recent years],” says Chris Momsen, executive vice-president of sales and solutions at Advent, which provides software and services to the global investment management industry.

“The service providers that we work with offered basic position-keeping at first and are now moving into really different value-added services such as collateral management and helping funds optimise their use of capital. There has definitely been a move from the back office to the middle and front-office areas of the business,” says Momsen.

Since Citi acquired its hedge fund-servicing business from Bisys Group in 2007, it has broadened upstream to encompass middle and some front-office functions, according to Sleightholme. “Much of the new business we are winning at the moment is being driven by those outsourced middle-office services,” he says.

Sameer Shalaby, president and founder of service provider Paladyne, believes this growing trend towards outsourcing middle-office functions has necessitated the more collaborative approach between hedge funds and service providers in recent years because of the need for more frequent contact.

“Middle-office services really support the front office so there needs to be much more integration and a tighter collaboration between the hedge fund and the service provider, often on a daily basis,” he says. “Before, it was a monthly activity to provide a fund’s net asset value [NAV] and
so this didn’t require a lot of interaction. But with middle-office functions [increasingly being outsourced], people are much more engaged and collaborative, even operating as partners.”

A service provider can essentially lend a hedge fund its expertise and experience, rather than making the commitment to hire and pay a person or a team to manage a function internally. However, these outsourced elements cannot simply be passed on to a third party and forgotten. Hedge funds are required by regulators as well as investors to maintain oversight.

“The fund or manager must knit a group of disparate, high-expertise team members with different technical areas of expertise into a functioning group that supports the firm and its unique aspects,” says Deborah Prutzman (pictured), chief executive of the Regulatory Fundamentals Group (RFG), which designs and implements business and risk solutions for alternative asset managers and institutional investors.

“The expectations of stakeholders in the hedge fund industry such as investors and regulators increased significantly [after the financial crisis]. Investors now want much more transparency and regulators want to ensure proper controls are in place to insure against a repeat of 2008,” says Gravitas’s Prakash.

Additionally, investors and regulators expect to be able to peer into outsourced systems and processes. During the due diligence process, management needs to be prepared for close inspection of its operations, including those parts that are outsourced.

In compiling a list of outsourcing best practices for its cloud-based risk management RFG Pathfinder platform, the company reviewed the requirements stated by a number of industry organisations and investors about how they view outsourcing when conducting due diligence.

“If a hedge fund is using a third-party service provider to value the underlying portfolio, for example, that’s an area where investors are much more likely to want to really understand the service provider’s internal controls and how they interact with the hedge fund,” says Prutzman. “At a baseline level they want to ensure that service providers that have access to the client’s funds, or could otherwise impact the assets or their value, are using the proper controls.”

Although regulators have not deemed outsourcing ‘good or bad’, hedge funds are expected to maintain close contact with any service providers for compliance purposes. “We tell all of our clients that you can outsource a lot of the heavy lifting in terms of building operations and technology platforms and so on but you can’t outsource the responsibility. At the end of the day, you’re still accountable as the manager and therefore you need to be able to demonstrate that you have appropriate oversight, visibility and control of your outsourcing provider,” says Citi’s Sleightholme.

Managers that outsource need to be able to demonstrate to regulators they are in control of and knowledgeable about the activities of any service providers with which they have a relationship.
Like many other service providers, Citi has designed its offering to allow for full visibility in this respect.

“Anyone who has outsourced to us is able to peer into what we do as if they were sitting next to us but electronically via the internet,” Sleightholme (pictured) says. “Clients are able to demonstrate that they do have control and oversight.”

The development of technology has underpinned these changes to outsourcing and how it relates to the hedge fund industry. Many believe technology will continue to effect change in this area.

Shalaby launched Paladyne in 2005 to capitalise on the increased need for technology to support hedge funds that were expanding their networks to include multiple third parties, particularly multiple prime brokers, in order to diversify counterparty risk. Paladyne provides clients with the means to communicate with a number of service providers and their various technology platforms.

The need for such technology has increased alongside the growth of outsourcing services. “With one prime broker, for example, you’re probably not going to get the best service or rates right across the board. It may be more expensive for you to trade Japanese equities with a certain prime broker, for example,” he explains.

“The more sophisticated hedge funds realised this early on and started adding second and third primes. Then small and medium-sized funds began to consider using that same model at a much earlier point in their lifetimes,” Shalaby adds.

Predicting that this would become the norm, Shalaby established Paladyne to provide a technology platform and operational support for such hedge fund networks.

The 2008 financial crisis and specifically the collapse of Lehman intensified this movement away from concentrating too much in a single counterparty or service provider towards diversification.

“Before the collapse of Lehman Brothers, hedge funds could rely on their prime broker for a lot of ancillary services – for nearly everything, really,” says Advent’s Momsen (pictured). “Once Lehman Brothers failed, it was no longer viable to allow your primary trading partner to provide middle and back-office services. The Lehman Brothers collapse was a catalyst moment that forced hedge funds to change how data and processes would be maintained internally.”

While she agrees that the financial crisis certainly played a role in encouraging hedge funds to spread risk by diversifying their counterparties and other key business relationships, RFG’s Prutzman believes “the increased
ability to communicate and the growth of intelligent technologies in the face of rapidly evolving requirements” has really pushed outsourced service offerings forward.

“The ability to outsource and the trend towards downsizing would have occurred anyway, because if you have a complex area and the ability to distribute the cost of maintaining information and developing systems across 100 or 1,000 clients, it just doesn’t make sense to build and maintain it on a one-on-one basis,” she adds.

Such thinking can also be applied to the most recent development in the outsourcing arena: cloud services. Developed as a cost-effective and infrastructure-light way to access information, cloud services can put the smallest of funds on a par with the largest when it comes to technology.

Fund managers can access resources provided by a third party via the cloud. Hence, costs are vastly reduced and there is no need to devote time and resources to building heavy infrastructure.

Paladyne, for example, operates data centres around the world so it can provide 24-hour coverage to clients. “It’s a huge cost structure and it would be very difficult for the average hedge fund to make such an investment,” says Shalaby (pictured). “But for us with the scale we have in terms of client numbers, we can certainly afford it.”

Many market participants view cloud services as the future for outsourcing, particularly when it comes to data management. Shalaby adds: “This is exactly how we see outsourcing evolving: specific cloud services offering certain business functions. For example, a managed cloud service offering to clean/complete reference data.”

Outsourcing enables hedge funds to minimise key person risk while simultaneously accessing economies of scale in terms of technology and other core back-office functions and, more recently, middle-office functions.

“I think you’ll always see a combination of insourcing and outsourcing at hedge funds and this will change throughout a fund’s lifecycle based on needs,” Advent’s Momsen says. “These guys are masters of risk and return, so they’re going to optimise their set-up, just as they would optimise their portfolio.”