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THE WATCHWORD IS CONVERGENCE

The market for alternative fund administration services remains highly competitive, providing clients with a wide range of choices. While consolidation has greatly benefited those at the top of the spectrum, it has also created an opening eagerly exploited by boutique players, whose specialist approach continues to enjoy surprising popularity. Dave Simons reports from Boston.

THE SCRAMBLE FOR liquidity has been keenly felt within the hedge-fund sector, leading to a marked reversal in investment psychology as evidenced by the surge in long-only, 130/30 and other divergent strategies. Not that any of this has necessarily been bad for the business of alternative fund administration. Despite the growing list of notable implosions within the hedge-fund world of late, fund flows from large pension plans, endowments and high net-worth individuals have shown extraordinary resilience, and the long-term trends point to continued growth. Hedge funds need to put that money to work; and at the same time require an outside source capable of handling the entire realm of administration duties, particularly as fund flows increase and products become even more sophisticated. As a reflection of that, alternative assets under administration have been growing at least as rapidly today as they were before the crisis began. "We are seeing a convergence between alternative and traditional managers," says Paul Schaeffer, managing director of strategy & innovation for SEI's Investment Manager Services Unit. "About three years ago, the industry was still organised into silos of mutual funds, hedge funds

and separate accounts but all that has been washed away by what we are now calling convergence."

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From the perspective of Jack Klinck, executive vice-president, offshore and alternative management, State Street, alternative fund flows remain strong, and evidenced by the vigorous expansion of the company's administration revenues. "Our assets are growing as rapidly now as they were a year ago," affirms Klinck. "In short, despite what has happened, people are still keeping their long-term strategies in place." Current demand for alternative administration services is such that both stalwarts and upstarts can happily co-exist, notes Klinck. "In the short run, you have a market that is growing at up to 20 percent annually, the margins are good and the barrier to entry is relatively low. As such, it is a good climate for entrepreneurial newcomers to come into the space."



Marina Lewin, managing director and head of relationship management and business development, alternative investment services unit, Bank of New York Mellon, believes that growth trends for alternative administration can easily support the expanding field of competitors, at least for the time being. "Which is a great thing," says Lewin. "However, from our perspective, having the backing of a large financial institution that can custody long assets, take in cash, provide valuation under duress, and has been instrumental in injecting liquidity into the market is a real plus, particular for those who are looking for real diversity of product base." Photograph kindly supplied by Bank of New York Mellon, May 2008.

Should large institutional investors such as pension plans and endowments continue to drive asset flows, however, it may be more difficult for smaller players to stay in step, he adds.

Moreover, he explains that when it comes to the quality of back-office administration services provided, these types of investors are much more demanding. "For instance, we have had hedge fund clients come to us with their knuckles sort of dragging on the ground, saying, 'We have just won this great piece of business from this pension plan, but in order to make it happen they insist on outsourcing our operations to you.'" Additionally, many of these institutional clients already have pre-existing custodial relationships with State Street, and view working with State Street as, "A sort of a good housekeeping seal of approval," says Klinck. "When they choose us over a boutique, they get things such as size, scale, a balance sheet, disaster recovery plans, all within a highly regulated environment. For many investors, that's absolutely critical. In short, there is a feeling of safety and security when you are working with a big, global, highly regulated, deep-pocketed, rich balance sheet type of organisation."

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While a standalone administrator offering a niche service may have its merits, in times of crisis, those with long positions looking for a safe haven often find solace in the massive infrastructure and breadth of choice offered by a commercial bank. "A hedge fund may be diversifying into a hybrid private-equity structure, or perhaps moving into long assets as a reaction to the shake-up in liquidity," says Lewin. "In these situations, the ability to offer a multitude of products is a natural advantage." Product alternatives ranging from long only and 130/30 to more sophisticated solutions will propel the alternative administration sector over the near term, and providers must be able to accommodate all the different strategies in order to fully capitalise on that growth, explains Lewin. "Strategies go in cycles, and the beauty of hedge funds is that they can be flexible enough to move in and out of the various strategies as they see fit, knowing that a strategy that may be out of favor at the present time may come back full force a few years from now," she adds.

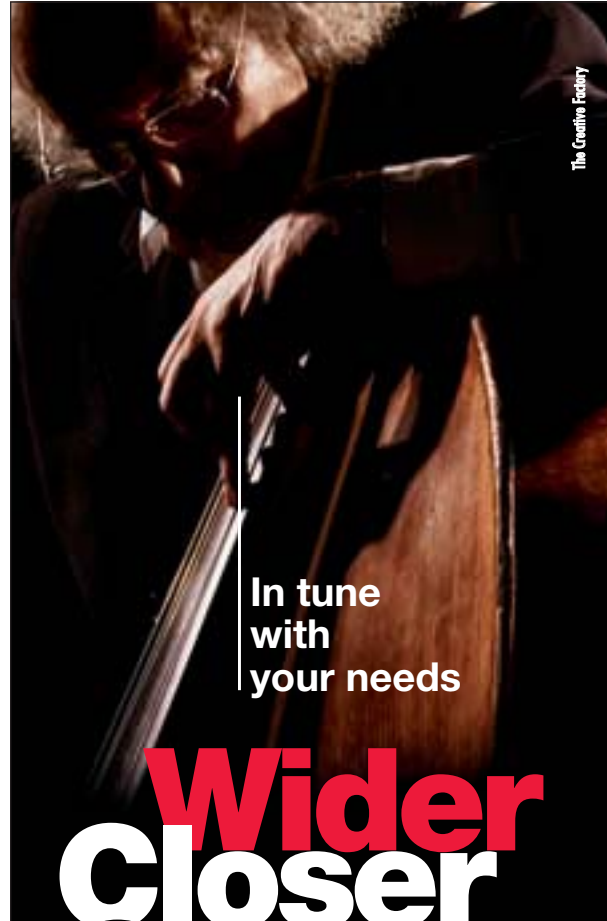
Small Alternatives

For their part, niche administrators have been circling the wagons in hopes that their specialist approach will continue to reap benefits in an increasingly homogenised world. One of the newest members is Bermuda-based ISIS Fund Services, an offshore hedge-fund administration group formed last fall by a breakaway team of ex-Citigroup alternative-fund specialists led by chief executive officer Ede Conyers, the former head of Citi Bermuda's Alternative Investments group. In a business where scale is increasingly regarded as the key driver of growth, ISIS, which currently boasts \$2.5bn in assets under administration, sees steady demand for the kind of customised solutions that smaller niche players can readily provide. "Larger administrators and investment banks that participate in the hedge fund administration space are focused on two primary criteria—profitability and assets under administration," offers ISIS managing director Jason Bibb. To keep up with the demands of technology and other internal resources, the world's leading administrators have in some instances raised their minimum market threshold per client to as high as \$500m. However, as Bibb points out, nearly two-thirds of the market is comprised of hedge funds with under \$100m in assets; fertile ground for niche firms like ISIS. "This is creating opportunities for smaller boutique administrators to enter the market, and as they get bigger, these small firms grow in tandem," says Bibb. Additionally, large administrators regularly divest themselves of smaller, less profitable clients, providing fresh prospects for mid-size and smaller providers, he says.

Offshore jurisdictions such as the Cayman Islands, Bermuda, the British Virgin Islands (BVI) and the Channel Islands of Jersey and Guernsey as well as Ireland continue to figure prominently in the growth of the worldwide alternative administration space. At present, total alternative assets in offshore funds are estimated at approximately \$2trn, compared to some \$655bn for onshore funds. Bibb suggests there are a number of factors at work besides traditional tax considerations. "For one thing, there is a concentration of expertise [in these regions] in fund structuring, hedge-fund administration and third-party provision servicing," he notes, "and that plays a huge role in perpetuating the success of the offshore world."

Flexibility often makes boutiques better equipped to deal with the complexities and exceptions inherent in smaller, more complicated funds that are frequently cast off by larger administrators, offers Tim Clipstone, partner, Investment Funds and Regulatory with BVI law firm Harneys Westwood & Riegels, an advisor to offshore fund managers and administrators. "Arguably, boutique administrators could be the best choice for all but the largest funds with unusual strategies. Also, due to their lower overheads, the boutique administrators are able to undertake the work profitably for lower fees."

Furthermore, adds Clipstone, offshore jurisdictions are likely to become increasingly important as managers and



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