

HEDGING WITH TECHNOLOGY

By Rinku Tyagi

Hedge funds are no longer as shrouded in mystery and as immune from regulation as they were in the days of George Soros. Neither are they as untouched by technology. Today hedge funds use technology as a prime tool for portfolio management. While this opens up opportunities for the sourcing of IT services, it is not easy to find providers that have an understanding of capital markets

GETTING HIGH RETURNS irrespective of whether markets goes up, down or side ways, is what hedge funds do. In fact, unlike equities where everything depends on how the market moves, whether it is soaring or sinking, hedge funds behave very differently. Making money in hedge funds depends a lot more on your fund manager and his skills rather than the performance of the market.

However, as the hedge-funds market grows because of increased disposable incomes and liquidity, there is need for tools and solutions to better assess hedge funds' performance, and to reduce the existing dependence on the maturity and skills of fund managers. Moreover, the complexity of financial markets and the increasing regulations on the once unrestricted hedge-funds market also calls for the use of tools that enable portfolio management with high-quality reference financial data. Lack of such solutions mean greater risk for the invested amount.

Yet, the fact is that there are scarcely any solutions or solution providers in the capital-markets space, who have dedicated solutions for the hedge-funds market. The market lacks portfolio finance systems for hedge-fund professionals that cater directly to the needs of hedge funds.

"The hedge-fund middle-office services are crying for technology," says John DiRocco, CEO, HedgeSpeed Technology, a financial-software solutions company set up in 2005 to offer solutions for effective and efficient automation solutions around liquidity management.

Mid-office Process Outsourcing

Realizing that while there are umpteen solutions available to take care of the front- and back-office needs, there is a void of liquidity-management solutions in the middle-office segment for hedge funds, and confident that "throwing bodies at the jobs" cannot solve the unique issues in the hedge-funds industry, early this year DiRocco set about

CASE  **STUDY**

Special Report

finding ways to fill the technology void in the middle-office area. He set about evaluating IT service providers that both understood the capital markets, and were flexible to work with a company that had only 10 employees. And, to his disappointment, he found very few.

HedgeSpeed aims to provide its customers a single middle-office platform that spans the complete hedge-funds spectrum, including stock locate, borrows, swaps, margin and cash management. Predictably, it wasn't easy to find a provider that had demonstrable experience in the domain.

Soon into the effort of finding an IT service provider, did HedgeSpeed realize that a generic software-development company wouldn't be able to provide what they were looking for. They needed someone who was familiar with the capital market and was open to change and innovation. The provider's understanding of the domain was critical to HedgeSpeed, as it was seeing an outsourcing partnership freeing them up to concentrate on building customer relationships and market presence.

In August this year, after much evaluation of their work, DiRocco found a partner in DataArt, a Russian IT-services company, headquartered in New York, that has industry expertise in the capital-markets space. To HedgeSpeed's benefit, there was already some exposure that DataArt had that led HedgeSpeed to show faith in them to handle all development for their middle-office liquidity-management solutions. DiRocco had been closely watching the work the provider had done for Paladyne, a company that is penetrating the hedge-funds space and he was "impressed."

DataArt would now take care of all the software-development work for HedgeSpeed's unique needs, as also quality assurance.

Under the present scheme of things, DiRocco declared that this would be a multiyear strategic deal, and HedgeSpeed would pay for the resources used. While this was a unique deal from the point of view of a customer, the service provider also brought in their bit of uniqueness with their model of working. Less than 10 percent of DataArt's team works onsite unlike the industry average of 30 percent. The majority of development work is done offshore in the R&D facility of DataArt in Russia, and only the necessary integration and business analytics is done onsite.

This 1:9 ratio of onsite to offshore workforce not only saves cost for HedgeSpeed but also enables efficient resource management for both the customer and the provider.

On the other hand, DiRocco's in-house team at Hedge-

Speed concentrates on customer development and business requirements. They are now able to devote more time to establishing new relationships and bringing in more revenue streams, as they ought to.

A Happy Alliance

Despite the current satisfaction with their outsourcing relationship, the decision to outsource to DataArt did not come easy for HedgeSpeed. Since the company is only two years old that started settling only in the last quarter, they were looking for a partner who would devote time in understanding their needs, and wouldn't be influenced by the fact that it worked with only 10 employees and two consultants. Also, the provider needed to be one that could not cost them an arm and a leg to be outsourcing to them.

"Outsourcing has its own unique challenges that have to be managed — time, distance and even verbiage," says DiRocco when asked about the challenges one faces in outsourcing services. But today, it is a happy customer-provider alliance. DataArt is satisfied that they are not doing another generic IT project in the financial-services space, and HedgeSpeed is a satisfied customer.

"I like the personal attention we get at DataArt. Remember we are a small firm, and would not necessarily garner the attention and resources DataArt provides us," adds DiRocco.

Time is yet another prime concern for financial markets as dynamic as hedge funds. Being a little lax may mean loss of thousands for the investor. "In the hedge-funds market, you should be able to reduce the time between product vision and implementation,"

says Alexei Miller, EVP, DataArt. And now that most of the dealings happen over the wire and the funds need to be managed on a real-time basis, the faster the better. "The whole premise is acceleration," says Miller.

Though it is only a few months to the deal and a little too early to measure success, HedgeSpeed has already begun to see signs of improvement. In fact, both the customer and the provider are confident that they will be able to squeeze the time of delivery. The deal targets 30 to 50 percent saving on time and roughly the same range of cost savings for HedgeSpeed.

Going forward, both the companies are likely to extend this cooperation into the customer-support space.

Outsourcing Opportunities for Hedge Funds

The technology infrastructure required to manage funds can either be owned or outsourced, though it requires care-



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WHO'S SERVICING HEDGE FUNDS



- Advent Software
- Algorithmics
- Beauchamp
- BISYS Alternative Investment Services
- CITCO Fund Services
- Citi Practitioners (acquired by Capco)
- Eze Castle
- Fortis Prime Fund Solutions
- GlobalOp
- Goldman Sachs
- HSBC's Alternative Investment Services
- IFS, a State Street Company
- Imagine Software
- Indus Valley
- InfoHedge Technologies
- Investors Bank & Trust
- JP Morgan
- Morgan Stanley
- Omgeo
- Paloma Partners
- Paladyne Systems
- RandomWalk (acquired by Accenture)
- RFA
- SS&C Fund Services
- UBS Fund Services
- Vantage Reporting
- Viteos Fund Services

Source: Global Services

ful evaluation on the part of fund managers and investment planners who need to make the choice. While going with one would mean bearing the cost of an equipped and skilled technology team, siding with the latter would mean trusting the technology/process partner for sharing the data. And the hedge -funds industry is hard pressed to take this decision fast enough to meet the pace of rising competition and capital-market swings. And the cost differential and up-to-date technology make outsourcing the obvious choice.

The hedge fund industry, though a late starter in services outsourcing is now not only exercising the choice of application and IT infrastructure and processes, but also business processes outsourcing. Some of the business processes can improve fund efficiency including daily cash management, collateral management, flash P&L reporting, risk reporting, and cash and position reconciliation.

To ensure smooth trade and reconciliation in a dynamic market where investments need to be made at the

right time and in the right fund, hedge-fund administration procedure can be divided into three levels of operation — front, middle and back office. The front-office operations include various active trading and liquidity-management solutions that form the visible link between the investor and the market. The post trade but pre-settlement operations that form the middle-office include liquidity analysis, stock loan, margins and derivatives, asset-management solutions, analytics and cash management. Accounting and tracking operations comprise the back office.

As most of the limelight is hogged by the fancy front office and the plain and simple accounting processes, most of the technology usage is limited to these areas only, and not to middle office where opportunities lie in abundance. Infrastructure and technology for hedge-fund managers is limited mostly to the back office (accounting and tracking operations) and the front office (trading and portfolio-risk management) operations. **GS**