TowerGroup

Outsourcing the Hedge Fund Middle Office: Why This May Be the Next Buy-Side Outsourcing Battleground

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TowerGroup Take-Aways

- Globally, an estimated 90% of hedge fund managers already outsource back-office functions to fund administrators, but middle-office functions have traditionally remained in-house because of their inherent complexity.
- TowerGroup expects that hedge fund managers will increasingly look to reduce operational costs and focus on their core competencies of asset gathering, portfolio management, and trading and will increasingly outsource unrelated operational functions.
- As managers have changed their attitude toward outsourcing the middle-office, service providers have improved their capabilities in many middle-office functions and now offer a compelling choice for their hedge fund clients.
- TowerGroup estimates that service providers earned $71 million (USD) from hedge fund middle-office servicing in 2005 and that earnings will increase significantly to $268 million by 2008.
- The importance of the value-added services relative to the core services in outsourcing is shifting as core functionality becomes commoditized and value-added services become the true product differentiators.

Report Coverage

Hedge fund managers worldwide have shown a growing interest in disassociating themselves from many of the operational aspects of their business. An estimated 90% of hedge fund managers are already outsourcing their back-office fund administration, accounting, and shareholder servicing to a fund administrator. However, the middle-office functions (loosely defined as post trade but presettlement) have traditionally remained in-house. This practice is changing as fund managers deal with the complexities of reconciling higher volumes of more complex trades and the strain that this puts on staff and IT. At the same time, service providers have improved their capabilities in many of the middle-office functions and now offer a compelling choice for their hedge fund clients. Both fund administrators and prime brokers have their eyes on this market, setting the stage for what may be the next battle in buy-side outsourcing. This TowerGroup Research Note analyzes the growing demand for outsourced middle-office capabilities.

Vision

TowerGroup expects that globally, hedge fund managers will push to reduce operational costs and focus more on their core competencies of asset gathering, portfolio management, and trading and will increasingly look to outsource unrelated operational functions. Although back-office operations will remain at the heart of the outsourcing offering, fund managers will search further upstream for functions ripe for outsourcing. This shift will happen in parallel with an increase in the capabilities of service providers (fund administrators and prime brokers) as they extend their IT platforms, adding

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the technology necessary to support the middle office. As a result, more and more hedge fund managers will outsource their middle-office functions to their service providers, while the service providers will be all too happy to extend their relationships with their lucrative hedge fund clients and make those assets "stickier" (less likely to leave for another provider).

The success of outsourcing the back office across the buy side is well known. TowerGroup estimates that 90% of hedge fund managers have outsourced their back-office functions of fund administration, accounting, and shareholder servicing, and a similar percentage is seen in traditional asset management. While there has been some pull-back of assets as funds have reached a certain scale and economics have favored insourcing some back-office functions, the majority of hedge fund managers will not pursue this route. On the other hand, TowerGroup estimates that only 7% of hedge fund managers have outsourced middle-office functions. TowerGroup expects that this demand will more than double by 2008 when 15% of hedge fund managers will outsource some or all of their middle-office functions. Exhibit 1 shows TowerGroup's estimates for adoption rates of back-office and middle-office functionality among traditional asset managers and hedge fund managers.

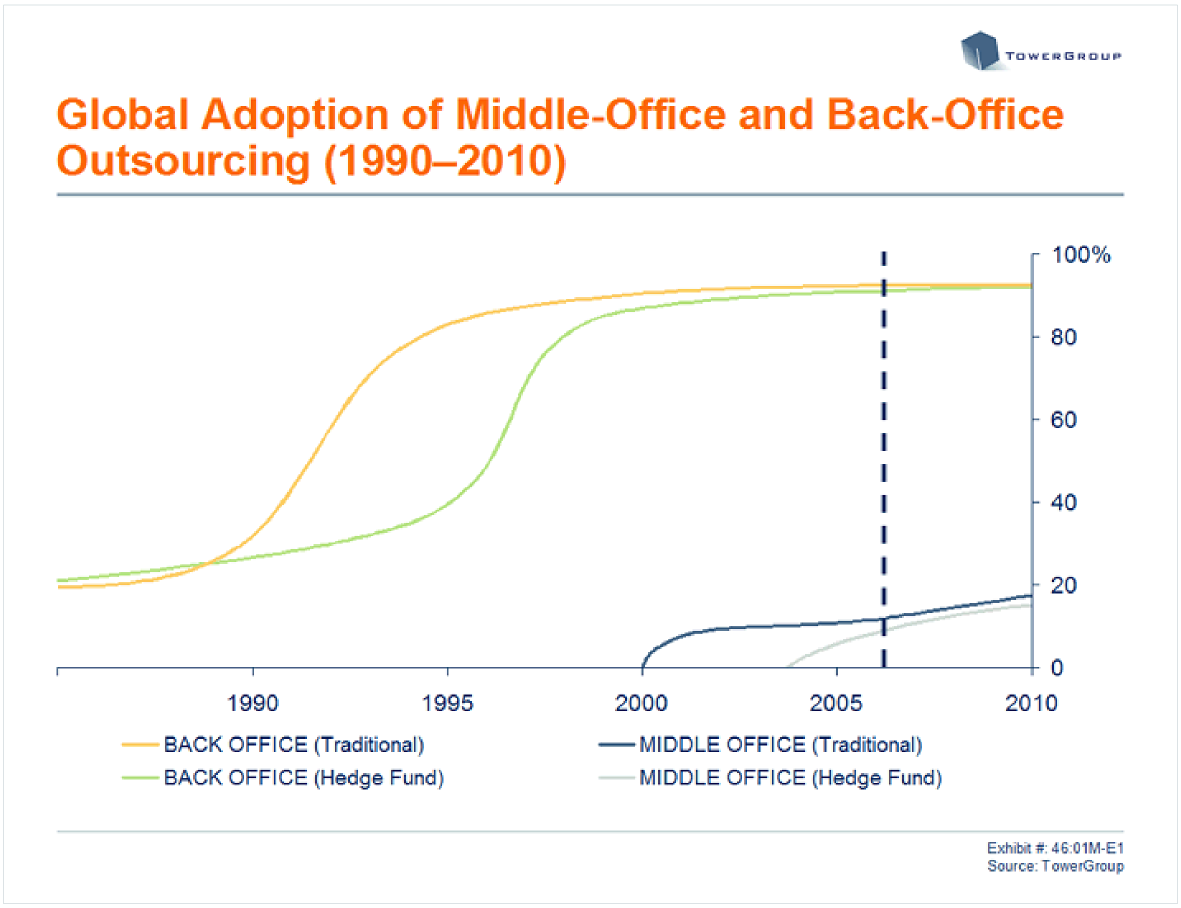

Exhibit 1
Global Adoption of Middle-Office and Back-Office Outsourcing (1990-2010)
Source: TowerGroup

Clearly, the rates of outsourcing for middle-office functions pale in comparison with those for back-office outsourcing. However, middle-office servicing will be a supplementary revenue stream for service providers as well as a means of increasing a provider's relationship with the fund manager and making the assets stickier. TowerGroup estimates that service providers earned $71 million (USD) from hedge fund middle-office servicing in 2005 and that this amount will increase significantly to $268 million in 2008.

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Background

The best place to start any discussion about middle-office outsourcing is by defining exactly what makes up a middle-office service for hedge funds. Different sources in the industry vary greatly regarding that definition. Some providers believe the middle office includes just daily profit and loss (P&L) reporting and perhaps some additional client reporting. Others define it as including a myriad of services, such as trade capture and reconciliation, investment accounting and real-time ("flash") P&L, performance measurement, confirmation of over-the-counter (OTC) derivatives trades, and even management of reference and corporate actions data.

Looking across the spectrum of traditional asset and hedge fund managers, TowerGroup defines the middle office to include functions servicing assets post trade but presettlement. Among these are the core services of trade processing/support (confirmation and allocation), position and trade reconciliation, and investment accounting (as opposed to portfolio, fund, or net asset value (NAV) accounting). The middle office also includes a variety of value-added, shared services, which may be functions of one or more of the front, middle, and back offices. These include foreign exchange (FX) and cash management, collateral management, the closely related functions of performance reporting (middle office), and attribution analysis (front-office). Also included are reporting (both client/shareholder and internal), corporate action processing, straight-through-processing (STP) workflow management, data management, and risk management. Exhibit 2 details TowerGroup's definition of the core services of the front, middle, and back offices as well as the functions that are shared by the operating units.

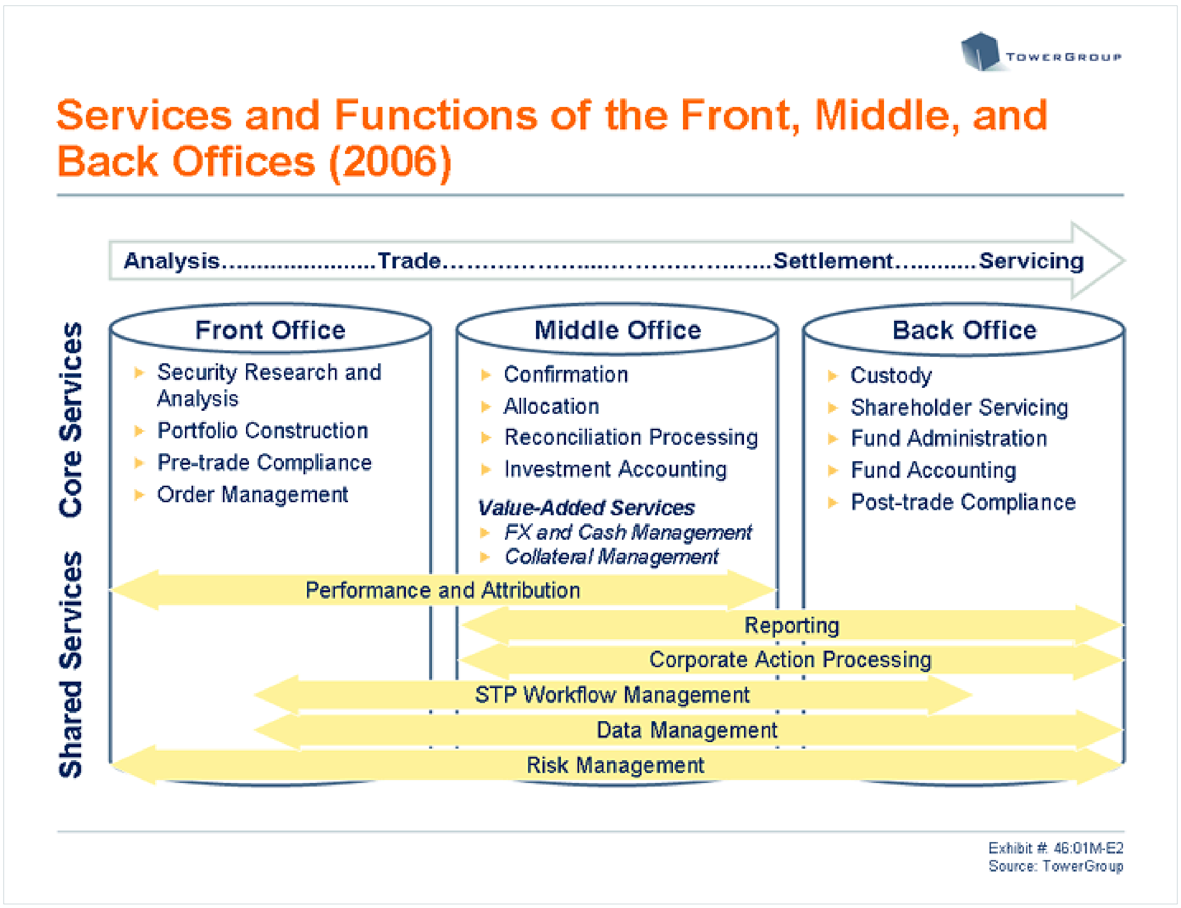

Exhibit 2
Services and Functions of the Front, Middle, and Back Offices (2006)
Source: TowerGroup

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Increasingly, TowerGroup is recognizing a shift in the importance of the value-added services relative to the core services as core functionality becomes commoditized and value-added services become true product differentiators. The same observation can be made of the fund administration and prime brokerage markets, where core functionality has become commoditized to a large degree and value-added services and client service have become the differentiators. Certainly, service providers need to perform core services proficiently, but they can truly set themselves apart by offering breadth and quality in their value-added services. This Research Note also discusses the impact of this trend on outsourcing revenues.

What's Motivating the Interest in Middle-Office Outsourcing?

Several factors are driving the demand for middle-office outsourcing. Some of these drivers are parallel to those for outsourcing traditional asset management operations. However, the complexities of hedge funds, particularly their increased use of complex derivatives as well as their frequently high trading volumes, shine a bright spotlight on the hedge fund middle office.

Revenue Pressure

While hedge funds are still outperforming traditional assets on average, the days of 30%+ annual returns appear to be over. Hedge fund returns have normalized as markets have become more efficient, and the number and size of the hedge funds attempting to exploit the same perceived inefficiencies have increased. As relative performance has decreased, no such widespread decrease in hedge fund management and incentive fees has occurred. Earning a 2% management fee plus 20% of profits ("2 and 20") still reigns supreme. TowerGroup expects this pricing to decrease in the coming years, as evidenced by the growing number of hedge-like mutual funds and one-off discounted pricing deals for institutions. The amount that the fund manager earns from the incentive fee on profits, often saddled with a hurdle or a high-water mark, is shrinking. As a result, hedge fund managers are actively seeking ways to cut their own internal costs, and the most likely place to do so successfully is not in the front-office where the money is earned, but rather in operations.

Focus on Core Competency

The desire to focus on core competencies of asset gathering, portfolio management, and trading is a common theme whenever discussions regarding outsourcing arise on the buy side. This is particularly true in the hedge fund market where fund managers with less than $250 million in assets under management (AUM) are not likely interested in or staffed to handle IT management. In these smaller shops, the focus is strictly on asset gathering and portfolio management (although outsourcing the asset gathering to a prime broker is a viable option). Regardless of the size of the fund, there's little to no competitive differentiation through insourcing back-office or middle-office functionality, so it makes perfect sense to pursue an outsourced arrangement whereby the business can be focused and profit margins improved.

Trading Volumes

As noted in other TowerGroup Research Notes covering the hedge fund industry, estimates place hedge funds behind 40-50% of the daily volume on the New York (NYSE) and London (LSE) stock exchanges as well as significant percentages of the volumes in credit derivatives, convertible bonds, distressed debt, and other exotic securities. Applying some simple math to current NYSE and LSE volumes suggests that collectively, hedge funds execute roughly 706 million trades annually on just these two exchanges, which averages to over 165,000 trades annually per equity hedge fund. These numbers are rough averages, and some funds will trade significantly more than others. However, this certainly highlights the potential challenges associated with hedge fund operations given that hedge funds are spreading these trades across multiple counterparties and employing multiple prime brokers and that these trades and positions must be reconciled between these parties and the fund manager.

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Derivatives Processing Challenges

Traded volumes in derivative instruments have soared in the past few years, and hedge funds are often cited as a major contributor to that growth. But the securities industry as a whole faces tremendous challenges arising from the growth in derivatives. Lack of a standard, common identification scheme and security reference data and the lack of complete pricing data as well as the paper-based nature of the deals themselves have created an industry average nine-day processing backlog for some types of derivatives trades. Rather than attempt to source and maintain obscure securities data from multiple sources (such as Markit Partners and Lombard) and reconcile these complex trades and positions in-house, hedge fund managers are finding that outsourcing these functions to a service provider with strong technological capabilities, established vendor links, and staff expertise is a very attractive alternative. The alternative involves a large commitment of the hedge fund's IT capital to the processing systems and required reference and pricing data as well as experienced operations staff with a knowledge of the products and the strategies. The costs and operational risk associated with this alternative become inherent barriers to trading these instruments.

Product Expansion

The fastest-growing segment of the hedge fund market today is for multi-strategy funds, whereby managers may pursue any investment strategy in any asset class or part of the world as they see fit. This approach gives managers tremendous freedom, and the strategy's rise during a time when critics are pronouncing some hedge fund strategies (e.g., convertible arbitrage) dead is no surprise. According to a recent listing of the top global hedge funds, 13 of the top 25 global hedge fund managers offer more than one fund strategy in their complex, indicating the industry's desire to broaden product lines in search of new opportunities and revenue. However, it's likely that with a limited IT staff and in-house operations, hedge fund managers will be handcuffed in their desire to pursue these new strategies and markets. To accomplish an expansion beyond their operational "comfort zone," fund managers need to understand their own capabilities and be aligned with service providers that can support new security types, portfolio strategies, and new global markets.

Challenges Facing Service Providers

While the factors driving demand for middle-office outsourcing are likely to cause fund managers to review options in outsourcing, they also represent some of the challenges facing the service providers. Complexity in fund operations, strategies, and traded products highlight the importance of a service provider but also may bring unwelcome attention to its deficiencies. If a prime broker's traditional strength is in servicing long/short equity funds, it may have difficulty servicing the middle office of a derivatives-based strategy because of the IT and professional challenges associated with these securities.

A Broken Record? Derivatives Processing Challenges

Perhaps the greatest challenge facing service providers is also a top driver for fund managers considering outsourcing their middle office. The explosive use of derivatives, particularly among hedge funds, places a tremendous strain on service providers and requires both scalable, flexible middle-office technology and skilled staff. Service providers looking to enter the marketplace need to be aware of this demand and assess their capabilities accordingly.

Rising Importance of Value-Added Services

TowerGroup anticipates that more importance will be placed on the value-added services of a middle-office provider as the core services become commoditized. As defined earlier, the core services of trade processing, reconciliation, and investment accounting, while unique to the middle office, may be logical extensions of the service providers' other business units (prime brokers, for example, would be well equipped to handle large-scale transaction processing). As providers extend their services, the true differentiator of a middle-office service provider may be its ability to handle the value-added services such as FX and cash management, collateral management, internal and external reporting, performance measurement and attribution, and data management. Depending on the service provider's origin, these services may also be extensions of other

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business units, but some will be unique and will require new IT investment, raising a potential barrier to entry for new participants.

TowerGroup research on the split between core and value-added services and their respective revenue contributions across the buy-side outsourcing spectrum shows that, in 2005, core services contributed 69% of revenues, while value-added services contribute the remaining 31%. TowerGroup predicts that the shift will further migrate toward value-added services in the coming years, resulting in a split of 65% core and 35% value added by 2008. This change equates to a 2004-09 compound annual growth rate of -2% for core services and 4% for value-added services. Exhibit 3 details TowerGroup's predictions on this trend.

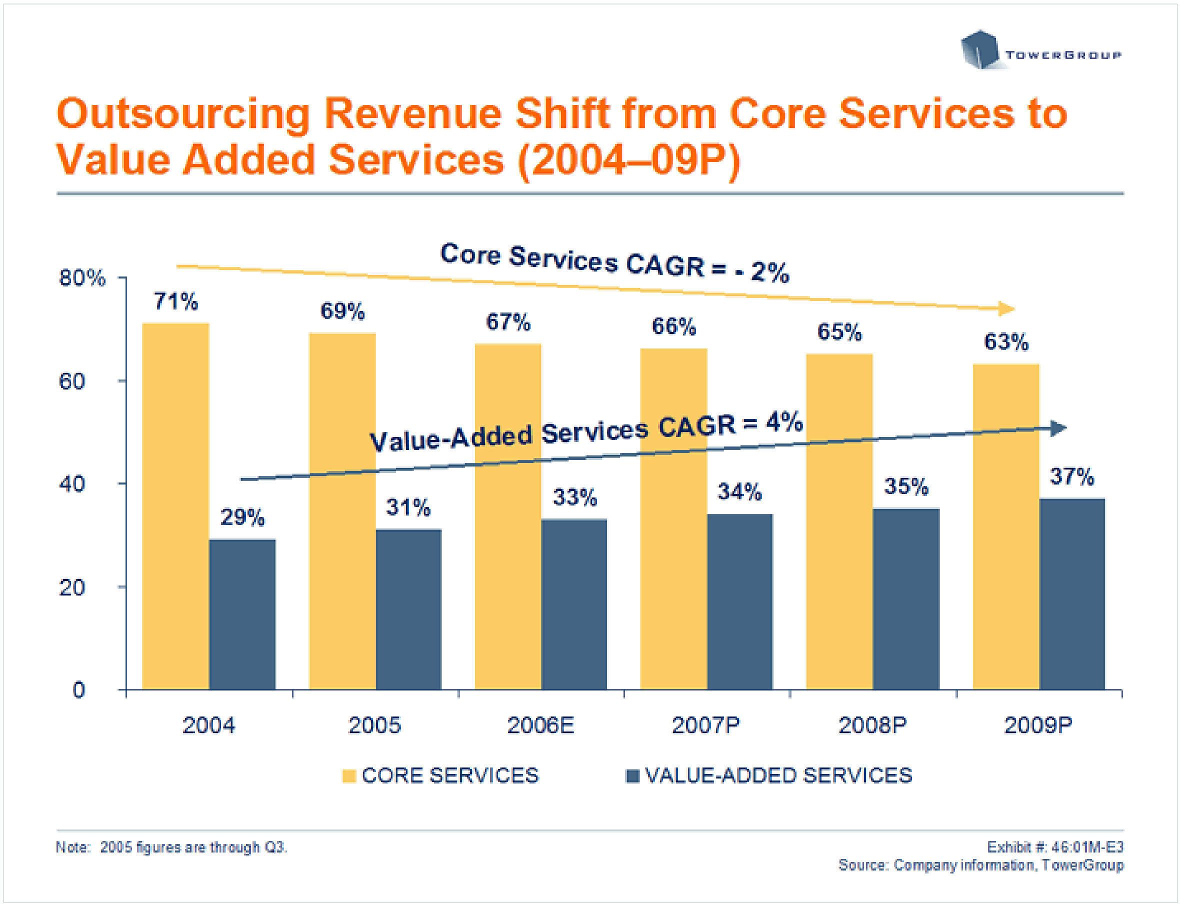

Exhibit 3
Outsourcing Revenue Shift from Core Services to Value Added Services (2004-09P)
Source: Company information, TowerGroup

Revenue Opportunity in the Hedge Fund Middle Office

Pricing for middle-office services offered to hedge fund managers is likely to be significantly higher than pricing for comparable services for traditional asset managers. Whereas traditional asset managers are likely to pay a mere 3 to 5 basis points of AUM specifically for middle-office services, hedge fund managers are likely to pay 7 to 10 basis points. Reasons for the disparity between hedge fund and traditional assets include the complexity of the securities processed and the trading volumes, which are likely to be significantly higher for hedge fund managers. This is comparable to the disparity in pricing for back-office services (albeit in reverse), in which traditional asset managers are likely to pay more than hedge fund managers because of the complexities in shareholder servicing, daily valuation, and NAV calculation for traditional asset managers.

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With 7% of hedge fund managers outsourcing their middle office and with the current fee schedule, TowerGroup estimates that middle-office outsourcing generated $71 million in revenue for service providers in 2005. While this equates to only 6% of the revenue opportunity from back-office outsourcing, TowerGroup expects this revenue to rise to $268 million by 2008, equating to over 13% of the back-office revenue. Exhibit 4 details TowerGroup's predictions for the revenue opportunity from hedge fund middle-office outsourcing.

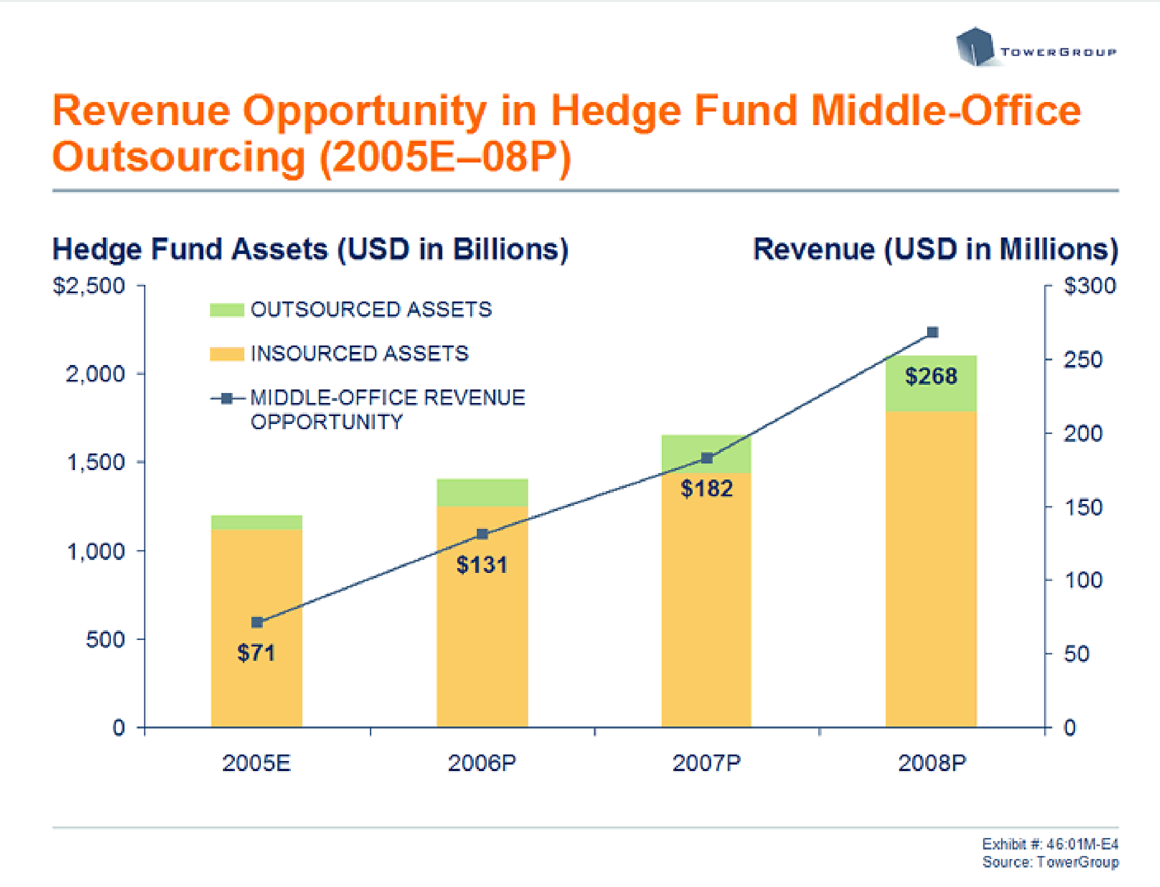

Exhibit 4
Revenue Opportunity in Hedge Fund Middle-Office Outsourcing (2005E-08P)
Source: TowerGroup

The Players

Several players are lined up to service the hedge fund middle office, and even more are waiting in the wings, preparing to enter the stage. All players are driven by the desire to strengthen their relationship with their lucrative hedge fund clients; however, some players have more at stake than others. In TowerGroup Research Note V44:09M, *The Changing World of Hedge Funds: Implications for Fund Administrators*, TowerGroup predicts that fund administrators will earn $1.4 billion in 2005, meaning that middle-office servicing could contribute an additional 5% in revenue. Prime brokers earn five times that amount in revenue, so for them, middle-office revenue would contribute only 1% to their bottom line.

Each player brings a different toolset to the table, and each has particular strengths and weaknesses. As new players look to enter the market, they may face different challenges based on the origin of their business:

- **Fund administrators** are likely to have some of the most skilled professionals, knowledgeable about the securities, portfolio strategies, fund structures, and accounting

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requirements. However, they may lack some of the technology platforms required for trade processing and collateral management.

- **Prime brokers** are likely to have skilled client service and trade processing staff and much of the technology already in place, but they may require additional investment to develop the necessary accounting and data management capabilities. Prime brokers are also likely to have strong securities lending and borrowing capabilities, which TowerGroup views as an added bonus but not a core or standard value-added service.
- **Custodian banks** are likely to have much of the technology in place because of their ability to provide middle-office services for traditional asset managers. However, they may require technology enhancements to handle the complex derivatives involved and may lack some of the hedge fund servicing staff. Custodians are also likely to have securities lending capabilities.
- **Other service providers** constitute a fourth entry to the market that is only beginning to arise. It consists of providers such as OpHedge, a new service provider that spun out of the back office of hedge fund Oak Hill Partners. Oak Hill contributes a strong, integrated middle-office and back-office solution. Similarly, Merlin Securities is a multifaceted provider of technology, prime brokerage, and middle-office ("prime of primes") services. Such new entrants are likely to have strong technology platforms without the shackles of legacy technology and siloed operations; they also have strong servicing staffs.

TowerGroup expects to see more "joint ventures" arising from investment banks with both a prime brokerage and a fund administration unit under their umbrella. The combination of these services into a full-service, one-stop shop for the hedge fund manager could be a strong force in the fund servicing marketplace. Exhibit 5 shows the parties converging on the middle office.

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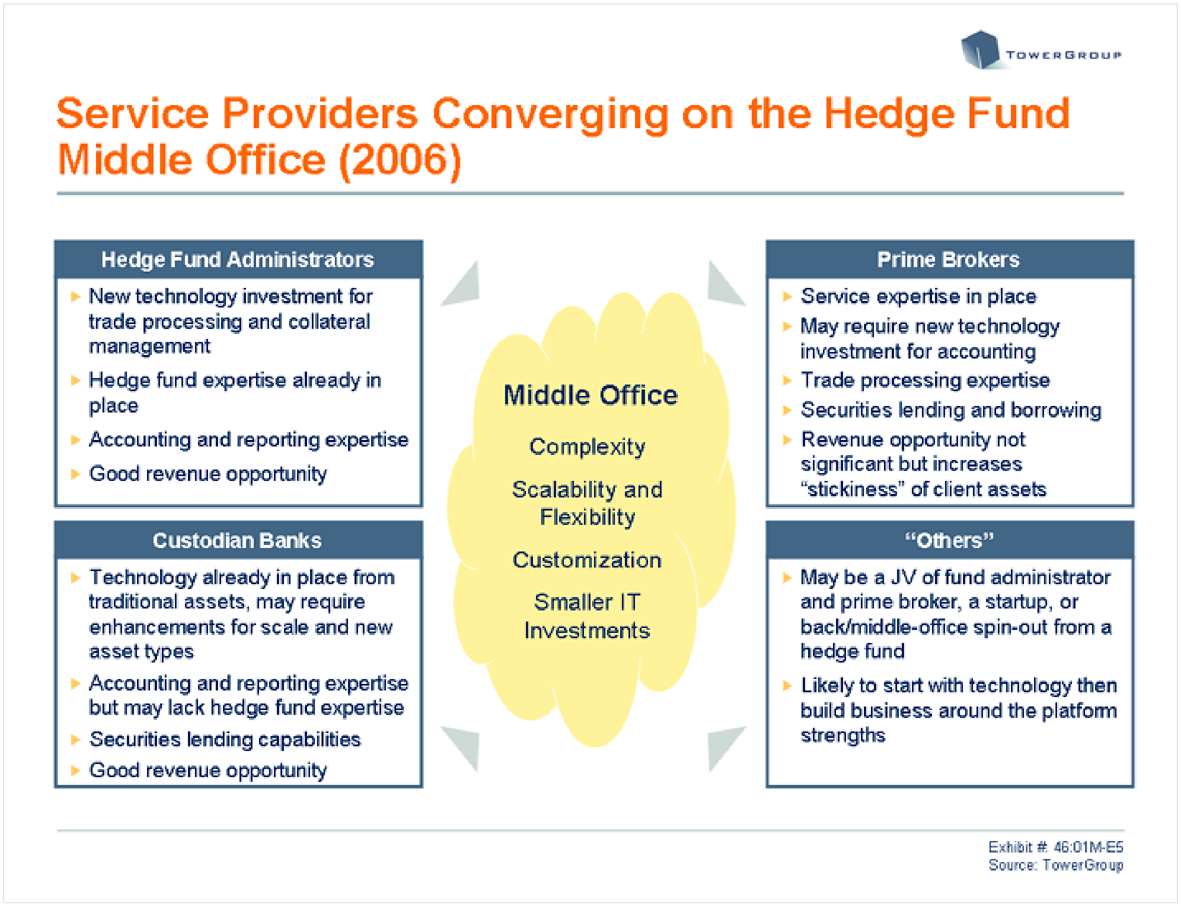

Exhibit 5
Service Providers Converging on the Hedge Fund Middle Office (2006)
Source: TowerGroup

Technology Vendors

A look at the core middle-office services reveals the need for multiple platforms to handle trade processing, position and trade reconciliation, investment accounting, performance reporting, and other functions. The number of vendors is directly related to the breadth of the provider's middle-office offering, so the required technology investment will vary from provider to provider. Various past and upcoming TowerGroup Research Notes discuss the specific details of the vendors listed in Exhibit 6.

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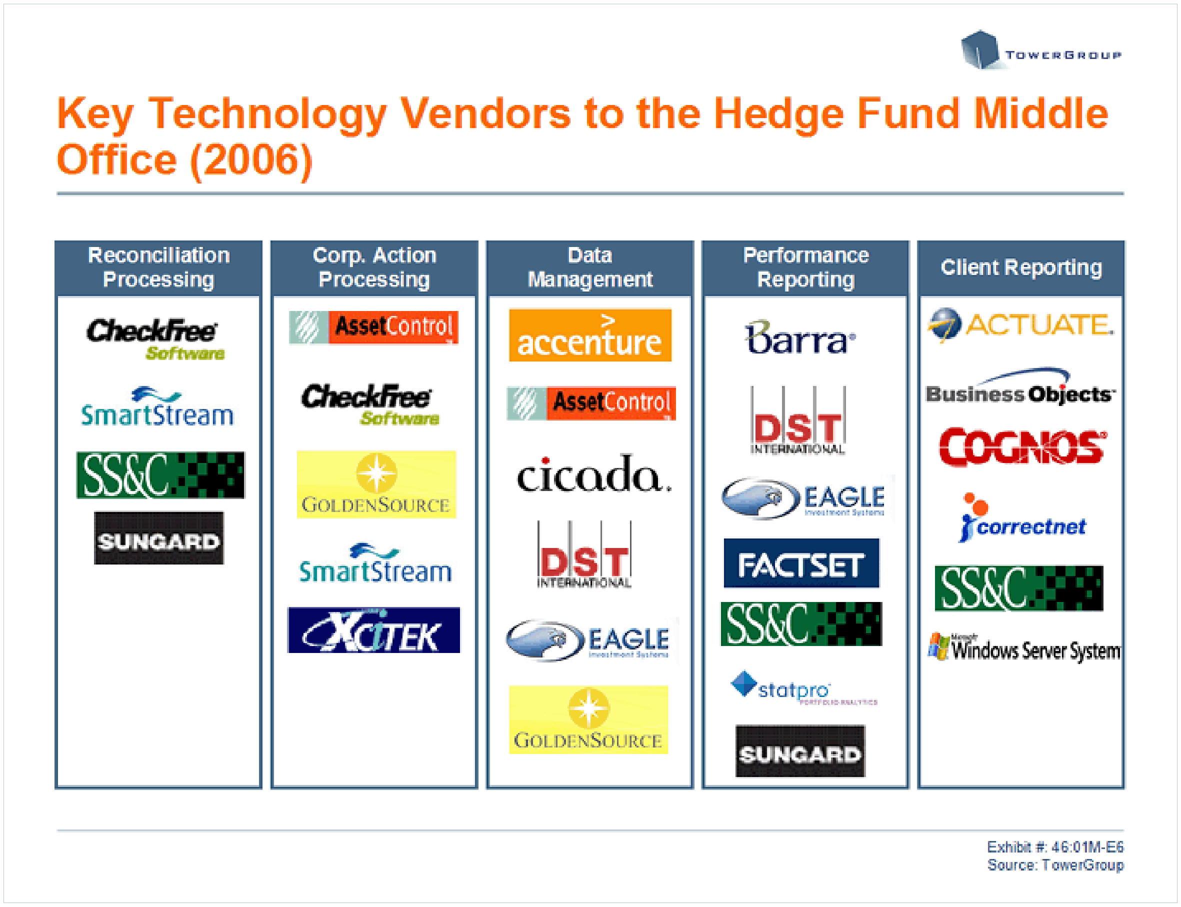

Exhibit 6
Key Technology Vendors to the Hedge Fund Middle Office (2006)
Source: TowerGroup

Reconciliation processing vendors, including CheckFree/Accurate, SmartStream, SS&C (formerly FMC), and SunGard, offer tools designed to acquire files of information from disparate sources, match the data, and report and in some cases act on exceptions through workflow management tools. While these products originated from the need to match positions, trades, and balances on an "ours versus theirs" basis, vendors are generally looking to extend their platforms to handle generic matching exercises. Generic matching could include, for example, disparate sources of securities identifiers (CUSIPs, SEDOLs, CINs, etc.) or customer name/address data.

Corporate actions processing solutions range from a handful of software providers like Asset Control, CheckFree, GoldenSource, SmartStream, and Xcitek to full-service bureau solutions offered by Fidelity ActionsXchange and the Depository Trust and Clearing Corporation (DTCC). These solutions handle the complexity of gathering corporate actions data from multiple sources, normalizing the data, adjudicating discrepancies between the data, and feeding the data to multiple downstream applications. Similarly, data management solutions from many of the same vendors plus additional names like Cicada, DST International, and Eagle Investment Systems support the receipt, scrubbing, and distribution of reference data within an organization. Emerging solutions from Accenture, Asset Control, Capco, and Cicada offer fully outsourced data management via a service bureau relationship. Efficient data management processes are required of a service provider that wants to succeed in the middle office because of the data-intensive nature of middle-office functions. Trade processing, performance, and client reporting, for example, all require clean and consistent reference data.

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Although not a core requirement of the middle office, performance measurement and reporting is certainly one of the value-added services that can help to differentiate a service provider's offering. The type of audience will determine the level to which a performance offering is designed. For internal, front-office audiences, a more robust performance measurement and attribution service is warranted, whereas an external, client audience would merit a less robust performance reporting service providing only a basic level of detail. For more information on the technology vendors to the performance measurement market, see TowerGroup Research Note V37:32M, *Buy-Side Performance Measurement and Attribution Tools: Reviewing the Rulers*.

In order to efficiently process the volumes of portfolio and client data and present the information back to the client (whether that is the fund manager or the fund's individual clients), many service providers are employing vendor solutions that assist with the aggregation, normalization, storage, and presentment of disparate sources of data. A variety of solutions exist to meet client reporting needs, including open database connectivity (ODBC) report generation tools as well as XML-based aggregation and reporting tools. For more information on many of these vendors, see TowerGroup Research Note V42:01M, *Institutional Client Reporting: Automating the Manual Processes*.

Summary

While industry participants do not agree on a definition of the "middle office," hedge fund managers do show a growing interest in outsourcing more of their operations, reducing operational costs, and focusing on core competencies. TowerGroup subscribes to the definition of the middle office as encompassing functionality that is post trade but presettlement. This includes core trade processing, reconciliation, and investment accounting functionality and may also include value-added services like cash management and FX, collateral management, performance measurement, data management, and reporting. As core outsourcing services become commoditized, the industry is placing a more importance on value-added services. This is evident in the shifting revenue contribution reported by major buy-side outsourcing providers like State Street and Investors Bank & Trust.

Given the high rate of adoption of back-office outsourcing in the hedge fund industry and the persistent need for fund managers to cut operational costs, TowerGroup expects to see a wave of hedge fund middle-office outsourcing in the coming years. We estimate that 5-7% of hedge fund assets outsource their middle office today, and we expect this percentage to approach 20% by 2008, generating over $260 million in revenue annually for service providers.

Established and emerging service providers from the fund administration, custody, and prime brokerage arenas as well as new "hybrid" providers exclusively targeting the hedge fund space are converging on the middle office, possibly setting the scene for the next buy-side outsourcing battleground.

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