

---

## FoHFs Beginning to See the Open Road with New Technology

By Richard Koppel and Owain McNeill

Imagine driving in a blizzard on a remote road trying to reach a place you have never been before. You can't go too fast, or you may run off the road or get lost. Occasionally, the snow stops and you check the scenery to see whether you are headed in the right direction. The next thing you know, the blizzard starts up again.

That is what it is like managing a fund of hedge funds (FoHFs).

As participants in a relatively new industry, most FoHFs rely upon unsophisticated tools and imperfect data to track their hedge funds investments, cash, FX exposure, hedging positions, and liquidity schedules. Based on extensive studies of the industry over the last four years, we estimate that 95% of FoHFs with less than \$1 billion in AuM, as many as 80% with \$1-\$5 billion in assets, and a solid 25% with more than \$5 billion rely exclusively on linked spreadsheets or some combination of spreadsheets and in-house systems to assist them with portfolio management.

### **Percentage of Funds of Hedge Funds By Type of Portfolio Management Method**

Portfolio Management Method	Assets Under Management (AuM)		
	Less Than \$1B	\$1B-5B	More than \$5B
Spreadsheets	70%	20%	5%
Spreadsheets/In-house System	25%	60%	20%
In-house System/3rd Party FOHF PMS	5%	20%	75%

These spreadsheets are typically programmed by one or two people in-house. With the rare exception of some of the oldest FoHFs, few of their calculations are rigorously tested, and there is no audit trail to monitor changes. Data is taken from e-mail and faxes, inputted manually, and sometimes entered multiple times. When the fund manager finally views the resultant reports, they are often out of date, and sometimes incorrect.

Complicating matters are the unique management information needs of the FoHF business:

- FoHFs need to track performance at the fund level and for investor share classes having intricate structures, different fee regimens, and various currency denominations.
- Hedge fund subscriptions involve lockup terms, notice periods, fee and settlement schedules, and gating.
- Terms can be overridden for particular trades.
- Fee calculations employ several different methodologies and often involve complex equalization adjustments.

- Prices arrive at different times on an estimated or confirmed basis, making it difficult to determine which price to use when valuing investments.

The only time a FoHF has a clear view of a portfolio is two to three weeks after the month has ended, when net asset value statements are received from the administrator. By that point, however, many values have already changed.

To appreciate how archaic the situation is, look at equity trading, clearing and portfolio management. With modern portfolio management systems, supported by T+1 settlement and Straight Through Processing (STP), a hedge fund manager knows within minutes, and certainly by the next morning, exactly how a stock transaction has affected his or her portfolio.

It's taken time, but now, with regard to FoHFs, the blizzard is lifting. The industry has reached the point where awareness of the problem, technological advances, and demand from institutional investors are leading to the deployment of modern, online FoHF portfolio management systems (FPMS). We estimate 5% of FoHFs with less than \$1 billion in AuM, 20% with \$1-\$5 billion, and 75% with more than \$5 billion under management are using an in-house or third party FoHF Portfolio Management System (FPMS), such as the Hedge Fund Information Provider (also known as the HIP) from youDevise, Webfolio from Digital Shape Technologies, or HedgeSphere from Infonic AG.

Using the HIP as an example, major capabilities of FPMS can include Portfolio Management, for tracking and evaluating investments in underlying funds; Shadow Accounting, for monitoring, reconciling and forecasting portfolio cash, payables/receivables, and FX balances; Liquidity, for determining how much cash is redeemable from hedge funds over time; and FX Hedging, for calculating FX exposure, hedging needs, and gains/losses on existing hedges. Data needs to be input only once. The HIP also accepts automatic electronic feeds from external third-party administration and/or in-house systems.

After a relatively short amount of time, FoHFs using FPMS report they are operating with greater confidence and that they have improved their performance, increased their ability to raise institutional funds, and expanded their investor reporting capabilities.

One FoHF, based in London, with \$200 million under management, believed their growth was hampered because the people maintaining their spreadsheets were overwhelmed. Within six months of replacing the spreadsheets with an FPMS, greater controls made it possible for it to open two new funds in record time and increase assets under management by 75%.

Key Asset Management, with offices in New York, London, and other European capitals, believes that the installation of an FPMS has helped it better report to existing and prospective investors, attract more institutional investors, and more than double assets under management, which now approximate \$2.8 billion, in less than 18 months.

Theta Capital Management, based in Amsterdam, uses an FPMS to provide a fully transparent web-based portfolio risk monitoring and performance attribution solution for its institutional clients. Within eight months of adopting the system, Theta also doubled its assets under management, to about \$1.2 billion.

As more FoHFs install FPMS, it will become easier to move to the next phase of FoHF technology -- electronic STP links between FoHFs, their administrators and banks, their investors, and the hedge funds in which they invest. This will enable data to be transmitted on an increasingly real time basis, someday perhaps rivaling the speed at which hedge funds themselves operate.

In light of the recent market volatility, the development of FPMS is well timed. Moreover, according to the latest statistics from The Barclay Group, FoHF assets under management broke the \$1 trillion USD mark for the first time during the quarter ended March 31, 2007, and now account for more than 39% of all money invested in hedge funds.

###

*Richard Koppel ([rich.koppel@youdevise.com](mailto:rich.koppel@youdevise.com)), Managing Director of youDevise Limited, advises funds of hedge funds on how to reduce risks associated with inadequate management information. Rich has more than 20 years experience in information technology development, implementation, consulting, and management. Prior to youDevise, Rich guided financial services clients for 10 years at McKinsey & Company on IT management issues, developed product and market strategies for leading IT providers, and helped lead the firm's computer industry practice. Rich was also a management consultant at the Information Consulting Group and at Coopers & Lybrand. Rich received a BS in physics from the Massachusetts Institute of Technology, an MBA from New York University, and a Ph.D. in English Literature from the University of Rochester.*

*Owain McNeill ([owain.mcneill@youdevise.com](mailto:owain.mcneill@youdevise.com)), Business Manager, Alternative Investments, for youDevise Limited, has become an expert on the unique management information needs of funds of hedge funds. Owain manages business development and project delivery in the alternative investment sector. Prior to becoming Business Manager, Owain managed the successful implementation of a custom billing solution for a major utilities company. Owain has an M.A. in History, and a B.A. in English and History from Prifysgol Cymru (The University of Wales, Aberystwyth).*