

Bradford Rowley of **Pacific Fund Systems** tells *HFMWeek* how fund administrators are responding to a changing environment

Trends in fund valuation



Bradford Rowley is a senior business analyst for **Pacific Fund Systems** and is based in London when he is not visiting clients.

As fund administration continues to play an increasingly important role in the hedge fund industry, the need for secure and efficient systems built to support the fund administration process is becoming ever more vital. For companies wanting to ensure they consistently provide a high-quality service to their clients, Pacific Fund Systems provide flexible, adaptable and scalable software solutions which enable fund administrators to work with both increased speed and cost-efficiency.

In light of the changing economic climate, Bradford Rowley, a senior business analyst for Pacific Fund Systems, explains how the fund administrators are responding to changes in the market and why effective and efficient software solutions are now playing a crucial role in the administration industry.

HFMWeek: In what ways does the application system provided by Pacific Fund Systems differ to other applications in the industry?

Bradford Rowley (BR): The core strength of PFS-Paxus lies in its integration. From the outset, our objective was to build a single system to support administrators to cover the breadth of their business. The functions of an administrator can be supported by a single system without having to build interfaces between various standalone systems that were not designed to talk to each other.

To my knowledge, there are few systems out there that can offer the same breadth of functionality for administrators on a single platform, and the advantage of this is that it maintains consistency of data throughout the fund administration process in a single database. This increases the efficiency of the fund administration process and gives administrators a single point of reference. Helpful side effects also include reduced IT costs and reduced training costs, due to the consistent interface. It is easy to make system selection far more complicated than it need be by having various competing systems under the same roof. An integrated system also allows for rapid recalculation of valuations. This is particularly relevant for the fund of funds sector where underlying asset prices are subject to regular revision and performance estimates are often demanded with each change in underlying asset price.

As one of the 'original' offshore fund administration centres we see Bermuda as a repository of high-quality fund administration knowledge and skills. We have been working with the Bermuda fund-administration community for 10 years, and feedback from that community has contributed to our product offering significantly. In my opinion, what makes the Bermuda community unique is the entrepreneurial approach they bring to their clients, and the boutique offerings they strive to provide to each of their clients. In turn, this has required us to be able to add functionality at short notice to provide for all manner of nuances – for example, there are a surprising number of different ways to calculate a management fee.

As specialists in the hedge fund administration industry we understand the demands of the industry and can respond appropriately to new requirements. When an administrator approaches us with a new requirement they do not have to explain it twice and, if for some reason the request cannot be rapidly built

into PFS-PAXUS, we are in a good position to advise on how best to accommodate it until permanent changes can be made to the application.

HFM: How has the changing financial climate affected market performance and what impact is this having on administrators' business?

BR: Many administrators saw very substantial reductions in assets under administration (AUM) in the third and fourth quarters of 2008. Given that their revenue is largely basis point derived this had a direct impact on revenue. We have seen encouraging signs of growth in the last three months, with many of our clients reporting that AUM are increasing again. The global financial crisis has also led to the creation of a significant number of side pockets which complicate administration and require highly skilled staff to oversee.

Despite the return to some form of normality in the markets, at least in terms of asset class correlations, many hedge funds are still below their high water marks (HWM). For those funds with annual HWMs, many missed their HWM at the end of 31 December 2008 and so the performance losses have been carried forward to the following performance fee period.

This has a significant effect when hurdles are involved and it is likely that some managers may attempt to change the way hurdles are calculated to incentivise them. In these cases the pertinent variable becomes the hurdle capital date. Where a fund is below the HWM, is the hurdle calculated upon the original HWM or is it reset at the date the HWM is tested?

For example, let's say a fund starts on 1 January 2008 at Net Asset Value (NAV) 100 and falls to NAV 75 at 31 December 2008. If the HWM is tested on 31 December 2008, does the hurdle apply to the starting price of NAV 100 or upon the 31 December 2008 NAV price of 75? This can have a material impact upon the future investment returns required for the manager to achieve a performance fee.

If the hurdle rate is 5%, then under the first approach the effective investment returns require to achieve a performance fee becomes 6.6% (for example Hurdle Rate 5% / NAV75 = 6.6%) which is obviously a more challenging target.

We are also seeing an increasing trend to change the way in which hurdles are applied as a result. Traditionally once the performance exceeds a hurdle, the performance fee is calculated upon the 'out-performance' (for example the performance above the hurdle). For example, if the hurdle is LIBOR (London Interbank Offered Rate) + 1% spread, and the LIBOR is 4%, then the performance fees will only be calculated upon returns exceeding 5%, and so if the performance is 8% the performance fee will be calculated upon the excess return of 3%.

More recently we are seeing an increased use of an alternative method where the performance fee is calculated upon the 'total performance' so long as the hurdle rate has been achieved. Using the same example, if the performance is 8%, the performance fee will be calculated upon the total 8% performance, but if the performance is 4.9%, the performance fee will be zero.

These calculations can be automated in Paxus under the multi-series or the performance fee equalisation models.

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HFM: How do you feel the fund industry is changing in terms of investment methods?

BR: The need for side pockets has become apparent as a result of the continued market volatility. Side pockets can be the best solution to enable the normal entry and exit of investors into the fund whilst ring-fencing distressed or illiquid investments to the group of shareholders who were invested at the time the issue manifested.

In this way the fund can continue normal operations and the NAV can be struck without the encumbrance of having to value illiquid or hard-to-value assets before finalising the NAV. By creating a side pocket, those specific assets can be owned by specific shareholders without affecting the performance of new shareholders who have entered the fund after the creation of the side pocket.

The calculation of both profit allocations and performance fees in the presence of side pockets can become considerably more complex as it is not equitable for the shareholder to pay performance fees on their original shareholding if the side pocket is bearing a performance loss.

In PFS-Paxus, any profits and losses arising from the side-pocket investments can be automatically allocated to the side-pocket shareholders. This is an example of where integration of portfolio, general ledger, fee calculations and share registry brings real benefits.

HFM: Going forward, what is the outlook for the fund-administration industry?

BR: We believe the future is bright for fund administration in Bermuda. As the changes to the regulatory environment unfold, we believe the resulting trend will see an increasing demand for transparency and independence of valuation driving demand for the services of fund administrators. There is also an increasing call for separation of duties, which may impact large institutions that offer both prime brokerage and fund administration services thus creating opportunities for boutique administrators.

As a result these trends will manifest in increasing investment in private equity-style investment vehicles (to avoid regulation), managed accounts (for transparency) and alternative investment managers will begin to step into the traditional manager space (due to regulatory supervision).

Much has been said recently about the likelihood of institutions pushing for managed account vehicles, although the push may be tempered once institutions consider the increased costs and potential unlimited liability that can arise from these vehicles in some circumstances.

Traditional hedge fund administrators in the offshore market need to be able to offer private equity in their suite of administration services, so we recently invested in PFS-Paxus to provide functionality to support private equity-style vehicles.

This is part of our commitment to support Bermuda administrators; we want to become business partners in helping entrepreneurs grow their fund administration business to share mutual success. ■