

# Outsourcing Trends in the Asia Pacific Hedge Fund Industry



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## Scope & Objectives

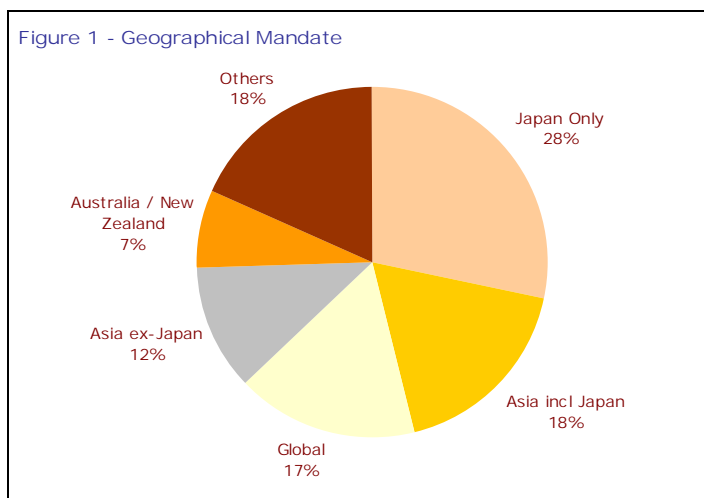
During the period from March to May of 2006, Quality Risk Management & Operations Limited (QRMO) commissioned the Statistical Department of City University of Hong Kong to conduct a telephone survey on outsourcing needs and requirements for hedge funds in the Asia Pacific region.

The survey aimed to achieve the following:

- Recognize the operational expenditure pattern in the hedge fund industry;
- Identify the areas within the hedge fund industry where the most improvement is needed;
- Understand the demand for independent operations and risk management;
- Know the outsourcing needs for the industry's operations and risk management functions

## Population Description

According to our database, as of March 2006, there were a total of 725 hedge funds with geographical investment mandates in Asia. After combining funds within the same fund group, the total number of hedge funds in the region was 376. Their geographical concentrations can be seen below:



**‘Long/Short Equities is the most popular strategy for hedge funds in Asia’**

As seen in Figure 1, the “Japan-Only” geographical mandate is the largest among the hedge funds in Asia (28%) with the second largest being “Asia incl Japan” (18%). The smallest is “Australia/New Zealand” (7%).

According to the database, among the 725 unique funds the most popular investment strategy is the “Long/Short Equities” (61%), the second most popular strategy is “Multi-Strategy” (14%), and other strategies are less than 10% of the total. The “CTA” strategy is the smallest (4%). This is depicted in Figure 2.



‘Majority of the hedge funds in the region are quite new with an average age of less than 2 years’

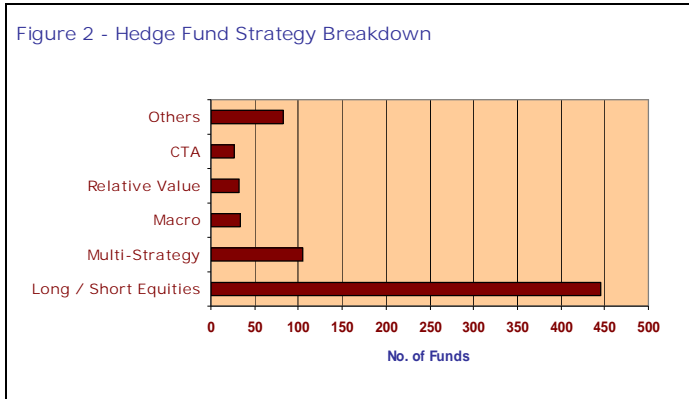
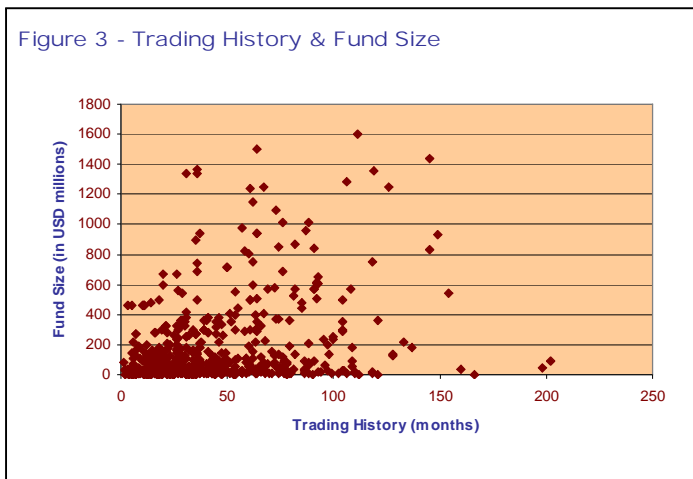


Figure 3 is a graph showing the relationship between Fund Size and Trading History for Hedge Funds investing in the Asian Region.



As shown in Figure 3, there is no direct correlation between Fund Size and Trading History. In fact, the correlation between the two variables is 0.33. For instance, there is a fund that has been trading for 166 months but only has a Fund Size of USD4 million whereas another fund has only been trading for 3 months but has already grown to USD461 million.

However, the data above only provides a snapshot of the Asian Hedge Fund industry and does not consider past fund injections and redemptions. Noticeably, there is a large cluster of funds located at the bottom left of the graph. This suggests that a great number of new entrants into the hedge fund industry. In fact, these new entrants make up most of the funds in the Asian region (about 40% are less than 25 months old). Table 1 shows two percentage breakdowns, one depicting fund age and the other fund size.

‘As compared to hedge funds in other regions, the ones trading in Asia are relatively smaller where fund sizes generally are within USD200m.’

Table 1 – Fund Size & Age of Funds

| Size (USD mio) | No. of Funds | Percentage |
|----------------|--------------|------------|
| 0 - 200        | 481          | 75.9%      |
| 201 - 400      | 79           | 12.5%      |
| 401 - 600      | 33           | 5.2%       |
| 601 - 800      | 13           | 2.1%       |
| 801 - 1,000    | 13           | 2.1%       |
| 1,001 - 1,200  | 4            | 0.6%       |
| 1,201 - 1,400  | 8            | 1.3%       |
| > 1,400        | 3            | 0.5%       |

| Age (months) | No. of Funds | Percentage |
|--------------|--------------|------------|
| 0 - 24       | 251          | 39.6%      |
| 25 - 48      | 200          | 31.6%      |
| 49 - 72      | 94           | 14.8%      |
| 73 - 96      | 53           | 8.4%       |
| 97 - 120     | 23           | 3.6%       |
| 121 - 144    | 8            | 1.3%       |
| 145 - 168    | 3            | 0.5%       |
| > 168        | 2            | 0.3%       |

Note: Of the 725 funds in the database, only 634 reported both their age and size, as shown above



## Summary of Findings

Out of a population of 376, there were 96 respondents that completed the survey during this period (25.5% response rate). They answered questions about their current system and operational infrastructure and their willingness and requirements for outsourcing any of their operational functions (i.e. Middle Office, Back Office, Risk Management, Legal & Compliance, Information Technology, Company Secretariat and Administration). Here are some of the key facts obtained from the survey results:

**‘Hedge funds in the region are aware of the needs from investors and regulators to strengthen their risk management and operational infrastructure.’**

- 29% of the respondents reported not using systems for the Middle Office, Back Office and Risk Management functions. The remaining 70% either have systems in place or services provided by their prime brokers and fund administrators, of which 3% of them are not satisfied with their current systems or services
- 50% of the respondents have been requested by either their investors or regulators to have a robust risk management and operational infrastructure in place

The following table indicates the % of respondents who either are willing to outsource or have already outsourced the various operational functions.

Table 2 – Outsourcing demands for each function

| Function                    | Willing to Outsource | Already Outsourced |
|-----------------------------|----------------------|--------------------|
| Back Office                 | 17%                  | 18%                |
| Middle Office               | 14%                  | 13%                |
| Risk Management             | 15%                  | 9%                 |
| Information Technology      | 25%                  | 39%                |
| Legal & Compliance          | 23%                  | 31%                |
| Secretariat & Administrator | 20%                  | 20%                |

‘Cost savings is the main criteria for hedge funds in outsourcing their supporting functions.’

- Almost all of the respondents who have already outsourced the above functions are satisfied with the current providers’ services.
- Of the respondents who already have an operational system infrastructure in place, 12% are still willing to outsource their Middle Office function; 16% for Back Office; 14% for Risk Management; and 25% for IT.
- In choosing an outsourced provider for the above functions, the respondents determined the top 3 criteria to be Cost Savings (25% of respondents), Timely Responses from the providers (15%), and Reputation of the providers within the industry (13%).

The findings of this survey indicate that almost one-third of the hedge funds trading in the region do not have a robust system or operational infrastructure in place to handle the Risk Management, Middle Office and Back Office functions. When investors are requesting their fund managers to not only generate a decent return on their investments, but also to have a solid support infrastructure in place to ensure all aspects of their risks (i.e. market and operational risks) are well-mitigated, fund managers are seeking to outsource these functions, mainly depending on costs that can be saved from developing them in-house.



## Analysis of Survey Results

### Independence of risk management and operational infrastructure

**‘The survey results strongly support the trend that hedge funds are facing increasing pressures from investors and regulators to implement a robust and independent risk management system.’**

The survey results state that 50% of the respondents have been requested by either investors or regulators to have robust operational and risk management systems in place. This data strongly supports the current trend that hedge funds are facing increasing pressure from their investors to have the best risk managers to implement sophisticated risk management systems. The idea of utilizing an outsourced independent middle/back office and risk management company will provide these investors with a greater level of security and comfort. Investors’ view that having an independent risk management and operational infrastructure give them more comfort as this provides independent monitoring of fund managers’ trading activities. It is most often the case that the operation staff and risk managers hired by the fund do not act independently and they do not challenge the fund managers on the transactions from a risk perspective. Consequently, it may be reasonable to state that investors will be more inclined to invest in a fund that has a sophisticated and independent operational and risk management infrastructure as opposed to one that is built internally and/or competitively unsophisticated.

‘Regulators in the region are in constant discussion of improving or tightening policies for monitoring the hedge fund industry.’

## Regulatory Developments

Recent regulatory requirements such as Sarbanes-Oxley and Basel II Accord demand many financial institutions to have robust internal controls in place. Although the hedge fund industry is currently not regulated in many countries, recent collapses of fund houses such as Long-Term Capital Management, Tiger Funds, and Refco have signaled the regulators that they should tighten controls in this industry as well. They are debating on this issue as some say that further tightening might hinder market liquidity as hedge funds are the major participants in the markets. Others say that by monitoring the conduct of the fund managers who are registered with the regulator is simply not sufficient as they cannot monitor their trading activities/transactions. As such, it might be deemed better to establish requirements for closer monitoring on their activities. Although it should not be the sole reason for having highly developed and independent operational and risk management systems, hedge funds that invest in them are likely to be better prepared in dealing with tougher regulatory requirements if and when they are imposed in comparison to hedge funds that do not have such systems in place.

After China joined WTO in 2001, the Chinese government is scheduled to open up its financial market to foreign institutions in 2006. In order to maintain their competitive strength, Chinese financial institutions have to improve their risk management functions in order to gain investor confidence and also to maintain market share in the China financial market. In order to aid in this effort, it may become the case whereby the Chinese Government adopts principles as contained in, for example, the Basel II Accord and IAS. This may eventually lead to legislation requiring both domestic and foreign investment vehicles investing in China regardless of origin, including Hedge Funds, to attain a certain standard of operational and risk management proficiency.



‘The number of hedge funds in the region is growing at an average rate of approximately 40% a year. Investors are looking for more returns and have been shifting their investments into the emerging markets.’

## Industry Trends in the Region

Outsourcing middle office, back office, and risk management functions is an increasing trend within the fund industry. Many funds are established with a team of traders and usually with only one or two operational staff handling functions including valuations, trade processing, fund administration, documentation, etc. These staff might not have the time or even proper knowledge in handling all these different tasks. As such, many funds opt for outsourcing certain key functions as they acknowledge there are potential operational risks if these functions are not properly addressed. Also, the cost of internally building a team of support staff as well as a proper booking and valuation system is not trivial. Therefore, they are more than willing to pay a fixed amount of fee for this service if the outsourced service provider can perform better than they do and at a cheaper cost, so that they can focus on what they do best – investing and trading.

The number of hedge funds trading in Asia is growing at a rate of ~40% per year. This growth spur was mainly due to the shifting of cash from G7 developed countries into emerging markets in the past 2-3 years as investment managers find the return of investment to be much more attractive in these regions. With the economic expansion of the two largest countries by population – China and India – these governments have gradually loosen

up their market control policies, enabling foreign investors to participate in trading the local markets. We expect this trend to continue for the long run as this is only the beginning. Whilst investors are searching for more return on their investments, they need to be aware of the risks embedded in these emerging markets as well. They need to concern themselves on market liquidity, geopolitical factors including relationships with neighboring countries, the amount of government interference on the market through laws and regulations, as well as the level of market transparency. More often, investors might not have the time to monitor the above on a daily basis and thus would rely on the fund managers to manage the risks of their portfolios. However, the main objective of these fund managers is to generate a return on investments and may not have the time to be fully aware of these types of risks when trying to achieve the targeted return. Therefore, investors are now requesting their fund managers to put in place solid risk management procedures and a strong operational support infrastructure as a criterion for them to invest in the funds. This has created opportunities for outsourcing companies who specialize in these areas to provide quality services at a reasonable cost. Furthermore, they act as an independent or "second opinion" advisor to the investors when they need it.

If you would like more information on the results of this survey, please contact [info@qrm.com](mailto:info@qrm.com)



## About QRMO

Quality Risk Management & Operations (QRMO) Limited is an independent professional company providing specialized outsourcing solutions in the areas of risk management, back office, middle office and other administrative functions for hedge funds, financial institutions and corporations in Asia.

Visit [www.qrmo.com](http://www.qrmo.com)



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