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Unexpected Surge in Trading Volumes and Volatility Raises Infrastructure Concerns for Hedge Funds

The market decline of Feb. 27 has prompted hedge funds to rethink their trading infrastructures to ensure they can cope with higher volumes and volatility.

By [Ivy Schmerken](#)
[Wall Street & Technology](#)
April 30, 2007

In the wake of the rising volumes, computer glitches and capacity shortages experienced during the market's brutal decline in late February, hedge funds are reevaluating their systems and capacity needs, according to several industry consultants and IT service providers. After [Feb. 27](#), when the stock market dropped 416 points and there were market data lags at Dow Jones & Company and slowdowns at the New York Stock Exchange, it's not surprising that hedge funds are reviewing their infrastructures to ensure they can perform in a more-volatile market.

Consultants and service providers say most large hedge funds were not impacted by the volatility in late February in terms of executing their orders and getting back position reports. "Larger firms that have invested in technology and operations have a robust technology infrastructure," says Jayesh Punater, CEO of Gravitas Technology, an IT services firm in New York that provides consulting, software development and systems integration for the alternative investment community. "Not only were they better able to cope with the market [decline], they were able to cope with market dynamics."

Still, hedge funds are concerned about their applications and the capacity of their infrastructures to withstand heavy trading volumes, say sources. "On a macro-level it definitely pushed people [who rely on automated trading] to look at capacity not only within infrastructure, but sustaining speed when capacity gets pushed," says Greg Treacy, director of U.S. sales at Neonet, an agency broker that provides direct-market-access trading to hedge funds and other buy-side firms.

Business as Usual?

Even prior to the recent market [volatility](#), hedge funds that attract investments from institutional investors were focusing on business continuity and disaster recovery (see related article, page 21). "When volatility strikes, you can feel the tension around making sure the operations are up and running," says Jim Loy, managing director at Gravitas. "There's definitely a link between volatility and the business continuity and disaster recovery curve."

Now hedge funds also are looking to beef up the real-time applications that generate reports on the funds' current investments and power their ability to perform "what if" scenario analysis on their holdings. These tools can be "nicely integrated with accounting systems and OMSs [order management systems] to allow the portfolio manager to make decisions," Gravitas' Punater says.

Some funds are setting up internal data warehouses so that they can generate their own reporting infrastructure and look at risk across portfolios, adds Loy, who previously was head of infrastructure at [Tiger Management](#), a leading hedge fund in the late 1990s, and subsequently worked in Morgan Stanley's prime brokerage business. "It truly simplifies the job of the operations departments as to what's the overall P&L for the firm, and there's attribution to different portfolio managers," Loy says. "It also gives hedge funds control over their data without being locked into canned reports," he explains. "You're not beholden to a vendor and you can slice and dice your data."

Another area of concern is the back-office "plumbing," such as making sure "the Microsoft applications and the e-mail and business continuity are robust so they are able to deal with huge volumes in trading," adds Gravitas' Punater. As hedge funds grow larger and they expand into multiple strategies and products, they are finding that their back offices have not kept up with their rapid growth in assets, he explains. In particular, hedge funds are focusing on accounting and back-office processing of trades, Punater observes, noting that investors also are demanding that funds have robust back-office recovery plans. In addition, "[funds] are also having a hard time getting the data to the portfolio managers," the Gravitas CEO asserts. "They may need to reengineer or re-architect their operations."

Small Firms, Big Problems

Small hedge funds, which comprise the bulk of the industry, have the most issues to deal with, as most have not invested in robust systems and could be running their positions and reconciling trades in spreadsheets, warn industry consultants and vendors. Out of the total universe of 9,000 hedge funds (or 13,000, as some studies report), there are only about 400 or 500 that have robust infrastructures, estimates Sameer Shalaby, CEO at Paladyne Systems, a provider of a hosted front-to-back-office technology for the hedge fund community. "The bulk of the market has little or no technology infrastructure," he contends.

Typically, only funds with \$1 billion or more in assets can afford a strong infrastructure, according to Shalaby. They don't get to be a multibillion-dollar fund without investing in infrastructure, as institutional investors require this as part of the due-diligence process, he notes.

But the bulk of the industry's assets are in the smaller hedge funds that can't afford to build their own infrastructures, Shalaby continues, and these funds may "start cutting corners" by doing some things on spreadsheets, or wait until next year to invest in an accounting system or order management system. "They'll definitely cut corners to manage costs until they have capital to deploy the infrastructure," Shalaby says.

But having the right risk-management systems in place is critical, particularly during volatile trading periods. "You can't fly a plane without radar, and in trading, some of these players have hundreds if not thousands of positions, and if you don't have a good risk-management system, you don't know what your risks are," says Steven Harrison, president and COO of Imagine Software, which offers Derivatives.com, a real-time hosted risk management system that aggregates positions from multiple prime brokers.

To tap functionality they otherwise may not be able to afford, most of these smaller hedge funds rely on their prime brokers to supply their technology, which usually includes connectivity to execution venues, market data and software to manage their positions. But, "The moment the hedge fund adds a second prime broker, it finds out the technology that one prime broker provides cannot aggregate the positions of the second prime broker," relates Gravitas' Punater. While some prime brokers offer a service to aggregate the data from the other primes, it's not in the interest of the hedge fund to let one prime broker see all of its positions and risk revealing its proprietary strategies, which is why the fund has multiple prime brokers in the first place, he notes. But if hedge funds can't consolidate all of their positions, they may not be aware of their overall risk, Punater stresses. Clearly, this could raise risks for the fund's clients, he adds.

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Rather than face these IT infrastructure challenges on their own, many hedge funds are turning to [solution providers](#) that can offer an integrated hosted infrastructure with all the components that the hedge fund needs as well as sufficient backup capabilities. "The idea is to supply a hedge fund with all the technology it needs to run its business, taking care of redundancy, disaster recovery requirements and all the connectivity to markets," says Paladyne's Shalaby. For its hedge fund OMS, Paladyne partners with other vendors, including NYFIX for order routing and market connectivity, Reuters for market data, and Advent's Geneva for derivatives accounting. "Our clients could frankly trade from an Internet cafe if they had to access their portfolios," Shalaby contends.

Such bullet-proof capabilities are becoming a competitive differentiator for hedge funds. According to Shalaby, one reason hedge funds are reacting to the recent market turbulence is that they are facing scrutiny from institutional investors that are asking about the resiliency of the funds' infrastructures and how they performed under previous emergencies, such as 9/11. "These are now becoming standard due-diligence questions," Shalaby says. "If you were down and you're competitor was up, then guess what, I'd rather invest with your competitor." <<<

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