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INFORMING THE HEDGE FUND COMMUNITY ISSUE 31 OCTOBER 2007

# Renaissance Investment Management

In the vanguard of frontier markets

**Blood on the Street**

A summer of crisis

**Responsible Self-Regulation**

With influence comes responsibility

**A New Source of Carbon Credits**

Carbon emissions projects in China

# Contents

October | 2007

4 **News**
News summaries from the UK, Europe, the US and Asia

12 **Renaissance Investment Management**
Looking to be in the vanguard of asset management in frontier markets. Simon Kerr reports

20 **Alternative Beta Replication**
The new investment paradigm, by Jaakko P Karki and Tapio Pekkala, Blue White Alternative Investments

24 **Structured Credit**
Why the rollercoaster ride is not over yet, by Erik Larsson, AlphaSwiss Group

25 **Japan**
No beta but plenty of alpha available, by Veryan Allen

26 **Responsible Self-Regulation**
With influence comes responsibility, by Paul Marshall, Co-founder, Marshall Wace Asset Management

27 **What Can We Learn from the Summer**
Market turmoil poses some awkward questions, by Liz Chong, EIM

28 **Blood on the Street**
A summer of crisis could be testing ground for managers, Stuart Fieldhouse reports

34 **Managing Regulatory Risk**
Hedge fund managers need to wake up to regulatory risk, says Craig Nichols, IMS Consulting Ltd

36 **Synthetic Replication**
Introducing a dynamic multi-factor approach, by Klaus Gams, Dr Martin Kuehrer and Dr Miroslav Mitev, Siemens AG

42 **Second Annual Hedge Funds Care UK Benefit**
October 3rd 2007, Natural History Museum, London

44 **Emerging Markets: Latin America**
The long and short of new equity issues in Latin America, by Stefan Herz, Charlemagne Capital

46 **Australia: Hedge Funds**
Will hedge funds down under become a dominant force, asks Laurence Davison?

50 **Time to Look over the Hedge?**
Litigation and liquidation strategies, by Jeremy Walton, Appleby

52 **US Capital Markets**
When liquidity becomes too much of a good thing, by James A Melcher, Balestra Capital examines

54 **Mining a New Source of Carbon Credits**
Man Investments backs carbon emissions projects in China. Stuart Fieldhouse reports

56 **Best Execution**
Lightening the hedge fund trading footprint, by Barry Marshall, CEO, BidRoute

58 **Regulation of Hedge Funds in Capital Markets Law**
A never ending story, by Dr Andreas Fillmann, Partner, Squire, Sanders & Dempsey

62 **Russia**
President Putin and Russia's Succession, by Denis A Maslov, Europe & Eurasia Analyst, Eurasia Group

63 **Reducing Back Office Operational Risk**
Raising investor confidence through back office reliability, by Ron Kashden, President, TKS Solutions

64 **Fed Rescues Wall Street**
Global interest rates peak as activity begins to slow, an economic outlook from Haydn Davies, Barclays Global Investors

66 **Fund Analysis**
Following in the footsteps of the Renaissance men, by Michael Markov, MPI

70 **Equity Portfolio Construction**
Enhancing "Alpha Engines" by Patrick Braun, MSCI Barra

72 **Hedge Fund Research – August 2007 fund rankings**
Performance data from HFR

76 **Professional Liability Insurance**
Using insurance as a way of managing exposures, by Sandy Crystal, Frank Crystal & Company

77 **People**
People news

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# Reducing Back Office Operational Risk

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When analyses of operational risks are performed the tendency is to focus primarily on the front office and largely overlook the back office. Questions such as: Were the trades properly funded?; Did any activity go beyond the fund's strategy?; or even, Are there concentrations that violate the offering memorandum? are addressed. Even when the back office is considered it is usually in terms of how it affects the portfolio, such as valuations. Reviews of important accounting areas such as investor income allocations or fee calculations are often completely overlooked, and even worse, are more often that not inaccurate. This situation is further compounded by the prevalent use of spreadsheets in the preparation of statements. It is this lack of attention that has led to the cycle of firms revising monthly statements and investors losing confidence.

By reviewing critical aspects of back office processing and focusing on the common troublesome areas described below, many of the typical operational risks can be mitigated. Furthermore, implementing one of the new solutions available on the market can provide a comprehensive view of investor accounting, unifying both partners and shareholders into one offering, and largely eliminating exposure to restatement risk.

### Calculations

The supervision of both the allocation of income to investors and the subsequent calculation of performance fees has been a particularly vexing problem in the industry. Offering documents continue to devise more ingenious ways of charging investors and equitably distributing income at the expense of back office procedural complexity.

First, the process of allocating income needs examination. Most of the time income allocation is based on investors' capital but there are many instances when this is not the case, such as income related to new issues. Certain investors, due to their relationship with broker dealers and other hedge funds, are precluded from participating in new issue income. Problems will arise if during the month-end processing all income is blindly allocated based upon capital without any consideration to the eligibility or ineligibility of the investor.

To mitigate this risk a review of the composition of the monthly returns must be done. For each category of income, determine if it pertains to all investors or just a subset. This study will reveal whether a portion of income needs to be specially allocated, as well as determine the participating group of investors.

After the review of income composition is the analysis of the fee calculations. Although the fees might appear simple, say 20 percent of income, this calculation can be deceptively complex. It is common for funds in their start-up phase to waive or reduce fees to attract initial investors. Combining those tranches of investors with the most basic loss-carry forward provisions and a simple 20 percent calculation falls beyond the capacity of most hand-held calculators.

For management fees, make sure the correct rate for each class of investor is used. Also confirm the date methodology used to pro-rate the fee. The most common are either 30/360 or actual/actual. One surprising industry mistake is to calculate a fee as 30/365, thus ensuring that the manager loses five days of fees every year.

For performance fees, review all the components of the calculation including: Has all the income been included in the base? Is the rate correct for the investor class? Was an existing loss carry forward taken into account? Was any claw back properly applied?

Continuing the focus on possible performance fee miscalculation, a review of all investor withdrawals should occur. It is a typical practice to charge a pro-rata portion of the accrued performance fee on investors in corporate feeders while not charging investors withdrawing from the partnership. If the fund has a loss carry forward, make sure a portion of the carry forward is reduced proportionally to the capital being withdrawn.

**Additional aspects**

There are two areas of exposure that usually can only be controlled through a review of the actual investor statements. The first is the verbiage used on the statements. Unfortunately, statement preparers can get creative when drafting headings and notes. Headings such as “Final Statement” or “Fund Collapse” (trying to describe the typical yearly shares series roll up) are two examples of such creativity that ultimately led to investor anxiety.

The second exposure that can only be addressed through manual review of the statements is the performance returns that are commonly presented. Most accounting systems just display the investor’s income and capital balance and only show the performance on the statements themselves. The entire workflow can proceed without anyone verifying the performance shown on the statements.

Another error prone area is subscription prices, which actually relate to the start of the period, rather than at month’s end. The most common industry practice is to use the prior month’s gross price per share for new subscriptions. Unfortunately, between the net prices and multiple share classes, an administrator has many prices to choose from for these new subscriptions. While choosing the wrong share price will merely alter the number of shares subscribed to, it can also force a reissuing of statements and damage investor confidence. It is not completely surprising that many organizations have resorted to using the initial share price from the offering memorandum in an effort to simplify the process.

Finally, the yearly process of generating tax returns should be taken into account. Many times tax processing is only considered as an after thought, though mistakes on the tax returns will cause tremendous frustration for the investors. Although a detailed discussion in tax preparation is beyond the scope of this article, suffice it to say, it should be given the consideration worthy of its potential exposure.

**Looking Forward**

The hedge fund industry continues expanding, with over approximately 9,000 funds surpassing 1.1 trillion USD under management. This growth is driving the need for more sophisticated back-end infrastructures and processes. Back-office processes are critical functions for any fund, especially now that more and more investors are asking about them. Investors are realizing that monthly reports are a potential exposure issue if information is incorrect, so they are demanding to see more overall control. The good news is that in addition to being vigilante about overseeing these processes, there is a hope on the horizon for managing investor reports. New software is available to automate these month-end tasks, which eliminates some of the reoccurring issues mentioned earlier.

Incorporating technology alongside a fund’s best practices reporting greatly reduces the back office exposure to operational mistakes. Technology and business vendors are working to better tailor software solutions to meet the demanding investor and monthly reporting activities for hedge funds. These software offerings combine the best of the old partnership and shareholder systems, and have rule based defaults so workflows become more systematic. While back office risks will not cause regulatory issues or violate the fund’s offering memorandum (like trading and front-office exposures), they can lead to the revision of the monthly statements and a loss of investor confidence. Maintaining the reputation of a fund is crucial to its longevity. Losing the trust of the investor base is a sure way to a fund’s early demise.

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