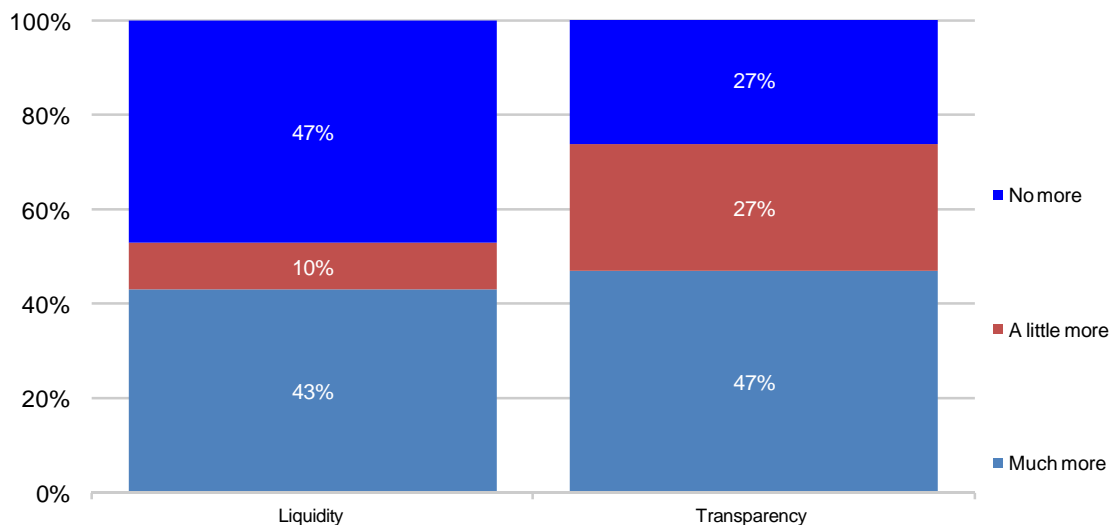


The market's drive for greater transparency and liquidity

Investor demands for greater liquidity and transparency in alternatives are unquestionably on the rise. This is one of the main conclusions that International Fund Investment (IFI) drew from the research that it did with KPMG early in 2010. As a result, it decided to explore the subject in greater detail and present its findings at a roundtable hosted by Koger, Inc. in New York City on 16 September.

At the roundtable, 22 investors, fund managers, administrators and consultants came together to discuss the results in light of their own experiences. IFI began by presenting the highlights of the research. She noted that roughly half of the investors interviewed (53%) believe that liquidity and three-quarters (74%) believe that transparency are more important now than it was two years ago when determining which alternative investments to allocate to (Figure 1).

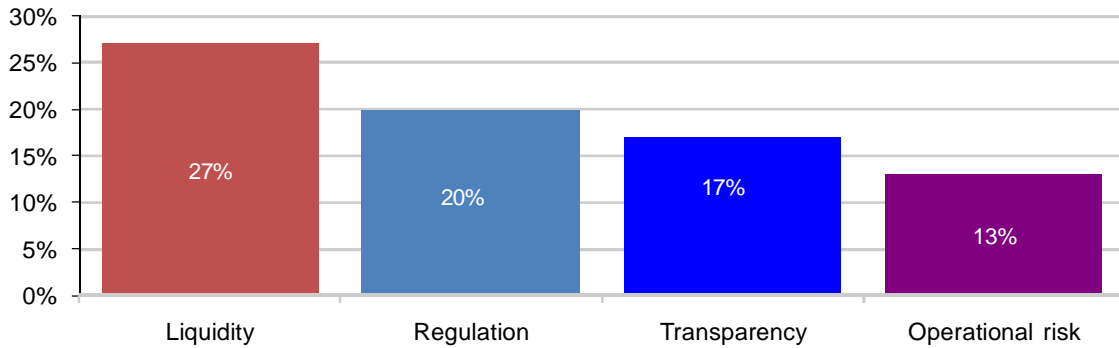
Figure 1) How much more important is liquidity when determining which alternative investments to allocate to than it was two years ago?



Source: IFI, 2010

When comparing these concepts to other issues of importance, the findings reveal that, outside of performance, liquidity has become the single most important concern facing alternative fund investors, as claimed by over a quarter (27%) of respondents. This is followed by regulatory issues (20%), demands for further transparency (17%) and operational risk (13%) (Figure 2).

Figure 2) What do you consider to be the most important issue facing alternative fund investors today (besides performance)?

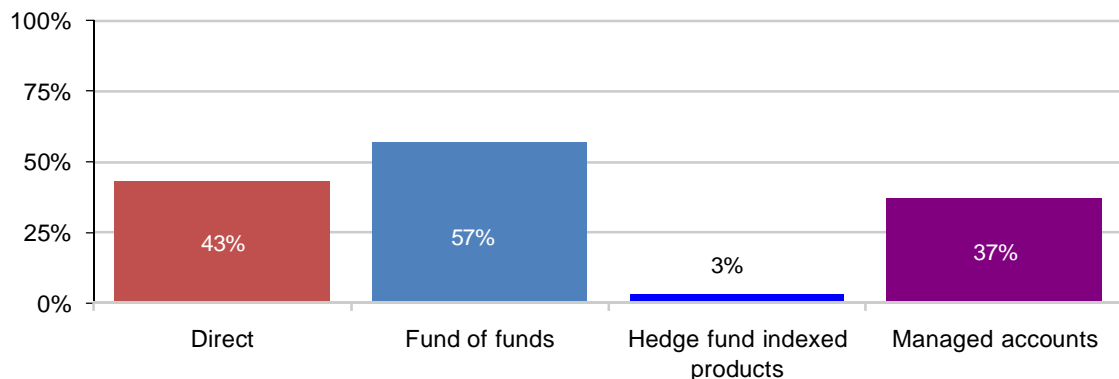


Source: IFI, 2010

Koger, Inc. initiated the discussion by delving into why liquidity and transparency have become such important topics in today's market. In doing so, participants recalled how the market crisis resulted in a rise in lock ups, gates and side-pockets which resulted in an inevitable liquidity crisis for investors.

Whilst the appetite for investing in alternatives has returned, there is still concern about the stability of funds and their ability to achieve long-term returns, and so the market is shifting towards more liquid investment strategies in what certain members of the table referred to as "a flight to liquidity". Investors, particularly the larger ones, are also trying to retain more control over their portfolio by investing more directly and via managed accounts, rather than through fund of funds. A number of the smaller investors are similarly displeased with the performance of fund of funds, but are unsure of how else to invest, as they often lack the financial capacity to invest directly or through managed accounts (Figure 3).

Figure 3) Which methods of investing will you be using for your allocations to hedge funds over the next 12 months?



Source: IFI, 2010

Investors also have on-going concerns about the lack of liquidity in the market and so they are being far more careful to match their investment strategy with their liquidity

requirements. To achieve this, they are expanding their due diligence procedures, and demanding more transparency from fund managers and service providers, particularly in the way of reporting requirements. Tom Davis from Meridian Fund Advisors stated, "What I've found is that managers are now more careful to match liquidity with strategy, and investors are using administrators, prime brokers, consultants and attorneys to review matters more thoroughly to ensure that the liquidity terms match what they are looking for."

When asked what investors now specifically require in terms of transparency, it emerged from the discussion that transparency in itself is not a straight forward concept. Rather, it seems to mean different things to different investors based on their angle in the market, and the dynamics of their business model and strategy. "What is transparency? Where does it begin and where does it end? What is enough transparency to one investor is not enough to another. Is it giving them the entire book or is it giving them access to the meetings of the pricing committee? I think that these are difficult questions to answer because it is a unique and custom requirement for every investor," said Greg Fenlon, Citco.

Despite this varied interpretation, there was a general uniformity of consent surrounding when a framework for transparency-related expectations needs to be created and that is in the due diligence process when investors are first establishing their funds. It was remarked that this is when investors relay to fund managers, and subsequently to service providers, their expectations regarding the on-going level of visibility and insight that they require.

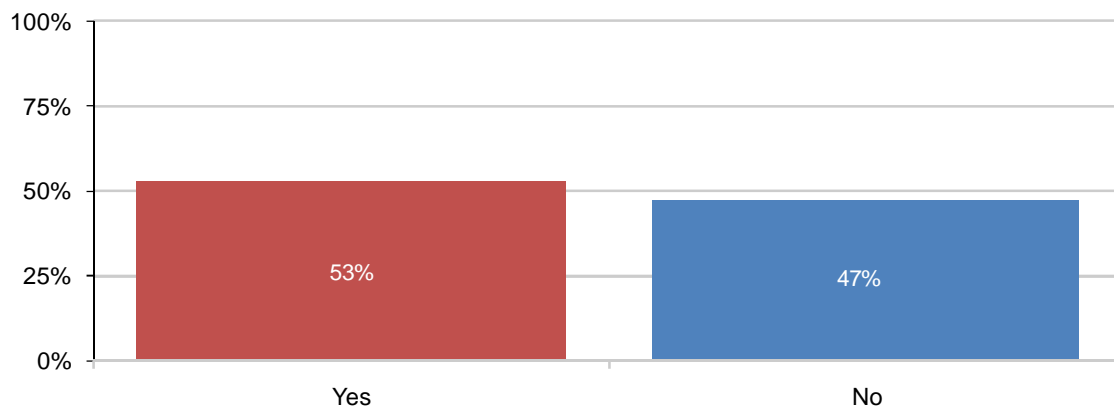
The attendees also uniformly agreed that such requirement levels have grown significantly. Myles Edwards from Foreside claimed, "Demands for greater transparency have increased exponentially. Investors are demanding it from a purely capitalistic standpoint; they need to provide a similar level of transparency as their peers."

In response, investors are making greater demands on fund managers and service providers and that this is, in turn, increasing the involvement between those in the front, middle and back office, thereby signifying a shift in the way the market is run. Paul Westhead from Rimrock remarked "Institutional investors are starting to emphasize good governance and the aspects behind the manager, and not just treating the manager as a specialised type of group that can go out there and make money for them. Now there is more emphasis on how they are running the fund."

Like a chain of command, this rise in investors' involvement is then flowing from the middle to the back office, altering the way that investors and managers work with service providers, and increasing the expectations they have of them. In the words of one attendee, "Investors are looking for much more transparency about the inside pieces of the business – securities and how the administration of those securities is being handled. I think that investors feel that they cannot get transparency through securities, and even if they do, what do they do with it. Therefore I think that they're much more focussed on internal transparency through their administrator and what they are doing with their books and records in the back office."

This claim was echoed by IFI's research findings, which showed that over half (53%) of investors claim that fund servicing issues are becoming more important to them (Figure 4).

Figure 4) Are fund servicing issues becoming more important to you?



Source: IFI, 2010

As a consequence, administrators are being required to provide more fund reporting information not only to managers, but also directly to investors, and the increasing demand placed on them has raised some concern. Karan Sampson from Macrum noted that some of the smaller administrators “do not have the infrastructure in place to provide the type of transparency or information that some of the institutional investors need”. Costs tend to climb the more transparency an administrator is required to provide, and some are struggling to pass such expenses onto managers and investors, and this is weakening their ability to offer such services. “Administrators try and pass on [the costs to the managers and investors], but they have to compete with others. It’s a huge challenge trying to keep up,” said Tom Davis.

Despite this, he further noted that improvements in fund servicing technology have enabled administrators to add more granularity and speed to their fund reporting. ‘When you go back five years and compare it to what we are doing today, it’s unbelievable. Advances in technology are enabling us to get more needed information and format it in the time frames desired.’

Another point that emerged from the discussion was that fund managers are beginning to duplicate some of the administration functions to retain more control over the handling of funds. “We’ve seen a number of cases where asset managers are replicating a lot of the work that administrators are doing,” claimed Keith Parker, Koger, Inc. “Managers either have shadow accounting systems or they use these systems to run parallel with the administrators to check the NAV on a frequent basis and make sure that it is spot on.”

In response, he added, ‘Is such replication a redundant exercise or is it always going to be the nature of the beast? ...When is enough, enough? How close are we to reaching the level of transparency that everyone is after?’

Myles Edwards replied, “We’re not at 100%. If I were to give you a number, I’d say that we are probably at 75%. But again it really depends on the fund, the manager, and really what the investor demands.”

All in all, this suggests that while the market crisis turned the funds industry on its head, investors, along with fund managers and administrators, are making progress towards alleviating uncertainty, instilling investment practices which are based on caution and calculation, and bringing stability back after a period of global turbulence.

Whether the changes in practice that have occurred will be adopted long-term or are just a temporary 'knee jerk reaction' to a market in chaos is still to be seen. IFI, however, predict that the centrality of transparency and liquidity's role in the market are likely to remain for years to come.

List of roundtable attendee firms:

Advanced Fund Administration
Magnitude Capital
Whitebirch
LaCrosse Global Fund Services
Citco
Columbus Avenue Consulting
Custom House
Concept Capital
Marcum
Trident Trust
Scott Goldring and Associates
Cadogan Management
Foreside Advisors
Rimrock
AIS Fund Administration
HSBC
Meridian Fund Advisors
Apex Fund Services
Koger
International Fund Investment

Koger, Inc., a leading provider of software and services for the fund administration industry, hosts roundtables on important industry topics at the Yale Club in New York City, bringing together leaders of top firms in fund administration, as well as fund managers and investors.

Established in 1994, Koger products are used by some of the largest and most respected financial institutions in the world. With offices in United States, Ireland, Slovakia and Australia, Koger provides comprehensive technical 24/5 support.

If you are interested in information regarding Koger, Inc. software solutions for administrators, hedge funds, pension funds, fund accountants, and fund of funds, please visit us at www.KogerUSA.com, or e-mail us at information@KogerUSA.com.

