

Industry Trends in Treasury Management: How have hedge funds' views on this function changed since Q3 of 2008?

The market turmoil of 2008's fourth quarter, the continuing credit crunch of 2009, and increasing due diligence from sophisticated investors have all forced treasury management to the top of Hedge Fund CFOs' "to-do" lists. The greater scrutiny of the processes and best practices in treasury management raise multiple questions for every fund: Where is the best place to put "free cash" to use? What's the risk exposure to your counterparty and how do you mitigate it? How do you balance security with optimal earnings? And what operational structure(s) should you put in place to do all of this as effectively as possible?

The HFBOA interviewed four players in the hedge fund industry, and asked each to share his unique perspective on treasury management by answering ten targeted questions on the subject - how have the views of these professionals changed since last fall?

Meet our panelists:

Hedge Fund, Panelist A:

CFO with 16 years industry experience. The firm, which employs 80 people and operates in eight countries, was formed to invest in special situations and distressed or otherwise undervalued assets and securities located primarily in Asia, and has \$1.5B in AUM.

Hedge Fund, Panelist B:

CFO with 13 years of experience, the last 9 of which in the hedge fund industry, and currently with a Short-Term Trading "Commodity Trading Advisor" that systematically trades Managed Futures & Foreign Exchange Forwards, with 12 employees and approximately \$463 Million in Assets under Management.

Hedge Fund, Panelist C:

A Chief Financial Officer of a \$500mm investment manager, currently with 18 employees, that focuses on global macro through both onshore and offshore hedge funds, with over 17 years experience in the hedge fund industry. Firm is multi-primed along with the fact that each fund has a segregated bank account used for paying all expenses. Most of the financial instruments traded are OTC so the firm usually has excess cash as collateral requirements are low and therefore the CFO is responsible for not only overseeing the Treasury Functions but the creation and maintenance of the firm's policies and procedures.

Topic Expert:

Carl Versella, Principal of HC Associates, an independent consulting firm that has successfully implemented treasury management functions on behalf of its clients.

The Interview:

1. What encompasses the treasury management function for a hedge fund in today's world?

Carl Versella provided a comprehensive definition of treasury management and explained that it encompasses 5 major concerns:

- ♦ Cash management: the effective utilization of any excess cash you may have
- ♦ Collateral management: understanding where the collateral is housed for trading and the effective optimization of that collateral
- ♦ Interest monitoring: Understanding and reconciling interest calculations for debit, credit, rebates and fees
- ♦ Securities lending: encompassing both those positions needed to short as well as potential positions where you may want to lend
- ♦ All other fees associated with the financing of a portfolio: understanding the actual cost of doing business, including additional fees charged by custody banks, brokerage firms and prime brokers

The CFO panelists each focused on a different aspect of Versella's definition, and their varying operational structures and fund strategies make for different approaches to the problem. Of course all cited capital preservation of excess cash as a top concern, but while Panelist C listed counterparty and credit risk as his top concerns, Panelist A said that cash flow forecasting and continual monitoring against forecasted funding requirements was a top priority, given his firm's distressed asset focus. For Panelist B, internal controls such as tightly monitoring the authorization and movement of funds and coordinating the efficient and timely movement of incoming and outgoing funds was the focus.

2. Why is treasury management so important in today's environment?

On this, all of the CFO panelists agree that counterparty risk and answering to the due diligence of investors are what most concerns them, and this outlines the basis for their treasury management decisions. Panelist B points out that "the safety of funds and the health of financial institutions are grave concerns."

Panelist A's fund invests notable resources in its treasury management function, which works closely with the firm's risk management team, to monitor exposures in multiple currencies to multiple counterparties. He says, "While counter-party risk is obviously at the top of our priority list, the monitoring of potential cash flow mismatches and having a well rehearsed plan to move cash amongst various counterparties, particularly in countries

which do not offer government guaranteed accounts, is also a key focus.”

Panelist C points out that “I wouldn’t be answering to my fiduciary responsibilities to the investors in our Funds if I didn’t do the best I can with that free cash.” He’s constantly judging how to ensure the cash is as secure as possible, without completely sacrificing its earning power. Now that his investors are asking harder questions in their due diligence process, he gears his treasury management practices to be able to answer these concerns as completely and as accurately as possible.

While Versella agrees that the above are important, he also stresses a third point overlooked by the other panelists: The cost of doing business. Versella points out that the last 18 months have brought on an extreme contraction in the ability of brokers and custody banks to extend credit, which of course puts tremendous pressure on the hedge fund community for its financing needs. Also, the dynamics of a hedge fund’s portfolio change every day and understanding these dynamics – and how they affect the bottom line – is crucial. “The fact is that the same entities that were lending you money freely last year are no longer lending it freely – the cost of doing business has changed.”

3. Which treasury management function should a fund focus on first?

Panelist C maintains that “cash is king,” and so believes that funds should focus first on the safety and security of their excess cash. “If your cash is not secure and safe and your prime broker goes belly up, you may be stuck not being able to trade, a death knell.” Panelist B again stresses the importance of internal controls, such as a system that effectively coordinates the efficient and timely movement of incoming & outgoing funds. Both he and Panelist A agree that monitoring counterparty risk and ensuring cash preservation remain big concerns, even if “systemic risks have subsided for the time being.”

Outside of understanding the counterparty risk concerns, Versella takes counterparty monitoring to the next level in his advice for funds. “I tell each client the same thing – it’s the block and tackling – you have to understand the fundamental way counterparties are financing your portfolio. If you don’t understand the basics, you can’t do the sexy stuff.” Versella notes that oftentimes prime brokers and custody banks calculate interest incorrectly, mismanage margin concerns and are slow to adjust rates in the clients’ favor. It is the hedge funds’ job to understand and monitor accordingly. Understanding how rates change from day to day, how interest is calculated, margin reconciliation... these key and simple components are what funds should do on a daily basis, and learn to do first.

4. Can the treasury management function be used as an alpha generation tool?

All panelists agree: Yes, the treasury management function can indeed be used to generate alpha.

Versella says that once “you have the fundamentals in place, you can then utilize your existing portfolio to generate additional alpha. Once the fundamental components are under control and counterparty risk is identified, only then can you get to the more sexy stuff.”

Panelist C says, “We don’t look at it that way – we’re more conservative. I want to make sure its safe and secure – I want to ensure I have the cash there that can pay them [the investors].” Panelist B agrees that alpha generation “shouldn’t be the primary focus” of treasury management, “and it also should not occur by reducing tight internal controls, the efficient movement of funds and capital preservation.”

Panelist A’s treasury management team also takes a conservative approach given its investment focus in illiquid assets. While they try to seek the appropriate balance between yield enhancement and capital preservation, the alpha generally comes through “monitoring our current and forecasted exposure to various currencies and effectively hedge currency exposure and optimizing conversions back into U.S. dollars.”

5. What credit risk concerns have to be identified while doing this function?

The unanimous decision? Counterparty risk.

Versella says, “Hedge funds have to understand the underlying credit concerns of the counterparty you’re dealing with.” He noted the key questions he would advise any fund to ask themselves are:

- Who is stronger in which areas in terms of extending credit? Why?
- Do you have diversified credit risk? How is diversification employed in terms of your assets?
- Are there any concentrations within your counterparties and what are they?
- How quickly can assets be moved from any particular entity of concern?

Panelist B monitors the credit-worthiness of their counterparties on a constant, ongoing basis and Panelist A’s fund carefully monitors cash balances held with various counterparties as well as the CDS spreads and stock prices of those counterparties. He also ensures he has bilateral CSA and ISDA agreements.

Last fall, Panelist C ran a daily report to ensure his traders had enough cash with their prime broker to continue trading, but absolutely no more than necessary, as the fall of 2008 brought about fears of default by prime

brokers, sans the reasons why they are now multi-primed. Now he runs that report weekly and monitors the risk he's exposed to with his four counterparties.

6. How should securities lending be managed, and where should it reside in the organization?

While the funds we interviewed don't employ securities lending as part of their treasury management function, Versella offered tactical advice for funds that do lend securities:

- ◆ Securities lending should be managed daily by the trading desk and reported to the COO or CFO
- ◆ It has to be analyzed and reconciled on a daily basis, as the interest rate market is dynamic, especially in today's environment.
- ◆ An outgrowth of today's credit concerns: firms are introducing a credit management team. In some cases there are dual reporting lines or a more formal dialogue from the securities lending/financing desk to this team. This could be accomplished with existing analyst staff if there is one that concentrates on the financial sector.

7. How does the OTC counterparty documentation impact the treasury management function?

Versella recalls how "cross-defaults crushed the portfolios of a lot of funds in the last quarter of 2008 ... there are situations where terms in ISDA agreements can definitely impact your treasury management function." Panelist C agrees, and says it boils down to this: "Have you read the agreements and do you understand the arbitration rules?" In an environment where the prime brokers are always wanting to renegotiate triggers in ISDAs and financing in swaps, Panelist A's team "also focuses attention at the trade level to ensure that confirmation language is consistent with that negotiated at the master level in ISDAs and CSAs to avoid unfavorable termination provisions and collateral posting."

8. What operational requirements are needed to effectively manage the treasury function?

Each of the funds integrates treasury management into their operations differently. Panelist C's role as the CFO of his fund evolved last fall to take on treasury management as a part of his daily responsibilities. Thanks in large part to their strategy as a global macro fund, "it didn't add more than 15 minutes a day to my job, as we already had controls over cash movement. We just added a layer of counterparty review." Panelist B maintains that a firm with the necessary manpower and technology can surely integrate treasury management into its existing operational framework. Panelist A, whose fund has a well-established treasury

management team, shares this advice: "It's about having experienced resources to manage counter-party relationships and portfolio financing needs along with personnel with strong attention to detail to monitor and call collateral on a timely basis."

Versella provides this viewpoint, as someone who assists funds in establishing this function from scratch. According to Versella, funds need:

- ◆ Someone who understands the financing of the portfolio
- ◆ Someone with experience and who understands inherent risks in OTC counterparties that are extending credit
- ◆ Fundamental procedures in place to adequately recognize all the data points, in order to make assessments of financing needs
- ◆ Adequate reporting lines, where there's a fluid process from the actions taken by the treasury manager and senior management to understand the inherent risks and where the portfolio(s) reside.

9. How should margin and liquidity of the portfolio be managed?

The short answer: Daily.

Panelist A & Panelist C both rely on their staff to monitor the marks of positions held with counterparties and to call collateral consistently.

Panelist B independently monitors their portfolio's margin requirements on a live 24/7, real-time basis, via their proprietary database system. This, coupled with the daily margin reports they receive from their prime brokers, notifies them of the current excess margin over the initial or maintenance margin requirements, or notifies them of the current shortfall, whichever the case may be. When excess margin exceeds a certain tolerance level, they get swept into a commercial bank account of the fund and then U.S. treasury bills are purchased with the proceeds.

10. In this world of multi prime brokerage facilities, what is the most important aspect that funds need to concentrate on when it comes to the information provided by the prime brokers?

"More information is better than less, obviously," Panelist C points out. He monitors the margin reports, cash/debit reports and collateral reports from his prime brokers. More important than the information they provide, however, is what the prime broker can actually do for his fund. His prime broker "can clear any type of financial instrument we trade."

Panelist B focuses on three key questions, when considering multi-prime brokerage facilities:

- ◆ Does it mitigate counterparty risk?
- ◆ Does it provide an additional source of alpha-generating ideas?

- ◆ Does it provide an additional source for capital introductions?

Although Panelist A's fund doesn't use much leverage and his positions are typically fully funded, he thinks that generally prime brokers need a strong reporting platforms that can , amongst other things, provide timely data on segregation and rehypothecation on an asset-by-asset level. Versella advises all funds to concentrate on the reporting being received from prime brokers – do you truly understand it completely? He notes that many of his clients may not fully understand what the prime brokers are providing them. "Each [prime broker] has different platforms, risk tolerances, reporting schema, and margin calculators ... it is our job to educate our clients on the nuances of each credit counterparty," Versella stressed again, "Understanding the basics is key – once you know the basics, you can get into the alpha generation phase and be successful at it."

Food for Thought:

The HFBOA will be delving deeper into this issue during our annual meeting this September in New York City. Join your peers and other HFBOA members, hedge fund executives from around the country, during this closed-door breakfast session on Friday morning, September 25th:

8:00 – 8:45

Hedge Fund Manager Closed-Door Breakfast

Treasury Management: The Balancing Act between Preserving Cash & Searching for Higher Returns

Join other hedge fund executives in this closed-door session and discuss this timely issue with your peers – don't miss this opportunity to share and learn best practices with other attendees over a hot cup of coffee!

The program agenda for the 4th annual meeting is now available online. Visit us at www.hfboa.org to check out the event, and to register!

Special thanks to:

HC Associates

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Patrick is the Co-Founder of iFind Group. He began his professional career at Arthur Andersen and practiced nationally in New York, Silicon Valley and Chicago as well as abroad in Europe. He worked both in the Audit practice as well as the Transaction Advisory Services group. Patrick earned his Bachelor of Business Administration degree in Accountancy from the University of Notre Dame graduating with honors. He was also a member of the Division I track and cross country teams. He is in the Founder's Circle of the University's Sorin Society and active as a member of the Monogram Club. Also, he serves as a volunteer in the Job Opportunities Program (JOP) – a mentoring program that teaches New York City high school students relevant job skills. He successfully passed the Uniform CPA Exam.

Patrick, his wife Flavia and their child enjoy living on the Upper West Side.