Valuation, transparency and liquidity are watchwords

The impact of the financial crisis on the hedge fund sector will reverberate for some time. Auditors and accountants expect to have to grapple with the fall out of fund closures and restructuring for some time.

Olwyn Alexander, partner in assurance investment management at PricewaterhouseCoopers (PwC) in Dublin, believes the impact on the hedge fund industry from restructuring, gates and suspended redemptions will continue to haunt the industry for some time. Like many others, she believes liquidity and transparency issues will dominate the funds industry together with continued concerns over valuation and operational risk.

Despite the gloom, Alexander believes managers are already seeing opportunities in distressed debts and assets. While she is cautious about the type of structures funds will opt for in future, she too thinks regulated products may become more common than in the past.

Ken Owens, a partner in assurance business and advisory services at PwC agrees that investors may be looking more at regulated products than before.

He believes if hedge funds can fit their strategies into a regulated product, it could attract more investors. He sees the Ucits global brand as a highly regulated and safer product for investors.

Regulated products, believes Owens, will be more attractive to the larger hedge funds who can afford the costs of compliance. The smaller Cayman Islands funds that have more flexibility but lack the infrastructure needed for compliance will be less interested in products such as Ucits he believes.

Andrea Kelly, another partner in the assurance sector, also thinks clients are looking at alternatives to the traditional Cayman structures. She thinks in Europe the Irish qualified investor funds and Ucits will attract the most attention and, hopefully, more business opportunities for Ireland.

The allure of regulated jurisdictions without any taint or hint of tax haven status should also play to Ireland's strengths. Alexander particularly thinks OECD countries that are "not on any lists" will be more attracting in future for both fund managers and investors.

Overall she does not think regulation will come as too much of a shock to the industry. As it has matured, more regulation she thinks was inevitable. The fallout from the financial crisis has, however, speeded up the process. What she and her colleagues are most concerned about is an attempt to have a "one size fits all" legislative approach. For example, they think the draft EU directive on alternative investment managers leave a huge number of unanswered questions, not least of all a clear definition of the investment manager. They caution against knee jerk regulation that could have unexpected and adverse effects on the industry.

Owens believes the excessive secrecy of some hedge funds has not

IRISH-REGISTERED UCITS FUNDS

Year end	Net asset value (€ million)	Annual growth (%)	% of total NAV represented by Ucits
2000	145,413	54	70
2001	214,820	48	75
2002	238,467	11	78
2003	285,642	20	79
2004	343,377	20	79
2005	465,339	36	79
2006	582,737	25	80
2007	647,469	11	80
2008	517,702	-20	80
March 2009	510,975	-1	81

Source: Irish Financial Regulator

At Ernst & Young partner Aidan Tiernan echoes the thoughts of many. The financial crisis has had a dramatic impact on clients, he says. There is now a sharp focus on how hedge funds operate, prime broker relationships and hedge fund counterparty risks.

helped their cause. More transparency he believes is the best antidote to arguments against hedge funds and could also diffuse investor concerns about liquidity issues as well as operational risks. He predicts that hedge funds across the board will be giving investors a lot more information in the future, regardless of what regulations are imposed on them.

Whatever the future of the hedge fund industry will be, Alexander believes Ireland's "huge pool of experience" will put it at the forefront. Its strategic position as an EU member state but with strong ties to the US give it, she believes, a core advantage that will not change regardless of what regulations is enacted on either side of the Atlantic.

Owens is particularly optimistic about Ireland's ability to attract more work and interest from the Middle East. He points out that Ireland's financial regulator has been briefed on the differences between Shariah-compliant fund structures and existing QIF and Ucits rules.

He thinks the wide scale understanding and acceptance of the Ucits brand already by Middle Eastern investors and fund managers should help Ireland attract more business from that area of the world.

At Ernst & Young, partner Aidan Tiernan echoes the thoughts of many. The financial crisis has had a dramatic impact on clients, he says. There is now a sharp focus on how hedge funds operate, prime broker relationships and hedge fund counterparty risks.

He believes the real catalyst that has led to deep and profound changes in the hedge fund world was cause by the collapse of Lehman Brothers in September 2008.

That event more than any other highlighted some of the shortcomings in hedge fund operational structures and at the same time led to real liquidity problems.

While fallout from the Madoff debacle will impact the sector, too, Tiernan believes the more lasting consequences of the Lehman bankruptcy will shape the industry in future.

Tiernan also thinks fund closures could continue well into 2011 and even 2012. While some may be relaunched, he thinks the long-term winding down of some funds will be dictated by the inability to sell some assets and the complexity of unwinding some fund positions.

Although he is not predicting a decrease in growth this calendar year, he like others wonders if the pendulum is swinging over towards regulated vehicles.

Unlike others, he thinks there are still many reasons why unregulated, traditional Cayman Islands products will continue to be attractive to both fund managers and investors.

Big questions

The big question, notes Tiernan, is where capital will come from in future. He is less sanguine about the ability of smaller funds to survive. With a relatively small number of funds at present already commanding the bulk of hedge fund investments, he wonders if smaller funds will be able to survive a more regulated environment. What eventually emerges from the European legislative machinery could also determine whether funds will be able to launch with smaller asset levels. The high cost of compliance may prohibit these in future.

Fellow partner at Ernst & Young, Eoin MacManus, is cautious about saying if regulated funds will dominate in future. He points out that the industry is certainly evolving. The fund of hedge funds sector as well as the single manager funds are undergoing major overhauls.

MacManus also has concerns surrounding valuation of assets and in particularly hard to value over the counter assets. He expects clearer accounting rules and a bit more convergence between the US and international accounting rules to help bring some order to this area.

If models are too different, depending on which one is used, funds could come out with very different net asset values.

This he believes increases the problems auditors will have in signing off fund accounts in future, particularly if clarity is not brought to the issue.

On the issue of Shariah compliant hedge funds, MacManus says there are few auditing problems.

He points out that Ernst & Young have been decaling with Shariah-compliant clients for over a decade.

However, he thinks this could be an area for growth in future and is something Ireland's funds services sector is well placed to take advantage of.

At Deloitte, director of audit services Christian MacManus is cautious about the future. He says the rapid fall in assets under management has hit the Irish fund industry hard. He says it is an "exceptionally tough environment" to operate in and he agrees with Ernst & Young that it could take time for some funds to wind down and close.

On the positive side he believes the economic decline in Ireland has had something of a positive effect on the funds industry and for the jurisdiction as a whole as it has helped boost operational efficiency and driven costs down.

With most companies imposing pay cuts or freezes as well as trimming staff, he thinks Ireland's fund services will emerge from the economic downturn in a better competitive position, concludes Deloitte's MacManus. ■

ETF POPULARITY SHOWS PROMISE FOR IRISH EXCHANGE

Exchange traded funds (ETFs) have become a well established and rapidly growing product. The Irish Stock Exchange (ISE) introduced its first ETF on Irish underlying to the Irish market in April 2005 with the launch of the ISEQ 20 ETF which tracks the ISEQ 20 Index.

This index was specifically developed by the ISE to provide a benchmark for index-based products such as ETFs and its constituents are twenty of the leading Irish stocks based on market capitalisation and liquidity.

At the end of April 2009, there were 1,677 ETFs, with 3,009 listings and assets of $706.87 billon from 90 providers on 43 exchanges around the world.

Given the global growth in ETFs to date, projections for $2 trillion global AUM in 2011 and the scope for significant growth in ETFs as an asset class in Ireland, the ISE has launched an ETF segment giving investors the opportunity to gain investment exposure to a broad range of underlying assets via ETFs traded on the exchange.

Settlement of ETFs traded on the ISE is through CREST. Standard settlement is on a T+3 basis. ETFs at the ISE are central counterparty eligible securities.

Investors can access via the exchange a suite of products from ETF Securities and the existing ISEQ 20 ETF. The initial 13 ETFs from ETF Securities are mainly sector and commodity specific with a global reach.

ISE ETFs are subject to the same regulatory regime as other instruments admitted to trading on the ISE. The Irish Financial Services regulatory authority authorises the prospectus and has supervisory responsibility for the authorisation of Irish domiciled ETFs. The Irish regulator also authorises the management companies of Irish domiciled ETFs.

Some ETF issuers, such as ETF Securities, use derivative products instead of the traditional method of purchasing securities in the underlying index in order to replicate the performance of the index. By entering into swap agreements the issuer can negate some of the factors that contribute to tracking error and achieve a more accurate replication of the performance of the underlying index.

Cash invested in an ETF issued by ETF Securities is held in a basket of money market instruments with the interest income earned is used to pay the swap provider. In return the swap provider pays the performance of the underlying index to the ETF.

The cash invested in the basket of money market instruments is segregated from the swap provider thereby minimising counterparty credit exposure.