

## Conquering the cloud

By Rob Langston - March 20th, 2014

*How hedge funds are incorporating cloud infrastructure and the path to greater adoption*



Technology remains among the biggest outlays for start-up hedge funds and one of the key areas often identified for investment. As costs and regulatory burdens have increased, so the use of cloud technology has grown.

Once considered faddish and expensive, cloud services are now a crucial part of many hedge fund managers' businesses.

Greater education in recent years has helped funds understand the technology better. An increased focus on controlling costs has also helped raise the popularity of cloud services, as managers seek to avoid building and maintaining internal systems.

"The cloud has been a long time in coming," says Henry Duncombe, managing director at British IT consultancy Lanware. "Initially it was a tough sell. Cloud services were expensive, a lot of the infrastructure had to be dedicated to each client. The culture within the fund industry is to keep assets within the office walls, but it is very clear now that investors think there are more secure locations."

### **Adoption grows as services expand**

Service providers are witnessing first-hand the growth in adoption of cloud services by hedge funds.

"We are seeing more and more cloud-based solutions in use at hedge fund firms, starting with their CRM [customer relationship management] systems," explains Jim Warren, managing director for solutions at SEI Investment Management Services.

“As managers become more and more comfortable with the capabilities of their CRM providers, they are looking to store other data in the cloud as well.”

“There is still some luddite-like thinking about cloud service, and the notion that your data is safer internally is simply false,” adds David Collins, global head of strategic alliance at US firm SuperDerivatives. “This is the usual objection most businesses have when considering whether to adopt cloud storage.”

More recently, cloud service providers have started expanding their offerings to provide a one-stop-shop for managers, moving on from CRM and data storage and into other areas.

One example, given recent regulatory developments and an increased emphasis on transparency, is in the area of risk management. Indeed, the regulatory burden with new reporting requirements brought in by initiatives such as AIFMD and Form PF has been embraced by cloud service providers.

Robert O’Boyle, senior vice president of business development and sales at New York-headquartered hedge fund technology firm Liquid, says an increasing number of managers are interested in risk analytics and reporting services from the cloud.

“Funds are recognising there is a need for real-time risk reporting so they can handle investor requests for transparency as investors asks for it,” he explains. “This is a real change in the risk landscape [for managers] because traditionally it was end-of-day or week and might come from the prime broker or somebody else, the systems were very expensive.”

One benefit for managers using cloud service providers is the level of trust placed in them by institutional investors and seed investors. In difficult asset-raising environments similar to what has been seen in the past few years, the use of cloud services can make gathering assets easier. Although hedge fund managers may try to control costs initially, not spending on robust systems early on could harm their chances gaining momentum.

### **Private clouds and adoption hurdles**

Public cloud offerings are likely to be frowned upon as unprofessional by more some investors who demand security and transparency before committing cash to existing and emerging managers.

“There is no appetite for public cloud from allocators,” says Nigel Brooks of London-based provider Capital Support. “There is an appetite for community cloud, but if you’re serious and talking about getting a \$50m-\$100m ticket the ultimate is still private cloud.

“You can go online and get a couple of e-mail addresses and Dropbox, but if you’re serious about getting big ticket investors, they’re going to run a mile. You can’t control where your data sits, you can’t 100% say data is secure, you’ll probably struggle to comply with new regulations.” he explains.

Separately, one London-based hedge fund manager agreed. “If you want a good seed investor they are going to want to know that you have an institutional -grade solution to this issue, our seeders in particular want to know that we have a very robust disaster recovery function.

“In this day and age if you want institutional investors, they will want an institutional outfit in return; you’ve got to have your disaster recovery in place.”

For some hedge fund companies the idea of transferring to cloud-based systems may be difficult to envisage, and some of the larger, well-established firms have found it difficult to make the transition. One service provider commented that for one well-staffed UK asset management client, with AuM of more than \$400bn, it had taken a year for the process to complete.

“You might find some of the very large hedge fund firms with their own systems and processes in place that they feel comfortable with,” says Steve Kremidas, senior vice president and chief development officer at SS&C Technologies. “But I think over time a lot of the start-ups that grow into large firms, don’t currently have money to buy all the infrastructure will start with cloud-based provider.”

One vendor commented there may be a perception among hedge fund CTOs at established firms, who may be nervous about converting to cloud-based systems, that it could force their exit or a reduction in their role and responsibilities.

Even still there is appetite for cloud services from established funds although uptake has been at a much lower rate than in the start-up market, likely because the process for smaller start-ups is much more straightforward.

With ever greater numbers of hedge funds set to take the plunge into cloud services in the future, what are the main qualities in a provider they will be looking for?

### **Security, service level top concerns**

Several US hedge fund managers *HFMTechnology* spoke to highlighted reliability as the major quality they sought from a provider. Security is also never far from managers’ thoughts, particularly given some of the large fines for financial services firms data breaches in recent years. The concerns are something the cloud sector has been addressing almost since inception.

“In relation to businesses generally, customers are concerned about getting proper security obligations from cloud providers and whether they can trust them with data,” says Renzo Marchini, special counsel at Dechert’s London office and author of *Cloud Computing: A Practical Introduction to the Legal Issues*.

“Part of the learning curve for adopters of cloud is the eventual acceptance that the provider’s business hinges on keeping data secure and are more likely to have state-of-the-art security measures than a customer is.”

Nevertheless, data security remains a concern for managers and investors alike.

“The main thing is to evaluate the benefits versus the risks of the cloud,” says SEI’s Jim Warren. “From a risk perspective, the two biggest concerns relate to data breaches and have to deal with investment data and investor data. While risks related to security are decreasing, managers need to ask themselves how secure their partners’ clouds are.”

Lanware’s Duncombe says managers have to conduct their own due diligence and control the risk of outsourced systems. He says taking references from other clients, checking service level agreements and ensuring a robust contract was in place were all ways of reducing risk.

A number of providers commented that the location of data within the cloud was also a potential concern for managers given different national laws governing access.

SEI's Warren notes that an investment in cloud systems needs to be followed with ongoing education, helping hedge funds to manage their security as their business grows.

"One thing to note is that the operational data is becoming more and more relevant in managers' business decisions," he explains. "The right operating system not only protects the information, but enables managers to leverage it to improve their business performance and hone their strategies.

"As more managers leverage all of the operational data, it is incumbent upon service providers to educate them on the escalating security requirements associated with it."

Understanding the ins and outs of a cloud provider and its offering is an important point. A lack of research into the services on offer may uncover failings at a later date which could harm a hedge fund's business model.

One New York-based firm offering investment services to hedge funds claimed a manager client had encountered difficulties with a provider that wasn't able to deliver on the level of service required by its investment strategy.

"We used a top cloud data provider, and the results were very poor," she explains. "The core problem with the cloud was latency: when you need the data most, everyone else needs it too, and the delay in getting the data could exceed two full seconds for what is supposed to be a real-time service."

Yet, service issues are always likely to crop up, in every aspect of a hedge fund manager's business. Some managers speak of the evolution of cloud technology since it first launched in the hedge fund sector.

"To start with the cloud was extremely expensive, quite flaky, nobody really understood how it would failover properly, investors didn't really like it very much, but I think that's changed during the past three or four years," says the London COO of a \$300m hedge fund.

"For a small-to-medium sized fund, I think the cloud works very well," he adds. "Security is a lot better than it used to be, connectivity is your only issue, you have to have a robust line, but apart from that, I don't see why you would go to the expense of having everything in house, the follow-ups it requires, having your own IT guy in-house."

### **Growth may be inevitable**

As more hedge funds see the benefits of the technology, providers increase, and offerings are diversified, usage is likely to grow over the longer term.

"Hedge funds are very entrepreneurial and appreciate the risk of trusting somebody else with data, but they are also realistic," says Dechert's Marchini. "They are not so conservative as traditional businesses, such as the high street bank sector who aren't taking up clouds. The fund world is not afraid of adopting."

Growth of the sector seems destined to continue, with a recent survey by consultancy EY claiming 47% of hedge fund firms currently outsource technology and data management, while a further 28% expected to outsource more during the next two years.

Indeed, cloud vendors are bullish about growth prospects for the sector in the coming years.

“The cloud will continue to grow – services are expanding, choice is growing and the cost benefit is undeniable,” says Collins of SuperDerivatives. “Soon installed systems will soon become a bit like analogue TV signals.”

## **SLUG: Feature**

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