Credit Suisse | Tremont HEDGE INDEX

March 19, 2008

Prime Broking in Today's Market

The developments in the financial markets over the past several days have been unprecedented in recent years and has raised questions in the fund of hedge fund community about the business of prime broking and its implications on the broader financial market. In light of the near collapse of one of Wall Street's largest prime brokers, we offer a brief summary to explain how the prime broking industry has evolved, clarify the services offered by prime brokers to hedge funds, and explore why hedge funds would choose a single or multiple prime broker strategy.

When prime broking first became a business service in the early 1980s, the core strengths were seen to be delivering high quality centralized clearance, custody and reporting for predominantly equity-based hedge funds. However, the advancements in technology over the last two decades have eliminated any real differentiation in the ability of one prime broker to settle trades and custody and report positions any better than their competitors. Today, a large percentage of hedge funds use more than one prime broker. The origin of the term 'prime broker' (meaning primary broker) no longer holds true when funds are working with multiple providers.

As hedge funds have broadened their investment strategies, technical platforms are now less of a factor in prime brokerage success. Managers want access to trading, lending, capital introduction, financing and advisory services – all on a global scale.

As institutional investors have replaced high net worth investors as the dominant flow into hedge funds, these investors have unique requirements such as enhanced transparency, well-developed reporting and sophisticated risk management. Those prime brokers that have been able to differentiate themselves in these areas have been able to gain a share of the more than $8 billion a year business (source: Sanford Bernstein). Including trading commissions, the investment banks that are involved in prime broking are earning upwards of $26 billion annually from hedge funds (source: ABN Amro analyst Kinner Lakhani).

Deciding on a single vs. multiple prime broker strategy

In addition to the aforementioned services, prime brokers are also involved in Securities Lending, formerly known as 'Stock Loan'. The evolution of Stock Loan has gone beyond the initial focus of facilitating settlement of failing equity trades and short sales to providing market liquidity across all asset classes and in various forms, such as synthetic supply via swaps. Whether it be in the form of Stock Loan, Swaps or Repo, the primary objectives of facilitating delivery and the ability to hedge a portfolio for both bull and bear markets still form the core principles of hedge fund financing. Using multiple prime brokers enables a hedge fund to have access to additional sources of supply and liquidity since no one firm can adequately facilitate every short and every settlement. Diversifying across multiple prime brokers provides additional freedom from balance sheet constraints and exposure limits with one counterparty and acts as a natural Business Continuity Plan (BCP), offering a mark to market across providers on pricing and rates and access to multiple firm resources.

In today's market environment where credit is increasingly squeezed, the largest hedge funds have up to 5 or even 10 prime brokers to ensure they not only have access to liquidity but also a wealth of choice in pricing, reporting and specialized services. Given the latest near collapse of one of Wall Street's top firms and prime broking powerhouses, those hedge funds who have multiple prime brokers will find security in their ability to move assets quickly and will be ready to take on the opportunities which come in a volatile market.

Sources: Credit Suisse Prime Services, Whitney Group

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