Swapping technology for strategy

By Peter John

Hedge funds have always had an interesting and diverse relationship with IT: from mission-critical, proprietary systems and prime broker-sourced systems to creating ad hoc spreadsheets – or ignoring IT altogether.

But in recent years a new alternative has emerged: broker-neutral technology from independent software vendors that take the best elements from systems designed for asset management firms and create lighter weight packages for hedge funds. The broker neutrality of these systems is attractive to hedge funds trying to prevent information leakage, and is an efficient, cost-effective replacement for disparate applications. They also help address investor pressure for robust technology that meets the demands of today's complex – and recently very volatile – market.

The functionality of these systems – particularly their asset-class coverage and strategy support – has really raised their profile. What we have seen is a large-scale intelligence swap in which institutional investors have adopted more exotic financial instruments and occasional high-risk strategies traditionally employed by hedge funds, while the hedge funds have taken on the technology developed to support this new approach.

This is why the software now available has become much more interesting to hedge funds. This is most noticeable in the field of derivatives trading, which has seen three key stages of development. The first was the creation of systems that could model and manage derivatives as part of a diverse portfolio. The next was to overcome the previously prohibitive complexities of measuring exposure to underlying instruments, so that an end-to-end investment management workflow, powerful, real-time P&L and pricing analysis, validation and reporting could be realised.

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That opened up a new range of opportunities in terms of modelling and portfolio management, so the third stage of the technology's development offers the ability to calculate accurate and comprehensive exposure and with it truly interactive hedging.

To illustrate interactive hedging, consider a trader who holds bonds plus interest rate, credit default and inflation swaps. Historically, he would have to buy and sell several bonds with different lengths of maturity to change the duration on his exposure numbers.

But with full, interactive hedging capabilities he can highlight a number of bonds that need duration management and ask the system to propose the most appropriate swap. With that single swap he can change a portfolio of 20 bonds. The same technique can be applied equally successfully to inflation and credit management, or even to long-term LDIs.

The same functionality can also be used for interactive speculation, by using it to look at the impact of using derivatives on a multi-asset portfolio and act accordingly. In effect, it gives hedge fund managers the tools to test theories, look at portfolios from a modeling point of view, and then implement strategies only when satisfied that they will work and deliver expected results.

There is little question that hedge funds will benefit from the execution and order management capabilities initially developed for institutional asset managers. Interactive hedging and speculation will radically alter the way funds are able to respond to market moves, and are one example of how innovations on the buy-side are now matching, if not outpacing, sell-side systems. The trend for more vendor-supplied solutions is set to continue for some time yet. ■