All business relationships are driven by the belief that both sides will receive a mutual benefit that will allow for a long term sustainable partnership between firms; the alternative asset manager / prime broker relationship is no different.
All business relationships are driven by the belief that both sides will receive a mutual benefit that will allow for a long term sustainable partnership between both firms. For a prime brokerage /alternative asset manager relationship this principle is no different. An alternative asset manager (“AAM”) looks for certain services from its prime broker (“PB”): financing, access to balance sheet, securities lending, capital introduction, research, corporate access, technology and other services that are essential to the AAM as it deploys its strategy. PBs are looking to generate an attractive after cost return based on the revenue generated from the client vs. usage of financial resources such as balance sheet and capital.

Driven primarily by post financial crisis regulatory pressures, banks and prime brokers are being faced with significant new requirements, which have changed the client interaction dynamic and has led to changes in balance sheet allocation, business objectives, and capital markets activity. While the fundamental nature of the business relationship has not changed between hedge funds and PBs, AAMs need to understand the impact of regulation on the PB business and how best to optimize their impact on the prime brokers’ balance sheet in order to optimize the overall relationship.

While Basel III is the primary driver of this change, perhaps the most significant shift in the PB model has been the introduction of the return on assets (“ROA”) metric on a pre-tax basis as opposed to the pure top line revenue that previously drove the business. In summary, a balance sheet denominator has been added to the revenue numerator creating an ROA equation that now determines the health of a prime brokerage relationship. To be most efficient, AAMs need to focus on the optimization of a prime broker’s balance sheet to ensure that they are providing “balanced” portfolios to their PBs and that they are “efficient” portfolios in order to achieve the highest ROA possible while considering their impact on:

- Liquidity Coverage Ratio (LCR)
- Net Stable Funding ratio (NSFR)
- Tier 1 capital ratio
- High-Quality Liquid Assets (HQLA)

Open Communication is essential

When selecting a prime broker, AAMs should establish an open line of communication with senior management at the PB. Preliminary discussions should aim towards being as transparent as possible so that both parties develop a deep understanding of each other’s methodologies and motivations, as well as pain points that may drive financing decisions. Maintaining this type of relationship and open line of communication will also foster a better understanding of trends and market color impacting the PB, and may serve as a resource for any impending changes that could impact the relationship.

Further, transparent and open lines of communication will help the AAM reconcile the portfolio and leverage needs of the fund to the funding model of the PB, where feasible. In short, selecting a PB should be based on comprehensive data and mutual understanding, not just financial considerations.

Establishing connectivity with management within credit and risk, in particular, can also be an effective strategy, especially in times of market stress. Having this form of dialogue with a PB facilitates the AAM’s ability to utilize each PB relationship in a manner that maximizes the value of its portfolio to each PB, and make it a more efficient client.

AAMs should have regular conversations with their PB around their current and future financing needs. One example is portfolio leverage consideration. If portfolio margining is the most balance sheet-efficient method of financing with a particular PB, and the account is already at an adequate leverage but the AAM anticipates requiring additional financing, there will need to be a review on the balance sheet impact for the additional
leverage. Enhanced leverage may not always be the mutually beneficial solution. The more transparency in the relationship will allow for adequate time for risk management reviews and will allow the PB to provide solutions for the AAM.

Entity structures and risk management protocols will vary from PB to PB and understanding impacts and risk reviews will help minimize potential account disruptions.

**Transparency between hedge fund and prime broker is important**

Transparency and open dialogue are key components to a successful AAM/PB relationship. In addition to leverage, AAMs often have several touch-points with a counterparty, and may therefore utilize PB resources apart from financing and securities lending, such as capital introduction and/or business consulting services. An AAM needs to appreciate its impact to the liquidity profile of its PB, as well as their overall value to the institution holistically.

Ongoing conversations may also help manage expectations as to what being a more “efficient” client means to its PB(s), as it may vary from prime broker to prime broker. This requires a fund to identify its portfolio balance sheet utilization and the overall ROA its business represents to the PB. It is also crucial to understand how each prime broker defines ROA as each counterparty may view it differently.

**A dedicated treasury function can help maximize efficiency**

Depending on the AAM’s size and complexity of strategy, the AAM may need to allocate resources to a dedicated treasury function focused on maximizing efficiency and transparency across their funding counterparts. Treasury management starts with the fund having a thorough understanding of its balance sheet footprint, which includes transparency around prime brokers’ funding models, liquidity of collateral, impact of margin lock-ups, increased cost of funding due to regulatory initiatives and its ability to rebalance portfolio positions among prime brokers while retaining internal capital efficiencies.

Another key component of treasury management that has surfaced over the past few years is the dialogue between funds and their PB’s around enhancing portfolio efficiency by sharing lists of position needs/excess with their prime brokers to increase the internalization of the client’s portfolio and enhance the return profile. Allocating shorts and longs in this manner increases portfolio optimization which leads to enhanced returns on balance sheet and capital.

Another way to optimize an AAM’s balance sheet footprint is to work with PBs to make collateral allocation adjustments that create mutually beneficial optimization on a name-by-name basis.

In summary, the key to building an effective PB relationship is for AAMs to have frequent dialogue with their counterparties and to understand key financing return metrics that are important to the Prime Broker. In addition, AAMs should consider their overall wallet share with PBs and move towards a more holistic client relationship that tracks overall resource consumption including secondary resources such as capital introduction, business consulting, corporate access versus trading, and financing revenues generated.

The overall wallet of an AAM should be considered when allocating commission dollars to those counterparties providing balance sheet in order to increase the attractiveness of the client from an ROA and return on equity perspective.
About Wells Fargo Prime Services

Part of the Institutional Investor Services group, Wells Fargo Prime Services offers comprehensive prime brokerage services and solutions for alternative asset managers. Through our multi-asset class platform, we help managers meet their operational and financial goals with:

- Integrated financing solutions
- Technology and operational solutions
- Capital introductions
- Business consulting services
- Risk management solutions

wellsfargo.com/primeservices

About the Business Consulting group

The Business Consulting group delivers subject matter expertise for alternative asset managers including: business development (from launch to franchise management), best practices, peer analysis and benchmarking, and thought leadership.

We help fund managers focus on their day-to-day investment objectives and improve the efficiency of their operations. By leveraging our knowledge of industry service providers we facilitate key introductions and discussions to achieve the right operational fit for our customers’ business. We offer subject matter expertise across the full spectrum of hedge fund operations including formation and structure, strategic growth, trading workflows, and technology platforms.

For more information:
Wendy Beer, Head of Business Consulting
(212) 822-8731 | wendy.beer@wellsfargo.com

We regularly host industry events addressing hot-button topics specifically effecting Alternative Asset Managers. Please contact us for information on our next event:

On the Horizons Conference Series
A users guide to capital changes: regulatory, capitalization and liquidity considerations for alternative asset managers post Basel III

March 23, 2016
375 Park Ave | New York City

Please save the date

The opinions expressed in this article are general in nature and not intended to provide specific advice or recommendations. Contact your investment representative, attorney, accountant or tax advisor with regard to your specific situation. The opinions of the author do not necessarily reflect those of Wells Fargo Prime Services LLC or any other Wells Fargo entity.

Wells Fargo Securities is the trade name for the capital markets and investment banking services of Wells Fargo & Company and its subsidiaries, including but not limited to Wells Fargo Securities, LLC, a member of NYSE, FINRA, NFA and SIPC, Wells Fargo Prime Services, LLC, a member of FINRA, NFA and SIPC, and Wells Fargo Bank, N.A. Wells Fargo Securities, LLC and Wells Fargo Prime Services, LLC are distinct entities from affiliated banks and thrifts. © 2016 Wells Fargo Securities, LLC. All rights reserved.