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July 2017

A Shifting Broker-Manager Relationship

Don't believe any rumors involving the death of the prime brokerage. In fact, prime brokers are still very much alive despite the introduction of the Basel III capital adequacy regime, its Liquidity Coverage Ratio (LCR), and, most importantly, the Net Stable Funding Ratio (NSFR). While the industry's entire business model was brought into question with the emergence of this regime, prime brokers have not only survived the rising cost of capital, but continue to thrive despite the constraints.

According to data analyzed by McLagan, eight leading prime brokers represented a collective revenue of $16 billion in 2015, with direct margins that averaged 85%. Within those aggregates and averages, however, lies a wide disparity in terms of performance. The largest prime broker achieves 4.5 times the revenue of the smallest, while the most profitable prime broker enjoys margins that are 15% above those of the least profitable.

Of course, the LCR and NSFR have not left the hedge fund clients of prime brokers untouched either. In particular, investment strategies that rely on the financing of short positions and copious amounts of leverage consume more of the balance sheet of a prime broker, rendering them less profitable after capital is taken into account. In response, leading prime brokers have re-shuffled their client portfolios, focusing their business on the clients that afford them the highest returns. The prime brokers that have managed this transition successfully are now outperforming their competitors in both revenues and profits – and by wide margins.

So, how is the prime brokerage-hedge fund manager relationship changing? Here's a closer look at leading prime brokers, and their quest to gain more "bang for their buck" from their hedge fund clients.

Profitability, Not Quantity

Prime brokerages have adapted to this transformative, post-regulation environment by optimizing the clients they choose to support. Brokers are re-evaluating specific clients based on the needs of the funds they manage, and requesting fundamental alterations – including dropping clients altogether – to achieve an economically viable relationship.

Competing for Assets

In the immediate aftermath of the financial crisis, hedge funds responded to the rise in counterparty risk by increasing the number of prime brokers with which they worked. They have since refocused their business with a smaller number, taking advantage of the fact that prime brokers are competing for the most profitable clients. Hedge fund managers have also realized that one way in which they can compete more successfully for assets to manage is by handling their service providers and the costs of doing business with them more effectively than their rivals. Hedge funds are now further assessing the level of service they receive compared to their peers to determine if they are being super-served or under-served by their prime brokers.

Transparent Environments

Interest in annual hedge fund expense, staffing, and productivity has never been higher, and maintaining a cost-conscious, transparent environment is key. The prime broker-hedge fund relationship can achieve this level of candidness by having open conversations, which in turn, help to manage expectations on both sides.

In such an increasingly translucent industry, managing risks and costs downwards while executing more successfully than your peers is an important tool in securing institutional allocations. It is extremely useful to integrate revenues, operating, capital, and liquidity costs with employee compensation, and what customers think of the products and services they receive, as well as what products and services they would like to obtain in the future. Fresh insights such as these, which delve into the strengths and weaknesses of the evolving prime brokerage-hedge fund franchise, are necessary to attain a competitive edge in an ever-changing industry.

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