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# Picking the right prime broker: 5 things to focus on in the year ahead

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## As another eventful year winds to a close, hedge funds are experiencing something that feels rather unfamiliar: a growing sense of normality.

People are travelling. Meetings are being held face-to-face – or at least mask-to-mask. And investors are growing more intrepid after many months of feeling like they needed to play it safe. There are signs that allocators are starting to look more aggressively for attractive places to put their money.

Against this backdrop, the aftershocks of a major hedge fund implosion are still being felt. Several large banks have already announced they were pulling out, scaling back or placing new restrictions on their prime brokerage activity. Speculation is rife that more banks will withdraw from the market, particularly those firms where prime brokerage is not a key part of their business.

In such an environment, hedge funds are choosing their prime brokerage providers more carefully than they have for a very long time. More than anything else, they want to build partnerships that can help them grow, as the investment community aims to put the pandemic in the rear-view mirror.

**Here are five important trends we see dominating the prime brokerage space in the year ahead.**

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## 1. A shifting competitive landscape

The prime brokerage industry is, in many respects, just like any other. There is always intense competition, with providers all looking to gain an edge to squeeze out their rivals. What is different now is that the competition has broadened. Larger bulge bracket prime brokers increasingly are taking on funds with smaller amounts of assets under management. In the past, most of these providers would not have even considered a fund with AUM of, say, $25 million. Now that happens with much more regularity, particularly if the fund manager has a solid track record.

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One implication from this trend is that there inevitably will be more offboarding for the smaller funds later on. Large providers have revenue pre-requisites from their hedge fund clients and if those are not met, eventually the bulge bracket firms will want to discontinue some of the relationships, leaving those funds looking for new prime brokerage providers.

At the same time, many funds themselves have requirements that they have multiple prime brokers. These funds also are changing their behaviour. Instead of having two bulge bracket providers, a number of them are opting to choose one large bank and another mid-sized provider. These are typically firms that want more interaction with their providers. Bulge bracket banks have hundreds of prime brokerage clients, so for many funds under $1 billion AUM, or even $500 million, the TLC factor may feel like it's missing.

Then there are those emerging funds that do not have access to the bulge bracket sector. Attention from mid-sized providers on that segment is expected to increase as well, particularly as fund launches pick up now that the worst of the pandemic appears to have passed. These funds generally will favour those providers that can match the bigger banks in terms of asset class and general capabilities. At Cowen, we have the size, reach and infrastructure to meet these needs.

It's worth noting here that some funds are based on strategies that can only allow for so much growth before they cease to become viable. But these funds still need a prime broker that can routinely give them top-notch service even if they are not growing in size. A prime broker that is truly client-centric, which is what Cowen aims to be, will cater to all of its clients, not only the ones that are focused on growth.

## 2. Investors are getting back in the game

Capital introduction is one of the most important aspects of any prime brokerage partnership and in the year ahead it will be more critical than ever. The pandemic had put on hold a lot of conversations that funds would normally be having. We see that changing. For many investors, Zoom calls are just not enough. They want face-to-face discussions before committing capital. As airports get busier, we expect more investment to take place.

The process appears to have already begun. The AIMA Hedge Fund Confidence Index for Q3 2021 showed AUM for respondents rose to around $1.6 trillion from $1 trillion in Q2. The increase was fuelled by rising asset prices, as funds on average showed double-digit returns net of fees. But a portion of the growth also will have come from increased investment.

But it's also clear that hedge funds want more from their providers. In the latest prime broker survey by Global Custodian, capital introduction was one of the areas that saw the largest year-on-year declines in terms of client satisfaction.

At Cowen, we think that calls for a more precise approach to capital introduction, rather than the more scattershot approach that many firms take. We see our job as introducing the right money at the right time. This kind of surgical thinking has made us popular not only with our clients but also with allocators. We recognise the importance of allocators being shown funds where there is a good fit, and of funds not spending their valuable time in front of the wrong potential investors.

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## 3. Consulting services in demand

Just as a number of investors have been on the side-lines, many smaller funds have had to postpone launches because of lockdowns and the inaccessibility of capital. Such obstacles no longer stand in the way, so we expect fund launches to pick up. That will create more demand for consulting services.

For a large number of funds, the launch represents the first time that a fund manager is running a business. That can be true of even fund managers with extensive market experience. As a result, capital introduction is often just the start of a deeper relationship with their prime brokers.

**How should the fund be launched?** Should it have a COO or an outsourced COO? What service providers will be needed, and will they tick the right boxes for the investors? These are the sorts of questions that many new funds will encounter. Whether it concerns administration, tax or legal requirements, it's critical that emerging funds have people who can guide them and present the best options.

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Even for funds that feel prepared to do the bulk of the work themselves, they know they can benefit from having a good sounding board. So, as a fresh wave of fund launches begins to crest, we expect closer scrutiny of prime brokers for their consulting capabilities. Cowen's buy-side background and customer-focused ethos mean we are always looking for ways to help our clients succeed.

## 4. The aftershocks of a large fund implosion

Much has been written about the Archegos collapse. As much as anything, it has served as a fresh reminder that even with all the advances in risk management systems, there is always the chance of a sudden calamity.

For the hedge fund community, the affair has had specific ramifications. One is that it has forced some of the larger prime brokers to begin to rethink their participation in this market. While a number of banks have made clear that they are committed to the prime brokerage sector, there is still uncertainty. For funds, this means considering the possibility that one day they may need to find a new lead prime broker or a new number two. There is also potential movement of key personnel as prime broker veterans have naturally wondered about their employers' plans.

Archegos created uncertainty in an industry that had become increasingly stable, with immediate knock-on effects. Pricing shifted and margin requirements increased as prime brokers reassessed the environment. Yet hedge funds, who must grapple with the hyper-dynamic nature of world markets, truly value stability. We do expect the aftershocks to fade, but for the early part of 2022 there will be lingering concern.

At Cowen, we have always taken a conservative approach to margin requirements. We believe it is important for hedge funds to have a sense of predictability as they navigate the choppy waters of global markets.

## 5. A more selective client base

What is clear from the first four trends is that despite the upheaval caused by the pandemic and high-profile events such as Archegos (and before that GameStop), competition among prime brokers for new fund clients is set to intensify. Given that, we expect both established and emerging hedge funds to be increasingly selective as they choose their providers.

From the funds' vantage point, two factors are likely to make a big difference. First, how responsive is the prime broker likely to be? Can a fund manager speak to the right personnel quickly and easily? Will the manager get the time and attention they feel they need? Second, does the provider truly understand what a hedge fund is looking to achieve?

Large prime brokers are well stocked with personnel who have served this market for many years and know precisely how to deliver. But all along the spectrum, there is still a dearth of providers who have their own buy-side pedigree and can look at the various fund management challenges from that perspective. Cowen, for instance, is unusual in that sense in that its Prime Brokerage leaders have actually run hedge funds.

Prime brokers should be prepared for more searching questions from prospective hedge fund clients about the level of service and the responsiveness that will be on offer.

## A different mindset: Moving from providers to partners

As the trends play out, one thing for us looks certain: funds will be expecting more from their prime brokers than ever before. It is no longer enough to offer first-rate lending and custody services. Hedge funds want the ability to work closely with their prime brokers to grow their business. In other words, they want partners, not just providers.

From where we sit, that makes the year ahead all the more exciting, because that is exactly how we look at the prime brokerage space too.

**Cowen offers a full range of prime brokerage services for funds of every size and style. For more information, visit https://www.cowen.com/capabilities/markets/prime-brokerage.**

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