

# Strong client relationships support rise of boutique prime brokers

Interview with Dale Klynhout, Warren Goward & Nicholas Stotz

**T**ransparency, trust and a clear understanding of the prime broker's risk management process can help managers build long-term sustainable relationships with their providers. This is especially critical among boutique and mini-prime brokers. These firms are meeting a growing need among emerging hedge fund managers as the traditional providers step further away from this part of the industry.

"There is no one-size-fits-all solution for prime brokerage, as different fund managers and investment strategies have different needs. A boutique prime broker is best able to service hedge fund managers when they have a deep understanding of the manager's investment strategy, trading needs, and operational pain points, meaning managers can expect their broker to invest significant time and resources during the onboarding process," advises Dale Klynhout, Managing Director at Lazarus Capital Partners.

The industry has witnessed the rise of boutique and mini-prime brokers, as these groups grow to be better suited to service smaller, less profitable managers. "The growth in the industry has been driven by customers demanding a better experience and traditional providers stepping away from the industry, and these trends are likely to accelerate in the near future. The attitudes of the tier one prime brokers to these managers will continue to tighten into the future where mini-primes will further be able to adequately service them with a more comprehensive service offering," Klynhout outlines

Hedge fund managers need rapid turnarounds for their service requests to operate smoothly, and boutique prime brokers are

better positioned to promptly service their clients thanks to being free of administrative bureaucracy and legacy technology found in large investment banks and discount brokers. Managers often prefer boutique prime brokers due to their level of service and capabilities to take administrative headaches off their hands.

Klynhout explains how the 2008 global financial crisis and subsequent regulations on the banking sector also created an opportunity for boutique prime brokers: "A tightening of bank balance sheets in conjunction with increasing compliance and onboarding costs has resulted in the major investment banks restricting their prime brokerage services to larger hedge funds (~USD100 million - USD200 million+).

"This has created the opportunity for a comprehensive prime aggregation business model to service small-medium sized hedge funds who are not yet large enough to be a standalone client at a major investment bank, but still require high quality prime brokerage services."

## Overcoming challenges

The retreat of the major investment banks is a double-edged sword for boutique primes however, as major investment banks are requiring ever-increasing levels of due diligence and capitalisation in order for boutique primes to utilise their capabilities. Klynhout comments: "Changing liquidity requirements and the need for higher grade assets are further putting pressures on the viability of mini-prime brokers operating under the tier one prime brokerage umbrellas."

When selecting a prime broker, managers must be sure to gain an understanding of the broker's risk management process. A broker

with clear rules regarding margin maintenance and collateral requirements is more likely to have a quality balance sheet that can weather a full market cycle.

“With asset prices at healthy valuations, it is becoming increasingly important for boutique prime brokers to employ robust risk management processes to manage their exposures. Many prime brokers were caught over their skis in the global financial crisis, having overextended financing with inadequate collateral. As the Archegos fall-out illustrated, prime brokers who sacrifice lending quality and risk management in the pursuit of fees are exposing themselves and their clients to catastrophic risk,” advises Nicholas Stotz, Risk Analyst and Associate Dealer at Lazarus Capital Partners.

In his view, increased regulation in conjunction with high profile situations like Archegos will further accelerate the trend of major investment banks reducing their prime brokerage operations, thereby increasing the pool of high-quality clients for boutique prime brokers to service.

Klynhout expects there to be some segmentation in the boutique prime market as different firms tailor their value proposition to hedge funds of varying size: “A hedge fund with AUM of USD5 million often has different needs to a hedge fund with AUM of USD100 million. Within these segments, we will likely see consolidation as larger players look to gain market share and shore up their balance sheets.”

## Differentiation and operational efficiency

Appointing a boutique prime broker can help improve an emerging hedge fund's operational efficiency. This is an incredibly important advantage given that emerging managers have little room for error while building up a track record to retain current investors and attract new ones.

“A key differentiator between a boutique prime broker and a discount broker is the level of operational support provided to the fund,” Klynhout observes. “Time intensive operational tasks such as outsourced trading/dealing, third-party trade settlements, capital raising allocations, customised reporting and dealing with external functions attached with the managers are handled by the mini-prime broker. These additional support services further open up time and resources for emerging hedge

funds to allocate to portfolio management and business development.”

Access to experienced dealers with intimate market knowledge is another key differentiator of boutique prime brokers. Suboptimal trade execution can significantly drag down returns, and the rise of high frequency and algorithmic trading means the market is often shallower than what appears on a trader's screen. “By using a boutique prime broker, managers can leverage the expertise of their dealer to implement bespoke trading strategies that reduce price slippage and market movement,” suggests Warren Goward, Director of Prime Services at Lazarus Capital Partners and former institutional trader.

Klynhout notes: “Managers should perform thorough due diligence when choosing to partner with a prime broker, including gaining insight into the broker's service offering, risk management and compliance policies, and the capabilities of senior management. Time and effort invested in the early stages of a manager-broker relationship forms a solid foundation for future success, and often offers an added advantage of stability for both manager and prime broker during market downturns.”

Klynhout concludes by stressing that transparency and trust are essential for a successful long-term partnership between a manager and a prime broker: “Over the course of the due diligence process, a fund should expect their prime broker to provide formalised documents detailing their internal processes as it relates to margining, maintaining client privacy, ensuring compliance, etc.

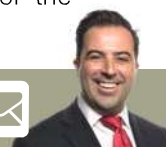
“Managers should also be prepared for their prime broker to ask numerous questions regarding their business, to gain a high-level understanding of the firm's investment strategy, current operations, and plans for the business in the near future.” ■

**Dale Klynhout**  
Managing Director



Dale Klynhout is a Managing Director of Lazarus Capital Partners and is the founder of its prime brokerage business. Dale is actively involved in the management of all aspects of the firm's operations, risk management, compliance and client development. As the leading member of the investment team, he is responsible for delivering on mandated investment management objectives that generate further value for Lazarus clients.

**Warren Goward**  
Director Prime Services



Warren Goward has 18 years experience in financial markets advising both private and institutional accounts. He has specialist knowledge of the prime brokerage and equities financing industry and has extensive international equity markets experience. Warren worked for 12 years in the Prime division for Credit Suisse which included 4 years in London trading European Equities, and 3.5 years in Tokyo trading Japanese equities.

**Nicholas Stotz**  
Dealing Associate and Risk Analyst



Nicholas Stotz started his career as an Investment Research Analyst for a leading private wealth firm in Sydney, analysing all major asset classes including global shares, bonds, real estate and private equity. At Lazarus Capital Partners Nicholas sits on the dealing desk servicing client portfolios, and has leveraged his professional experience in portfolio construction and education in quantitative finance to develop comprehensive risk management tools to help monitor and mitigate business risk.