REDUCING THE **COST** AND **COMPLEXITY** OF SUPPORTING **ALTERNATIVES**

CROSS-ASSET PLATFORM SUPPORT PAVES THE WAY FORWARD FOR MULTI-ASSET INVESTMENT STRATEGIES

SimCorp

THE ALLURE OF **ALTERNATIVES**

Given the last decade of depressed interest rates, low-yielding bonds and increasing liabilities, institutional investors around the world have embraced multi-asset investment strategies to help close the gap on returns.

Industry analysts predict in the next five years, alternative assets will play an even more important role in institutional portfolios. Having grown rapidly in the last decade, alternative investments are expected to continue their rise, concurrent with the progress in both the number of investors drawn in to this investment category and also the mounting size of allocations.

And the logic is sound. Since the 2008 financial crisis, institutional investors have continued to protect themselves against severe market swings, through portfolios that diversify as far and wide as possible. In insurance particularly, fixed income has dominated the portfolios for many years. However, given consistently low interest rates, returns have been less than satisfying in recent years. Meanwhile, alternatives like real estate, infrastructure, private equity and private debt have fared much better, largely because their often illiquid and long-term nature has shielded them from the after effects of 2008 and subsequent market shifts. It's estimated that half of investors committed to private equity, hedge funds or real estate, now allocate a minimum of 10% or more of their total assets.[1] And an overwhelming majority of investors, 84%, plan to increase their allocation to alternatives in the next 5 years.[2]

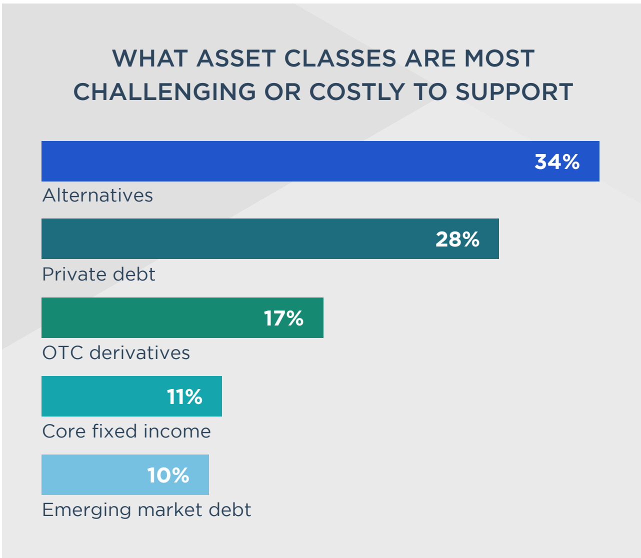
In fact, as Preqin reports, over the last three years, investors perception of private equity performance has largely met expectations, with a sizeable 38% citing it has even exceeded expectations.[3] And performance isn't the only positive. Amy Benstead of Preqin notes, alternative investments also offer institutional investors a "significant hedge against inflation" and "a strong profile of risk-adjusted returns".

While such benefits are not exclusive to institutional investors, this last point is particularly important for them, given their risk averse nature and the very real need to address a global increase in liabilities.

WHY ALTERNATIVES ARE THE MOST CHALLENGING ASSET CLASSES TO MANAGE

Like any investment category, the challenge for institutional investors is to achieve a finely-tuned balance between satisfying investor transparency, remaining cost-effective, reaping the highest returns, and minimizing operational risk. The reality however, is that at a time where investors are demanding more affordable and transparent access to non-traditional asset classes, asset management operations are finding it increasingly hard to support these in a cost-effective way.

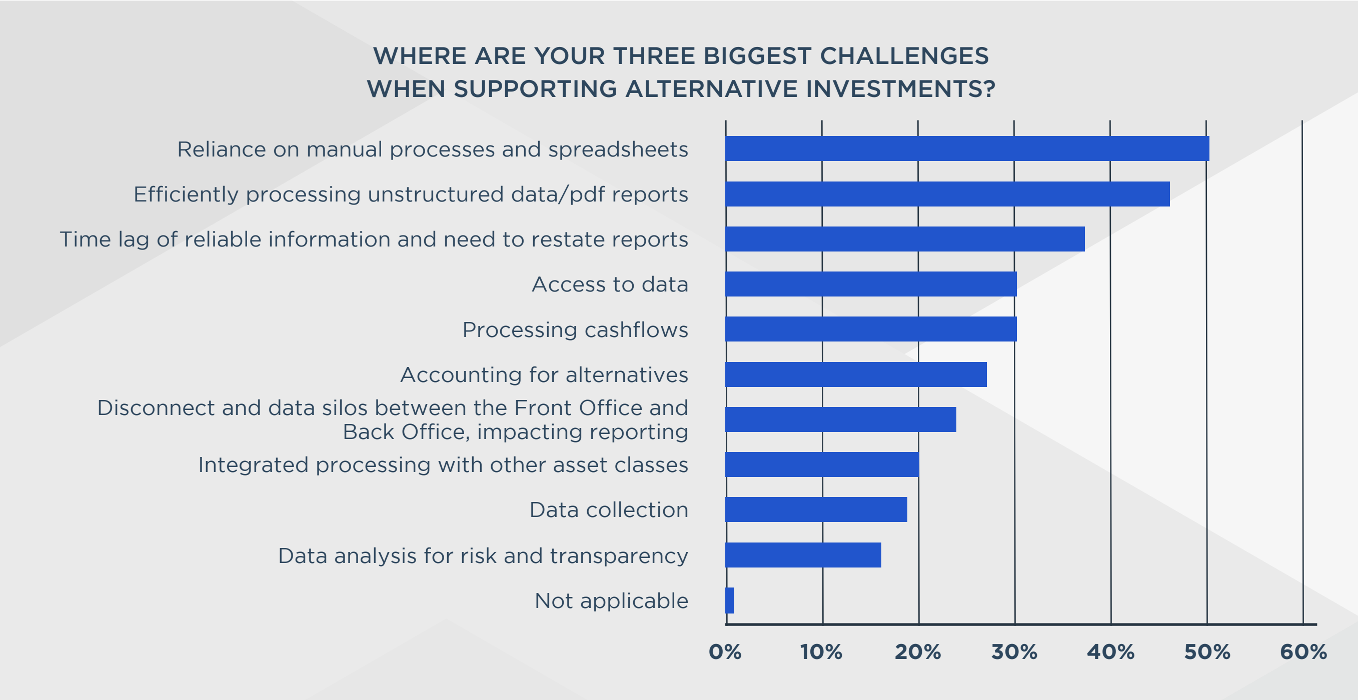
In a 2018 WBR Insights survey, 100 North American heads of buy-side operations revealed that alternative investments were the most costly and challenging asset classes to manage (62%)[4]. The findings were mirrored by a similar report conducted in Europe (51%)[5].



A 2018 InvestOps Survey of 100 North American heads of buy-side operations

1 Alternatives Investments: A core asset class. Journal of Applied IT in Investment Management, SimCorp June 7, 2018
2 The future of alternatives. Prequin, October 2018
3 Prequin Global Private Equity and Venture Capital Report. Prequin, 2018
4 Operations as a Competitive Advantage for the Buy Side. WBR Insights, 2018
5 Buy-Side Operations: Cutting Through Complexity. WBR Insights, 2018

In early 2019 the same research team dug deeper into the issue.[6] They uncovered that the outsized burden is due to alternatives' reliance on manual processes and spreadsheets, and the subsequent lag in receiving reliable information for reporting. There is no reason to think that these challenges will go away given the predicted growth of the market.



2019 North American InvestOps Report: Empowering Multi-Asset Front-to-Back Investment Operations

These findings illustrate an inefficient core infrastructure and limited capabilities to match the growing interest in non-traditional assets. They also highlight how multi-asset investing presents operational challenges, especially in traditional best-of-breed system landscapes where performance and risk calculations are tough across the entire book of business because there is no Investment Book of Record (IBOR) or single source of truth on transactions across the investment lifecycle.

Some measure of manual processing for alternatives may be a reality although organizations like ILPA (International Limited Partnership Association) are advocating for more communications standards between General Partners and Limited Partners.

OUR VIEWPOINT

We believe you can start minimizing manual work, first with the ability to process cash flows and account for alternatives accurately and efficiently in a multi-asset investment management system. When this foundation is achieved, most of the reliance on spreadsheets and other operational inefficiencies will be minimized. Additionally, we have proven that with this approach look-through exposure measurement can be calculated daily instead of relying on data that is three to five months old.

See how Danish pension firm PenSam reduced data processing and cut operational risk in their alternatives portfolio.

6 InvestOps USA 2019: Empowering the Buy Side to Optimize Cross-Asset Front-to-Back Investment Operations. WBR Insights, 2019

WHY THE TRADITIONAL APPROACH DOESN'T WORK FOR ALTERNATIVES

Achieving operational efficiency for a portfolio that includes alternatives investments, requires a different approach, particularly when it comes to risk management. This is because alternatives are often opaque in their nature. As Strategy& note in a report, most private equity funds report information only quarterly, while the lack of mark-to-market valuations in commodities contracts can create pricing ambiguity.

In the aforementioned 2019 WBR Insights survey[7], 82% of respondents chose "best of breed" solutions as the favored strategy to mitigate the challenges of supporting alternatives and private debt. However, asset managers, including those from pension funds or insurance firms, have tried to overcome the shortcomings of fragmented in-house built and best of breed systems by spending significant money on configuration, custom development and manual workarounds.

OUR VIEWPOINT

We agree that point solutions for CRM, deal flow and other specialized functionality makes sense, but we are very encouraged to see that 74% selected the consolidation of alternatives and private debt with other assets classes on a single platform as a critical strategy for the next 24 months[8] instead of having disconnected IBOR and ABOR per asset class.

The reality is that a separated IBOR and ABOR have simply served to create a complex medley of expensive systems and heavy manual reconciliation, to bridge data gaps and ensure accuracy. Simplifying this tangled infrastructure and gaining automated front-to-back investment management is essential to reducing operational costs and risk, but also delivering the innovation that is vital in the search for returns.

Watch a special webinar where Zeynep Meric-Smith, named one of the "50 Leading Women in Hedge Funds", discusses the role of alternatives in long-term growth and portfolio optimization.

IS THE ALPHA WORTH THE EXTRA COSTS?

Late 2018 the Financial Times reported[9] that low-cost passive investment funds are attracting significantly more new cash flows than alternatives – but alternatives commend a disproportionate share of overall fees and revenues. According to the Boston Consulting Group about 15% or USD 12 trillion of the USD 79 trillion global pool of invested assets was run by alternative managers by end of 2017. But alternative managers accounted for 43%, or USD 117 billion of the USD 275 billion revenue pool in the same year.

In addition to higher trading fees, institutional investors also incur extra costs related to compliance and consultants. Investors may be willing to overlook higher than average fees if they are offset by higher than average returns. But what happens if alternatives move into mainstream territory? As the market becomes flush with alternative products and competition among managers increases, there is speculation that future return expectations will diminish. Considering existing fee pressure investors cannot afford to take on more costly and complicated products that fit into existing processes.

NEW INTEREST IN A CROSS-ASSET APPROACH

In the aforementioned WBR survey, respondents second choice was to consolidate alternatives and private debt with other asset classes on a single platform. More and more heads of operations in buy-side organizations are starting to respond to the growth in alternatives and the challenges these assets create by implementing cross-asset platforms to ensure accurate data across the front, middle and back offices and ensure efficient investment processing. It's likely that this approach will gain more traction over best-of-breed solutions over time.

In North America 80% of operations heads said they'd like to see Alternatives consolidated on a single platform for front-to-back processing.[6] A consolidated operating model plays a key role in enhancing transparency, by bringing together all data points, throughout the entire investment lifecycle, in one system. By operating a multi-asset class approach where alternatives investments are run together with cash and equities, institutional investors can eliminate the operational risk associated with harboring important data

7 InvestOps USA 2019: Empowering the Buy Side to Optimize Cross-Asset Front-to-Back Investment Operations. WBR Insights, 2019
8 InvestOps USA 2019: Empowering the Buy Side to Optimize Cross-Asset Front-to-Back Investment Operations. WBR Insights, 2019
9 Flood, Chris "Big investors give in to alternatives' alpha allure. Financial Times, December 10, 2018

in siloed applications and the painstakingly laborious manual processes undertaken to make it accessible across the investment chain.

The desire to see all investments in one place is also influencing operational strategies. When asked what strategies they're putting in place in the next 24 months to mitigate the cost and challenges of supporting alternatives and private debt, 74% said they plan to consolidate alternatives and private debt with other asset classes on a single investment platform.

NOT ALL SOLUTIONS ARE CREATED EQUAL

There's a difference in the available solutions though. Historically vendors could claim to be multi-asset if they supported equities and fixed income. Today the expectation is much higher, and to make the claim of multi-asset a vendor should be able to natively handle more esoteric asset classes such as alternatives and private debt.

Asset managers should look for a solution with tightly coupled cross-asset and IBOR capabilities, one that can handle the time-consuming and challenging look-through for risk and performance measurement, as well as cross-asset stakeholder reporting.

Additionally, gaining the automation that comes with consolidation is an advantage that is particularly important when it comes to alternative investments. In the current asset management landscape, while many asset managers can achieve relatively high Straight Through Processing (STP) in the management of traditional asset classes, finding that same level of automation and integration for growing illiquid, alternative investments has proved difficult.

OUR VIEWPOINT

Historically one of the biggest obstacles in the consolidation of specialized asset classes onto a single investment management platform, has been the fear there would be a compromise in the functionality required to deal with the specifics of illiquid instruments. However, at SimCorp, our philosophy has always been to provide a modern multi-asset platform which deals natively with growing asset classes such as private equity and infrastructure beyond the traditional allocations.

A cross-asset platform built on top of an IBOR is especially beneficial to those increasing allocations to alternatives because it gives the front office performance and look-through capabilities which in turn provides important risk and performance insight daily.

Unlike best-of-breed tools, with a cross-asset platform, the front office does not have to wait three to five months to get underlying investment exposure information for illiquid assets. Instead, they can get these important risk indicators re-evaluated daily, affording them more agility in investment decision-making even with real assets.

Watch Celent's Head of Wealth Management Research discuss the benefits of managing your alternative investments on a consolidated platform.

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To be able to handle these new asset classes along with existing ones, we foresee that investment managers will be requesting integrated IT architectures with multi-asset class support to standardize processes and reduce the number of operating systems, the need for Excel sheets, etc.”

HUGUES CHABANIS
Product Manager for Alternative Investments, SimCorp

THE DATA CHALLENGES OF INVESTING IN ALTERNATIVES

Data, and more specifically data management, is becoming a key concern for investments operations teams, given the burgeoning volumes, sources and uses of investment data, on already overburdened legacy infrastructures. Data aggregation for example, has become an almost impossible task.

In the WBR Insights report, heads of operations in both North America and in Europe stated accurate measurement of firm-wide limits and counterparty exposure was one of the top challenges in the front office. It's not hard to see why, when to do so, they must aggregate data that is not only split across multiple sources, systems and interfaces, but may also need scrubbing or cleansing to gain any meaningful analysis from it.

To successfully overcome this, firms must address the discrepancy between data available in the back office and front office. Empowering the front office with greater transparency, through integrated solutions that deliver accounting analytics and functionality will ultimately better inform the decision-making process and enrich simulations for portfolio management. By bringing together the data in all these disparate systems, into one single IBOR, institutional investors can leverage firm-wide data for superior analytics, which provides a distinct competitive advantage. Given that one of the hardest elements in managing alternative investments, is the data itself, this is a notable advantage indeed. To summarize, the characteristics and market factors that concern alternative investments vary significantly from traditional asset classes.

Researching alternative funds can be time consuming and expensive, because market data is not always readily available. At the same time, traditional investment systems simply cannot accommodate different data sets such as company KPIs and commercial real estate tenant details. Measuring analytics and performance becomes a highly customised task, which often leads to a combination of complex, costly architectures and an over reliance on Excel spreadsheets to fill in the necessary gaps. When data is managed on an IBOR, it gives rise to advanced analytics, where asset managers can access organizational data for a 360-degree view, with slice and dice functionalities and a more granular view of performance, for tightened risk management.

Interestingly, the long-term make-up of alternative investments instruments, often outlives the technology systems managing them, leading to a constant refinement of manual workarounds to cope with the reducing functionality of best-of-breed systems.

Though alternative investments continue to gain momentum, their performance more recently is beginning to plateau as more investors pour in, leading to greater scrutiny of the costly IT and manual interference involved. Soon, this burden will no longer be justifiable nor scalable. In their latest asset management report[10], EY note that data will indeed be crucial to "the front office of the future". In its report it deems the replacement of disparate Excel models, with consolidated scalable architecture as essential for data analytics capability.

ADVANCED ACCOUNTING FOR INSURANCE FIRMS: BRIDGING THE GAAP

Like its peers in pension funds, asset management functions within insurance firms will now have to contend with multiple accounting and tax frameworks across multiple currencies. For example, they must support local GAAPs (Generally Accepted Accounting Principles) such as SAP (Statutory Accounting Principle) or starting in 2022 international standards like IFRS. They also must comply with growing global regulations and compliance standards. Recent regulations such as Europe's Alternative Investment Fund Managers Directive and the U.S.'s Foreign Account Tax Compliance Act, which have recently come into play, are already causing a stir.

In the same report as mentioned earlier, Strategy& state that managing regulatory compliance is now becoming one of the largest challenges, where the back office is concerned. As we see these evolving, they will demand more from a firm's accounting support, than ever before. Bridging the GAAP has never been more important.

If this was not enough, insurance firms, also have a distinct complexity to deal with compared to the rest of the buy side, with multi-tier legal and company structures that require reporting to authorities across different jurisdictions and geographies. While many of these institutions have traditionally turned to outsourcing to address this mammoth task, increasing obligations have caused a shift, where many asset managers are finding themselves running a shadow book of record, to ensure data received back from their outsourcer, is indeed the same data that is being sent out to the ARM or regulator.

[10] When the ground beneath your feet is shifting, do you stand still or leap forward? A view on the new asset management global operating model. EY, 2017

> *"Going forward, ensuring sufficient support for alternative investments and having the right operating model setup will be crucial for investment managers to succeed with this increasingly popular asset class."*

AMY BENSTED
Head of Hedge Fund Products, Preqin

CONCLUSIONS

With many institutional investors' asset management arms operating on a global scale, establishing a multi-asset class IBOR that can standardize workflows and integrate to the firm's Accounting Book of Record (ABOR), is the best model for successful management of alternatives investments. Operating on a single source of truth that can provide a single view for accounting and regulatory reporting, in-house, will not only cut down on costly duplication and arduous reconciliation, but also delivers further control and advanced accounting analytics capability, relieving in-house talent to focus on more high value tasks.

THE ROAD AHEAD

While preserving returns is key to current growth, investing in a sound multi-asset operational infrastructure that will enable competitiveness in what is now a crowded market, and meet institutional investors advanced accounting requirements, is argued to be essential for longer term success. This operational efficiency will not only play a crucial role in ensuring a competitive edge, but will also prove vital in the successful pursuit of an investment play fast becoming a perfect match for institutional investors – alternatives.

Institutional investors will need to assess what it takes to close the gap on returns, while managing the balance between transparency to investors, and keeping operational costs and risk low. Though it may be tempting to forge ahead without much adjustment to existing infrastructure, those that do adopt a consolidated infrastructure will be best placed to acquire the operational efficiency and agility that will sustain long-term growth.

With the same support for alternative and traditional asset classes in one system, asset managers can deliver new investment strategies and products quickly, manage data, and decommission costly systems and interfaces, making alternative investments a relationship that will stand the test of time.

FOR MORE INFORMATION – CLICK HERE

ABOUT SIMCORP

SimCorp provides integrated, best-in-class investment management solutions to the world's leading asset managers, fund managers, asset servicers, pension and insurance funds, wealth managers and sovereign wealth funds. Whether deployed on premise or as an ASP solution, its core system, SimCorp Dimension, supports the entire investment value chain and range of instruments, all based on a market-leading IBOR. SimCorp invests around 20% of its annual revenue in R&D, helping clients develop their business and stay ahead of ever-changing industry demands. Listed on NASDAQ Copenhagen, SimCorp is a global company, regionally covering all of Europe, North America, and Asia Pacific.

For more information, please visit **www.simcorp.com**

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