

The CutterAdvantEdge

Commentary on Investment Systems
and Operations



Buy-Side Investment Strategy Bifurcation: Operational Impacts

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In the investment world, the term *bifurcation* has recently been used to refer to the subtle practice of shifting AUM away from traditional, actively-managed assets into two types of investment management strategies: Passive and Specialty. But why have investment management firms started to on-board assets according to these two distinct categories? Coming out of the economic downturn, firms have begun to look for opportunities to differentiate themselves, gain revenue, and grow AUM—all while keeping a sharp focus on maintaining or reducing costs. The *Passive* strategy is straightforward, and includes widely available, mature asset types such as ETFs, provided primarily by a few key players. So at Cutter Associates much of our focus has been on helping firms with assets for the trickier *Specialty* strategy.

Investment management firms are diversifying their product offerings by acquiring or building out new, specialty assets, such as hedge funds, funds of funds, private equity, real assets, liability driven investments (LDI), and currency overlays. But supporting these new asset types requires operational infrastructure different from the infrastructure required for traditional, actively-managed assets.

So what are the implications of this bifurcation into two separate strategies for client facing and sales staff, data management, and investment manufacturing and monitoring? What are the impacts on operational processes and existing infrastructures?

Client Facing and Sales Staff

Sales and Client Management teams always need to be well-versed in the intricacies of any new product lines. But they might need extra time and effort to understand the assets used in specialty strategies. They need to understand why the products are being added, how they correlate with the existing products, and how they are reported upon. For example, a specialty strategy might include adding a currency overlay to a group of portfolios. It is probably not sufficient for client facing teams to simply understand the concept of a currency overlay. They should also understand what new reports might be required, as well as the differences in report timing for these portfolio groups and sub-groups.

BI.FUR.CATE

[v., adj. bahy-fer-keyt, bahy-fur-keyt;
adj. also bahy-fer-kit, bahy-fur-]
verb (used with object),
verb (used without object),
bi•fur•cat•ed, bi•fur•cat•ing.

1. to divide or fork into two branches.
2. divided into two branches.

There are also post-sale implications. To deliver accurate reporting, these product types (such as the currency overlay covered above) often require data sources different from the ones used for more traditional asset classes. To report on a client's holdings holistically, client facing professionals must understand this challenge and work with their data management colleagues to operationally "roll-up" what can be highly-fragmented data sources.

Firms that have successfully positioned and sold their new offerings, while at the same time properly training client facing professionals and addressing new reporting needs, are growing AUM. Cutter Associates has clients like these, who have shown strength in selling and providing that specialized high quality product and high-touch client service that clients demand.

Cutter Recommendations

To ensure that your Sales teams understand why they are selling a newly created product line, empower them with the right information. Ensure that they have the proper materials to articulate the value proposition that these assets can provide.

Enable your client management team to evaluate and determine what other types of reports are going to be necessary, and perhaps just as important, what type of data they are going to need in order to provide the appropriate reports across these new assets.

Investment Manufacturing and Monitoring

At Cutter Associates, we use the term *investment manufacturing* to encompass all activities, operational and research, performed before a trade is executed. And we use the term *monitoring* to encompass all activities performed while a security is held, including activities related to compliance, risk analysis, performance measurement, and attribution.

In our May 2013 CutterResearch study, *Derivatives Platforms: Ready for Cross Asset Coverage?* we revealed that many asset managers and software vendors are not yet ready to handle the operational nuances of managing derivatives alongside traditional asset classes. Some of the most esoteric asset types used in specialty strategies, including real assets, real estate, and private equity, have unique periodicity, settlement delays, and valuation criteria that don't fit the established operational structure used for traditional, actively managed assets.



Firms rely on the dexterity of existing staff to ensure the appropriate trading, compliance, and performance measurement and attribution of these new assets. Of course any manual process, however diligent, leaves firms open to tremendous risk in terms of operational due diligence and compliance. For example, if you cannot value certain assets appropriately, how can you report, run performance, or provide opening balances or risk exposures in a timely manner?

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Similar to client facing staff, operational professionals require timely access to the right data to calculate accurate holdings and valuations. Additionally manufacturing staff must be provided with portfolio accounting, performance and attribution tools that can accommodate these new assets. Dealing with these assets manually is not sustainable and re-evaluating this approach is warranted.

A firm must be able to provide a holistic view to their portfolio managers to support investment decisions. With the addition of assets that may reside elsewhere or funds which are intended to offset the risk of other assets, decision support gets more complicated. There are tools that are attempting to accommodate these more sophisticated strategies – the software vendors see this trend and are beginning to address it.

Data Management and Governance

With bifurcation comes increased complexity of data management and governance. In their processes for creating investment management products, firms need to include the operations and technology leaders to ensure that the impacts on the operational infrastructure and systems, or the need for additional tools, are well understood.

As we noted in our [Cutter AdvantEdge: Balancing Act: Building a Successful Data Management Program](#) (April 2011) controlling data within an enterprise is paramount to a firm's ability to address the unexpected and effectively execute strategy, or to hold and grow a competitive position in the marketplace. To enable a smooth transition as asset strategies diverge, firms must ensure that current systems will be able to accommodate new types of instruments, new regulations, and new types of market data.

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Data underpins all of a firm's operational processes. Data management and governance grow exponentially more complicated as the business, operational, and technical relationships grow and diversify. To determine the data architecture and infrastructure required to accommodate this augmented data set, think about where the data is sourced, where it needs to be aggregated, and where it should be distributed.

Other Implications of Bifurcation

Sub-Advisory and Managing Assets Internally

Firms that have historically managed assets internally may be shifting toward sub-advisory arrangements for specialty assets to reduce the time to market and lighten the operational load on staff and infrastructures. Also, because there are already clearly-defined winners in the ETF space, many firms are not providing ETFs branded with their name. They are happy to provide ETFs of other firms to their clients. The ETF market has a high cost of entry and the ETF has become commoditized.

Disintermediation of Investment Consultancies

With the expansion of specialized asset product solutions, some institutional asset managers are now offering their clients more strategic solutions, including asset allocation strategies—a service that has historically been provided by investment consultants. Will clients lean on investment consultancies less, leading to the possible disintermediation of investment consultancies?

Bifurcation: Ready or Not Here It Comes

The trend towards bifurcation is subtle but important, as even small shifts in the AUM of large asset managers have remarkable impacts on capital markets and the buy side industry as a whole.

For firms that are struggling with any aspect of how to effectively manage bifurcation, Cutter Associates can help. With expertise in client facing solutions, data management, and operational best practices, Cutter Associates has the resources and insights needed to succeed. Contact us to find out more by calling 1-781-261-0066 or by email info@cutterassociates.com.

About the Author

Eryn Kelley has 15 years of experience in the investment operations and portfolio accounting industries, specializing in operational efficiencies through systems and best practices. She has extensive experience in buy-side institutional operations. Since she joined Cutter Associates four years ago, she has enhanced the Benchmarking Practice, including the implementation of the Cutter Associates Capability Models, an approach that harnesses Cutter's expertise in all investment manufacturing disciplines.

About Cutter Associates, LLC

Cutter Associates, LLC provides truly independent investment process expertise for the investment management community. Through three interrelated services, Cutter provides investment management firms the knowledge and tools to ensure that their business technologies and processes are competitive. **CutterResearch** offers member firms detailed, actionable research to reduce risk, lower costs and keep up-to-date on systems and operational processes.

CutterBenchmarking provides bespoke reports measuring firms' investment processes by capabilities, risk and effectiveness through comparisons based on tried and tested capability models. **CutterConsulting** partners with firms to evaluate, select, and implement systems and to develop leading technology and operational strategies. Cutter Associates is headquartered in Rockland, MA and has subsidiaries in Canada and the UK, and is on the web at

www.cutterassociates.com.