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The CutterAdvantEdge

Commentary on Investment Systems and Operations

Hope and Fear...The Outlook for 2012

If 2011 was "The Year of Living Dangerously", then we should expect more of the same for 2012. IT and Ops budgets for asset managers reveal modest increases for 2012, but continued market turbulence and concerns over the future of the European and US economies could put spending plans in jeopardy. Instead of showing bold, constructive leadership, politicians on both sides of the Atlantic have chosen to posture and pontificate, hoping that muddling through will suffice. Given the uncertainty, most firms have developed detailed contingency plans should economic conditions deteriorate.

What are asset managers' priorities for their systems and operations in 2012? Based on CutterResearch and CutterBenchmarking members' votes, and demand for CutterConsulting services, the answer is clear—pretty much the same as 2011: data management, risk management, performance measurement and attribution, trading, social media/new technologies, alternative investments, and operating efficiencies.

Data and Data Management

Data management is no longer a back office or technology initiative in asset management firms. In the past many firms invested in technologies they felt would solve their data management problems, and these were often designed to address tactical issues. Today, data underpins high priority business drivers. Accurate and timely data is deemed critical for investment decisions and risk management across the enterprise, and for providing agility to address business and regulatory changes. However, after large investments in technology to manage data with no clear ROI, firms have recognized that the success of data management initiatives revolves around proper management and governance; as a result market leaders are developing and implementing enterprise-wide and highly structured data governance programs.

Many firms have re-organized to support the data management function and have redefined roles and responsibilities. These changes have led to enterprise-wide control and revised organizational structures around managing data.

CutterBenchmarking has found that data is the second largest cost item after human resources. The increased cost of index and benchmark data has caused great consternation as vendors now charge for things that used to be free. The industry has not found a solution given the structure of contracts and the power of data providers. However, in a cost reduction effort several firms have developed consolidation programs and reduced their number of data providers. Other firms have looked closely at usage and cut back on the number of users and on the breadth of data they purchase.

Technology and service providers have responded to market needs and have expanded the depth and breadth of their offerings. We see the following trends:

- Vendors of investment data management products are consolidating and enriching their offerings to move from pure play reference data management solutions or data warehouses to "one stop shops" for all data management functions.
- Other investment application vendors (such as OMS and accounting systems) are incorporating data management functions and services.

- Outsourced data services from middle office service providers are gaining traction.

Risk Management

We're seeing a large increase in technology spending for risk management for the upcoming year. A survey of CutterResearch members indicates spending increases averaging nearly 35%. The business drivers are clear: market volatility combined with reactions to rogue traders, Lehman Brothers, and Madoff ordeals have clients demanding greater transparency and tighter reigns on risk. In volatile, event driven-markets it is critical that the front office receive timely and accurate information so they can quickly execute investment decisions. Furthermore, because rating agency data has proven unreliable, firms are investing in proprietary data solutions, risk calculators, and other analytic tools. Many firms are deploying tools to understand exposures as well as the valuations and risks associated with OTC derivatives.

In the past, risk management has been put into silos. However, with the emergence of the Chief Risk Officer, investment managers are looking at risk from an enterprise perspective. Once again, reworking how data is organized and managed is the key. Many firms have established a centralized data management function to provide exposure and current positions across all products. Firms are looking hard at counterparty and credit risk. In addition, to support risk management and other functions, asset managers have established data governance and data quality programs. Speed and accuracy cannot be compromised for decision makers.

Performance Measurement and Attribution

The asset management industry continues to struggle with performance measurement and attribution, driving CutterResearch to complete 10 research reports over the past decade. CutterConsulting continues to see strong demand, and it remains a hot topic for CutterBenchmarking members. We believe there are multiple reasons for this ongoing emphasis:

- Fixed income attribution is still a major challenge for firms. Lack of standards, instrument complexity, and the vast number of "effects" that need to be calculated all add to the challenge.
- A large number of firms still calculate attribution with a proprietary system or spreadsheet.
- While some firms are starting to use a single system for the entire performance function (measurement, equity attribution, fixed income attribution, and GIPS) other firms tend to separate measurement from attribution, viewing attribution as much more of an analytics function
- Linking ex-ante risk with ex-post performance is still "the holy grail."
- There is some convergence between the risk and performance functions, but it's moving slowly.
- Daily calculation of performance and attribution has become common, with more firms needing to support ad-hoc performance calculations
- There is an increased demand for performance data—it's not just the portfolio managerss and performance analysts who want access. Sales, Marketing, third party consultants, and the investors themselves now want access to performance data.

A recent CutterBenchmarking survey found that 64% of participants are using four or more systems for performance measurement and equity attribution, fixed income attribution, composites, and GIPS compliance.

The good news is that software and service-based solutions have greatly improved for performance measurement and attribution and the enhanced capabilities mean that firms can consolidate systems. As a result, spending on performance measurement and attribution will remain strong.

Trading

Many firms are still using more than one order management system (OMS) primarily due to asset coverage, and no single system can support all asset types. Firms would rather deal with the integration challenges of multiple systems than sacrifice best of breed functionality. While clients would prefer a single trading platform, some OMS vendors are moving in the opposite direction, expanding functionality to support the investment book of record (IBOR), risk, performance, and data management. Conversely, other vendors are building out front office functionality, continuing the "fight for the front office."

Spending on front office tools continues, and given the product and strategy changes among OMS suppliers, asset managers confronted with major system upgrades are weighing alternatives.

Social Media and New Technology

Of the firms responding to a recent CutterBenchmarking study, 76% have established a technology innovation program. Nonetheless, while social media and new technology are getting plenty of buzz, they're not getting much investment. Firms seem to be doing what they can do get their names onto social media communications forums, especially LinkedIn, but it's primarily for marketing purposes, and they're not using the tools to their fullest potential. Most firms have established policies around employees' use and rights in these contexts, in order to protect the corporate brand. Yammer has gained some traction as a tool for internal communications.

Tablet technology, iPhones, and other mobile devices have become standards. However, as employees have client and investment data on their iPhones and other devices that they can access from virtually anywhere, there are legitimate concerns about the lack of control over confidential information. Some companies partition company content from personal content in order to address security issues.

Alternative Investments

Alternative Investments have been around for quite a while, but now they are exploding. Due to expectations of low returns for the foreseeable future in the public markets, investment firms—led by insurance companies, hedge funds, and pension funds—are making significant strategic investments in alternative assets. Private equity and real estate are still the leading alternative investment types, but they are becoming more competitive. So firms are now branching out into timber, agriculture, oil and gas, renewable energy, commercial mortgages, and bank loans. The majority of the investments in real assets are in the form of Private Equity Funds, but we are also seeing direct investments growing in popularity.

- There are no standards for reporting, pricing, or valuation of alternative investments
- Due to complexity and a lack of transparency, reporting on alternative investments typically lags by three months, and there is a demand to shorten that timeframe.
- Asset owners are demanding more information transparency, as well as benchmarks and performance analysis
- There is a strong drive toward automation of the investment processes for deal management and monitoring.
- Firms are increasingly replacing their proprietary and Excel-based systems with vendor-supplied solutions.
- Although most systems are focused primarily on either the GP or LP, they are trending toward a "one size fits all" approach, with some success.
- Some firms use a best of breed approach (solutions from multiple vendors) for accounting and reporting, and an all-in-one approach for front-office activities such as proposal due-diligence, deal tracking, portfolio management.

- Vendors are trying to expand their product coverage for investments such as private equity and real estate.
- Outsourcing is growing in popularity, with all major custodians offering administrative services, focused primarily on back office functions.
- The number and scope of services available from specialist providers is growing.

Alternative investments are here to stay. There is great demand for robust, front to back vendor solutions to properly manage the lifecycle of these investments, and vendors are rapidly adding functionality to meet the exploding demand. We expect that spending on alternative investment systems will remain strong throughout 2012 and beyond.

Operational Efficiency

Many asset managers are looking hard at their operating models, striving to consolidate systems, improve work flows, and implement controls in order to reduce cost and lower risk.

Although workflow automation continues to be a hot topic among asset managers, they are typically addressing the issue in an ad-hoc, intra-departmental fashion, using capabilities embedded in existing vendor systems. Because they rarely address workflow automation as a discrete effort on an enterprise-wide basis, they tend to limit the overall effectiveness and impact to the bottom line.

However, firms are beginning to take a closer look at Business Process Management (BPM) tools to address operational efficiencies on an enterprise-wide basis. By providing a top-level, holistic view of total operations, BPM solutions can prove effective when working in conjunction with the workflow capabilities imbedded in a specific application. Although many firms have yet to deploy BPM products, interest among the investment community has grown in recent years and BPM providers are beginning to gain a foothold in what was once a predominately untouched market.

Outsourcing is a long-term trend and is seen as a way to reduce the burden of managing technology and operations. While results have been mixed, especially for the middle office, there has been significant success in outsourcing transfer agency, custody, fund accounting, and infrastructure functions, and using partially outsourced vehicles such as ASPs and SaaS.

Measuring ROI has proved problematic because most asset managers do not have strong cost accounting disciplines. A recent CutterBenchmarking survey found that 50% of firms cannot measure ROI from outsourcing because they do not have clarity around cost data. The cost data is very complex because of the difficulty in allocating and defining costs consistently. For example, should Bloomberg be classified as data, trading, analytics, or portfolio management? In spite of the difficulty in producing reports that provide actionable cost information, we see significant effort in building cost models. Firms are taking a high-level, “best efforts” approach to use one of the tools to enhance decision making.