FRONT OFFICE SOLUTIONS: EASING THE PAIN OF THE CHIEF INVESTMENT OFFICER

BY MELANIE PICKETT

Chief investment officers face a number of challenges in today's investing environment. This is especially true for investment officers at endowments and foundations, with an ever-growing set of requirements around transparency and reporting to external stakeholders, on top of their already difficult job of delivering superior risk-adjusted returns to their institution.

Over the past decade, institutional investment has grown substantially more complex and the asset servicing industry has struggled to keep up with this change. Endowments and foundations in particular have made increasingly large allocations to complex and often opaque instruments, including hedge funds, private equity funds, derivatives, and direct investments into private equity and credit opportunities.

But with these opportunities come great challenges: To maximize returns and minimize inefficiency, investment offices need a solution set and target operating model that offers a much more comprehensive way to manage the tangled web of data that accompanies such complex, multi-asset class portfolios.

Part 1: Complex Assets = Complex Data Requirements

Institutional investors have long gravitated towards alternative investments because of their long-term investment horizon and desire to obtain a premium in exchange for the illiquidity of these assets. In fact, the *2018 NEPC Endowments and Foundations Survey* shows that 80% of asset allocators polled believed the return of market volatility to be a long-term trend, and that hedge funds are best positioned to maximize this new environment. The same survey also found that private equity is expected to be the alternative investment that will generate the highest return over the next three to five years. Increased allocations to more complex investment classes has not just happened at endowments and foundations, but also at family offices, sovereign wealth funds, superannuation funds, pensions and insurance companies.

Alternative assets are often investments that come with an operational tradeoff for their projected higher returns—less liquidity, lower transparency, and far less frequent valuations, as compared with traditional asset classes. Understanding the existence and valuation for these investments is often more complicated, with fewer points of reference. This results in an incomplete picture of the portfolio's overall risk, exposure and liquidity characteristics across the risk factors these organizations care most about.

As asset owners have expanded into such diverse portfolios, most have attempted to piece together a technology and operations infrastructure to support their needs. This requires multiple vendors and manual data integration. And, if it works, each additional requirement often leaves the overall infrastructure in a more manual, and therefore precarious, state. This can result in systems that are redundant or not scalable or secure, and may also result in business processes that may rely on inconsistent or outdated data.

All of this can lead to investment decisions that are challenged by operational limitations. Rather than having a platform that allows for increased efficacy and investment insights, some asset owners are missing out on potential return opportunities because their current infrastructure cannot handle a more data-driven investment process. They also risk being unable to meet new demands for information from regulators or provide transparency to other stakeholders, such as donors and trustees.

What these investment teams need most is an infrastructure that supports and nurtures their investment process, versus being required to adapt their investment process around an infrastructure that fails to meet their needs.

Part 2: Applying the 'Operational Alpha™' standard

A useful metric for mitigating these investment challenges is the application of the Operational Alpha standard. Operational Alpha is best known as a measure for asset managers to create better performance through a comprehensive examination of their operational processes. It uses

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source: **Northern Trust**

3 CHALLENGES

FACING FRONT OFFICE INVESTMENT AND OPERATIONS TEAMS

Data floods into the front office from different sources in varying formats

Sharing data across teams isn't easy or seamless

Investment teams must fix errors and gaps before **analyzing data**

Few multi-asset class platforms manage **public and private market data** equally well

Custom solutions don't exist for **integrating disparate data**

Extracting key information is slow and tedious

Lack of **communication across teams and workflows** creates inefficiency

Managing risk and regulatory requirements is challenging

No **automated oversight** of daily trading, cash flows and reconciliations

119%

Increase in investments in alternative assets over the past 10 years

Source: Preqin

+200 -10

Custodians manage around 10 data points while asset owners track the rest

Source: Northern Trust

Investment and operations teams need a unified platform to enable data integration, team collaboration and portfolio analysis that leads to meaningful insights and confident decisions

the language and approach of the front office and applies it to middle- and back-office processes. Operational alpha can be equally effective when applied by asset owners seeking higher-quality investment decision-making.

To help ensure the strategy's success, operations and technology teams need access to and buy-in from senior investment professionals, ideally including the chief investment officer and/or the chief operations officer. The team should also set success metrics at the outset to measure improvement on a weekly, monthly, quarterly and annual basis.

An effective process starts by taking a comprehensive view of how data is currently handled in the investment decision process. This includes third-party systems used by an organization, service providers and data sets they support, along with internal models and macros created inside the organization. Employees may have additional data sets they keep in the course of their jobs. If an organization takes the time to ask the right questions at the outset of the project, their process can lead to the greatest amount of realized Operational Alpha.

With the inventory established, it can take time to realize savings. Many opportunities to increase portfolio alpha lie within the operations of the portfolio outside of just simply lowering internal overhead—these range from increasing the efficiency of the investment team to identifying areas of tax leakage or inefficient portfolio implementation. When it comes to Operational Alpha, there are three main ways it can be applied to large, complex asset owners.

With data, quality is king. The saying is widely known but still quite accurate: "Garbage In, Garbage Out". Bad inputs—whether out-of-date, inaccurate or skewed—can impact investment results. Test all sources AND uses of data to see if they are still relevant for decision making. Form an organizational inventory and hierarchy of data by importance, frequency, and type of usage. Diagram exactly how each data source currently fits in the investment and operational infrastructure, and note duplicates and unused parts of the process. Audits can also uncover opportunities to eliminate or consolidate rarely or seldom used systems.

Make better use of resources and technology. Ensure that investment data can be easily tagged and located throughout your system. Newer systems may be able to provide more frequent updates or ensure the accuracy of assumptions used in investment models. Also, ensure that the data model allows for flexible classification of assets based on multiple risk factors, such as geographical and sector exposure, along with leverage, liquidity and counterparty risk. Don't forget data security—today's organizations must apply as much vigilance towards internal controls and data loss prevention as they do preventing external data breaches. Public cloud solutions are proving to be as safe (or safer) for many institutions to utilize than internal systems.

Be lean and mean. Wherever possible, look to move from fixed costs to scalable solutions. Third-party providers can be scaled up or down depending on the changing need of the investment organization. With effective oversight by the organization, service providers can often provide additional levels of expertise that are expensive and time consuming to build internally.

The challenges inherent in today's investment office represent a chance for thoughtful CIOs to improve decisions and raise standards of transparency. Trustees and leaders need to take a comprehensive approach to building a better investment infrastructure in order to enable the positive impacts of this change. Technology innovation is crucial as investment teams manage the proliferation of data coming from multiple platforms in diverse formats.

But technology alone won't solve all problems. Technology solutions require a dedicated team to provide support and to implement these solutions. As long as CIOs continue to innovate new investment strategies to meet investment objectives in difficult markets, they will need to work closely with their operations teams to apply technology in the most effective ways. The human element will always be relevant. ■

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