



Meeting the Demand for Diversification

THE OPERATIONAL FOUNDATION FOR A
MULTI-ASSET ENVIRONMENT

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The COVID-19 pandemic of 2020 brought an abrupt halt to the longest bull market on record. And while markets around the globe managed to rally, volatility, uncertainty, and caution remain the watchwords of the new investment environment. According to the International Monetary Fund (IMF) June 2020 World Economic Outlook, the global economy is likely to contract by 4.9% in 2020, and GDP growth in 2021 will be slower than pre-COVID levels.¹

This slowdown has accelerated the trend among institutional and high net worth investors to seek broader portfolio diversification. Traditional equity markets are dependent on the strength of the economic rebound, which could bring opportunities, but also plenty of risk. Fixed-income yields have dropped sharply as the US Federal Reserve and central banks around the world have cut interest rates in an effort to shore up the economy. With US Treasuries slipping below 1%—and even going negative, in some cases—most observers do not expect to see a sustained rise in global bond yields anytime soon.²

Given the level of uncertainty, investors are increasingly looking to alternatives, such as hedge funds, private equity, private debt, infrastructure and real estate, for both diversification and alpha generation. According to Preqin, some 75% of institutional investors now allocate to at least one of these alternative asset classes.³ In an April 2020 Preqin survey, a majority of investors said the Covid-19 pandemic would not have a long-term impact on their allocations to alternatives. In fact, 29% of respondents said they expect to increase their alternative investments over the long-term in the wake of the pandemic.⁴

For asset managers, this raises a couple of important questions: are you prepared to meet this growing demand for diversification, and do you have the infrastructure to support multi-asset class investment strategies? If these questions were pertinent before the pandemic, the ensuing volatility and shifting investor sentiment has made finding answers all the more urgent.

Diversification for outperformance

The point of diversification is to offset the risk of asset class concentration with the goal of delivering returns that outperform key market benchmarks. In the buoyant markets of recent years, active managers have been hard pressed to compete with index-driven passive strategies. The market gyrations of 2020, however, have tipped the scales in favor of active managers who can demonstrate expertise in a wider range of asset classes and effectively employ diversification to improve overall performance. Alternative investments are critical to accessing the non-correlated returns achievable in different segments of the market.

In EY's 2019 Global Alternative Funds Survey, institutional investors claim to allocate an

average of a quarter of assets to alternatives. While hedge funds still take the lion's share of alternative allocations, private equity, real estate, private debt, and other fund types are gaining traction.⁵

A 2019 survey of global insurance CIOs by Natixis Investment Managers further underscored some of the sentiment driving demand for diversification. Institutions are finding it increasingly difficult to generate alpha, protect assets, and monitor the cost of capital in the prevailing regulatory environment. As a result, they are increasingly turning from the public markets to private assets, with 79% of institutions investing in private equity and 77% in private debt. Moreover, 68% of survey respondents say private investment will play a more prominent role in their portfolios in the years ahead.⁶

As traditional asset managers expand into alternatives, many are also adopting long-standing alternative fund strategies such as the use of derivatives for hedging purposes—whether simple equity and FX futures and options, or more complex OTC products such as swaps and swaptions. Though this activity may be relatively low volume and focused on a few clients, investors will likely expect some derivatives capabilities on the part of their managers.

Different workflows present operational challenges

To meet this demand on the part of asset owners, and thus retain and grow AUM, the first challenge for asset managers is to develop (or acquire) the investment expertise to manage these often highly specialized assets. An equally important, but often overlooked, consideration is whether their technology platforms and operations teams can support the intricacies of accounting for and reporting on a diverse asset mix.

While nuances exist, managing traditional equity or fixed-income portfolios follows similar workflows. Processing steps have

INSTITUTIONS SEEK GREATER DIVERSIFICATION

75% of insurers say investing in alternatives is essential to diversify portfolio risk.

53% use alternatives to replace low-yielding fixed income investments.

51% look to alternatives to help provide alpha.

57% are increasing investment in private assets, such as real estate and private equity.

72% delegate some portfolio management to external managers to gain access to expertise.

Source: 2019 Natixis Global Insurance Survey

become standardized and efficient, with high straight-through processing rates helping to reduce operational risk. Workflows for alternative assets are completely different. Different structures within each asset class bring added complexities that have to be managed.

Within the private investment realm, whether equity or debt, the terms of fund structures, which are dependent on the type of transaction, need to be supported. Complex waterfall calculations, expense allocations, hurdles, tiered incentive and management fees, liquidity terms, potential conflicts of interest and valuation processes must all be monitored and managed.

As for derivatives, monitoring and managing the underlying positions within derivatives instruments pose a further challenge. To determine total exposure and risk to a specific region, country, industry, company, or asset, managers need to incorporate and report on every position, including where those are embedded within the instruments. Traditional systems are configured to report on a position, not whatever underlies that position. These systems do not have the workflows to gather the data nor the set up to manage the underliers, and therefore cannot provide comprehensive reports on the true exposure and risk.

Data is critical. Any investment manager seeking to expand asset classes will need to access and integrate the relevant data sources to support those assets. Data governance, and maintaining a single, golden source of data, is another challenge. Providing accurate, consolidated reporting for both investors and internal purposes becomes more difficult if data is spread across multiple systems.

Legacy systems, built primarily for traditional instruments, are challenged to accommodate the specific processing needs of private asset classes and derivatives. Manual workarounds, inefficient processes, and a lack of proper operational control are too often the result.

Tracking ESG

Demand for investments that meet high environmental, social, and governance standards is on the rise. Around two-thirds of institutional investors surveyed by Natixis implement some form of ESG in their portfolios, a near 10% increase since 2017. While the majority incorporate ESG to align their assets to organizational values, more than half believe it can also produce alpha. Meanwhile, 61% of institutional investors in the 2019 Edelman Trust Barometer Special Report have increased their allocation to companies that excel in ESG factors.

Incorporating relevant external data, such as carbon ratings, to properly classify investments as ESG or not is one part of the difficulty for asset managers, another is proper reporting. Assets need to be tagged with the appropriate ESG rating, then the data aggregated or sliced by those attributes to ensure proper reporting. That requires a system that offers data extensibility, enabling users to add their own coding structure and classifications. Firms also require the capability to roll up information by different ESG attributes for reporting.

The need for scale

Without the right systems and skills, firms' forays into alternative asset classes typically involve considerable manual processing, which is inefficient and invites significant risk. Successfully expanding into other asset classes requires a scalable operational infrastructure to handle higher volumes, more detailed reporting, and more complex accounting.

As EY's Global Alternative Funds survey observes, "Scaling the business for more complex product offerings is critical, as costs remain an important gating consideration for allocators' investments. Technological advancements are providing opportunities to complement and enhance front-office decision-making, while streamlining operational and back-office functions."⁷

The “new normal” in asset management

The multi-asset class environment is here to stay. Client demand, market volatility, and margin and competitive pressures all compel traditional asset managers to look seriously at this trend and evaluate their level of preparedness. Expanding into new asset classes and fund structures offers big opportunities, but it requires a measure of business transformation. Having the operational expertise and infrastructure in place to manage multiple asset classes, deliver high-quality investor servicing, meet compliance requirements, and to do it profitably is paramount. Firms that can demonstrate their capabilities are well-positioned to take advantage of investors' growing appetite for diversification.

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KEY PLATFORM REQUIREMENTS: An operational checklist

What does it take to add alternatives to the asset mix for a diversified offering that is seamless to the client? A solution that manages, accounts for, and reports on multiple asset classes within a single platform, with capabilities including:



Asset class coverage: Support for complex instruments, strategies, and structures across the full range of alternative fund types.



Granular investor accounting: Deliver detailed look-through to track a funds' capital flows and calculate distribution waterfalls and management fees.



Transparency: Integrate portfolio management and investor accounting to ensure seamless data flows that enables firms to track investors across multiple investments and provide exposure reporting and opt-in/opt-out capabilities.



Automatic reporting: Track and generate accurate, detailed reports on all aspects of their investments.



Automated rebalancing: Rebalance automatically following the close of each investment round in closed-end funds to reduce the risk of errors, drive efficiencies, and improve client servicing.



Scalability: Accommodate the growing demand for non-traditional assets without stressing the system or driving up operating costs.



Data management: Enable the addition of new data types, fields and calculations to accommodate new instruments and asset classes.

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