Meradia

Performance, Risk & Analytics

2022 Industry Outlook: Investment Performance

Investment performance teams are under pressure to adapt to economic and market volatility amid rapid **industry consolidation, operational outsourcing and technological disruption**. When working with institutional asset managers, asset owners, wealth managers, insurers, and asset servicing vendors, Meradia has observed the impact of these trends firsthand. Here, we examine the forces at play and how the industry may evolve in 2022 and beyond.

CONSOLIDATION

Industry consolidation is driving vendor consolidation

Investment managers are shifting their focus to strategic core competencies while carefully reviewing operating margins. Firms are searching for the best way to shed costly overhead, legacy technology and inefficient operations while facing intense competition. This is apparent in how asset managers are consolidating operations and looking for more holistic solutions over internally-managed best of breed strategies.

Asset managers are searching for unified performance, analytics, benchmarking, attribution and risk platforms. There is a clear preference for fewer vendors across front-, middle- and back-office teams. This has spurred vendors to acquire missing components as well as invest in data and platform unification programs. Asset servicers and custodial banks are also moving in similar directions marrying disparate solutions into a unified model.

Vendors are seizing this opportunity to grow their value proposition by expanding their offering to try and deliver this holistic vision; for example, front-office vendors adding a performance historical book of record or middle-office vendors improving dashboards and real-time analytics. While this convergence seems to be a logical progression for asset managers it doesn’t come without potential operational issues. Without considering service models on where data originates and how data enrichment is executed, each portion of the organization could be overlooking operational issues that compound problems down the line.

Over the years, the investment performance function in organizations has proven critical to validating accounting and client reporting data. That meant ensuring the delivery of accurate results to all segments of the organization and externally. Performance teams usually contribute directly to a variety of reports, advertising, compliance statements and – in many cases – compensation evaluations. With so many critical firm-wide functions relying on performance teams, the interdependency on data has made it difficult to deliver a silver bullet solution. At present, a human element is still very much required.

While a single front-, middle- and back-office platform would be ideal and solve many problems, it continues to be out of reach for the vast majority of the industry. Investment managers have been waiting 30 years since the introduction of the Straight-Through Processing (STP) concept that was popularized in the early 1990s. Three decades later, it still appears unobtainable due to the pace of change in the industry. Today, the STP concept is available through a single managed services arrangement, but those services are not supported by a single organically developed technology platform. This amounts to some firms increasing operational risk when trying to accomplish the exact opposite.

OPERATIONAL OUTSOURCING

Performance outsourcing as a service lags other investment operational areas

The financial services industry is the second-largest consumer of technology and technology services behind the IT and software industries themselves [1]. While the investment management industry has benefitted greatly from technology, it is no longer willing to take on the infrastructure maintenance that came with it. Asset managers today are looking to transfer away the responsibilities associated with managing layers of hardware, software and cybersecurity. While asset servicers and performance solution vendors are both eager to deliver fully-integrated platforms, investment performance measurement and analytics is an immature marketplace for services. Unlike certain investment operations areas such as reference data, accounting and regulatory reporting, outsourced performance services will likely mature slowly over the next few years as asset servicers continue to build out holistic platforms. As a result, uncertainty will linger over which performance functions should be retained internally.

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Outsourcing is currently suited for highly repeatable and lower-risk functions. To date, outsourcing performance has been difficult for providers that adapt return measurement and attribution processes to new investments instruments, volatile markets, and private market cash flows as these are commonly high-risk or non-repeatable functions. Common practices suggest that managers should leverage custodial data and vendor technology to enable internal staff to shed "commoditized functions" allowing them to instead focus on the core value-added services.

Performance measurement and attribution analysis may be too critical to hand off entirely to a third party when considering the impacts to compensation and strategic investment evaluations undertaken by CIO and performance teams. Performance teams are currently the natural point of bifurcation, given they provide control checks and due diligence over fund management. Successful investment performance outsourcing focuses on the basic elements of performance measurement, including daily security-level contribution to returns and reconciliation. Keep in mind, this requires high-quality daily IBOR position and transaction accounting data in order to support a reliable view of security-level performance returns over common reporting time periods, per the Global Investment Performance Standards (GIPS®). Collectively, these sensitive functions add complexity that current service provider models struggle to manage.

TECHNOLOGICAL DISRUPTION

Technological improvements have been marginally helpful for current performance operational challenges

Bespoke applications or targeted functions developed in-house using popular programming languages and open-source analytical packages, like Python and R, continue to serve specific needs in a cost-effective manner. Today, the industry commonly recruits new talent with data science and computer science degrees along with experience in these types of tools. Together with the adoption of cloud-based services, recent technologic advancements bode well for investment managers trying to solve the holistic data, investment performance and attribution platform challenge in the coming decade.

Market data is starting to become available through API libraries that bring down the development time, reducing joins and coding links required across different data sub-domains. For example, a market calendar library can readily supply an exchange schedule. Checking invalid and holiday scenarios are no longer required as a part of the core system logic. Similar advancements have decreased project timelines for many operations, but not necessarily in support of enterprise-critical functions or highly audited activities.

These bespoke applications are effective low-cost mechanisms to meet one-off needs and short-term analytical projects; however, they are unable to effectively scale without enterprise-level workflow, control checks and monitoring. The industry's goal of end-to-end straight-through processing will depend on how asset servicers incorporate the latest technologies into newly consolidated platform visions. Whether this vision is called STP or consolidated platform, we expect to hear more on these themes in the coming years.

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OUTSIDE INFLUENCES

Additional influences pushing and pulling on the investment management industry

As these trends continue to transform investment performance operations today, it's important to consider other influences pushing progress forward and pulling firms off course. While the impact of an individual trend may be marginal, these following influences are converging and have the potential to transform investment performance operations in the future.

- **Broad acceptance of cloud-based solutions.** Nearly everyone has climbed on the rocket to the cloud. The asset management industry has overcome its initial concerns and started adopting the cloud in transformational initiatives, particularly with a private cloud.
- **Unrealized potential for outsourced data platforms.** The adoption of external data warehouses or data vaults have forced traditional performance vendors to reconsider their product architectures. Many providers offer a modular approach to functions and managed services, but struggle to maintain disparate data sources and scale processing on-demand for front-office areas like risk and portfolio management.
- **Preference to invest under Environmental, Social and Governance (ESG) considerations.** ESG is here to stay, as a result investment vehicles are trying to quickly adapt. Each global market domain will treat ESG slightly different with varying levels of compliance reporting and governance oversight. The operational challenge on most people's minds today is the poor quality and overlapping ESG ratings that expose challenges through conflicting data analytics.
- **The rise of alternatives and cryptocurrencies.** A myriad of new asset types have entered the market in recent years, particularly cryptocurrencies and private market instruments. Market volatility and liquidity issues associated with these instruments, along with the lack of clear guidelines, have disrupted performance measurement frameworks. While government central bank digital currencies might be easier to manage, it is unclear how other forms of digital currencies will be handled, causing global standards on crypto assets to be awhile away.

CONCLUSION

Clearly, our industry is facing a multitude of changes. Fee pressures continue to drive the need to further reduce costs and new investment markets are forming with ever-increasing complexity. Couple those with the operational challenges associated with previous attempts at updating legacy systems and an increasing number of asset managers are punting operations to service providers.

Planning transformations in a realistic manner prepares for both successes and failures. Investment managers must determine vendor weaknesses early and watch for immature technologies. Be prepared to accept that some operations are too close to core competencies and will need to remain in-house. Organizations should prepare for a slower uptake of complex functions like benchmark-relative performance attribution at the security level and complex risk analysis and modeling. Additionally, firms should take into account all underlying data dependencies and unique historical datastores while carefully reviewing non-standard operations and industry-standardized practices.

HOW MERADIA CAN HELP

Anticipating change and analyzing your options requires time and perspective that we know are difficult to acquire from inside an investment management organization. Meradia provides a spectrum of consulting services to guide executive-level strategic evaluations and program planning. Our industry experts conduct detailed analytical and workflow evaluations, technical implementations and project delivery that transform your business for the better.

[1] "Flexera 2020 State of Tech Spend Report". Flexera, https://www.flexera.com/about-us/press-center/state-tech-spend-report-execs-struggle-gain-cost-visibility-manage-spend-effectively

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This paper was produced by the Meradia Investment Performance Practice

Contributors include:

Richard E. Mailhos
Investment Performance Practice Lead
Richard has over 25 years of experience in the financial services industry with extensive consulting and project expertise ranging from operational and control reviews to global portfolio management platform deployments.

Laurie J. Hesketh, CIPM, PMP
Laurie leads strategic engagements for Meradia clients. With over 20 years of experience, Laurie specializes in investment data warehouses, investment performance and client reporting transformation.

Richard L. Galligan
Richard is a technology-focused performance expert with 30+ years of industry experience. Having worked at large service providers as well as investment management organizations, Richard leverages his diverse knowledge to provide successful implementation strategies.

Jose R. Michaelraj, CIPM, CAIA
Jose brings over 15 years of industry experience to Meradia's performance projects. His strong domain, functional, and technical skills; combined with end-to-end process knowledge, data management expertise and project leadership result in effective and efficient solutions.

Jeremy M. Welch
Jeremy is an expert in investment operations outsourcing with over 15 years of experience. He leverages his deep knowledge of project management, investment performance and global operations to support Meradia's clients through complex transformational programs.

Meradia
119 North High Street
West Chester, PA 19380
Phone: 610-738-7787

Info@Meradia.com
www.Meradia.com