How to achieve agility in alternative investments

New target operating models for asset managers

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Overview

Investors are increasingly eyeing alternatives as a way of diversifying their portfolios and achieving strong returns uncorrelated to volatile stock markets. In response, traditional asset managers are expanding their product range to offer a wider palette of private market investment opportunities to their clients. In the process, fund managers are reaching beyond go-to alts such as hedge funds and into areas that include private equity or debt, real estate, infrastructure, alternative credit, and more.

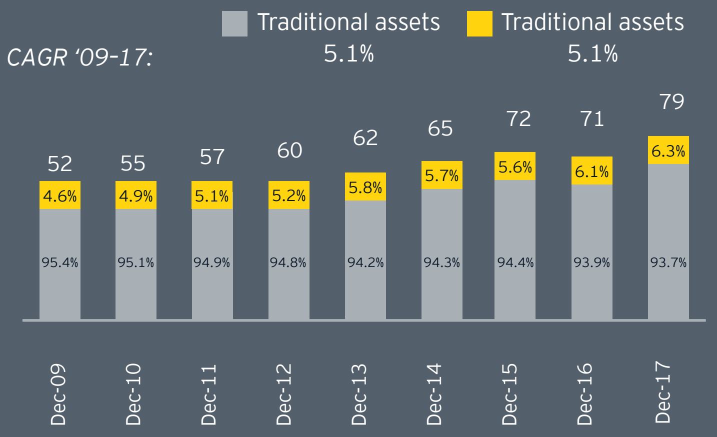
But do current operating models have what it takes to efficiently and profitably expand one's alternatives' footprint? By their nature, illiquid assets tend to be more complex than their liquid counterparts and also have different lifecycles. Accordingly, the capabilities needed to operate these types of strategies are fundamentally different, requiring asset managers to pause and consider how best to tap into this market.

From the importance of streamlining to the complexities of private markets valuations, to recruiting and retaining the right talent and the role of technology and outsourcing, our article outlines key considerations for finding the right operating model for asset managers growing their alternative investments business.

Introduction

In our latest annual ***Global Alternative Fund Survey*** titled "At the Tipping Point: disruption and the pace of change in the alternative asset management industry," we found that over one-third of investors are broadening their private equity exposures, with others looking to infrastructure, real estate and other private market offerings.

Global AUM[1] ($ trillion)



Source: Preqin

This move toward alternative asset allocation has accelerated in recent years, as historically low interest rates along with growing market uncertainty have forced institutional investors to look farther and harder in their search for returns.

In this article, we'll take a look at how the influx of institutional assets has not only boosted competition within the alternatives space, but has also led multi-asset managers to reassess how to achieve efficiency and scale as they expand into alternative investment strategies. As the traditional and the alternative investment spaces are increasingly converging to meet investor demand, asset managers are finding that the nature of illiquid alternative assets is ill-suited to traditional fund management processes and systems. Illiquid assets not only have different lifecycles than liquid ones, but they are often inherently more complex too, meaning the required skills and capabilities as well as the processes, controls, valuation and risk management are fundamentally different.

This lack of commonality often leads to fragmented operational models that are unable to function across asset classes and meet rising investor demands. The drawback of these operational silos includes not only lack of scale and efficiency, but also the lack of rigor, as alternative funds consequently struggle to demonstrate the type of institutional-grade control systems that traditional asset managers operate across their business-as-usual portfolios. Yet, institutional investors expect a similar degree of investment reporting efficacy from alternative funds as they would from traditional equity and bond funds. In addition, past scandals around private investment managers promising and temporarily delivering "too-good-to-be-true" returns have now ratcheted up investors' due diligence requirements.

Many private markets participants, therefore, have strict covenants requiring full transparency into the investment cycle. Asset managers must be able to demonstrate the integrity of their asset valuation, performance analytics, process monitoring, risk management and other essential skills, in addition to providing more frequent and detailed data than alternative asset managers have previously done. In order to properly scale the business for further growth, and meet investor expectations that the operations are institutional and robust in nature, investing in technology is now a prerequisite.

Expanding into alternative assets – from investor demand to operational efficiency

Asset managers who are looking to attract institutional inflows into their new alternative funds are finding that their existing target operating model (TOM) is aligned with the characteristics of equity and fixed income asset classes, rather than the specific nuances of private markets. The expectation of investors on large multi-asset managers is to have a well-controlled, robust and integrated targeting operating model that can service their needs.

Thus, the onus is on managers to promote more sophisticated data-gathering, reporting and compliance capabilities, in part by redesigning the company's target operating model in support of multi-asset class strategies. While this can be a challenging undertaking, it also promises to deliver opportunities to not just stem the outflow of assets to competitors, but to position the asset manager for future growth through increased operational efficiency.

The below chart illustrates a typical asset manager's alternative investments journey, from investor demand through to optimized operating models:

1

Investor demand

Investors are demanding products and solutions across a wide range of alternative asset classes, strategies and structures.

2

Product growth

Asset managers are responding to this demand by expanding into alternative investments, commonly through acquisitions, leading to a fragmented operating model across the business.

3

Target Operating Model

Traditional operating models are ill-suited to alternative investments because of the fundamental differences in their nature spanning from front to back office. This leads to inefficiencies, silos etc.

4

Optimized Target Operating Model

Faced with increased competition and the need to satisfy investor expectations, asset managers are seeking to develop integrated targeting operating model across the asset classes.

5

Operational efficiency

The target operating model review supports asset managers in their profitable expansion into alternative assets, while also allowing for increased operational efficiency at the back-end of the operating model.

Challenge 1

Functional and governance considerations

With alternative investments only growing in complexity, eliminating operational barriers is paramount. For instance, many firms have a dedicated investment team for every asset class or strategy, each with its own set of management standards. Furthermore, assets may be held in multiple regions and therefore need to comply with different regulatory standards. Other potential pitfalls include:

- A lack of harmonization between investment product and distribution chain
- Unchecked operational silos inherited through new business acquisitions
- A lack of expertise with alternative investment-specific risk management, legal and tax restructuring, distributions and other protocols

Without joined-up processes in place, traditional asset managers face steadily eroding margins as they struggle to efficiently meet investor demand. At the same time, the growing influence of large institutional investors has ratcheted up the funds' due diligence responsibilities, including greater transparency around valuations, liquidity and fees, along with more frequent and thorough reporting.

Managers of alternative assets require monitoring solutions that can provide real-time visibility across the entire organization. To accomplish this, asset managers must develop a robust target operating model that can harmonize different asset-class models, allowing managers to build scale and boost enterprise-wide efficiencies.

Some may ask, what's wrong with my current operating model? Assuming all you're tending to is a plain-vanilla basket of securities, probably nothing. When it comes to the comparatively opaque, illiquid world of alternatives, however, the sheer volume of regulatory mandates and client data requirements is such that companies often require a full model makeover. Historically, investment book of record (IBOR) technologies have typically been used to support the trade lifecycle of financial instruments across cash and derivatives. However, the nature of real assets and private equity investments requires specific investment, operations and accounting functionality.

An operating model that is optimized for alternative investments, on the other hand, promises to deliver:

- Agility in raising funds and launching new products to market
- Better investment decisions through data-based and technology-supported insights
- Increased investor trust and inflows due to client-focused regulatory and performance reporting
- Operational efficiency that can help protect margins
- Enhanced risk control through integrated processes and systems, resulting in more transparency

Client perspective: Operating Model Choices

"We were faced with deciding whether to integrate the new business with our existing systems and people structure, or whether we should have a standalone alternatives operating model.

When we had previously acquired an alternatives business, the new business unit remained separate and continued to use their own processes, systems and preferred service providers, but we realized that this autonomous operating model would not be right in all cases.

Large European asset manager

Challenge 2 Data and valuations

Compared with traditional strategies, private asset classes require a more nuanced, judgment-based approach to valuation, including the use of more sophisticated pricing techniques as well as complete and timely data documentation. Regulators have been keen to ensure adequate standards are met. As part of its ongoing investor-protections campaign, the US Securities Exchange Commission (SEC) has stepped up oversight into managers' valuation and fund-accounting skills, including assets held in custody, through broker-dealers as well as counterparties across various jurisdictions.

The below table outlines the main differences between traditional (public) and alternative (private) investments:

	Traditional	Private
Typical operating market	Liquid	Illiquid
Pricing	Managers are price takers	Managers are price creators
Pricing judgment	Low	High
Pricing models	Simple	Complex
Liquidity discounts	Not allowed for quoted price	Applicable for most private asset pricing
Governance and documentation burden for pricing	Low – prices available publicly	High – requiring committees and valuation specialists

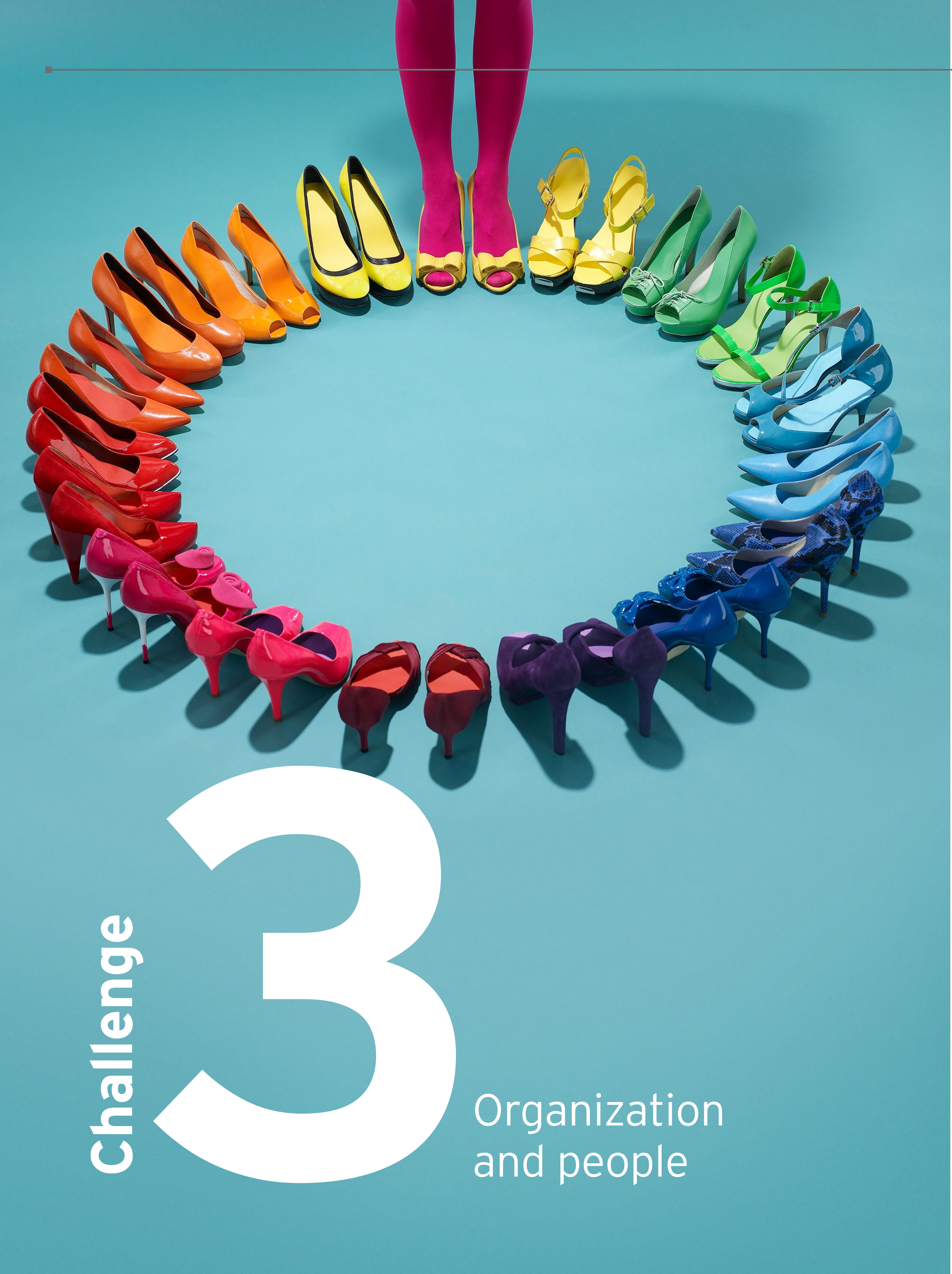
Client perspective: Data, Data, Data

"At first, we tried to integrate the new alternatives business with our existing systems and people structure. However, we quickly found that our data model and data teams were not familiar with the non-standard data from illiquid assets and it took them a long time to onboard these assets onto our systems.

We did consider outsourcing some of the work but didn't know which third party service providers would be able to handle these assets successfully.

Finally, we decided that our operations and product tax teams needed to be upskilled to manage these assets in the long term.

Large European asset manager

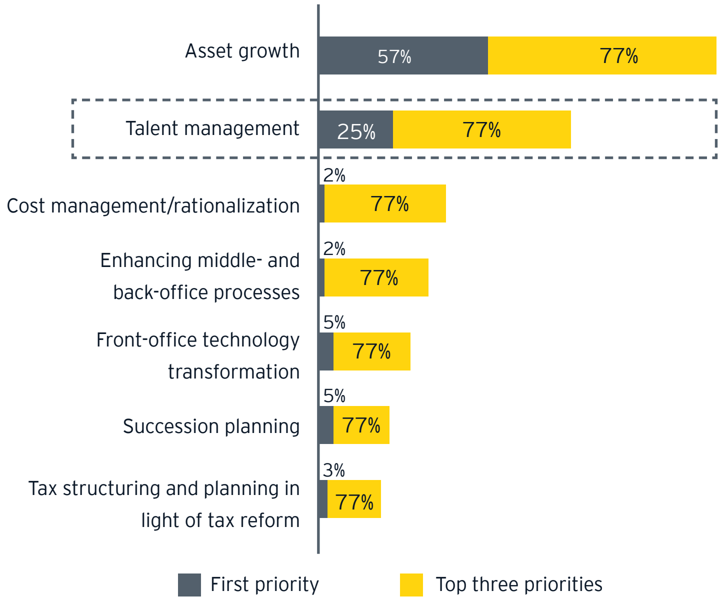


Challenge 3

Organization and people

Not only must firms secure top-flight technologies and processes, they also require the right people and governance to support the operating model effectively. Here, we will take a look at the people challenges in growing your alternatives business.

Please rank the top three strategic priorities for your firm:



Source: EY Global Alternative Funds Survey 2018

Acquisition is one strategy for expanding alternative asset management capabilities. Talent integration planning should begin early in the M&A timeline, i.e., even in the first stages of identifying and evaluating the alternative asset management company for acquisition, the acquiring asset manager should have an eye on future integration considerations and potential obstacles.

While this is true of any acquisition, it's especially pertinent for asset managers acquiring specialized alternative fund boutiques. In fact, our latest alternative funds survey has found that talent management is a top-three priority for 60% of surveyed alternative funds, and the first priority for a further 25% of alternative fund managers.

There are three key reasons why attracting and retaining specialized staff is particularly challenging for asset managers, regardless of whether they are growing by acquisition or organically:

Competition: Talent gravitates toward pure-play alternative managers due to generous rewards in the form of carry schemes and clear decision-making power. Whether growing through acquisition or organically, asset managers need to proactively manage talent by attracting, incentivizing and thereby retaining talent that is in demand, both by traditional asset managers broadening their asset class coverage and by pure-play alternative fund managers.

Governance: This can be a challenge for large asset managers. They need to balance reward and freedom for these specialist alternative investment managers, with the rewards and freedoms accorded to peers working on the traditional investments, e.g., equity and fixed income funds.

Private markets lifecycle: Compensation is complicated by the fact that the private markets lifecycle is not aligned to quarter-to-quarter targets. The different nature of the markets will create complexity, but a broad alignment and comparative assessment is still necessary. Failure to do so could create a culture clash, if remuneration is significantly different across traditional and alternative funds.

We recommend that asset managers looking to build their alternative investment capabilities determine a holistic, cost-effective and market-competitive compensation and benefit programs, for both the acquired business and the new ongoing business. A good first step is for the acquiring asset manager to conduct a retention study to gain an understanding of anticipated needs and concerns of the alternative investment manager's employees concerning their total rewards program, so negotiations can be conducted with those elements in mind. This approach is an important component to a retention strategy for employees and executives who are key to maintaining business continuity before and after closing. This is because the risk of losing key intellectual capital is heightened during the sales process, and key executives can be targets for the acquiring asset managers' competition.

Changing talent profiles

Alternative fund managers are keenly focused on talent management as they attempt to respond to and gain a competitive edge because of changing business dynamics. Technology advancements, product development expansion, and the realization that different and diverse points of view will drive better investment decisions are just some of the reasons for this massive pivot about how managers think about their people.

Relative to 5 to 10 years ago, how has the "profile" (e.g., educational background, past experience, diversity) of the employees you have evaluated/interviewed/hired changed?

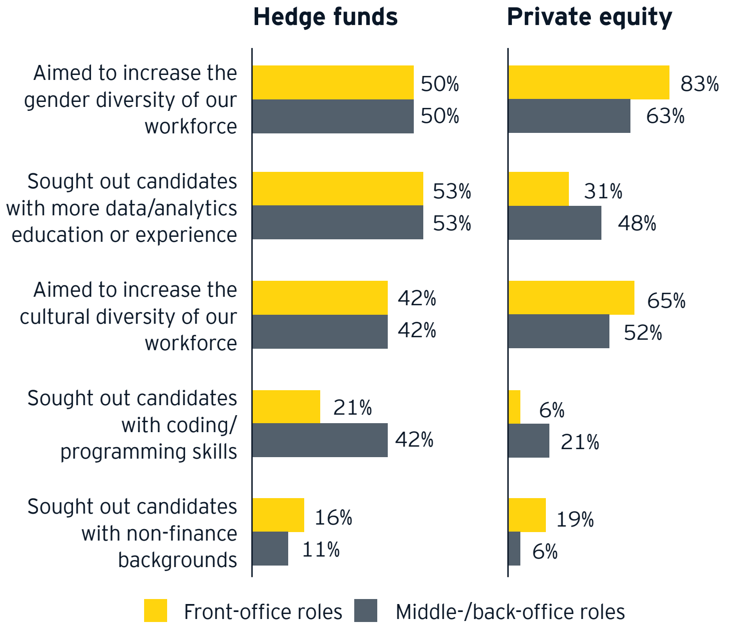


Figure 1 Source: EY Global Alternative Funds Survey 2018

An alternative way to grow your alternatives business

Another model for growing alternative investment capabilities without hiring staff or integrating businesses is to acquire a stake in an alternative fund boutique. We see many clients take this route, which involves taking a small to large stake in the smaller firm, leaving the staff of the boutique enough "skin in the game" to incentivize and retain them.

A brief case study

The client:

A global investment manager had grown its private markets capabilities through acquisitions to include private equity, infrastructure, real estate and private credit.

The challenge:

The operating model was siloed asset class by asset class. We found the client did not have standard platforms and was reliant on spreadsheets, leaving the firm unable to scale quickly. Some processes were outsourced and thus, there was a lack of consistency as outsourcing was based on legacy arrangements made by acquired businesses.

The answer:

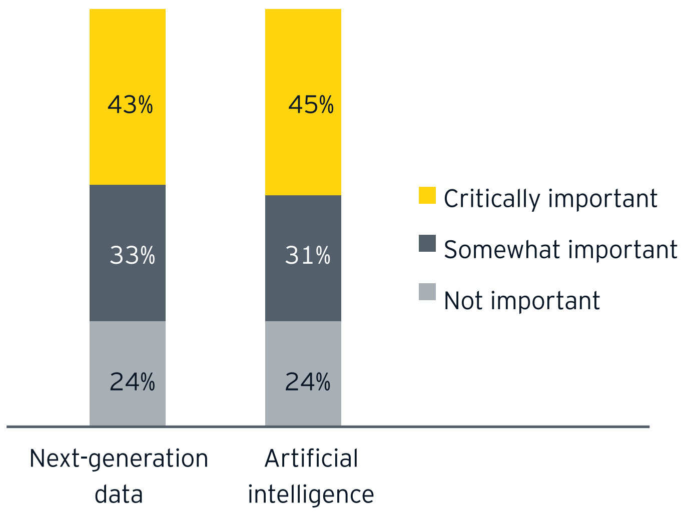
We supported the client's move to set up "private markets" teams within broader functions. This approach enabled these private markets functions to collaborate across the firm, share specific knowledge and provide transparency across the trade lifecycle, providing flexibility and control to meet changing business demands.

Enabler 1: Technology

Technology platforms have evolved over recent years to support the entire investment process, across a range of asset classes from front to back office. The point is clear: without access to dependable information, achieving accurate, granular data can be a hit-or-miss proposition, made only increasingly difficult due to the specific nuances of alternative investments. Well-designed platforms can support the entire range of equity and debt strategies, from corporate to investment to fund to asset, taking into consideration sectors, life cycle, asset type, asset use, regional markets and investment style.

Investors

How important is it that your fund managers use next-operation data and artificial intelligence to support their investment process?



Source: EY Global Alternative Funds Survey 2018

This has served as a call-to-arms for leading service providers, who have developed sophisticated new interfaces to augment core packages in order to give fund managers wall-to-wall coverage across the alternatives spectrum. As noted in our *Global Alternative Fund Survey*, next-generation data providers are boosting their presence, among them FinTech start-ups using application programming interface (API) platforms and distributed-ledger technologies to innovate how alternative assets are identified, funded and managed.

Investors

In which of the following areas would you most like to see your alternative fund managers become more "innovative" to positively benefit the business?

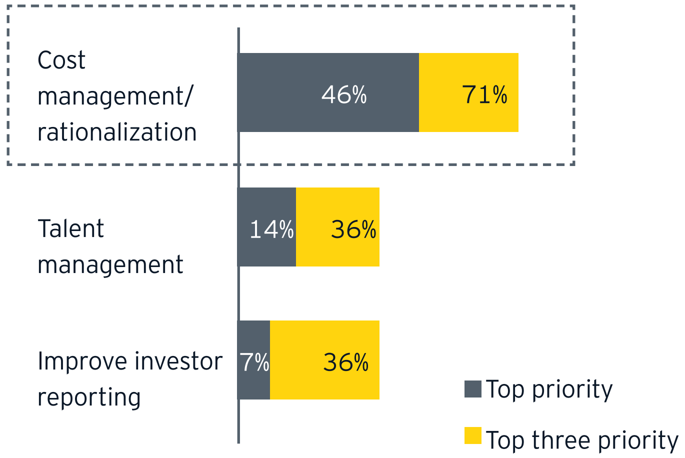


Figure 2 Source: EY Global Alternative Funds Survey 2018

Enabler 2: Outsourcing of non-core functions

As markets evolve, asset managers continue to see the benefits of utilizing outsourced solutions as part of the overarching operating model. This has led to an uptick in third-party activity in recent years. As the industry continues to change and regulation becomes more pervasive, traditional and pure-play alternative fund managers appear increasingly amenable to offloading non-core functions to a seasoned third party, in order to fully focus on generating investor returns. In fact, we believe that organizations looking to re-evaluate their operating model should consider both outsourcing providers and technology as key enablers of end-to-end change.

While typical outsourcing points of entry include financial reporting, fund or special purpose vehicle (SPV) accounting, and transfer agency services, fund companies may also call upon third parties for real-asset and portfolio-valuation expertise, in addition to tax reporting and portfolio monitoring. Additionally, integrated risk management platforms act as a crucial safety net, allowing managers to become more proactive with respect to stock selection, while also offering a broader view of multi-asset class portfolio risk.

With managers seeking a one-stop shop for all their outsourcing needs, asset servicers have responded by diversifying their core capabilities, including offering an even wider range asset-class coverage. Going forward, the investors' seemingly insatiable appetite for better data and analytics presents innumerable opportunities for independent providers offering newer, specialized technologies on an outsourced basis. Whether these solutions can help funds become smarter, more efficient managers of risk and returns will likely continue to resonate in the years ahead.

At EY, we believe that the outsourced alternative administration function of the future will be one that enables value creation in the business by:

- Adopting intelligent automation tools, artificial intelligence (AI) and distributed ledger technology (DLT) across the function and redeploying skilled resources upstream
- Dividing their business among a small number of firms to diversify risk while gaining negotiation leverage
- Revitalizing its talent pool to facilitate the analytical demands of the front office
- Empowering the relationship manager with smarter segmented content, enhanced digital experiences and more responsive, flexible service levels
- Creating efficiencies through its strategic approach to data, partnerships and next generation technology

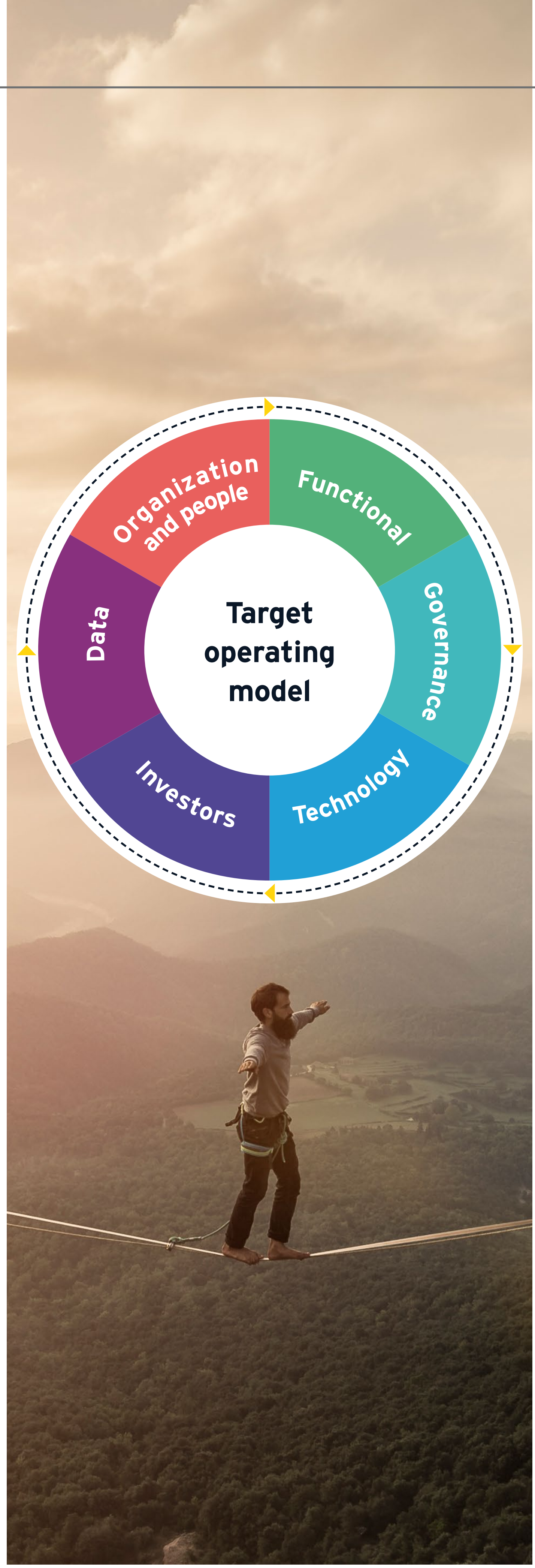
Conclusion

To succeed in the alternatives segment, asset managers must maintain an operating model that can function seamlessly within these relatively illiquid markets. We can advise fund management firms as they weigh the benefits of adopting new systems, tools and processes, as well as help assess prospective alternative opportunities prior to committing investment capital.

EY's leading-practice target operating model framework, which we introduced in this article, allows complex business scenarios to be decomposed into distinct views of the organization, which supports a structured and consistent analysis and design that EY uses to deliver the target operating model.

Please contact us to discover how EY can help asset managers create a sustainable alternatives target operating model, from strategy to implementation:

- Review potential business or strategic opportunities
- Conduct assessment of existing operating model
- Develop a target operating model framework and design the principles
- Review and recommend technology and outsourcing providers
- Provide knowledge service around illiquid asset processes, controls and valuations
- Help clients establish reliable operational governance



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