EMEA

Performance

A triannual topical digest for investment management professionals, issue 14, May 2014

In focus

Deloitte.

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Foreword

Dear friends and readers,

We are pleased to bring you this edition of Perform*ance*, by Cary Stier, our Global Investment Management Leader. Cary has brought together a wealth of interesting material from across the globe, underlining once again the reach and breadth of our contributors and focus.

It is always intriguing to note how our industry demonstrates both familiar characteristics and a huge thirst for innovation. It is an exercise in using experience in an ever-changing context and adapting to an ever-changing world. Never has this been truer than in recent months, where we have once again seen something of a shift in geo-political behaviour and the implementation of regulation vying for our attention and impacting our activities.

Keeping pace with the rate of change, let alone the change itself, is one of the major challenges that we all face daily. As the sheer volume of regulation grows, it is increasingly difficult to sift through the raw material and analyse, assimilate and transfer that acquired knowledge into meaningful action. Never before has it been so important to leverage the thoughts of others, to gain valuable insights from their experience. We believe that Perform*ance* has a key role to play in assisting you in your daily endeavours.

We are delighted to see that Perform*ance* is once again enriched through contributions from our readers, with an interview and cutting-edge pieces from the leaders of the asset management industry. We hope that the insights they provide and the contribution to our collective understanding gained from each experience will inspire others to take up their pens, or perhaps more modern tools and contribute their thoughts for future editions. For us, Perform*ance* is essentially your publication; sharing your thoughts, your experience and your understanding. We are delighted to also share our views from a service provider standpoint in the intellectual and operational domains in order to reach a mutual success with the readers and meet the challenges of both our businesses. We hope that after reading this issue you will agree.

We wish you a fruitful and enriching reading.

Vincent Gouverneur
EMEA Investment
Management Leader

Nick Sandall
EMEA Co-Leader
Financial Services Industry

Francisco Celma
EMEA Co-Leader
Financial Services Industry

Editorial

Dear readers,

It has been more than six decades now since Nobel Prize winning economist Harry Markowitz first laid the foundations for modern portfolio theory, and since that time, the global investment management industry has continued to extend the boundaries of diversification into new realms. Pensions, endowments and other institutional investors were major instigators of this important evolution, as fund managers sought new asset classes to meet these plans' unique obligations. In many ways, the allocation strategies these managers designed served as precursors for today's truly modern portfolios, maintained by institutions and individual investors alike.

This 14th edition of Perform*ance* catalogues how institutional investors are once again pushing those borders as they more fully embrace alternative investments amid growing evidence of tighter correlations between traditional asset classes.

Vanguard's Chairman and Chief Executive Officer, Bill McNabb and Chief Investment Officer, Tim Buckley lead the way, discussing the evolution of investment strategy at the company, which is widely known for pioneering index funds.

We provide this information to you at a time when we are trying to cope with the loss of a leader whose own insights helped our global practice flourish during a period of great flux and uncertainty. As you know, Stuart Russel Opp, our colleague and former Global Investment Management Leader, lost his battle with cancer on 4 April 2014 at the age of 46. Stuart no-nonsense approach and his penchant for problem solving helped bridge the divide between the many cultures and personalities that define our practice. Up to the very end, Stuart remained dedicated to his teams and was the true embodiment of the dynamism that drives this industry forward and how we all might seek to emulate his work ethic as we strive to exceed our clients' expectations.

We hope this issue provides you with ideas to up your own performance and helps you stay at the cutting edge of what should continue to be exciting developments for the industry.

All the best,

Simon Ramos
Editorialist

Cary Stier
Global Investment Management Leader

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F. William McNabb III

Chairman and chief executive officer of Vanguard, Mr. McNabb joined Vanguard in 1986, became chief executive officer in 2008, and chairman of the board of directors and the board of trustees in 2009. Previously, he led each of Vanguard's client-facing business divisions.

Mr. McNabb is active in the investment management industry, and serves as the chairman of the Investment Company Institute. He also serves on the boards of the Zoological Society of Philadelphia and the United Way of Greater Philadelphia and Southern New Jersey.

Mr. McNabb earned an A.B. at Dartmouth College and an M.B.A. at The Wharton School of the University of Pennsylvania.

Mortimer J. 'Tim' Buckley

Vanguard chief investment officer, Mr. Buckley is responsible for the oversight of approximately $2 trillion managed by Vanguard Fixed Income and Equity Investment Groups. The funds managed by these two investment groups include active and index stock funds, bond funds, money market funds, and stable value funds.

Mr. Buckley joined Vanguard in 1991 as assistant to the chairman, and has held a number of senior leadership positions over his 20-year tenure, including head of the Retail Investor Group from 2006 to 2012 and Vanguard's chief information officer from 2001 to 2006. He is currently the chairman of the board of The Children's Hospital of Philadelphia.

Mr. Buckley earned an A.B. in economics and an M.B.A. from Harvard.

A steady hand at the helm

Since its founding in 1975, The Vanguard Group has been a pioneer in driving costs down across the mutual fund industry. Today, it's one of the largest investment management companies in the world, offering more than 160 U.S. funds and over 80 additional funds outside the U.S. Cary Stier, Deloitte's Global Managing Director of Investment Management recently sat down with Bill McNabb, Vanguard's Chairman and Chief Executive Officer, and Tim Buckley, Chief Investment Officer, to discuss the company's longstanding investment philosophy, the role of international markets in portfolios, and ongoing fund innovation.

Deloitte: How has Vanguard's investment philosophy changed over the last several years given the environment we've been living in?

Tim Buckley
I've worked at Vanguard since 1991, and over that time period the investment philosophy has been unwavering. It's founded on four ideas: know your goals, set your asset allocation, keep your costs low, and have the discipline to rebalance to your asset allocation. We study this all the time. 'Are these the right principles? Do they hold up in this environment?' They still do. We have found that if people don't follow those best practices they can be giving up as much as 3% a year in their return.

Deloitte: How do geopolitical events that have happened recently impact your philosophy about maintaining international exposure?

Bill McNabb
I don't think it impacts it at all. Having international exposure is really important. U.S. investors have a very strong home-country bias, and one of the things that's really important from a diversification standpoint is to have exposure outside the U.S. You must have a long-term perspective. The market encourages people to think short-term and you have to resist that as an investor.

As I travel globally, I see just unbelievable opportunities to take what I'll call the Vanguard way of investing and take it to new markets

Bill McNabb

Deloitte: To your comment about staying the course, how do you see target date funds evolving as we move forward?

Tim Buckley
Target date funds have been incredibly successful for a good reason. In 401(k) plans, they're really *the* default investment option. It's a great way for people to start investing and for people to continue investing because the asset allocations get more conservative with time.

But, as with anything else in this industry, success is encouraging people to change the product and put their own spin of advice on it. Now people want to add alternatives to them, they want to add active management to them, they're saying bonds are dead, that they don't belong in these portfolios. Bonds belong in there. They're the ballast of the portfolio. They're there for the '08 crisis. They're the part that keep the keel down and the sails up. So we keep them in our target date funds.

Bill McNabb
The other thing I would add when you think about target retirement funds is that two of the most important things are transparency – so making sure investors really understand what's underneath the hood – and cost. Depending on the time period involved, roughly 80% to 90% of all return is based on your asset allocation, not your individual fund or security selection. That's why we put so much emphasis on getting the asset classes right and getting the cost and transparency right so that people can see that.

Deloitte: Are alternative investments ppropriate for retail investors? We're seeing more alternative funds that have a mutual fund or a RIC formula.

Bill McNabb
Alternatives can have a place in a very sophisticated, long-term portfolio.
For an institutional investor to have exposure to alternatives can make sense, given the institution's sophistication and long-term orientation. But we think that a lot of what we're seeing from alternatives in the retail space is an inferior way for most retail investors to invest.

Deloitte: As a pioneer of exchange traded funds, where do you see active ETFs playing a role in investment portfolios?

Tim Buckley
There's a lot of excitement about active ETFs, but the details haven't been worked out. First of all, what you're getting with most active managers is their proprietary ideas of how to beat the market. They're taking positions and they have to take those positions before anybody knows about them. But with ETFs, the first hurdle people have to get over is, can you be transparent with an active manager? I have yet to meet an active manager who says, 'Yes, I'm going to show you my hand every day.'

The next hurdle is that ETFs ultimately have to be scalable. You cannot just close them when you run out of ideas. Active managers only have so many ideas that add alpha. Eventually they say, 'Look, the portfolio is now at its limit, and I can't take any more assets.' It happens at Vanguard all the time, and we make the choice to close a portfolio. You can't do that with an ETF. As soon as you close it, it's a closed-end fund – it's not an ETF. And it now trades at a premium or a discount, and you've changed the nature of that investment.

So I think there's a lot of hurdles to get over if you're going to take what used to be traditional active funds and now make them ETFs.

Deloitte: How do you continue to innovate at Vanguard to keep the brand strong?

Tim Buckley
When talking about innovation, we have a primary rule here: you don't experiment with client's money. You can be bleeding edge with service ideas but don't be bleeding edge with investment ideas. We make sure when we launch a fund that it's something we would want to put our money in or our family's money in.

There's a place for innovation. It doesn't happen every day. It's more likely to happen on the service side, if you think about the build-out of the web, of mobile, how it's changing the face of advice. On the investment side, there have been a lot of gaps between the introduction of the index fund, the money market fund, the target-date fund and the ETF.

When talking about innovation, we have a primary rule here: you don't experiment with client's money

Tim Buckley

What fills in the gaps between is proliferation, which is cloaked as innovation. Over the past four years, 700 ETFs have been launched, and each one has claimed an innovative new approach to beat the market. Well, 200 have folded, and more than 350 of the survivors have underperformed the market by a percent a year. True innovation is rare.

Bill McNabb
Internally, the word we use more than 'innovation' is 'entrepreneurship.' There aren't that many truly innovative ideas, but when there are, the question is, 'Can you take a new service idea or a new product idea and actually create a business model that works?' And so what we encourage our people to be thinking about all the time is how to be a little bit more entrepreneurial in terms of creating value for the client.

Deloitte: It does seem, globally speaking, that the products and their uses keep changing, and we're seeing different initiatives people are undertaking to try to get distribution in Europe or Asia. How exactly does that innovation play into your thinking about global?

Bill McNabb
This is where I think being entrepreneurial is really important. Take the concept of indexing. It's hardly taken hold anywhere else in the world, and so we think there's a lot of opportunity there. ETFs are an expression of that, and they are beginning to emerge globally. The question is: Can we clarify the noise and sort through all the product proliferation and get people to the basic building block products in a portfolio that are transparent and low cost? These are all new phenomena around the world. As I travel globally, I see just unbelievable opportunities to take what I'll call the Vanguard way of investing and take it to new markets.

Deloitte: Bill, I know you're spending a lot of time on the regulatory front, as are many of your peers in the asset management community. What's your sense of where things are right now from the perspective of global regulations and how will it impact your business?

Bill McNabb
Since 2008, regulators and governments all around the world have wanted to respond in a way to avoid another crisis going forward, and so there have been a lot of new proposals. In the U.S., we have Dodd-Frank, which is 2,300 pages and 140 different rules, only about half of which are really clear.

The big questions that are out there now are all around systemically important financial institutions. It's really hard to imagine how that's going to play out. The major banks have all been designated. A couple of insurance companies have been designated. There's talk about whether asset managers should be included. We don't think so. Asset management is an agency business, whereas banking and investment banking are principal-based businesses where you're actually putting capital at risk. So I think there's still a lot more to go here.

Deloitte: Is the asset management industry in a challenging spot? Because the asset managers all are different, so it's not just you comparing yourself against an insurance company or bank, or even your peers in the asset management industry.

Bill McNabb
That's a great point. If you looked at a company like Vanguard, we are primarily a mutual fund company. That's 98% of our assets, and we're really simple from a conceptual perspective. Many asset managers are in multi-product lines, and I think that complicates the regulator's job. One of the things we try to do is just lay the data out so that the regulators and government officials can make informed judgments.

Hot topic question

How can fund managers assess cyber security threats?

Mary Galligan
Director
Deloitte

Cary Stier
Global Investment Management Leader
Deloitte

The increased number of reported cyber attacks on businesses and the evolving nature of the breaches have led many fund managers to reevaluate their cyber security strategies, particularly with regard to preventive protocols and timely responses.

Mary Galligan, a director with the cyber risk services practice of Deloitte & Touche LLP, who previously served as special agent in charge of cyber and special operations in the Federal Bureau of Investigation's New York office, discusses what fund managers should be thinking about to strengthen their preventive cyber security measures. Mary is joined by other industry specialists who provide insights on how fund managers can help mitigate reputational risk and develop response protocols in the event of a cyber attack.

Mary Galligan

Investment managers should assess cyber security threats by asking simple questions, such as who would want our information and why do they want it. When making such evaluations, it is important for organisations to start with a clear understanding of their vulnerabilities to make risk management and mitigation more informed. Investment management firms may want to identify critical assets, 'treasures', as part of their cyber risk management plan, then prioritise threats to those assets and consider the assets and threats with business leaders.

The ability for investment managers to identify cyber security risks facing their organisation hinges on its ability to answer the following five questions:

1. Which cyber threats and vulnerabilities pose the greatest risk to our business and reputation?
2. What are the key assets that we need to protect?
3. Do we have the right talent—quantity and quality?
4. Do we have good cyber threat management practices, including protective, detective and response capabilities? Is it fully integrated with our business strategy and processes?
5. Do we have the right gauges to measure the success of our cyber threat management programme?

Investment managers should understand that the hacker community is smart, big, nimble and usually a step ahead of risk prevention measures. That makes monitoring the flow of information in and out of an organisation and blocking threats challenging, especially for investment management firms with offices around the world.

Cary Stier

With the level of cyber threats rising along with the proliferation of new technologies, more investment managers are looking to elevate their approach to cyber risk. Today, leading investment managers are using advanced forensic and analytic techniques to mine intelligence from both internal and external sources. The goal is to develop a deeper understanding of the origin of the attacks and track specific adversaries to enhance future risk analysis.

Although cyber threats are pervasive and often complex, the building blocks of a proactive approach to addressing them are similar to those for any well-planned business initiative. Investment managers need to understand what is at stake and the maturity level of their current efforts, and then make improvements by applying their existing capabilities whenever possible.

As investment managers expand their network of third-party providers, cyber risk should also be a key component of supplier risk reviews. For example, some investment managers are evaluating whether each vendor has adequate security controls in place and maintains an internal incident response team for cyber breaches.

Cyber risk management should run throughout an organisation to include the active involvement of the CEO and board, similar to the way senior management and employees think about an organisation's code of ethics.

Cyber risk management should run throughout an organisation to include the active involvement of the CEO and board, similar to the way senior management and employees think about an organisation's code of ethics

Investment management viewpoints

Perspectives from leading Chief Technology Officers

Leading chief technology officers at Deloitte's Alternative Investment Symposium emphasised that cyber risks do not need to be malicious to be considered serious threats, especially given the potential for systems to be infected by malware when employees bring personal technology into the workplace or engage in seemingly innocuous behavior such as clicking 'silly' links. Such inadvertent acts can be curtailed if investment managers develop education programmes for employees about cyber security risks and circumstances. With that said, several types of cyber threats were seen as especially worrisome according to the Chief Technology Officers, including:

1. Loss of control over Internet Protocol (IP) addresses, which are the binary sets of numbers that identify devices, such as servers, on a network
2. Loss of critical data or data leakage—whether related to an unintentional or deliberate act
3. Social engineering, in which users are manipulated into disclosing confidential information
4. Spear phishing, an email fraud scheme similar to phishing, but usually targeting specific organisations and coming from what seems to be a trusted source
5. A man-in-the-middle attack, in which a system is compromised and encrypted information is rerouted to a hacker's server and stolen before being sent back to legitimate users

Technology leaders also recognised that senior leadership cannot expect the technology team to stop every threat and attack. However, the technology team should be free to brief senior leadership about the risk and be comfortable doing so.

In addition, senior leadership should provide support to the technology team with respect to implementing the organisation's resiliency plan. Such a plan outlines the timeline and steps required for an organisation to recover from an attack and begin normal business operations. It also describes how the organisation should interact with law enforcement agencies.

To the **point**:

- The increased number of reported cyber attacks on businesses and the evolving nature of the breaches have led many investment managers to reevaluate their cyber security strategies, particularly with regard to preventive protocols and timely responses
- Cyber risk management is not just checking a box or passing a test. It requires understanding where the organisation's prized assets are and how criminals can come at them
- Investment management firms are looking to elevate their approach to cyber risk well beyond the walls of the IT department, a challenge that now requires active participation of senior leadership
- It can be important for investment management firms to create an education programme for clients and employees focused on cyber risk and prevention tactics that includes users to immediately report activity that they suspect may be related to a threat or an attack

Data and analytics
A new battleground in the investment industry

Jack Klinck
Executive Vice-President
Global Strategy
and New Ventures
State Street Corporation

In the new age of 'big data', we are learning quickly that more is not always better. The businesses that thrive will be those that use their data intelligently to capture game-changing analytics and insights. By optimising their data and analytics strategies, they will use these insights to create innovative solutions — transforming big data into smart data and gaining a competitive edge.

Leaders and laggards

Recent research shows that 9 out of 10 institutional investors view data and analytics as a key strategic priority.[1] But many are not able to give their data the attention it deserves. In fact, this research, which included more than 400 institutional investors globally, revealed that the industry is divided between data leaders and data laggards. The data leaders strongly agree that data and analytics capabilities are a source of competitive advantage, while the data laggards are struggling to reap the full potential from their data.

Here are a few of the ways data leaders are widening the gap:

- Nearly half of data leaders (47%) see investment data and analytics as their most important strategic priority, compared with only 27% of data laggards
- 72% of data leaders express a high level of confidence in their ability to integrate performance analytics with risk analytics, compared with only half of data laggards
- Data leaders are more confident in their ability to optimise electronic trading strategies (65% vs. 53%)
- 70% of data leaders express a high level of confidence in being able to generate forward-looking insights from their data, compared with only 42% of data laggards
- One-third of data laggards say the complexity of managing data distracts key employees from focus areas, while this is a challenge for only 7% of data leaders

Being a data leader is not easy and does not happen overnight, but it is increasingly a defining factor for gaining a competitive advantage

1 *State Street 2013 Data and Analytics Survey conducted by the Economist Intelligence Unit (August—September 2013)*

The difference between data leaders and data laggards is not one of power, but of paralysis. It is one thing to have technology that can collect and crunch endless streams of data; it is quite another to turn information into actionable insight. Financial institutions have a huge opportunity to collect, manage and analyse data in ways that benefit investment decision-making, regulatory compliance and risk management, to name a few. And the right technologies can reduce costs, increase efficiencies and improve performance.

The good news is that firms recognise these advantages. According to our survey, 86% of respondents have increased their spending in data and analytics over the past three years. For 11% of firms, this increase in investment has exceeded 20%.

Action plan

So we know that firms are prioritising data and analytics and even investing in these areas, but where should they focus their investments if they want to join the ranks of the data leaders? What does state-of-the-art technology infrastructure need to deliver?

Our research identified five key actions:

- **Improve multi-asset-class risk tools**
  The need to drive up investment returns in a low-interest-rate environment has encouraged parts of the investment industry to diversify into new assets. Many alternative assets have very different risk profiles from the traditional investments that dominated institutional investor portfolios in the past. So, one of the key challenges of operating in this multi-asset world is building a coherent view of risk and performance across portfolios with a much more complex set of assets.
- **Develop better tools to manage regulation**
  A wave of regulations such as Dodd-Frank, Solvency II, Basel III and AIFMD are causing institutional investors to overhaul their IT systems and rethink their reporting processes and trading strategies. Complying with even one of the major regulatory initiatives can be costly and onerous, but the bigger challenge is keeping pace with the regulatory regimes across multiple jurisdictions. Managing this complexity across a global footprint requires extremely flexible reporting systems.

- **Manage and extract insight from multiple data sources**
  Integration issues are often the key barrier preventing institutional investors from achieving their data goals. They are also one of the biggest frustrations with traditional vendor solutions. One option is to bring data into an enterprise data warehouse—essentially a repository where data is stored in a way that makes it more accessible and easier to analyse across the enterprise.
- **Optimise electronic trading platforms**
  Significantly higher trading volumes have led to an explosion of data and market participants are struggling to translate that data from noise into language. The ability to act on investment strategies and insights rapidly is a key consideration for the overall IT architecture. This is why many data leaders are investing in order management systems/ execution management systems (OMS/EMS).
  The goal going forward is to integrate trading solutions to support near real-time decision making across multiple asset classes, as well as to capitalise on trading opportunities and minimise costs.
- **Develop a scalable data architecture**
  Institutional investors need flexible data infrastructure that can keep pace with evolving client needs and new regulations. They also need to manage new asset classes, complex mandates and offshore assets. Modular, flexible solutions that grow with the business are ideal.

To the point:
Being a data leader is not easy and does not happen overnight, but it is increasingly a defining factor for gaining a competitive advantage.
The time is now to make sure you are extracting the greatest measure from both speed and information—creating customised insights and solutions in real time. These advantages will be the edge that differentiates the successful organisations in the smart data revolution

Our recent research shows that 9 out of 10 institutional investors view data and analytics as a key strategic priority

Global tax and investor reporting
A changing landscape

Ann Morgan
Co-founder & owner
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Dave O'Brien
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Sara Offen
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Deloitte

The asset management industry is experiencing exponential growth with more investors, products, geographies and assets under management.

External forces, including investor expectations, global regulation and increasing attention from tax examiners, paired with internal pressures such as cost control and process efficiency, are driving the need and desire for operational change in the industry, posing clear challenges to in-house tax teams and service providers alike. Undoubtedly, both will be required to respond to these changing needs in new and innovative ways.

To better understand these needs, Deloitte commissioned independent market research to explore the asset management industry in a number of areas: the organisation and delivery of fund tax compliance and reporting, the challenges that the industry faces in this area, how decisions are made, the role of technology and the direction and pace of change.

29 key decision makers across 12 asset management firms of varying size and global presence were interviewed, and though each had a unique perspective and focus, there were three common drivers of need that materialised:

- To improve oversight of their fund related tax affairs and mitigate the associated risk
- To improve the efficiency of their internal processes to provide tax compliance and reporting
- To find ways to add value to the compliance and reporting process

Oversight and risk management

Better oversight and risk management were identified as priorities by almost all of those who were interviewed. The rapid expansion of the asset management industry through more funds and complex product offerings in more jurisdictions will stretch the capacity of an already lean workforce. High volumes of products and funds, multiple supplier relationships, complicated joint venture arrangements, and a relatively unsophisticated use of technology mean that they do not always have a broad-based and up to date overview of the funds under management. In turn, the associated tax compliance and reporting requirements, the visibility of current status in the reporting cycle and which external providers are used for each fund and function are all difficult to track.

Similarly, most asset managers would like to improve their fund tax compliance and reporting review process. Due to a lack of professionals and resources, most feel that they do not give sufficient time or attention to tax examination readiness and risk management. Interestingly, when asked about where they worry most about risk, all of the respondents were most concerned with investors, particularly related to reputational and commercial risk. Relationships with regulators and tax authorities were also important, but if given more resources, they indicated a definite focus on the investor first.

The volume and complexity of tax compliance and reporting work in the asset management industry is growing and this is expected to continue as more complex funds in new territories are established

Asset managers are consistent in wanting their providers to add more value over and above the day-to-day work. They are looking for their service providers to improve the efficiency of their own processes, be more connected regionally and globally, invest in leading edge technology as well as deliver better integration between investment structuring and tax compliance and reporting

Process efficiency

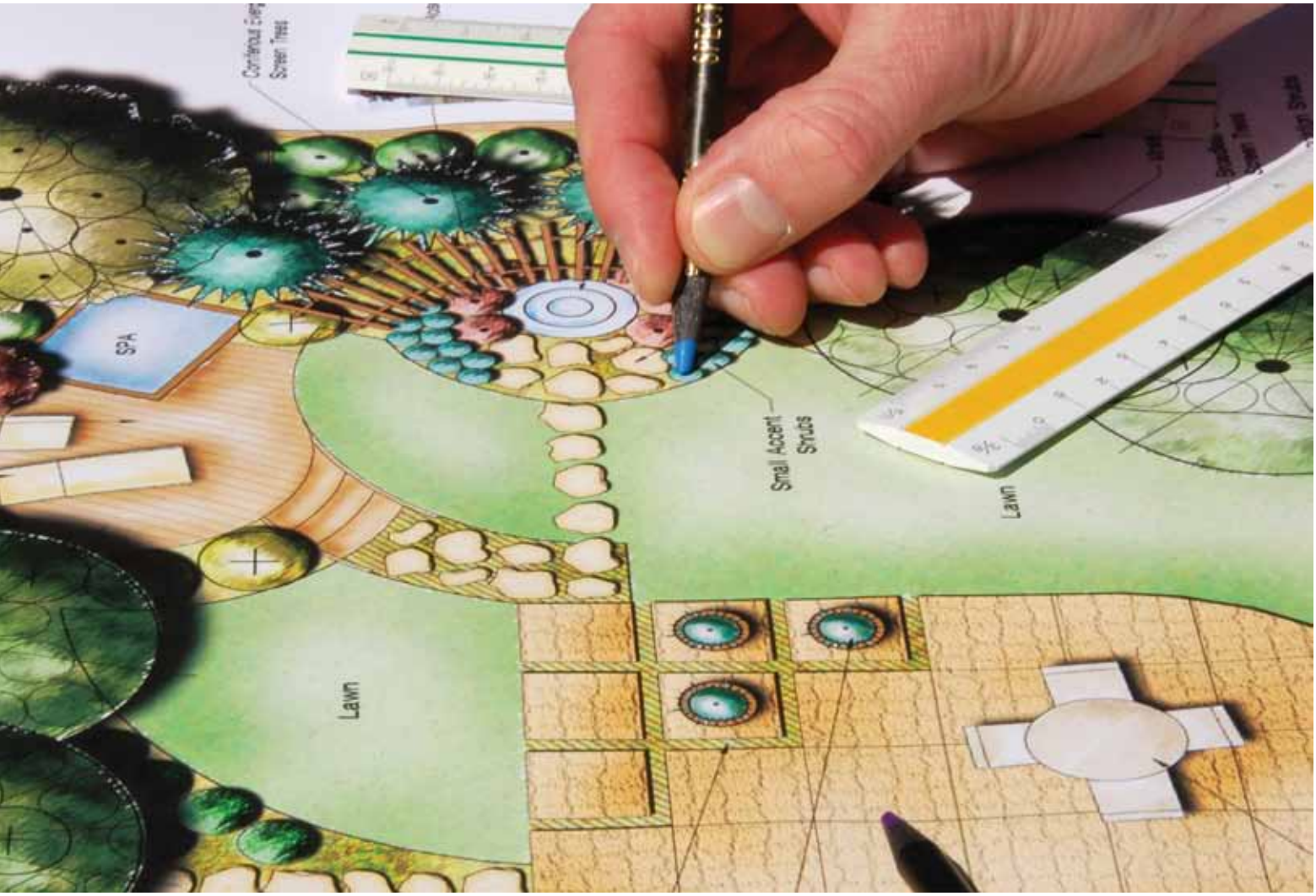
Many of those interviewed saw process efficiency as the key to helping them achieve better oversight. Improved internal processes might also help tax decision makers succeed against the backdrop of a rapidly increasing tax compliance and reporting workload on their limited internal resources. Process efficiency could also mean that a higher reporting volume might be managed faster and better, but for less cost per fund or other investment class. Not surprisingly, technology is perceived to play an important role, but with the lack of time and budget, tax teams appear to have little opportunity to invest significantly in technology and process improvement.

Value and performance

Asset management tax decision makers feel it is difficult for them to contribute to the bottom line in the same way as their corporate counterparts who can be measured by an effective tax rate and other metrics. They do, however, express a desire to add value. To stay competitive, asset managers continuously need to launch innovative product offerings and more complex funds in new jurisdictions, and tax departments need to keep up with the pace of these developments. The real market opportunity, as tax departments see it, is in the area of investor reporting. By using the data that is available, fund tax departments may be able to give their investors better reports with more meaningful analytics and differentiate their products and services from competitors.

The desire to change and what it means for industry service providers

The desire to change various aspects of their tax compliance and reporting model to achieve the improved oversight, efficiency and value-add is clearly expressed in the research. Asset managers would like to make better use of technology, streamline supplier relationships, innovate their investor reporting and change the size and focus of their internal tax team, but there are barriers to change.



Many have already made improvements to their model and processes and although further improvements would be ideal, they are not first priority. Not only is it hard to make the case for investment in change, but tax teams do not appear to be pushed from above to change.

The default approach with respect to tax compliance and reporting is generally to outsource the work to Big 4 firms. These organisations are the only providers perceived to deliver the right level of confidence for investors and to provide sufficient global reach and breadth and depth of specialisation, particularly in the tax compliance and reporting of alternative fund types.

Lack of internal resources, the need for a high degree of confidence, difficulty keeping pace with regulatory change and a perception that external providers may be able to provide the work 'faster, cheaper and better', are the most often cited reasons for outsourcing.

Currently, the typical delivery model is largely devolved, with multiple supplier arrangements in place. Providers are often engaged at a local or fund level, rather than under a single central agreement.

One benefit of this model that was highlighted by those interviewed is that it is very flexible, allowing asset managers to switch work between suppliers if there is an issue with service or cost, tap into the right knowledge and experience where and when they need it, and add more work to existing service relationships as new funds, often in new territories, are launched.

Yet despite the barriers to change and the perceived benefits of multi-supplier arrangements, some asset managers are moving towards more formalised service relationships with providers and consolidating the number of providers as part of their quest to improve efficiency and reduce costs. Satisfaction with their service providers is reasonably high, but asset managers are consistent in wanting their providers to add more value over and above the day-to-day work. They are looking for their service providers to improve the efficiency of their own processes, be more connected regionally and globally, invest in leading edge technology as well as deliver better integration between investment structuring and tax compliance and reporting.

Conclusion

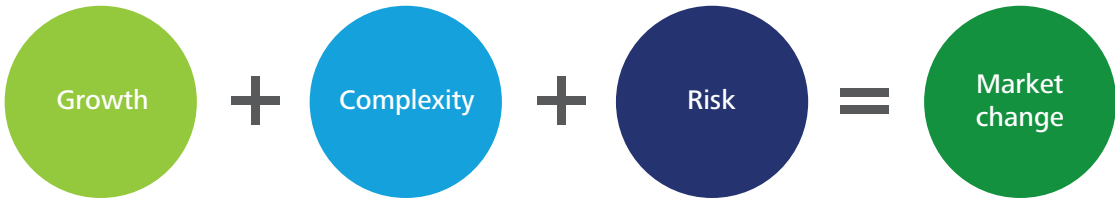
The volume and complexity of tax compliance and reporting work in the asset management industry is growing and this is expected to continue as more complex funds in new territories are established. Current operating and resourcing models deployed by asset managers are quite diverse and there does not appear to be a consensus about the leading model. However, tax decision makers in the asset management industry do appear to have clear and unmet objectives, and there is evidence of a desire for and direction of change.

Achieving change remains a difficult challenge for many of those interviewed although some asset managers are taking steps towards streamlining their tax compliance and reporting model, consolidating their outsourcing arrangements as well as investing in technology to help them pursue their goals.

In future issues of Perform*ance* magazine, we will be taking a deeper dive into the drivers and needs highlighted by this research, as well as examining how service providers can better advise their asset management clients to navigate change and thrive in this time of rapid growth.

To the **point**:

- Rapid expansion of the asset management industry may stretch capacity
- Increased regulatory scrutiny raises the stakes on asset managers' reputational risk
- Growth will likely come from increasingly complex products to accommodate diverse investors and investments
- Global expansion may provide new opportunities and challenges
- A desire for change is evident in asset management tax departments
- Improvement and innovation of investor reporting will likely continue to be a top priority



Tax decision makers in the asset management industry do appear to have clear and unmet objectives, and there is evidence of a desire for and direction of change

Luxembourg private equity asset servicing market survey

Gérard Lorent
Director
Advisory & Consulting
Deloitte

Jovy Therese Otgalon
Senior Manager
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This article presents the results of a recent private equity survey of Luxembourg's PE service providers, which mainly include fund administrators and depositary[1] banks.

Scope

Private equity had been touted as one of the key frontiers for the continued expansion of Luxembourg's fund industry. With the market anticipating a very positive growth trajectory in this asset class, we deemed it opportune to conduct this survey of Luxembourg's PE asset servicers in order to gain a broader view of their PE businesses and operations. Our questions focused on three main areas, namely:

- The PE organisation, clients and services
- The operational challenges and concerns of PE service providers
- The market growth and outlook in the PE business in the near and long term

Our survey respondents include a mix of traditional fund administrators and custodians and those handling only alternative funds. Their aggregate net assets under administration or custody cover a significant tranche of the Luxembourg PE market. Based on our analysis of the most recent data published, our respondents represent 87% of Luxembourg's estimated €48 billion in total net assets of regulated PE structures.

Luxembourg's PE fund providers are conscious of the fact that competition is intensifying

The range of core central administration (fund accounting, reporting and transfer agency) and custody services (transaction processing, asset monitoring and reconciliations) offered is generally uniform across all our respondents. With more demanding GPs and investors, competition is now shifting towards specialised, value-added services, a global service offering spanning international target investment areas, fees and overall service quality.

While core functions are generally performed in-house, most respondents revealed that they prefer to outsource certain large or repetitive tasks to central operating hubs or third parties. For fund administration services, 25% and 13% of respondents outsource fund accounting and reporting respectively; while for depositary services, 42% and 33% outsource reconciliations and transaction processing respectively.

1 References to 'custody' or 'custodian' in this article refers to the 'depositary' for a PE fund

Figure 1: Estimated contribution of PE in the organisation's revenues

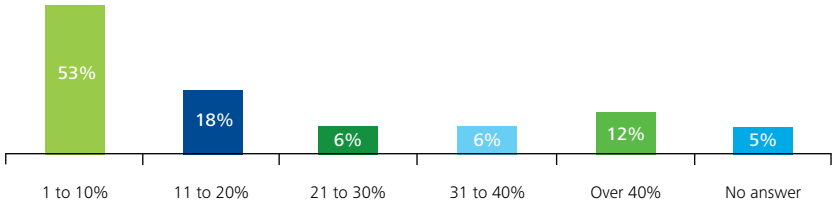
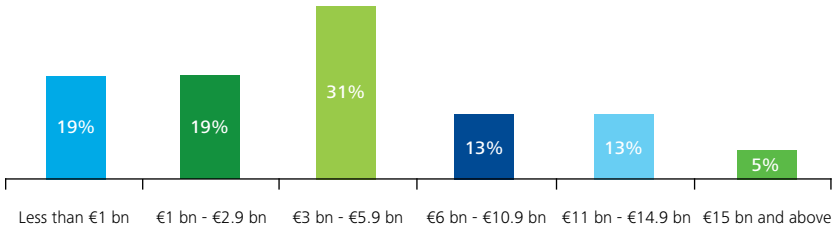


Figure 2: Net assets under administration



The majority of our respondents recognise PE as a strategic activity for their organisation

Most of them have established dedicated teams focused on PE back-office services. For 53% of respondents, the revenue contribution of PE operations accounts for up to just 10% of firm revenues, testament to the fact that the Luxembourg PE market is split across mainstream and pure alternative fund providers *(fig. 1)*. Our respondents acknowledge the need for a robust business development plan and an effective marketing approach to boost the current PE business. In order to accommodate the projected growth in PE, to handle increasing competition in service offering and fees, and ultimately to increase margins, it is essential to invest in comprehensive service solutions tailored to PE clients and ensure that the proper tools and systems are available.

The volume of assets serviced varies among the respondents and depends on whether an asset provider focuses on traditional or purely alternative services

31% of respondents catering mostly to PE clients (niche players) have higher-than-average levels of net assets under administration *(fig. 2)*. Although the majority came under the average category, there are still a number of fund providers whose individual total assets serviced fall below the average net assets range. Additionally, the majority of sub-funds handled have less than €1 billion in net assets.

A detailed upfront analysis of any client is paramount

An even more essential criterion than AUM when entering into a relationship with a PE client is the complexity of the case (i.e. type and location of the target investment, structure of the investment scheme). GPs are now involved much earlier in the fund creation process and are much more heavily involved with their asset services in order to establish a partnership that goes beyond what is normally required for a traditional fund. Information, transparency and document collection are crucial to ensuring that asset servicers will be in a position to deliver their services properly, with appropriate pricing and the utmost quality.

Our survey respondents request an increasing amount of documentation upfront and tend to review and understand the fund set-up and its complexity in greater detail prior to accepting a fund or giving GPs a fee quotation. However, it is fair to say that the depth of the requested documentation highly depends on the services requested (custody vs. fund administration) and the experience of the asset provider.

Even though we see an important convergence of operating model and services offered by asset servicers, the fee quotation mechanism is no longer purely based on basis points and is starting to differ from one provider to the next. Asset servicers are trying to model their fee quotes based on the profile and specifics of a fund while at the same time ensuring that a minimum cap is set to accommodate running costs.

Our survey respondents include a mix of traditional fund administrators and custodians and those handling only alternative funds

A focus on two key elements for GPs

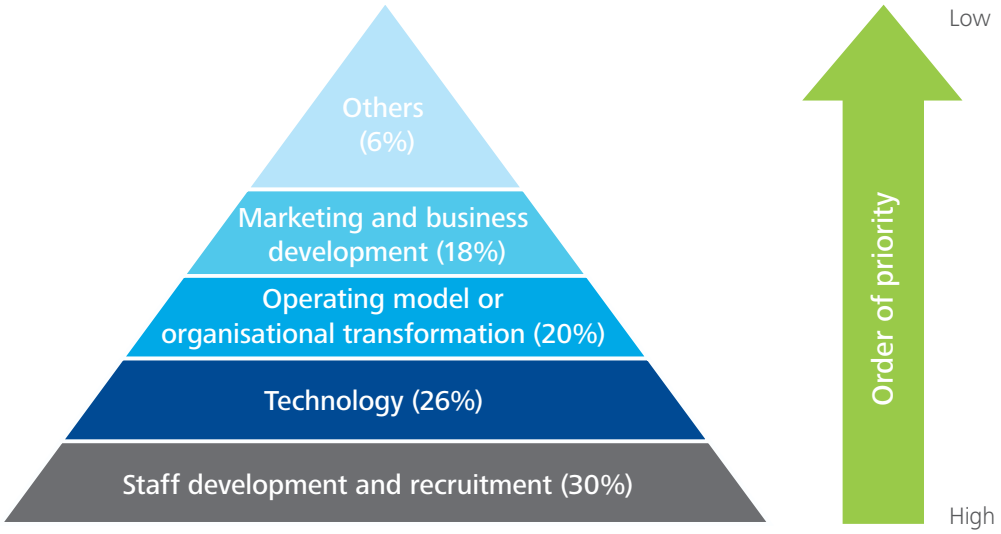
Asset valuation, even with AIFMD just around the corner, is not a request PE houses have transferred to their asset servicers. One comment frequently made by survey participants is that even though their clients may have requested valuation services, they do not anticipate offering this service. It is a much too complex and risky activity for a fund administrator.

> Information, transparency and document collection are crucial to ensuring that asset servicers will be in a position to deliver their services properly, with appropriate pricing and the utmost quality

The other key and specific factor relates to reporting to investors. This exercise is performed on a largely bespoke basis in the PE industry, as opposed to in the UCITS world for instance. However, the PE industry increasingly uses international standards, such as IPEV and ILPA, for investor reporting. Moving towards automation and standardisation is still considered to be a solution for the future, as investors still have specific needs and fund administration systems are not yet ready to store and structure data in the way required for investor reporting.

Generally, survey respondents are quite satisfied with their current PE systems; however, 65% still plan on changing or upgrading it. Indeed, it would not be sustainable to continue using multiple, isolated systems as business volumes increase. At least 65% of respondents are currently using multiple (at least two) PE systems, which implies that there is no single vendor solution in the market that is able to support the end-to-end processes in PE.

Figure 3: Organisation's future investments in PE activities



Expected sustainable and long-term growth in the PE asset class

All respondents foresee both investment and market growth in Luxembourg. However, the range of respondents' growth expectations remains rather broad. In terms of workforce size, growth expected in five years' time ranges from 5% to 30%, with 41% of respondents being in the upper category.

When talking about market growth, more optimistic respondents expect growth exceeding 50% within the next two years and continued growth of over 30% within the next five years. The expected rise in market size will mainly be driven by new PE firms coming to Luxembourg (either in regulated or unregulated conditions) and the organic growth of the current client base. We can also highlight a positive trend in the development of new products for PE asset servicing firms, mainly driven by value-added services offerings.

Some key takeaways from the survey

PE is a significant asset class and growth driver for each respondent. Competition is fierce among asset servicers and past differentiators in terms of offering and operational set-up have become market practice nowadays and are no longer considered competitive advantages. Moreover, the needs of GPs are constantly changing, with some requiring more streamlined middle-to-back office, bridge financing and a single point of contact for a cross-border and multi-jurisdictional service offering. The PE servicing industry seems to be moving towards operating models that include competence centres set up worldwide—much like where UCITS fund servicers started decades ago.

To the **point**:

- PE is considered by Luxembourg service providers as a strategic activity for their organisation, with further growth anticipated in this asset class
- Competition is fierce in PE and is now shifting focus towards specialised, value-added services, a global service offering, fees and overall service quality
- The cross-border and multi-jurisdictional service offering required by GPs prompted asset services to set up operating models that include competence centres across the globe
- During onboarding, a detailed upfront analysis of any client is crucial, primarily to the assessment of the complexity of PE operations
- GPs are more hands-on in the fund creation process and aim for a more collaborative partnership with asset servicers

Our respondents acknowledge the need for a robust business development plan and an effective marketing approach to boost the current PE business

EMEA Centre for Regulatory Strategy

A new landscape for EU capital markets

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The landscape for EU capital markets is set to change radically under new rules agreed in the revision to the Markets in Financial Instruments Directive and new Regulation (MiFID II/MiFIR). The reforms have been a long time in the making and are ambitious in scope.

Legislators are hoping that many of the benefits that MiFID brought to equity markets, such as lower transaction costs, reduced bid-ask spreads and faster trading times, will be extended to a wider range of asset classes. The reforms also seek to implement the commitments made to the G20 in 2009 to move more OTC derivative trading on to trading venues and to address the risks posed by the recent growth in dark trading and 'high frequency' algorithmic trading.

The investment management sector will face increased requirements under MiFID II/MiFIR, in particular relating to post-trade reporting, 'high frequency' algorithmic trading and investor protection. They will have new choices about where to execute their business and compliance costs are set to rise. But there is good news. Many of the new rules are designed to promote competition and support better price formation and should ultimately benefit the investment management sector and their clients.

New choices about where to execute business

Where and how investment managers execute their trades are set to change as regulators aim to bring more transparency to perceived opaque markets. A requirement to trade clearing eligible and sufficiently liquid derivatives on a trading venue will see large amounts of derivatives business move away from OTC execution to venues. Much of this business is expected to be executed on a new type of venue - the Organised Trading Facility (OTF). This will be available only for trading non-equities and is largely seen as equivalent to the U.S. swap execution facility.

Support for price formation

Changes to the transparency regime under MiFID II/ MiFIR are likely to be largely positive for the investment management sector, although much will depend upon how the regime is calibrated in the technical standards that will be developed by the European Securities and Markets Authority (ESMA). The pre- and post-trade transparency regime introduced for equities under MiFID will be expanded to equity-like instruments (e.g. depositary receipts and exchange traded funds) and to non-equities (e.g. bonds, structured finance products, emission allowances and derivatives traded on a trading venue). This is likely to promote price formation and narrow bid-ask spreads in these markets, as was observed in equity markets following the introduction of MiFID. The reforms also seek to limit dark trading in equities through introducing a cap on the use of some of the waivers from the equity pre-trade transparency regime.

However, while increased transparency is often positive for markets, too much transparency in less liquid markets can have a negative impact on liquidity. If market participants become concerned that others might be able to guess their investment strategies, they may be less willing to trade. This is particularly pertinent for asset managers when trading large orders on behalf of their clients. Consequently, it will be important that ESMA, in calibrating the transparency regime, is able to strike the right balance between ensuring investors receive the information they need, without harming liquidity. Investment managers will have a better view of post-trade data with the introduction of a regime for an EU consolidated tape. This is intended to be provided on a commercial basis, but if take-up by firms is not of the quality envisaged by the Commission, it may appoint a consolidated tape provider through a public procurement process. Investment managers will also need to comply with the expanded post-trade reporting regime. They will need to have streamlined and effective post-trade infrastructure, as well as robust data governance arrangements.

Competition driving improvements for market participants

In a break-up of the so-called 'vertical silos' between trading venues and central counterparties (CCPs), CCPs will be required to clear financial instruments on a non-discriminatory and transparent basis regardless of where the transaction is executed and, in return, trading venues will be required to provide trade feeds on a non-discriminatory and transparent basis upon request to CCPs wishing to clear transactions. For the investment management sector, the increase in competition between trading venues and CCPs may drive down transaction costs and improve services to market participants. However, the ability of trading avenues, CCPs and competent authorities to deny access in certain circumstances, as well as transitional arrangements, could potentially hinder the development at the regime.

Increased requirements for firms engaging in high frequency algorithmic trading

Firms engaging in high frequency algorithmic trading will need to have suitable systems and risk controls for trading systems and report certain information to regulators, including on their algorithmic trading strategies. They will need to test and monitor trading systems and have effective business continuity arrangements in place. Their trading activity will also be subject to greater scrutiny by trading venues, with venues able to limit high frequency algorithmic trading and charge higher fees for cancelled orders or for high frequency traders.

Many of the new rules are designed to promote competition and support better price formation and should ultimately benefit the investment management sector and their clients

Changes to distribution and focus on product governance

Designed to strengthen investor protection, a number of the reforms will affect how products are advised on and sold. Investment advisers will need to disclose increased information to investors on the services provided and on total costs and charges, with independent investment advisers banned from receiving and retaining third-party remuneration or benefits (with exceptions for some non-monetary benefits). Investment managers will need to consider how potential changes to independent investment advice business models in some EU countries may affect distribution of their products.

More products will be classed as complex and subject to the appropriateness regime, so that firms will need to apply additional checks when selling them. ESMA, the European Banking Authority (EBA) and competent authorities will also receive temporary product intervention powers. All this could potentially drive providers and distributors towards less complex products and dampen innovation.

Investment managers will also need to comply with extensive product governance requirements. They will need to have a product approval process that specifies an identified target market of end clients, with a compatible distribution strategy. Responsibility will not stop once the product is with the distributor. There will also be increased focus on conflicts of interest, in particular where they may be driven by third-party inducements or the incentive structures of staff.

What is next?

While the political agreement on MiFID II/MiFIR has set out the big picture of the reforms, the detail will still need to be filled in with ESMA technical standards and implementation of the Directive by Member States. The reforms are expected to enter into force in June/July this year and firms will then have until around Q1 2017 to comply.

To the **point**:

- The landscape for EU capital markets is set to change radically under new rules provisionally agreed in MiFID II/MiFIR
- The investment management sector will face increased requirements, in particular relating to post-trade reporting, high frequency algorithmic trading and investor protection. They will have new choices about where to execute their business and compliance costs are set to rise
- Many of the new rules are designed to promote competition and support better price formation, which should ultimately benefit the investment management sector and their clients. However, it will be important that ESMA, tasked with calibrating the pre-trade transparency regime in technical standards, is able to strike the right balance between ensuring investors receive the information they need, without harming liquidity
- The reforms are expected to enter into force in June/July this year and firms will then need to comply from around Q1 2017

Effective allocation of local capital could be a significant catalyst for Japan

Another tool to spur growth and end deflation

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In 2013, the Nikkei 225 stock index surged by approximately 57%[1] representing the largest single year percentage increase in more than 40 years. Market participants are quick to point out that the primary beneficiaries of this surge were foreign investors, as evidenced by the net foreign capital inflows of approximately US$145BN. Broadly speaking, local retail investors and pension/quasi-pension plans did not participate in these out-sized gains.

1 *Mogi, Chikako and Hirokawa, Takashi, 'Takenaka touts Nikkei surge', The Japan Times, 9 January 2014*

There are key macro-economic signs suggesting continued growth in Japan, including signs of inflation and inflation expectations, low unemployment and indications of wage increases.

While these positive signs are welcomed, there is no shortage of skeptics regarding Japan's ability to continue on its current path. One factor skeptics point to is the lack of true structural reforms, the third arrow[2] of Prime Minister Abe's so-called Abenomics, since Prime Minister Abe's administration took office in December 2012.To assist with identifying structural reforms in the capital markets, the Panel for Vitalising Financial and Capital Markets (the 'Panel') was established by the Financial Services Agency and the Ministry of Finance and whose recommendations are designed 'to make Japanese financial and capital markets more attractive.'

While detractors believe that the pace of change or even presentation of structural reform has not been fast enough, the more effective allocation of local capital, due to the sheer size of the potential new investment capital, will be a significant reform itself and could serve as a buffer against continued or advanced policies of the Bank of Japan (BoJ) and Japanese government

The Panel recently issued its recommendations, which identifies the following four areas that should be addressed with the goal of making Japan Asia's number one international financial center by 2020:

1. Establishing a positive cycle in which abundant financial assets held by households and public pensions are allocated more to funding for growing businesses (utilising 'inactive' funds)[3]
2. Realising Asia's growth potential, improving the market function of the Asian region, paving the way for integral growth of Japan and Asia (Supporting the development of financial infrastructures in Asian countries and fostering a necessary environment for Japanese financial institutions and companies to conduct business in Asia through cooperation between the FSA and relevant authorities)
3. Strengthening corporate competitiveness and promoting entrepreneurship
4. Developing human resources and establishing a better business environment

Allocation of capital – Current state

The current allocation of capital in Japan is not on par with global norms. It is not generating returns which create a positive cycle of reinvestment, growth and favorable sentiment.

Japanese household financial assets approximate ¥1,600 trillion (US$15.8 trillion)[4] and Japan's Government Pension Investment Fund's (GPIF) investment assets were approximately ¥128 trillion (US$1.27 trillion)[5]. According to fund flow statistics from the Bank of Japan, nearly 54% of Japanese household assets were allocated to cash and deposits and only 13% of households invested in stocks and mutual funds. Whereas, cash and deposits held by households in the United States and Europe is 13 and 36%, respectively[6] *(Fig. 1).*

2 Three arrows: 1) bold monetary policy, 2) flexible fiscal policy and 3) structural reforms The idea of three arrows comes from the story of the feudal warlord Mori Motonari, who taught his three sons that snapping a single arrow is easy, but snapping three arrows bound together is much harder. In other words, the power of three combined is mightier than that of a single

3 We've characterised this recommendation as 'Effective Allocation of Local Capital' and we will focus our attention on this topic for the remainder of the article

4 'Flow of Funds – Overview of Japan, U.S. and the Euro Area' – Research and Statistics Departments, Bank of Japan, 19 December 2013

5 Hodo, Chikafumi, 'Japan's public pension fund assets rise to record Y128.6 tril', Japan Today, 1 March 2014

6 'Flow of Funds – Overview of Japan, U.S. and the Euro Area' – Research and Statistics Departments, Bank of Japan, 19 December 2013

Figure 1: Distribution of household financial assets by country (Governmental Bulletin Online)

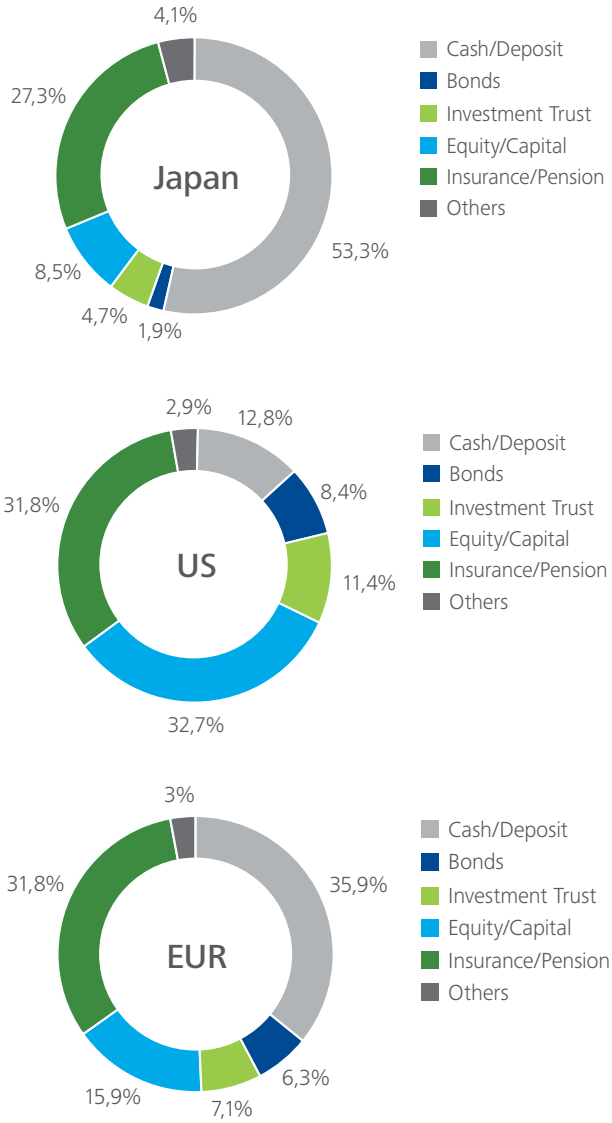


Figure 2: GPIF actual allocation (31 December 2013)

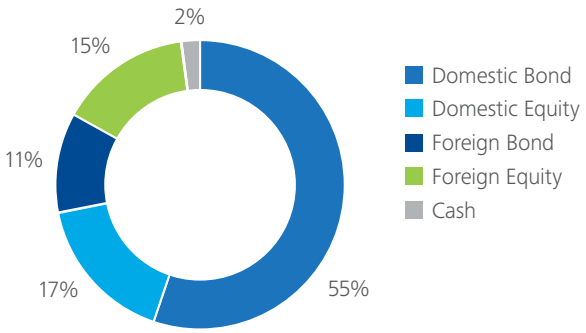
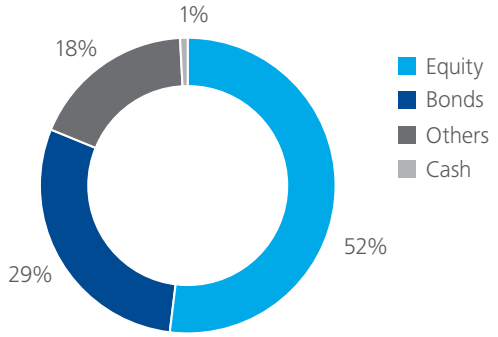


Figure 3: Global average allocation (Towers Watson study)



With respect to the GPIF's investment assets, as of December 2013, greater than 55%, or more than ¥70.5 trillion (US$697 billion), were allocated to domestic bonds[7]. For the period 1 April 2013 – 31 December 2013, these assets generated approximately ¥21 billion (US$208 million) in investment income. According to Towers Watson's 'Global Pension Assets Study 2014,' the average allocation for equities, bonds, other and cash is 52%, 29%, 18% and 1% respectively[8] *(Fig. 2/3)*.

7 *Government Pension Investment Fund, Japan*
8 *'Global Pension Assets Study, 2014', Tower Watson, January 2014*

Steps toward effective allocation of local capital

The Introduction of Nippon Individual Savings Account (NISA)

The Japanese version of the United Kingdom's Individual Savings Account programme was introduced in January 2014. NISA is designed for residents of Japan 20 years of age or older and is meant to encourage medium-to-long term investment horizons. Given the tax advantaged status of the accounts, the NISA programme is an attempt to spur household financial assets to diversify away from cash and cash equivalents. Expanding the pool of equity investors in Japan may well attract additional capital raising activities in Japan, increase initial public offerings and increase financial assets available for general business growth. Additionally, if inflation targets are met, enhancing personal rates of return will be necessary to maintain or advance Japanese citizens' standard of living. The government's goal is to have ¥25 trillion (US$247 billion) moved from cash to NISA by 2020. Based upon the figures provided above, this would be a movement of only 3% of the assets currently held in cash.

According to the Japanese Securities Dealers Association (JSDA), at the end of January 2014, it was estimated that approximately 5.6 million NISA accounts had been opened[9] and, according to Nomura Research Institute, Ltd. (NRI)[10], the average NISA balance was ¥593,000 (US$5,900). Furthermore, NRI survey results indicate that approximately 70% of those funding NISA accounts are doing so with savings or current income, as opposed to proceeds from existing asset sales. Finally, NRI estimates that by year end, 8.65 million accounts will be opened[11].

If NRI's February survey results are representative, by December 2014, approximately ¥5.2 trillion (US$51 billion) will be invested via NISA accounts and approximately ¥3.6 trillion (US$36 billion) of that total would have been from existing savings or current income.

{http://fis.nri.co.jp/en/news/2014/02/20140213en.html}

There are several restrictions / limitations that may make it difficult for NISA to reach its full potential. For example:

- Tax-exempt status is limited to five years (UK ISA has no limit)
- NISA accounts can only be opened within a 10 year timeframe (ISA has no limit)
- Tax-free exemption only applies to a maximum of ¥5 million in total investment (again, ISA has no such restriction)
- Participants cannot aggregate any loss generated by their NISA account with profit generated in other accounts in which they hold assets. As such, if an investor is unable to realise profit in their NISA account, then the significance of maintaining the account will be diminished.

These current restrictions can be addressed and government officials have intimated that changes are possible in the future. The first concern was launching the NISA programme to the marketplace. As provided by the JSDA, there have been several adjustments and iterations to the UK ISA and, as a result, participation has increased since introduction in 1999[12]. In the UK, it is now estimated that 40% of households have ISA accounts.

9 'NISA: Japan's new tax exemption scheme for investment by individuals', JSDA
10 'NRI conducts Nippon Individual Savings Account (NISA) Usage Survey, Findings Project 8.65mn NISA holders/applicants by year-end', Nomura Research Institute, 13 February 2014
11 ibid
12 'NISA: Japan's new tax exemption scheme for investment by individuals', JSDA

Figure 4: Comparison with UK ISA[13]

	NISA (Japan)	ISA (United Kingdom)	
		ISA for stocks and other products	ISA for deposits
Scheme establishment	Started on 1 Jan. 2014. Accounts can be set up for 10 years (until 2023).	Started on 6 Apr. 1999. While originally planned to terminate in 10 years, perpetuated in 2008	
Eligible persons	Persons who live in Japan and are aged 20 or older (as of 1 Jan. of each year starting NISA)	Persons who live in the UK and are aged 18 or older	Persons who live in the UK and are aged 16 or older
Tax-exempt period	5 years	Permanent	
Tax-exempt products	Listed stocks, investment trusts, etc.	Stocks, bonds, investment trusts, insurance, bank deposits, etc. (It is not possible to repurchase another product unless proceeds received from the sale of the previously invested product are withdrawn from the ISA account.)	Bank deposits, MMF, etc.
Tax-exempt incomes	Dividends, coupons and capital gains	Interest (except for interest on bank deposits) Dividends, coupons and capital gains	Interest
Maximum yearly investment amount	A maximum of ¥1 million (approx.US$10,000) (excluding commission payment)	A maximum of £11,520 (approx.US$18,800) including both types of ISA 1/ A maximum of £5,780 (approx.US$9,400) in an ISA for deposits 2/ Maximum yearly investment amounts are reviewed every year based on consumer price index)	

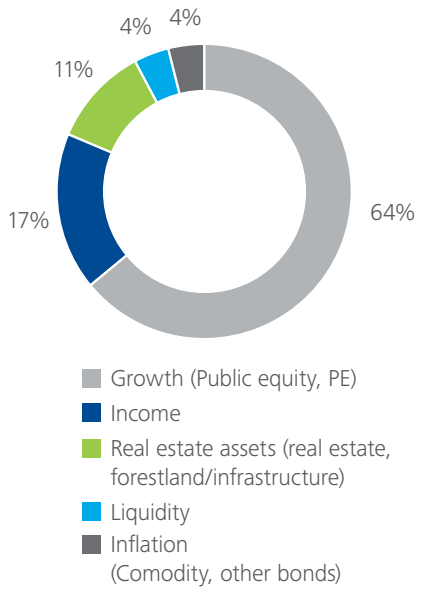
13 ibid

GPIF Signals an Increase in 'Riskier' Assets

On 6 March 2014, an advisory panel to GPIF indicated it was time to reposition its investment assets[14].
'Pension payments are correlated with wages, so it is natural for the target to be an additional return over wage growth, in times of deflation, domestic bond-centered investment was safe and efficient, but with the planned shift to a moderate inflationary environment, there is no need to focus on local debt anymore. GPIF should become more forward-looking.'

However, the recommended goal for a nominal rate of return, approximately 4.2%, is still quite low compared to other large retirement systems such as California Public Employees' Retirement Systems 7.5% target. CalPers targeted allocation demonstrate the differences in risk appetites.

Figure 5: CalPers targeted asset allocation[15]



A paradigm shift into local equities or alternative assets such as private equity, real estate, hedge funds and infrastructure funds cannot happen overnight. If the GPIF transitions to the global allocation norms, approximately ¥32 trillion (US$317 billion) of investment assets would become allocable to other asset types. It is not likely that allocation percentages will change that significantly, rather a somewhat gradual re-allocation will occur, which some will point out was already happening (while high compared to the global average, a 55% allocation in bonds is the lowest allocation for the GPIF in bonds for the past six years).

Additionally, on 28 February 2014, GPIF announced a new infrastructure investment programme to be executed with a co-investment agreement with the Development Bank of Japan and Ontario Municipal Employees Retirement System[16]. GPIF anticipates that the investment in infrastructure investments will provide:

- Stable income gains similar to fixed income
- Higher yields than typical fixed income securities
- Safety from public market volatility

The infrastructure investment programme will be five years in duration and the outstanding investment 'principal' may reach ¥280 billion (US$2.7 billion), or approximately 0.2% of the assets under management at GPIF[17]. While this percent of allocation is significantly below that of other pension plans, it is a very positive signal that additional risk will be accepted and risk-adjusted returns will be sought.

The current allocation of capital in Japan is not on par with global norms. It is not generating returns which create a positive cycle of reinvestment, growth and favorable sentiment

14 Kitanaka, Anna; Nohara, Yoshiaki and Nozawa, Shigeki, 'GPIF Needs Wage-Based Return Goal, Less Bond Focus: Panel', Bloomberg, 6 March 2014
15 CalPERS
16 'GPIF Launches Infrastructure Investment Programme under a Co-investment Agreement with DBJ and OMERS', GPIF
17 ibid

The final word

The sentiment and outlook has changed since Prime Minister Abe took office in 2012. While detractors believe that the pace of change or even presentation of structural reform has not been fast enough, the more effective allocation of local capital, due to the sheer size of the potential new investment capital, will be a significant reform itself and could serve as a buffer against continued or advanced policies of the Bank of Japan (BoJ) and Japanese government.

To the **point**:

- Capital allocation in Japan is not at par with global norms, with majority of assets allocated to cash and deposits
- This trend could change with the introduction of NISA, which could lead to households diversifying assets in other asset classes
- The Government of Japan is initiating several steps, including a new infrastructure investment programme to drive diversification in capital allocation
- A significant improvement in capital allocation could act as a significant policy reform in itself and provide a buffer against continued or advanced policies of BoJ and Japanese government

2014 Alternative investment outlook championing growth

Finding agility in uneven conditions

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One of the key attributes that has drawn investors to alternative investment managers over the years is their agility. Much like a downhill skier who needs to absorb the terrain to excel, these managers excel by navigating uneven conditions. Over the past few years though, the landscape has leveled out, with the booming stock market temporarily eroding alternative investment funds' historic competitive advantage.

A turning point is already unfolding in 2014. Institutional investors are piling into alternatives despite their recent uneven performance. These investors are attracted to the industry's long-term track record for producing non-correlated, superior risk-adjusted returns. At the same time, they are looking at alternatives through a new lens. Rather than viewing them as a separate asset class, institutional investors are increasingly deconstructing alternatives into risk and attribution themes.

How alternative investment leaders meet these demands, along with those of an ever-shifting regulatory landscape, will be a key theme to watch in 2014 as funds look to stay agile and attract more assets. Given the perennial importance of reputation in this industry, they will also need to ensure their risk management approaches mature to reflect today's increasing complexity.

The past few years have certainly been trying for most alternative investment managers; but in some critical ways, they are now in a better place as a result

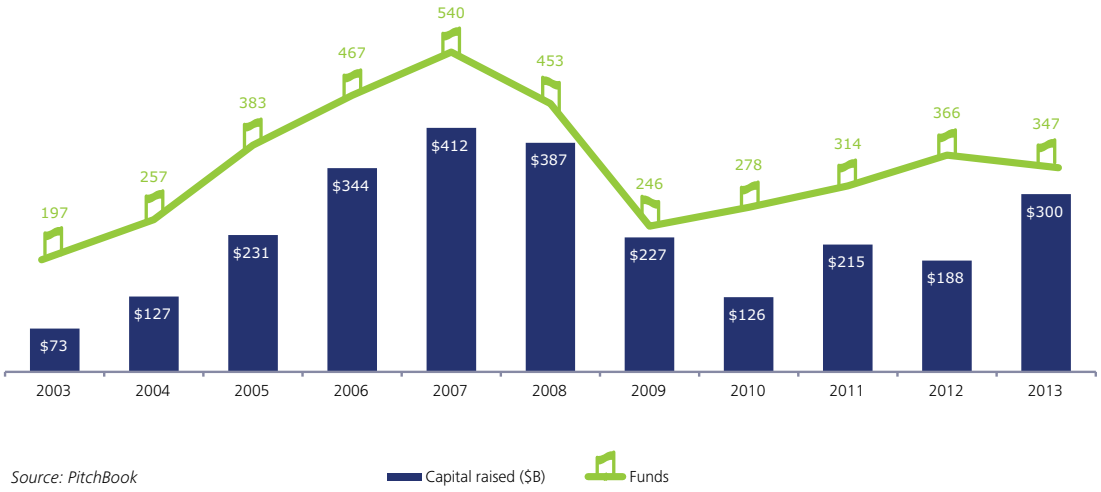
Attracting new assets with scale and differentiating strategies

In spite of a challenging investment environment and increased competition, alternative investment managers continued to raise record sums over the past year. Hedge fund assets under management (AUM) swelled to a record $2.6 trillion in 2013[1]. Not to be outdone, private equity firms staged their own rally, with fundraising reaching the highest levels since 2008 (see Figure 1)[2].

And yet, reviewing these numbers reveals great disparity. The biggest private equity funds continued to garner the most attention, with the remaining funds seeing their average new fund sizes reduced by as much as half that of previous efforts.

It was also a year of uneven performance for hedge funds, against both broader market measures and long-term trends. For the one-year period ending on 31 December 2013, the average hedge fund returned just 11%, falling short of the S&P 500 Index's 30% climb over the same period and even the 17% increase of an average balanced portfolio (60% stocks and 40% bonds) (see Figure 2).

Figure 1: Global private fundraising



Source: PitchBook

1 *Hedge Fund Research 'Hedge Fund Assets Surge to Record to Begin 2014,' press release, 21 January 2014*
2 *PitchBook, '2014 Annual U.S. Private Equity Breakdown Report,' accessed 20 January 2014*

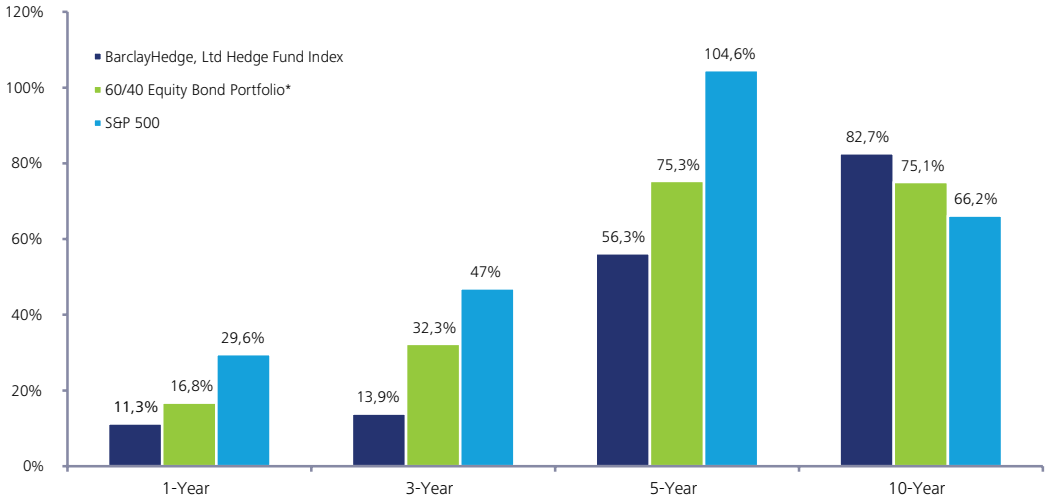
Private equity had a better story to tell after realising an almost 13% increase in capital invested last year, according to Pitchbook[3]. Even so, deal activity fell 14%[4] from 2012 and the question now is whether the industry will be able to put a record amount of dry powder to work.

Institutional investors such as pensions, foundations and endowments have stepped up their participation in hedge and private equity funds, driven by diversification mandates and drawn to the alternative investment industry's long-term track record for delivering uncorrelated, risk-adjusted returns.

Many investors remain satisfied with performance, even over the past year. For instance, 63% of institutional investors interviewed by Preqin stated hedge fund returns had met their expectations last year; another 21% said returns exceeded their expectations[5].

Figure 2: Hedge funds superior long-term performance

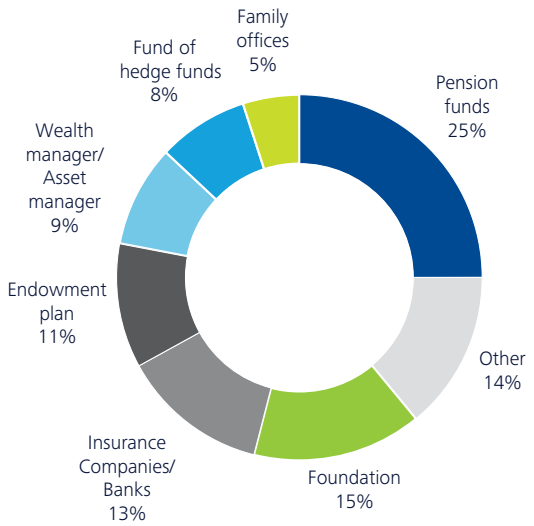
Hedge fund returns outperform broad market on long-term basis



Source: Source: BarclayHedge, Ltd., Bloomberg, Deloitte analysis
** 60% MSCI U.S. Broad Market Index and 40% Barclays U.S. Aggregate Float Adjusted Index Data as of December 31, 2013*

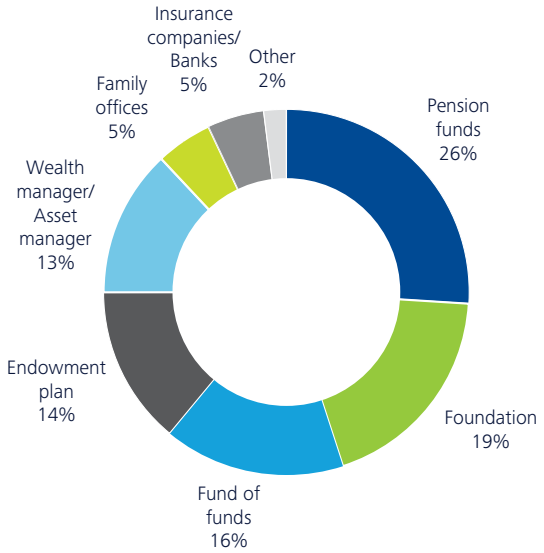
3 *PitchBook '2014 Annual U.S. Private Equity Breakdown Report,' accessed 20 January 2014, pitchbook.com/2014_Annual_US_PE_Breakdown_Report.html.*
4 *Pitchbook '2014 Private Equity Breakdown Report.'*
5 *Preqin, 'Preqin Survey: Investor Satisfaction with Hedge Fund Performance Is at Highest Recorded Levels,' press release, 19 December 2013.*

Figure 3: Breakdown of private equity investors



Source: Prequin

Figure 4: Breakdown of hedge fund investors



Source: Prequin

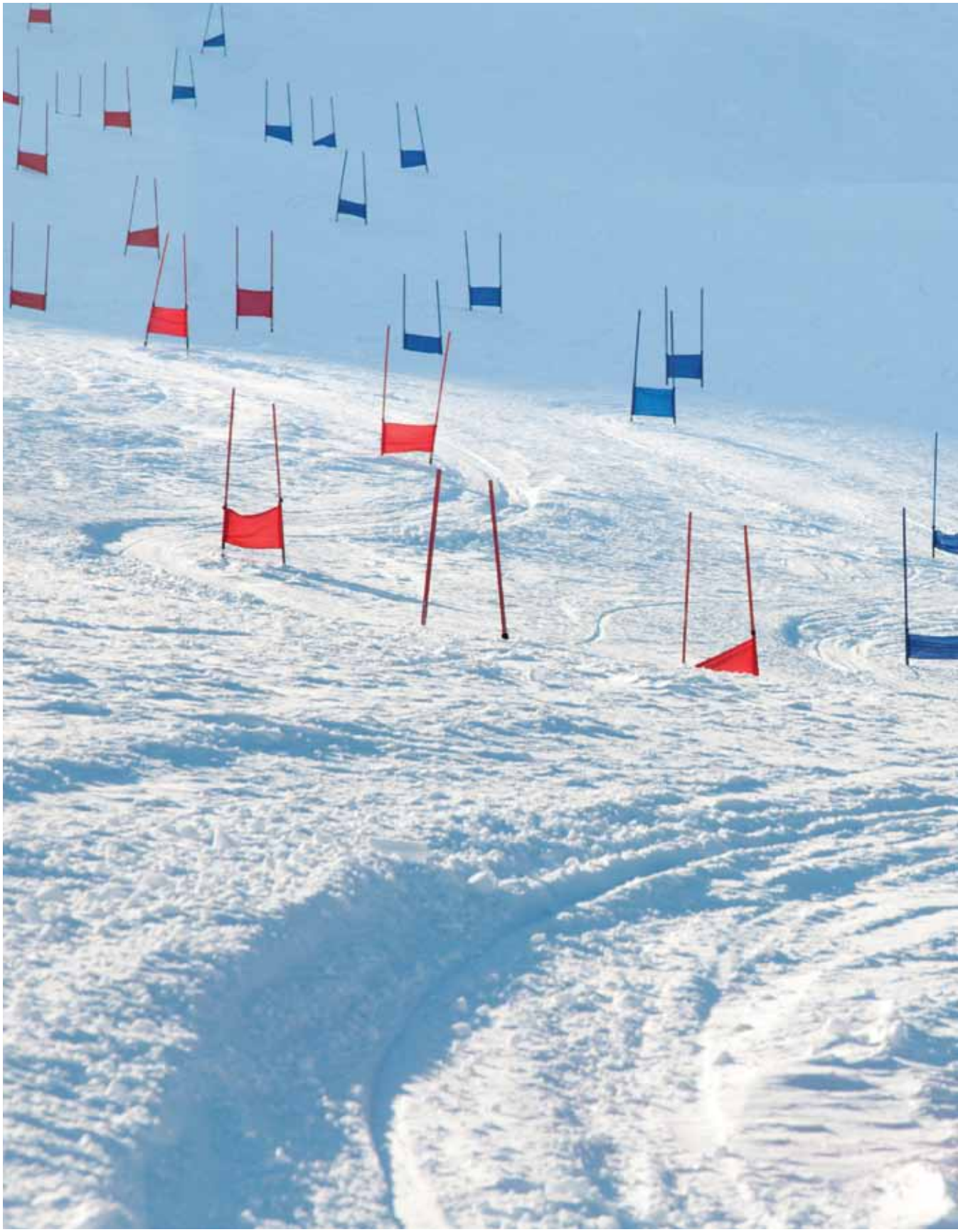
Institutional investors now represent more than half of the total capital being managed by hedge funds (see Figure 3&4),[6] and they appear poised to allocate an even higher percentage of their portfolio to alternatives going forward[7]. Sovereign wealth funds, led by Abu Dhabi and China, now occupy three of the top five slots among hedge fund investors, and four of the top ten[8]. An exciting new investor base is opening up with hedge funds poised to tap the domestic Chinese market for the first time. Recently announced in Shanghai, the Qualified Limited Domestic Partner Programme will soon allow several foreign hedge funds to raise money from institutions within China for investing overseas.

While increasing allocations by institutional investors is a more recent phenomenon for hedge funds, institutional investors have dominated private equity investing for some time; pension funds, foundations, and endowments still lead the way.

As institutional investors account for a growing share of the pie, the big alternative funds will likely continue to get bigger. Given that these investors' fiduciary responsibility makes them particularly sensitive to headline risk, they are naturally drawn to larger, well-established funds with impressive operational and compliance infrastructures.

The silver lining here is that while institutional investors allocate a majority of their assets to the largest funds, they still look to diversify a portion of their holdings in search of the occasional home run that emerging fund managers can provide. For the smaller and emerging players, the recent period of industry underperformance is turning up the heat to generate better returns and presenting windows of opportunity in a challenging fund-raising environment. According to Preqin, 81% of the largest institutional investors have invested in emerging managers, compared with 43% of all other institutional investors[9].

6 Preqin, 'Hedge Fund Spotlight,' June 2013
7 Credit Suisse Capital Services, 'Mid-Year Survey of Hedge Fund Investor Sentiment,' July 2013
8 Hedge Fund Alert, 'Top 20 Investors Contribute Mightily to Funds,' 20 November 2013
9 Preqin, 'Hedge Fund Spotlight,' May 2013



Adding more staff and manual processes to conduct such tasks is not a cost-effective, long-term solution.

'The challenges for alternative investment managers have never been greater, but the appetite for investors has never been greater either, so fund managers are feeding off that investor buzz,' said Cary Stier, head of Deloitte's Global Investment Management practice[10]

Meanwhile, smaller private equity firms continue to create a distinct value proposition for themselves by developing expertise in sector- or theme-focused investing strategies. Specific niches within healthcare, energy, technology and real estate attracted such funds' interest last year, and we suspect these areas as well as other emerging opportunities will help narrow managers' sights even more this year.

Finally, 2014 will likely see additional efforts by alternative fund managers to re-engage the retail investor base by taking their alternative investment strategies mainstream in a variety of more liquid products offered through '40 Act funds and UCIT products. AUM in liquid alternative products climbed to $279 billion as of 30 September 2013, up from $68 billion in 2008[11].

Still, it is unclear how far the industry will go in pursuit of retail clients. Many fund managers remain wary of new alternative mutual fund products fearing they will disadvantage existing investors and put their brand at risk. The costs to set up a retail platform and operations can be prohibitive, particularly when it comes to ensuring compliance with '40 Act regulations and meeting liquidity requirements. With that said, a recent Deloitte Dbriefs webcast polled industry participants and 45% indicated that they were interested in launching a mutual fund/registered product in the near future.[12]

Creating a competitive advantage through better data

As regulators and investors continue to press for earlier and more substantial reporting, the ability to leverage data quickly and in an accurate manner is becoming a competitive differentiator in the industry. Institutional investors, in particular, are no longer looking at alternative investments as a separate asset class, but instead are deconstructing them into risk and attribution themes — strategy, geography and liquidity for example — as the basis for making allocations to hedge funds and private equity funds.

This increasing demand for risk and performance attribution information is challenging investor relations teams to create tailored reports that pull data from various systems not originally designed for that purpose. In fact, investor demand for greater transparency in risk and performance was ranked among the top three drivers of change in the industry by more than half of the respondents in a State Street survey of alternative fund managers.[13] Some large investors are already making their capital commitments conditional on a fund's ability to generate this type of customised reporting as part of their due diligence on a quarterly and sometimes monthly basis going forward.

10 Stephen Foley, 'Hedge Funds Drop Fees to Win Big Investors,' The Financial Times, 12 December 2013, http://www.ft.com/home/us
11 Shelly K. Schwartz, 'Seeking Safe Havens? Analysts, Advisors Point to Liquid Alternative Funds,' CNBC.com, 24 November 2013
12 Deloitte Dbriefs webcast 'Blurring the Lines: When Retail and Alternative Investment Worlds Collide,' 15 August 2013
13 State Street Corporation 'The Next Alternative: Thriving in a New Fund Environment,' July 2013

These emerging investor requirements come at a time when alternative funds are already being pressured to respond to a litany of information requests from regulators. The key regulations affecting alternative investment managers — the Alternative Investment Fund Managers Directive, the Foreign Account Tax Compliance Act, Form PF and Form PQR — all require data-centric solutions. Looking ahead, over-the-counter derivatives reform and new limits imposed by Dodd-Frank on bank proprietary trading and sponsorship of hedge funds and private equity funds will likely have significant implications for data collection and reporting.

In meeting these diverse demands, fund leaders are discovering that extracting and integrating existing data into the required format is time-consuming and fraught with regulatory and operational risk. One key sticking point is that not all of the information required to meet these compliance demands comes from internal sources. Much of it will need to be provided by fund administrators, prime brokers, or other third-party vendors and that data will need to be retrieved and normalised. Adding more staff and manual processes to conduct such tasks is not a cost-effective, long-term solution.

Instead, leading fund managers have proactively spent the past few years investing in a comprehensive data strategy that wraps in data warehousing and advanced data modeling, with some making room for a chief data officer in the C-Suite to set and run the technology agenda. The potential rewards from harmonising this information into a single data platform are significant, not just in using it to grant greater transparency, but also to be a solution provider by creating customised client solutions. Leading alternative investment managers are already reverse-engineering investment offerings based on their clients' unique obligations to their own investors, and more managers will likely follow suit in 2014, making customisation a major theme.

'Data is the hottest topic by far,' said Ellen Schubert, a senior advisor in Deloitte's Hedge Fund practice. *'Every meeting I go into right now is about data — the amount of data that hedge funds have to retain, manage, manipulate and massage for their portfolio managers, their investors, their regulators and the entire company.'*[14]

14 Hedge Fund Alert, 'Survey: No End in Sight for Industry Growth,' 8 January 2014

In the year ahead, effective data management will be just as important for identifying new return opportunities as it will be for keeping investors and regulators happy. Leading private equity firms are already employing technology solutions to help track their portfolio companies on a real-time basis in a single place. Greater visibility into portfolio companies' operations is helping managers identify ways to help run the companies more efficiently, maximise the amount of cash they generate, and increase their exit value.

Meanwhile, hedge fund managers are increasingly relying on real-time data to make trading decisions. In fact, the fastest growing hedge fund strategy over the past five years has been 'quantitative' trading, including market-neutral, statistical arbitrage as well as high-frequency strategies. But there are also opportunities for more traditional managers to crunch data to improve their performance.

Managing external relationships and reputational risks

As investors and regulators increase their focus on risk management, alternative investment managers are working harder to gain a more holistic view of risk. With so much at stake from a reputational standpoint, they cannot afford to let key risks go undetected. As a group, the global financial services industry clearly understands this —a full 94% of industry respondents in a global risk management survey Deloitte conducted last summer[15] said their executive management teams are spending more time on the oversight of risk compared to five years ago.

Given the fee pressure that continues to reign over the industry, we expect to see hedge fund and private equity leaders being more strategic about identifying and weighing risks when deciding where to allocate resources. Risk-based resourcing models, which measure an organisation's exposure to a wide range of risks and identify the optimal resources for managing those risks, are being used by more firms as they investigate new product offerings and geographies.

These increasingly sophisticated approaches for balancing growth with risk and control will be particularly useful as alternative investment leaders explore new distribution avenues, such as more liquid products targeting retail investors. Another area where alternative investment leaders will need to be vigilant is the added risk associated with extending the organisation to a wider range of external service providers, from fund administrators to third-party solutions accessed through the 'cloud'. Even when sufficient resources are available, some fund leaders will still prefer to turn to capable service providers so they can focus on their core competency of generating investment returns.

To date, hedge funds have been more likely adopters of outsourcing, mainly due to the fact that the use of independent administrators was all but mandated in the wake of the financial crisis. However, private equity managers are increasingly adopters of outsourcing as the cost and complexity of their internal infrastructure is forcing chief financial officers to look to third-party capabilities as an option. As it is no longer acceptable for general partners to calculate their fund net asset value in-house, private equity firms are continuing to explore the optimal level of control over their books and records through different shadow accounting techniques.

15 Deloitte, 'Global Risk Management Survey, Eighth Edition,' July, 2013

'Cyber education can start with simple questions, such as who would want your information and why do they want it,' said Mary Galligan, a director with Deloitte & Touche LLP's Security & Privacy practice and former FBI special agent in charge of cyber and special operations. *'It's important for alternative investment managers to start with a clear understanding of their vulnerabilities to make risk management and mitigation more informed.'*[16]

Outsourcing regulatory compliance is still a touchy subject for many funds given the loss of control and increased risk that it brings without the ability to discharge the ultimate responsibility. However, outsourcing certain components of regulatory compliance, such as regulatory reporting, annual compliance reviews and personal trading, can help funds achieve capabilities within the industry that prevent them from becoming an outlier, an important consideration when regulatory requirements are in a constant state of flux.

By nature, these extended relationships are exposing fund managers to new or increased risks. These threats include potential business disruption, regulatory breaches, counterparty credit risk, service failure and the theft or inadvertent dissemination of personal identification information or intellectual property. Given the reputational harm and financial impact that can be inflicted when these risks turn into full-blown crises, it will be critical for fund managers to continue to fine-tune their risk management approaches and stay on top of emerging threats.

A critical component of these risk reviews pertains to cyber preparedness. Alternative investment funds have in recent years increased their focus on protecting against internal threats and building safeguards around IT infrastructure, and these efforts are paying off. With that said, there is still room for improvement, as alternative investment managers should understand that the hacker community is smart, big, nimble and usually a step ahead of risk prevention efforts.

At the same time, the extension of the enterprise to outside partners requires that fund managers expand the scope of these efforts and recognise that cybersecurity is not just an IT issue, but an enterprise risk issue that extends to its vendor relationships. As hedge funds and private equity funds expand their network of third-party providers, cyber risk should be a key component of supplier risk reviews. This goes not just for the obvious candidates such as plan administrators and prime brokers, but for technology, research, sales and marketing partners as well. Industry leaders should be sure to review that each vendor has adequate security controls in place and maintains an internal incident response team whose mitigation plans account for third-party cyber breaches.

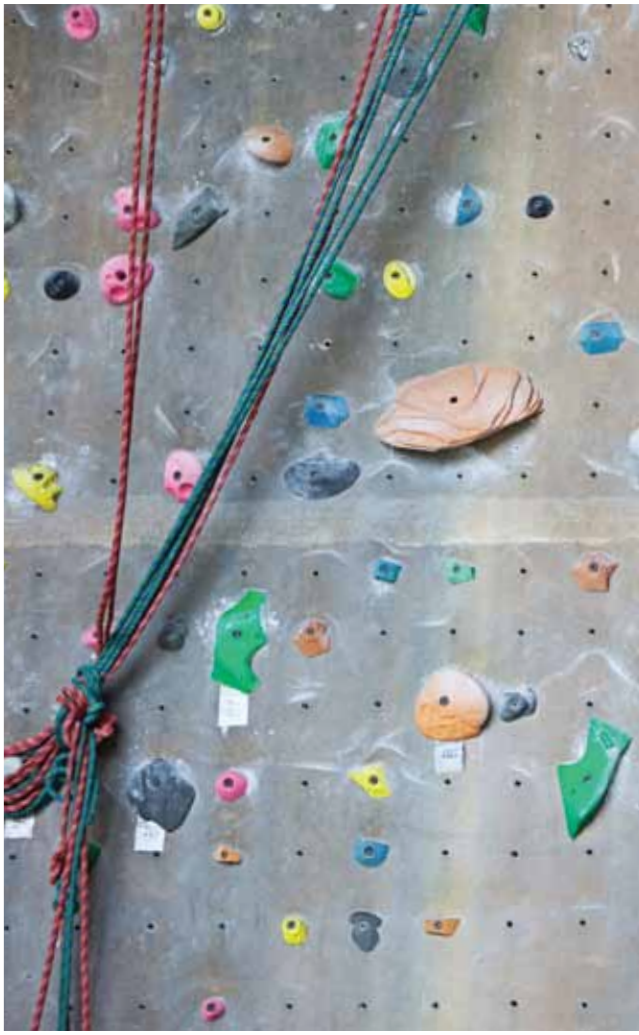
16 Mary Galligan, 'Deloitte's Alternative Investment Symposium' (panel discussion, The New York Public Library, New York, NY, 21 November 2013)

Conclusion

The past few years have certainly been trying for most alternative investment managers; but in some critical ways, they are now in a better place as a result. The increasing regulatory burden may have been a distraction, but the infrastructure investments made by firms to manage regulations have strengthened their organisations to become more efficient and better able to respond to investor demands. Private equity funds finally appear poised to put more of their dry powder to work, even if they have to set their sights on smaller deals. Hedge funds are embracing change in different ways by testing new strategies, geographies and distribution channels. The overarching story is no longer one of capitulation — but of growth. And that's a story we believe leading and emerging fund managers will enjoy telling this time next year.

To the **point**:

- Institutional investors are likely to allocate a higher percentage of their portfolio to alternative investments going forward
- More alternative investment funds will likely go mainstream to pursue retail clients through '40 Act funds and UCITS
- Alternative investment funds are looking to harmonise information into a single data platform to create greater transparency and customised client solutions
- More alternative investment funds will invest in a comprehensive data strategy that wraps in data warehousing and advanced data modeling
- More alternative investment funds are establishing service provider oversight frameworks to better manage their extended enterprise
- Alternative investment managers will take a more vigilant approach to cyber preparedness and establish an incident response team for cyber breaches



EU Fund administration

Embarking on a journey to overcome challenges and target operational excellence

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Since the global economic turmoil of 2007, the investment management industry has been hit by a series of headwinds, causing a sharp decline in Assets under Management (AuM). It is only recently that the pre-crisis level of AuM has been exceeded, but in the meantime, the industry landscape has drastically changed.

Mutual fund industries are dealing with shorter market cycles, and external events, such as the introduction of new regulations, which are reshaping the industry. During the economic crisis, asset managers tried to contain costs and create pressure to renegotiate fund administration fees. Although the situation has improved on the AuM side, the fund administration industry is facing a lasting low fees scenario. The sector has managed these circumstances in the short term by postponing investments and cutting costs, through the automation of operational tasks and offshoring/outsourcing operations. However, the capacity of these measures to reduce costs will soon be exhausted.

The industry is currently facing a wave of new regulations that are required to be implemented within a short timeframe, while AuM is expected to grow. As a result, the focus is now moving from costs to investments, and five main business drivers have been identified:

1. Competition
2. Cost containment
3. New product launches
4. Service offerings
5. Regulations

These factors are remodelling the industry, and in each case, specific challenges can be identified that may be tackled via the introduction of business and technology measures.

1. Competition

The past couple of years have seen many asset servicers opting out of the fund administration industry to refocus on their core business. Small players can no longer sustain a 'scissor effect', between increasing costs and pressure on fees. Hence, the low added value fund administration industry requires either a critical mass or a focus on a specific market to get positive returns.

A concentration of AuM among the top service providers has taken place and global competitors are emerging. Despite this, there were very few mergers and acquisitions during the economic crisis; instead, growth is essentially coming from a more favourable economic environment as well as organic growth, as companies slash prices to on-board new clients, further emphasizing the significance of scale economies and organisational efficiencies.

This status quo looks to be changing in light of the new regulations and the need to strengthen the service offering. Organisations are shifting from a cost-based approach to making the investments necessary to sustain growth and address the new regulatory requirements. Accordingly, the significant investment expected is highly likely to lead firms to seek to outsource this very low income activity and to create 'one-stop shop' businesses.

2. Cost containment

Cost containment is still one of the top priorities of fund administrators due to reduced margins and higher cost of new products and new regulatory requirements implementation, in addition to fund managers who are pushing to reduce fees. Clearly, one of the main drivers is to completely outsource non-core activities, such as IT infrastructure or development, which represents a low risk profile versus high expected savings.

The other trigger to consider is offshoring activities to low-cost Asian or Eastern European countries, even though this option has already been used by the majority of global players. The main challenge here is achieving the same operational standards and quality in these countries.

Running multi-site operational centres may be problematic and the expected benefits can sometimes be eroded (tax and regulatory hurdles, learning curve of the offshore location, etc.); there may also be advantages, however, such as the ability to provide Asian time-zone support to clients. As for onshore activities, staff reduction/containment, is creating pressure, as more and more tasks are requested by regulators or fund managers. To tackle this situation, investment in staff development and a reduction in manual processing is needed to drive down costs and manage operational risks.

3. New product launches

A diversification of the products used by investment companies is under way, as a result of the financial crisis and new regulations.

As the investment management industry launches new products, administrators are forced to keep up with the pace of innovation by offering services that will enable them to rapidly capture market share. But investment is needed and considerable organisational implementation efforts will be required. The exponential growth of ETF product launches is the perfect example of complexity, in both business and technology terms, with pressure on prices due to low margins. ETF products require management of cross-border activity and multiple intraday NAV computation with flawless data, as these are used by market makers.

Regulatory requirements were initially perceived as a burden but organisations have begun to move from aiming to be compliant to targeting their efforts towards driving efficiencies, and sometimes aiming to achieve a competitive advantage. For example, new fund structures have been developed and rationalised in light of the master/feeder structure allowed by UCITS IV.
New challenges are arising from the development of alternative products with the introduction of AIFMD, which is expected to boost this sector. Automating processes to manage alternative assets in the same manner as UCITS funds will require integration of new platform systems that can handle a variety of products, ranging from art to real estate. One of the key challenges will be data consolidation and the set-up of new connectivity flows with third parties for reporting and transparency to all parties.

Given the growing demand for diversified products, fund administration segmentation is likely to happen through either 'one-stop shop' fund administrators operating like a supermarket to deliver services to clients, or niche boutiques targeting specific markets.

4. Services

Middle office services are not part of the core business of asset managers. This is where fund administrators can step in to build extra services that will ease pressure on the core fund administration business by generating new revenues. Diagnosis is one thing, but the implementation of such services will require moving up the value chain and working more closely with the front office to provide services like trade processing and matching, collateral management or risk management. A side effect of maintaining both strategic positions at the pre-trade level and the end of the chain with the fund administration would add an extra level of data quality checks and reconciliation.

5. Regulation

As a rule, regulators are aiming to re-establish and maintain trust in the financial sector. A series of directives are now shaping a new landscape and impacting all aspects of the mutual fund industry. At the fund administration level, regulators are increasingly focusing on the transparency of the services delivered and the schedules of fees charged to funds. They are also indirectly on the spot when regulations are implemented and require extra reporting or monitoring that must be implemented to cover fund compliance. Consequently, operational architecture needs to be efficient in order to keep costs at a sustainable level.

On the other hand, these effects can lead to a new organisation based on competence centres that can respond to client needs in an efficient way. Besides, some regulations are clearly expected to have a positive impact, either by attracting new assets under management into existing funds, or setting up new products requiring fund administration services.

Business and technology measures

1. Business

During the global economic crisis, the fund administration industry was squeezed between plummeting fees and pressure to provide further services. As a result, operations and investments were set aside, since the industry took the approach of focusing solely on cost cutting or containment. One way actively used to handle the matter swiftly and efficiently was the offshoring of low value-added services in low-cost countries. Unfortunately, an attempt to ship more activities abroad could carry risks, if the only target is streamlining costs. Companies considering offshoring activities must shift from a short-term cost-cutting view to a long-term strategic plan. In fact, these offshore emerging markets are quickly developing, with firms seeking to reduce soaring human resources expenses, as well as growing internal demand, thanks to an emerging middle class.

> The industry is currently facing a wave of new regulations that are required to be implemented within a short timeframe, while AuM is expected to grow

Consequently, offshoring activities must fall within a global strategic plan to redefine the worldwide operating model of fund administration activities.

In this context, offshoring activities could be a way of testing the water of emerging markets, and seize pole position to capture market share. For instance, the initiatives of the Chinese authorities to build a UCITS-like framework could trigger the development of a local mutual fund investment industry. Alongside offshoring activities, other initiatives can be set up with competence centres around the world aimed at achieving operational excellence. To overcome overlap and inefficiency, every centre should be dedicated to a particular activity or product.

But focusing only on the cost side is to forget that the fund administration industry is associated with back office activities and low value-added services.
To challenge this view, the sector needs to innovate and promote new services that will generate extra revenue. This can be achieved by moving up the value chain and getting closer to the asset managers (e.g. development of middle office services).

2. Technology solutions

Accessing these new growth drivers will create considerable pressure to align business and organisational requirements with technology. Expensive investments in IT are needed to implement cutting-edge systems that are able to sustain the development of an agile organisation. The aim is to position the organisation in the starting blocks to be ready for future growth with up-to-date IT systems.

This is where the traditional debate between the advocates of in-house development and third-party software comes in. Steering a course between these two views is not straightforward. However, in-house solutions are viable for large multinational companies willing to invest in a software factory hub able to deliver state-of-the art technology solutions that are in tune with business requirements. The systems are fully integrated into the business and deployed on every site covering the full range of business services. To be fully efficient, no development is done onsite and only support teams work locally as an interface with the hub. Local development can still be an option to build a system from scratch to start an innovative business launch by a competence centre.

On the other side, the decision to call in a third-party software provider can be beneficial to all types of organisation. The fund accountants can get rid of the development activities, thereby reducing costs and allocating more resources to business support. Buying a well-known software package can be a win-win situation, as customers will require development to follow their business, with systems keeping pace with market trends regulations. Nonetheless, every solution comes with its price for the client and some key points must be monitored. A loss of flexibility can occur, and taking on a core system to cover the whole business chain can be challenging. As a result, interfacing multiple systems can be somewhat problematic, not to mention specialised systems that are not evolving in the same direction as customer needs.

Other technological concepts are emerging that are worth considering, such as Software as a Service (SaaS), which involves fully outsourcing the software infrastructure and architecture to a company hosting and maintaining it.

The only aspect left for the client to manage is the configuration of the application, without the hassle of upgrades, migration and so on, which is assigned to a team of experts. The main drawback is that this platform-sharing is done across multiple clients, with the loss of potential differentiation in terms of services offered. It is no surprise that this solution is for now used more for ancillary services, although it can be seen as a good alternative for a new product or service until it passes the incubation phase. The former concept, known as Business Process Outsourcing (BPO) goes one step further, in that it offers the option of outsourcing management of the entire business and infrastructure. It has the great advantage of turning fixed costs into variable costs, but it also has all disadvantages of SaaS, in addition to raising contracting, coordination and reorganisation issues. It goes without saying that this solution needs to be solely dedicated to non-core business activities, with standard and well-established procedures allowing little customisation.

Systems and software considerations are real issues for the fund administration industry, but they are only one part of the equation. The key underlying issue for both the business and technology aspects is data. At the end of the day, the only valuable information for the client is data that is delivered in a timely, accurate and reliable way. The increasingly stringent regulations on transparency and reporting, as well as the development of alternative products, are reasons to re-think an organisation from a data management perspective. Organisations should focus all their attention on data integration and build a consistent data repository interface, aggregating all the information needed by the asset manager. Here, the main issue becomes the interconnectivity of multiple core platforms through various business services and products. Internal and external data coming from different counterparties has to be aggregated too.

Conclusion

Recent years have seen a steady growth in AuM, and more growth can still be expected. It is now time for the fund administration industry to shift from cutting costs to reviewing and rationalising operational processes to secure future growth. The industry is embarking on a journey to implement new regulations, and needs to cope with requests from asset managers to implement new services in order to be compliant. A unique opportunity thus presents itself to gain from this situation by simplifying operating models and consolidating systems into core platforms.

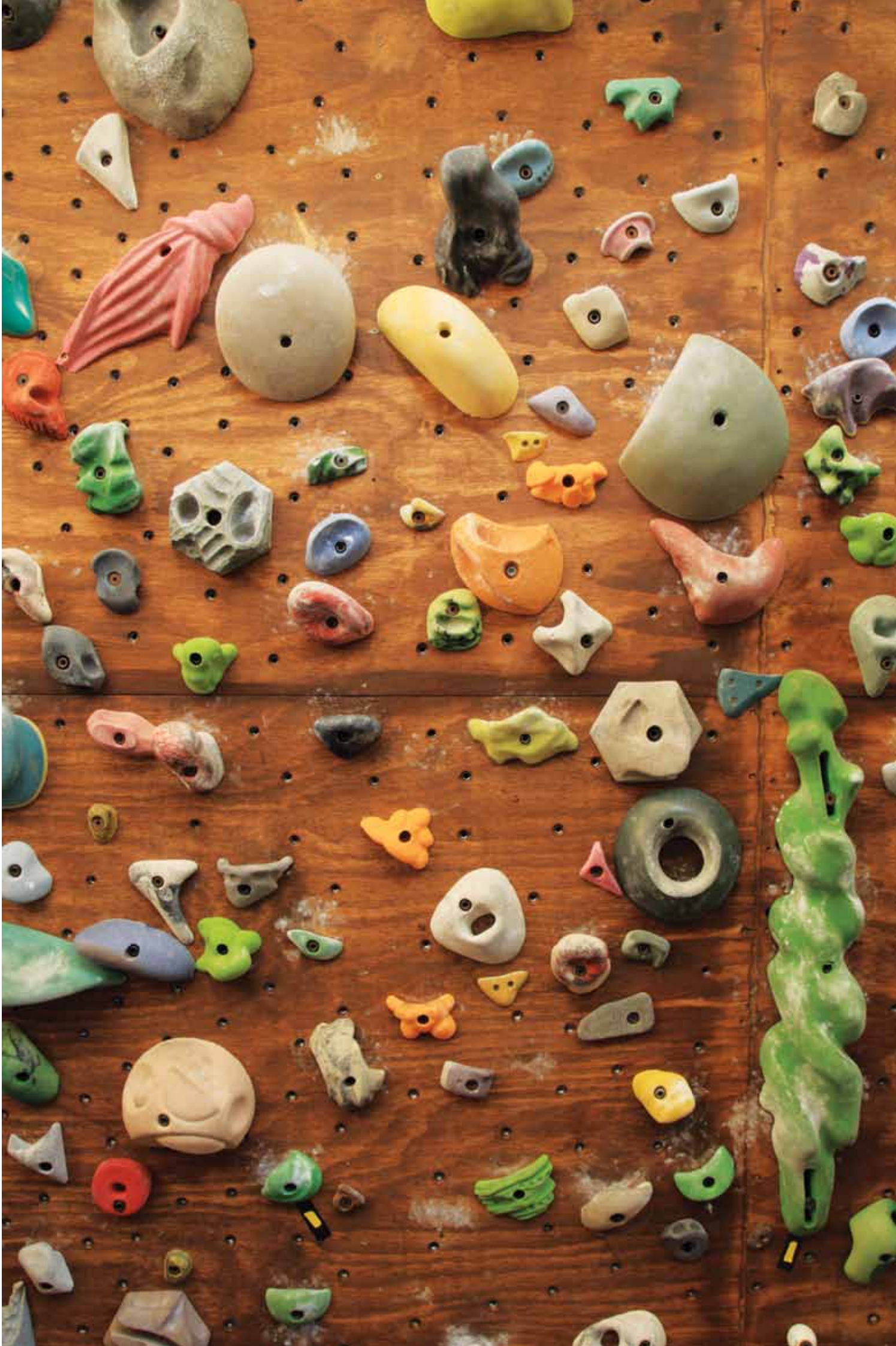
The fund administration industry has a new opportunity to seize through the development of new products and middle office services. To do this, companies need to define a medium-/long-term target operating model and set the milestone of becoming an agile organisation. To move in this direction, business processes must be standardised so that tailor-made solutions are the exceptions. Naturally, this will require significant investment in IT systems, so that the technology can support this development. There is no one system architecture model, but multiple solutions depending on the business model. However, the one common denominator to all these issues is data integration, as what is valued the most by asset managers is data. Finally, by taking these actions to review the business side and upgrade the technologies used, it will prepare organisations to grow smoothly and become more resilient to crises.

To the **point**:

There have been drastic changes in the EU investment fund administration industry since the global economic crisis, and the impact of the factors shaping the sector is stronger than ever:

- **Competition:** small players can no longer sustain a scissor effect between increasing costs and pressure on fees. This is why the industry requires either a critical mass or a focus on a specific market to get positive returns
- **Cost containment:** it is still a top priority to either slash costs or contain them through a wide range of solutions from outsourcing/offshoring to limiting headcounts. These solutions can have different effects and must be implemented in accordance with a targeted strategy
- **Products:** new products are being launched that are forcing the industry to keep up with the pace of innovation. Market share is captured by offering alternative products, although significant investment is required for the provision of appropriate services
- **Services:** middle office services should be offered by moving up the value chain to generate new revenues and ease pressure on the core business
- **Regulation:** regulatory requirements can be perceived either as a burden, or organisations can seize the opportunity to drive efficiencies and create a competitive advantage

AuM growth can still be expected and it is now time for the industry to shift from cutting costs to reviewing and rationalising operational processes. The target operating model must be defined in the medium-long term to set a clear path leading to the alignment of the business with technology. An agile organisation together with data integration will put organisations in the starting blocks to grow smoothly and become more resilient to upcoming and changing market circumstances.



Navigating the new operational frontier

Top 10 operational risks: a survival guide for investment management firms

Holly Miller
Managing Director of Middle Office Services
SEI - Investment Manager Services

Every investment management firm knows that even seemingly minor operational oversights or mistakes can have huge repercussions.

That is why operational departments work hard to automate and fail-safe their processes, conduct extensive reconciliations and develop detailed workflows and procedures. A great deal is at stake, and not just in terms of direct financial costs and legal liability.

Operational risk can stem from many sources. The Basel Committee on Banking Supervision defines operational risk as 'the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events.'[1] The definition considers the full range of material operational risks and lists examples ranging from fraud and data entry errors to hardware failures and floods.

As a provider of customisable operating platforms for investment managers all over the world, SEI views operational risk management as a primary objective. It is critical for investment manager to take a fresh look at common areas of risk, identifying priorities for action, and then considering the variety of relatively straightforward risk-management measures that can be deployed. Broadly speaking, these areas include concerns with personnel, supervision and training; organisational and support issues, including the roles of technology, which can be both a solution and a source of risk in itself; and common weaknesses in reconciliation, legal review and planning.

1 'Sound Practices for the Management and Supervision of Operational Risk', February 2003

While there is no generic checklist for identifying operational risk, our 'Top Ten' can help identify areas of risk that are frequently encountered by those who work in or around investment operations.

1. Complacency

These include flawed business continuity plans, poor recordkeeping and deficient insurance coverage. Other practices that place organisations at risk include hiring inexperienced or under-qualified staff, neglecting to train new employees, disregarding feedback from middle- and back-office staff, operating without an electronic document management system and failing to check employees' work. To tackle these issues, consider better training, tightening up internal procedures and improving communication.

2. The blind leading the blind

Mid-level and senior managers who are unfamiliar with investment operations may rely upon subordinates who are also unqualified for the task at hand. Outsourcing has benefits, but it is not a panacea and brings its own due diligence demands. External operational reviews can help illuminate these risks. To address them, consider ways to improve hiring, promotion and coaching practices as well as strengthening due diligence frameworks.

3. Novices, apprentices and soloists

Problem areas here include small, specialised teams that work in isolation and individuals who assume sole responsibility for a function or relationship, often zealously guarding their 'turf'. Thoughtful attention to organisational design, training and cross-training can promote teamwork and reduce key-person risk at all levels.

4. Dropped batons

Information handoffs between people, departments, organisations and systems are fraught with communication and timing challenges. The most useful tools for identifying potential trouble spots are system diagrams that identify all applications and their interfaces, and workflow diagrams that display hand-offs between teams or departments and between the firm and external counterparties, service providers and clients.

5. Naïve reliance on technology

While automation is a powerful tool for mitigating operational risk, it can create new hazards if systems are not carefully designed and implemented. To reduce those risks, make sure that staff and consultants who deal with operational systems know how to perform automated functions manually and, furthermore, understand their operational context, including system and workflow linkages. Keeping system access permissions up to date, maintaining system infrastructure, and building in thorough audit trails are all high priorities. The importance of written functional specifications and detailed testing cannot be overemphasised.

6. Playbooks

Nonexistent, obsolete or incomplete process-and-procedure documentation is frequently a factor in operational breakdowns. The remedy is workflow diagrams that are kept up-to-date and readily available. Not only are such workflows important in the effort to lower day-to-day risks, they are also useful in new-hire training, system- and process-improvement initiatives and disaster recovery. Firms should also have well-defined issue escalation protocols that take into account both the magnitude and timing of potential impacts.

7. Amalgamated assignments

When designing organisational structures, policies and procedures for the segregation of duties, it is critical to maintain the distinction between the firm and the fund(s) it manages. Operational reviews can help flag potential conflicts of interest as well as opportunities for theft or fraud. Firms may want to consider whether it is appropriate to institute some degree of shadow accounting, whereby investment managers maintain their own sets of books and records for comparison with those of custodians, auditors and independent third-party fund administrators.

8. Reconciliation gaps

Less-than-comprehensive procedures can leave investment managers unknowingly exposed to risks. To reduce that exposure, firms should conduct full reconciliations between their records and those of the custodians and administrators, with provisions for supervisory review and accountability. Full reconciliations include comparisons of cost basis and market value (in local currency terms), security identifiers, and local-currency cash balances; they also entail reconciliation of margin or collateral positions using statements from the party holding the assets.

9. Reading the fine print

Legal documents should be reviewed in detail by attorneys as well as knowledgeable operational managers. When assessing counterparty risk, firms need to identify exactly which legal entity is their counterparty, determine who has regulatory jurisdiction and continuously monitor net exposures as well as the counterparty's creditworthiness.

10. Poor planning and slow response times

Investment management organisations that fail to plan ahead may sustain huge business and operational impacts as a result of the sweeping regulatory, marketplace and competitive changes that are transforming the industry. Against a backdrop of expanding regulatory requirements, clients and investors are pressing firms to increase transparency, accelerate reporting and reduce risks—all while lowering advisory fees. Operational benchmarking can assist in analysing cost structures and the financial impacts of changes in key business drivers. As the line between traditional and alternative managers continues to blur, the former are encouraged to prepare for operational due diligence and the latter, to implement the GIPS® standards.

> It is critical for investment manager to take a fresh look at common areas of risk, identifying priorities for action, and then considering the variety of relatively straightforward risk-management measures that can be deployed

In light of the complexities and constant change in our industry, virtually every firm has the opportunity to take risk management to the next level. Operations departments function best when senior managers understand how things are done, provide the resources needed to mitigate risk, recognise that some events are beyond reasonable control and reward operations staff for their successful efforts.

It has been observed that operational risk offers no upside; to use Castle Hall Alternatives' phrase, it is risk without reward. In contrast, concerted and systematic efforts to reduce operational risk promise a clear upside. Not only can they help investment firms build a culture and framework for operational excellence, they create tangible investment value by reducing costs, increasing client satisfaction and reinforcing sound business relationships with trading partners. What's more, many risk-mitigation measures are inexpensive, demanding more in focus and foresight than in hard investment.

In these times of shrinking asset pies and stiff competition, the advantages to be gained through better risk management may be the real low-hanging fruit.

While regulated fund managers are no strangers to managing risk in order to meet stringent regulatory requirements, virtually every firm has the opportunity to take risk management to the next level. By understanding how things are done, providing the resources needed to mitigate risk and rewarding operations staff for their successful efforts, these managers can stay competitive, and meet the evolving needs of regulators as well as their investors.

To the **point**:

- Virtually every investment management firm has the opportunity to take risk management to higher level, taking a fresh look at common areas of risk, identifying priorities for action and then considering the variety of relatively straightforward risk-management measures that can be deployed
- Different organisations have different exposures and tolerance levels to operational risk, depending, for instance, upon their investment strategies, the markets in which they operate and the instruments they employ; thus there is no all-purpose checklist for identifying operational risk, nor is there a single, universally applicable set of mitigation measures.
- Concerted and systematic efforts to reduce operational risk help asset management firms build a culture and framework for operational excellence; they also create tangible investment value by reducing costs, increasing client satisfaction and reinforcing sound business relationships with trading partners
- Many risk-mitigation measures are inexpensive, demanding more in focus and foresight than in hard investment; in times of shrinking asset pies and stiff competition, the advantages to be gained through better risk management may be the real low-hanging fruit

For more detail on this topic, please review SEI's *Ten Operational Risks*, an online guide that catalogs a host of operational pitfalls along with potential ways to remediate them. The guide is available at www.seic.com/OpRisks.

Operations departments function best when senior managers understand how things are done, provide the resources needed to mitigate risk, recognise that some events are beyond reasonable control and reward operations staff for their successful efforts

Basel III
Unexpected consequences of a pharaonic project

Nicolas Gaussel
Chief Investment Officer
Lyxor Asset Management

Like the construction of the Aswan dam in its time, the implementation of Basel III is leading to significant and sometimes unexpected changes in the financial landscape.

For thousands of years, the Nile was a source of prosperity for the lands that it crossed. Its periodic cycles irrigated the neighbouring lands providing the resources needed for their development. However, once every ten years, extreme fluctuations led to famine and devastation. When too high, the flooding devastated entire crops. When too low, drought conditions prevailed.

Regulating these fluctuations was always a necessity. The culmination of these efforts was the construction of the High Dam at Aswan in the 1970s. This dam was designed to prevent major flooding while at the same time improving the irrigation of the Nile valley. Despite the dam's undisputed benefits, the equilibrium of the entire region was nevertheless modified, sometimes in an unexpected manner.

For example, it is estimated that evaporation from Lake Nasser, an artificial lake which was created after the construction of the Aswan dam, represents 14% of the flow of the Nile. In an even more visible manner, numerous ancient Nubian temples, including those at Abu Simbel and Philae, had to be moved stone by stone in order to avoid being submerged.

Like the Nile, the financial markets are necessary for the irrigation of the economy. However and like the Nile, their crises are destructive. Markets additionally obey the same statistical laws, whose principal parametre, the Hurst exponent[1], bears the name of a hydrologist who specialised in the Nile flooding. The dilemma concerning the regulation of the financial markets can also be described in a similar manner: how can we assure financial stability while continuing to finance the economy?

1 See for example Benoît Mandelbrot, Fractales, Hasard et Finance, Champs sciences, 2009

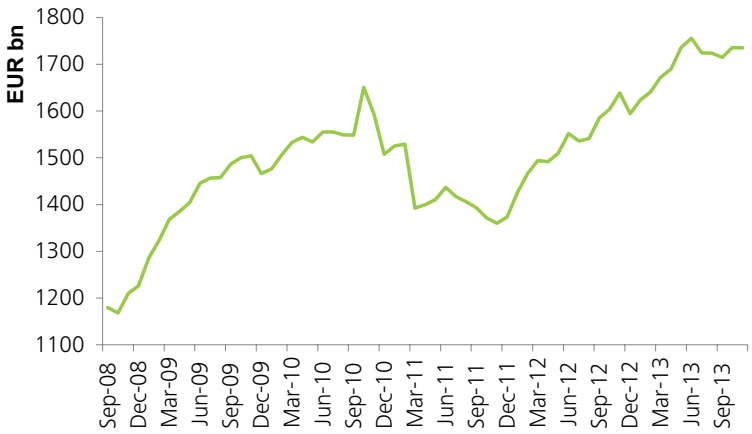
At a time when new regulations are in the process of redefining the banking and financial landscapes, it is worth paying attention to the unexpected secondary effects of these new pharaonic projects. We currently see two such effects that are profoundly affecting the structure of financial markets and that all investors should be aware of.

Public debt is now being held by banks at parity with insurance companies

Banking regulation has traditionally focused on so-called 'solvency' ratios, which ultimately lead to increased requirements in terms of equity capital ratios. Strangely enough, the liquidity risk, which is at the heart of banking activities, had never been directly addressed by the regulators. This has now changed. For the first time, the Basel Committee has introduced the concept of liquidity reserves. In order to reduce their vulnerability to liquidity crises (as in 2011 for example), banks must now set up reserves consisting of securities that can be easily sold in case of turmoil.

Therefore banks must now hold at all times a portfolio of high quality liquid assets (HQLA[2]), mainly composed of government bonds. According to ECB figures, European banks have increased their holdings of sovereign debt by €550 billion since 2008, to €1,700 billion at the end of 2013.

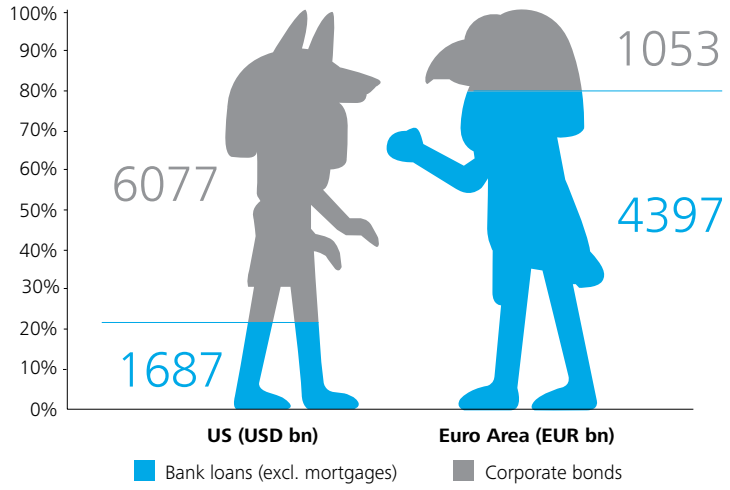
Figure 1: Holdings of government securities by euro area monetary financial institutions (MFIs)



Source: ECB, Lyxor

2 *High Quality Liquid Assets. See Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools (http://www.bis.org/publ/bcbs238.pdf)*

Figure 2: Sources of non-financial corporate financing (%): the 80/20 rule



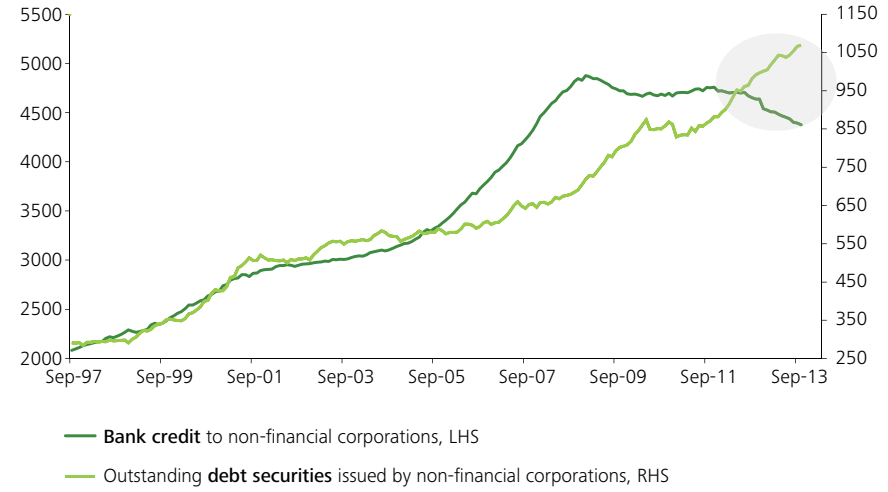
Data for Q3 13. Source: ECB, Federal Reserve, Lyxor

By way of comparison, according to EIOPA figures, the European insurance companies currently hold €1,600 billion of government debt. This illustrates the massive impact of Basel III on long-term interest rates and the new link that has been created between banks and sovereigns.

European insurance companies are now entering the corporate finance area

By reinforcing liquidity requirements for banks, regulatory authorities and bank supervisors are also reducing the level of bank intermediation. This is particularly the case in Europe. While 80% of the financing of non-financial corporates has been disintermediated in the United States, the situation is the opposite in Europe, where €4,400 billion of bank loans to non-financial companies represent 80% of their sources of funding. A 10% point increase in disintermediation would therefore represent a market totalling around €450 billion.

Figure 3: The process of corporate funding disintermediation has accelerated in the euro area (EUR bn)



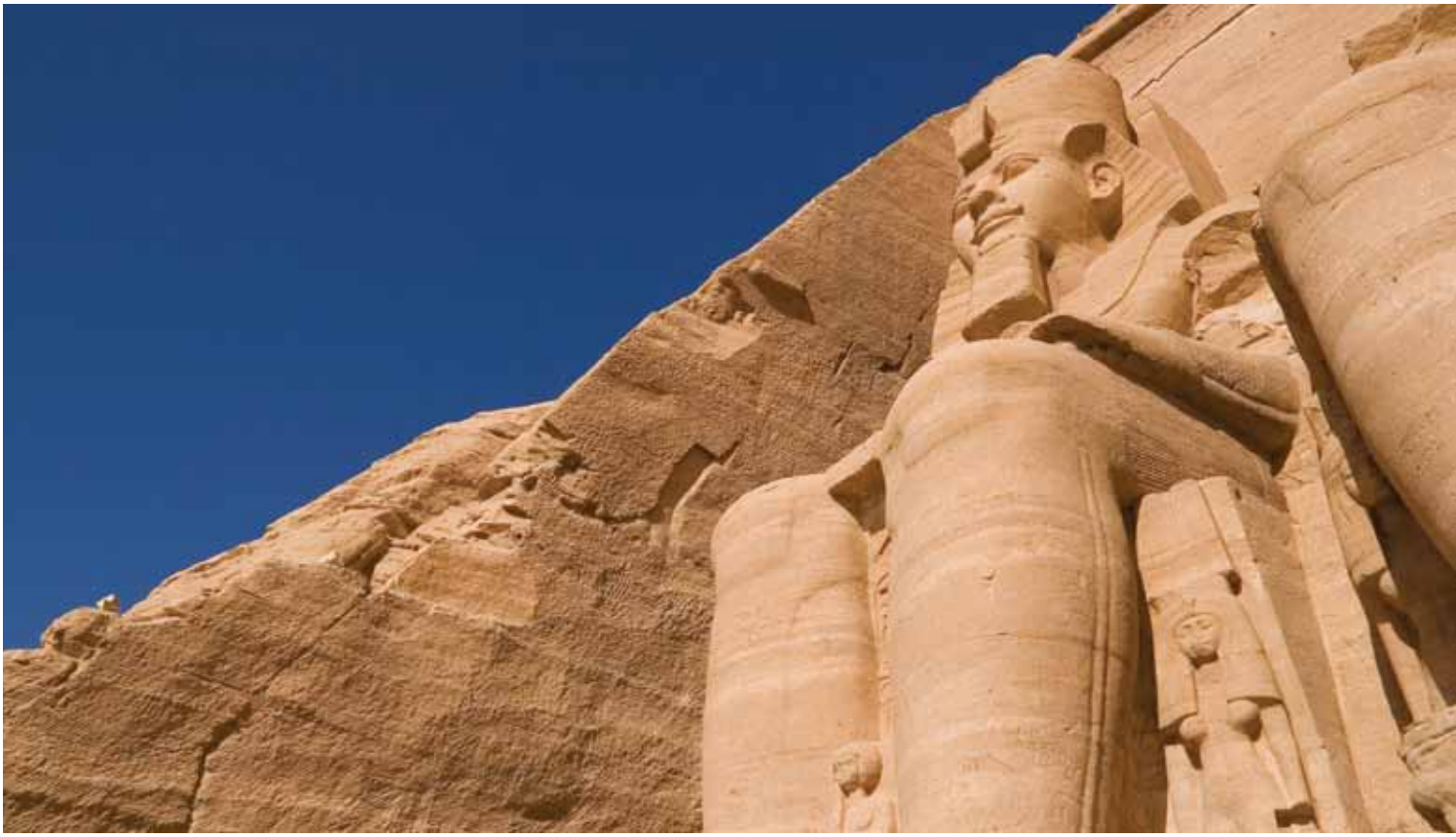
Nominal value of debt securities, all currencies combined, excluding financial derivatives. Source: ECB, Lyxor

Under the impetus of two powerful drivers, the transition towards a lower degree of bank intermediation is now underway in Europe. On one hand, the change in regulations, by increasing capital requirements, de facto reduces banks' balance sheet capacities.

On the other hand, low yields on government debt are pushing investors to look at higher yielding and therefore riskier assets. In France, the publication of a decree in August 2013 modifying the insurance code has authorised insurance companies (under certain conditions) to make direct loans to companies for up to 5% of their balance sheet total. What is more significant is that conditions are attractive. Loans offer higher yields than sovereign debt and are safer than high yield bonds[3]: senior loans, high recovery rate, fewer defaults, protection against a possible increase in interest rates through a floating rate structure (Euribor + 450 basis points in some cases).

Additionally, this disintermediation trend is giving insurance companies the possibility of investing in non-financial sectors such as infrastructures, energy, real estate, etc. We are therefore seeing a transfer of assets, and even expertise, from banks to insurance companies.

At a time when new regulations are in the process of redefining the banking and financial landscapes, it is worth paying attention to the unexpected secondary effects of these new pharaonic projects



3 *In the mood for loans, Societe Generale Cross Asset Research*

The specialist asset management companies: key players in the transformation

The banks which will have to hold substantial quantities of government debt on their balance sheets, are facing completely new challenges. They must act in such a way that these sovereign debt portfolios do not excessively weigh on profitability, without however accepting concentration risk on the most vulnerable countries, as these assets must be sellable when liquidity dries up.

Neither Basel III (which refuses to distinguish between countries based on their financial solidity) nor the rating agencies (whose history has demonstrated that they have been less responsive than the markets in crisis situations) will be helpful to the banks here.

There are concerns for long-term investors (particularly the insurance companies), while the major players have the ability to set up in-house teams to manage and invest in loans made directly or through funds, this is not the case for other players. This requires substantial human and financial resources as well as expertise in credit analysis.

Consequently, new players seeking to enter the private loan segment will also be well advised to make use of asset management firms specialising in the management of loan portfolios.

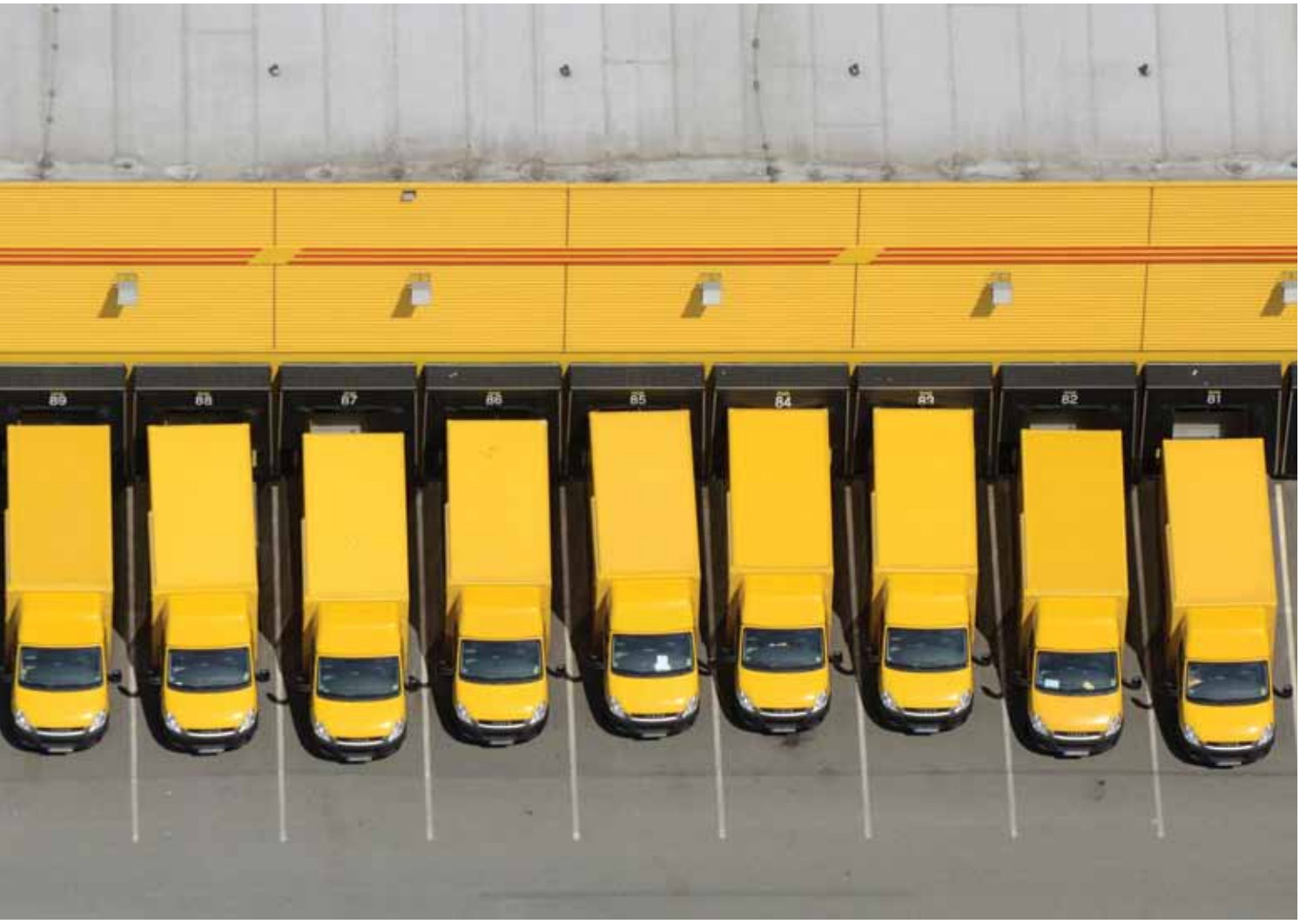
Similar to the construction of the Aswan dam, the adoption of effective regulations is a project that will run for more than a decade (2008-2019). It requires considerable resources and will lead to changes that have not yet been identified at this point. These types of changes require specialised players capable of satisfying the new needs in a constantly changing world. In light of these regulatory changes, asset managers will have an important role to play in this evolving world.

To the **point**:

- The banks must now hold risk-free securities. This is creating demand for sovereign debt similar to that from insurance companies
- The real economy is turning to new players for financing. This is *de facto* creating a new asset class, loans, for institutional investors
- Little affected by these regulatory changes, specialists asset managers have an important role to play by accompanying players impacted by these new measures

French asset management boutiques
Ready for export

Pascal Koenig
Partner
Advisory & Consulting
Deloitte



Since 2008, the French asset management industry has undergone significant structural development. What observers had considered to be a cyclical shock was actually a profound transformation of the business.

Driven by steady and recurring demand and with little exposure to foreign competition in its market, the industry had prospered with a certain degree of complacency. Having previously adopted margin protection policies based on the streamlining of product ranges, management structures had noticed by 2011 that their growth model could no longer rely solely on domestic sales. At the same time, it is true that other European markets, as well as the United States and Asia, regained momentum. Adopting an international market positioning, even if limited to local markets, requires the monolithic model to be adapted to a dual organisation, incorporating development functions on a wider scale.

From opportunity to strategy building

While, for the most part, the initial international successes were achieved from given opportunities, most entities now adopt ready-made deployment strategies that are commonly based on the answers to two questions: what? and how?

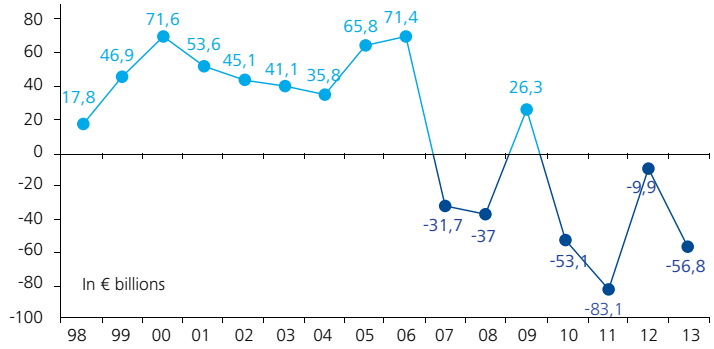
The 'what' refers to the question: what products are to be marketed?

Overall, the French players are general multi-class funds and are positioned in competitive expertise markets (e.g. 752 French funds out of 2,065 European large cap euro funds); furthermore, fund size is limited and they are generally denominated in euros. The aim is therefore to identify flagship products in product families whose differentiation in the French market could be transposed to the target foreign market (types of constraints, ability to use derivatives, hedged units). This stage is most often intuitive and still only very rarely based on the systematic use of a 'market appeal/competitive position' matrix. Regarding the eternal question of the comparative advantages of funds incorporated under French and Luxembourg law, there is no single answer.

Searching for a size effect (the 25 leading funds by sales represent 42% of European sales) often leads to streamlining based on a Luxembourg structure; sub-funds are built either by setting up a master-feeder structure or through a merger. However, while bilateral agreements between Luxembourg and certain Asian countries can prove to be advantageous for a Luxembourg solution (sale), it may be better to incorporate a fund under French law when comparing tax policies.

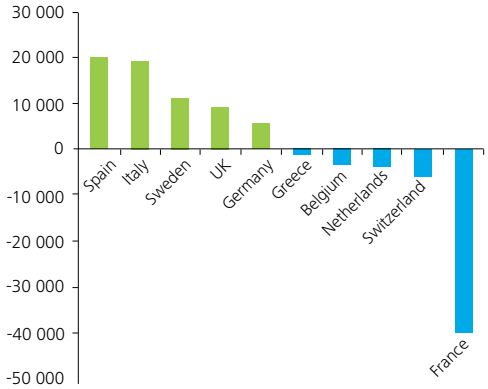
Figure 1: Redemptions

Market: evolution of annual net sales (France)



Source: EuroPerformance-a Six Company

Figure 2: Top and bottom five countries by sales



Source: Lipper 2014

Driven by steady and recurring demand and with little exposure to foreign competition in its market, the industry had prospered with a certain degree of complacency

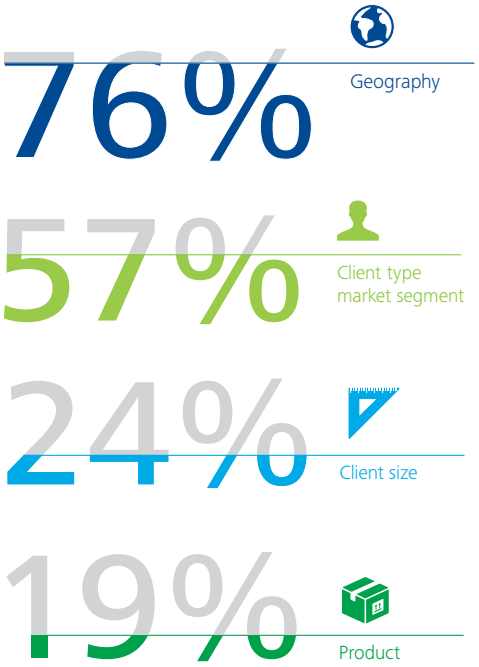
The 'how' refers to the question: how are the products to be distributed? Third-party marketer, in-house, partnership, branches?

The use of third-party marketers and an internal sales team is often only a temporary market learning solution. Partnerships are often sought but are difficult to find (NExT AM, a management company incubator, offers support via its network); as for commercial branches, local assets under management must be obtained beforehand to lessen the impact of the investment. Gaining knowledge of markets, culture and regulations is time-consuming and generally slows the process of reaching agreement on product adaptation and operational cycles or even regulatory or tax reporting requirements. However, this year saw substantial investments being made by French management companies in international commercial profiles and the establishment of branches in London, Milan, Geneva and Munich.

Figure 3: International learning process

Source: Deloitte IMS 2013

Figure 4: Segmentation of Sales force, 2012



Source: Cerulli Associates, in partnership with Institutional Investor Institute

A strategy that must be successful

There is no miracle solution: a substantial investment with no immediate return is needed, which is why the structured approach adopted is far from methodical.

Brand development is still insufficient in the largely competitive environment that prevails in Europe (3,200 management companies and 55,000 funds). Size does not systematically influence reputation. However, it is crucial that the communication policies of medium-sized entities combine brand and expertise and therefore create 'indispensability'; multimedia communication strategies covering the target geographical area provide the essential groundwork for any sales policy.

Messages come in multiple forms (management companies, flagships, use of the team's expertise and its market vision) and are sent via the local distribution channels (media relations, blogs, social networks, sites, newsletters, etc.).

The emergence of a true marketing strategy is only in its early stages; with very few exceptions, communication budgets are still:

- Determined instinctively without any clear link to the marketing strategy
- Broadly flat (62.5% of U.S. entities opted to increase their marketing budgets in 2013; only 36.8% have done the same in Europe—source: Cerulli Associates)
- Mostly focused on the domestic market

Moreover, the impact of communication budgets (product sales, site visits, rise in the number of RFPs, etc.) is not measured.

Figure 5: Features of a Manco brand

Source: Deloitte IMS 2013

There is no miracle solution: a substantial investment with no immediate return is needed, which is why the structured approach adopted is far from methodical

For the boutiques, **operational marketing** is gradually moving from a simple support function to a key differentiating instrument for the entity. Investor reporting adapts to new requirements by being:

- Multiple (institutional, retail, international)
- In step with management style
- Produced on a timely basis
- Personalised, with emphasis on a 'home-made' approach
- High value-added (risk indicators, performance attribution)
- Communicated using new tools
- In line with best international practices (GIPS)

Websites are overhauled to ensure that they meet the objectives of clarity, necessity and internationalisation. They have links to a regularly updated blog that fosters relationships between sales teams and clients via social networks. The long-term management of references with international and local consultants is vital to the creation of sustained demand. Adapting to their recommendations is the key to successful international development.

Due to the small number of calls for tender on French soil, responses must be reconsidered and teams repositioned in order to be able to provide solutions to foreign demand. Work on management efficiency cannot be ruled out in order to increase management competitiveness.

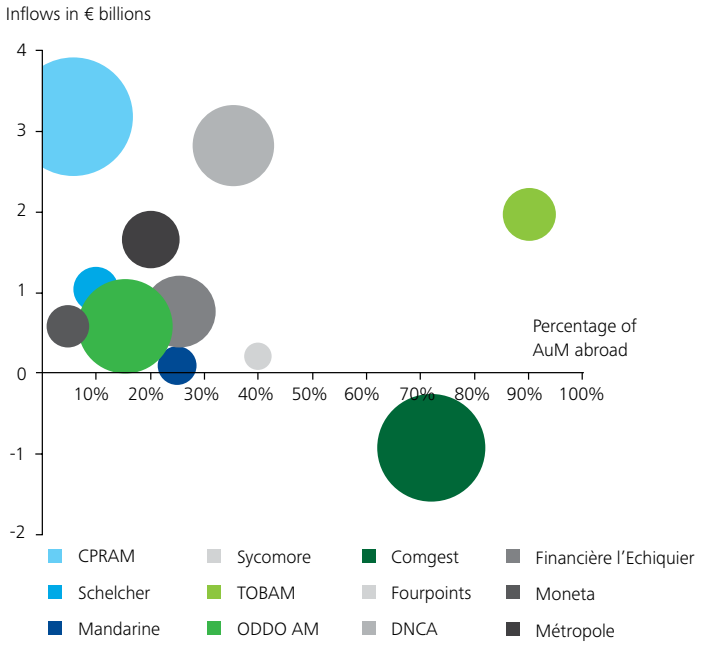
The last key to the success of French entrepreneurial management companies is to align **client services** with the expectations of international investors. Client services that were previously undervalued are no longer being allocated appropriate resources.

Strengthening client loyalty by being able to respond to operational issues, while providing sales teams with a full communications history, answering information requests in a timely manner and dealing with claims efficiently and in the client's native language (or in a language in which the client is proficient) is absolutely essential.

Figure 6: Distribution strategy key success factors

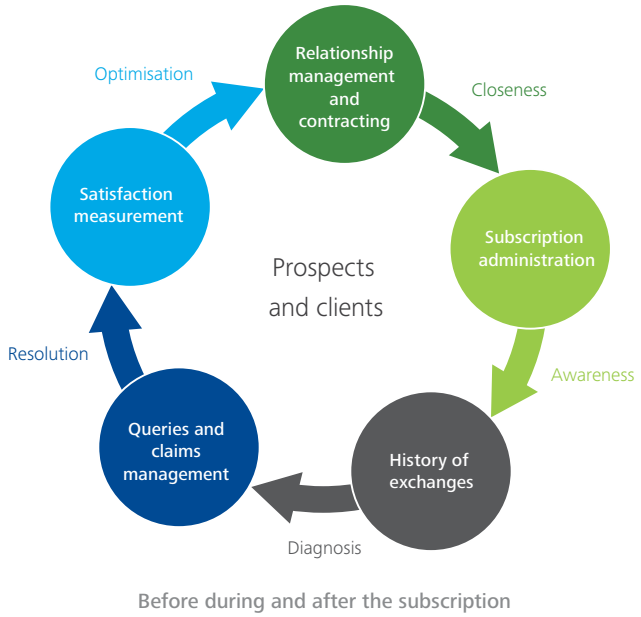
Source: Deloitte IMS 2013

Figure 7: 2013 for French 'boutiques'



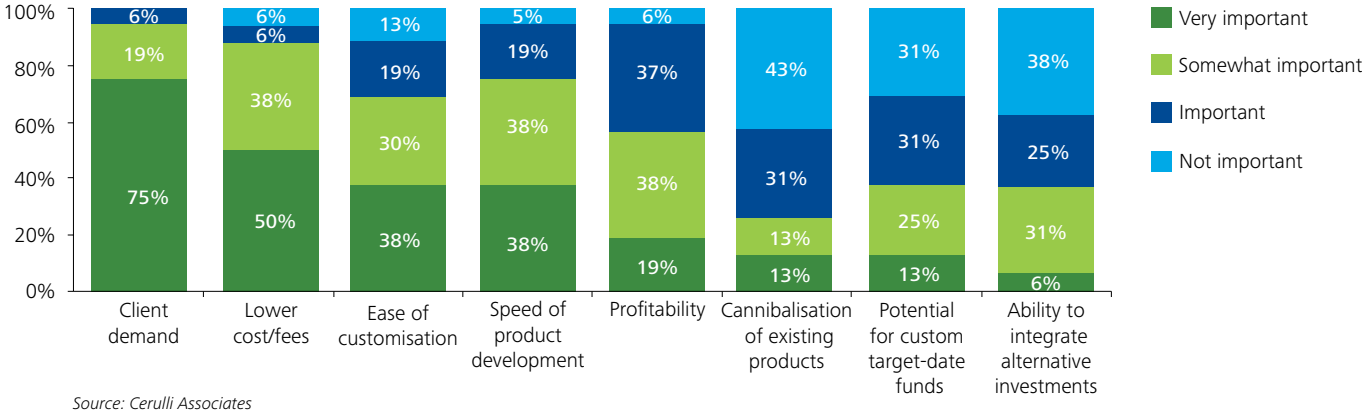
Source: Deloitte IMS 2013

Figure 8: Prospects and clients



Source: Deloitte IMS 2013

Figure 9: Asset manager considerations for development and distribution of CTFs, 2012



Source: Cerulli Associates

Approved quality products and marketing and sales functions to be developed

Even though considerable progress has yet to be made, particularly—as previously mentioned—in operational marketing, client service, brand development or even a strategic approach, French 'boutiques' are well on the way to providing international markets with well-established and diverse expertise.

Most of the services they provide are based on traditional equity, euro and balanced management approaches (DNCA, Sycomore Gestion, Métropole Gestion, Mandarine Gestion, etc.) but some also encompass management processes or operate in innovative sectors (Schelcher Prince Gestion, Tikehau, Tobam, SPGP, etc.). We are still waiting for the entire industry to come together to continue these initial successes and thus promote the emergence of these 'new champions.'

To the **point**:

- Faced with sluggish French sales over the long term, French boutiques have started to deploy their expertise internationally
- While their initial successes were achieved from given opportunities, they now build strategies based on the identification of products sold and the sales organisation
- Nevertheless, considerable progress is still needed in brand development, operational marketing and even client service
- The international expansion of French boutiques should enable investors to enrich their range of management strategies by relying on innovative management processes or original spheres of activity, as well as more orthodox management techniques tailored to current expectations

Adopting an international market positioning, even if limited to local markets, requires the monolithic model to be adapted to a dual organisation, incorporating development functions on a wider scale

French asset management boutiques
A success story

After having accelerated its development overseas over a period of two years, Oddo Asset Management is now starting to reap the benefits of its international development strategy. The French independent management company, which recently opened offices in Italy, Switzerland, Germany and Singapore, reported net asset inflows of €600 million in 2013, representing a 50% increase compared to the previous year. 65% of net inflows come from foreign investors and 55% from institutional investors. While the firm is seeing the positive outcome of its international expansion with distribution networks, especially in Italy, discretionary mandates have been won in Asia and the Middle-East. With the objective of pursuing its international strategy, ODDO AM has been certified as GIPS compliant, enabling it to serve a highly discerning international institutional clientele.

Reflecting on his experience, **Nicolas Chaput, Oddo AM's Managing Director,** gives us the do's and don'ts of going global.

Deloitte: Can you briefly describe your international development strategy?

Nicolas Chaput: If I had to summarise our strategy in just a few words, I would say that it is structured around three key directions: our geographical presence, our products and our targeted clients. The way we implement it is then directed by a core value, deeply rooted in our DNA, which is pragmatism. What I mean by that is the flexibility we can demonstrate and the objective vision that we have of our strengths and weaknesses. Our international expansion is intricately linked to this approach based on the experience we drew from our deployment outside of France and our ability to identify opportunities from our office in Paris. We make it a matter of principle not to get ahead of ourselves. Given our size we could not do it any other way. For example, the opening of our office in Milan in 2012 only came after extensive contacts were made by our salespeople in Paris. It was the match between the products we had to offer and potential clients in Italy that justified the provision of additional resources and the local presence.

Deloitte: How did you come up with the idea of going international?

Nicolas Chaput: Our international development strategy started from a simple observation: Oddo Asset Management was very well established in France, its domestic market. Although France accounts for 15 to 20% of the European Asset Management market, its growth potential remains weak. In this context, the eurozone, with its single currency and its intense movement of goods and services, appeared to be an obvious choice for us. By leaving our comfort zone, we also wanted to diversify our client portfolio, enter international competition and upgrade our level of professionalism. We also took this

step because we were certain that our business model could be exported. Oddo is a group with a long history; it has real capital independence and a structure based on partnership, associating the company's main stakeholders. These are principles and values that a great number of investors around the world can relate to.

Deloitte: What were the main aspects of your international development strategy?

Nicolas Chaput: Going back to the three main directions that I mentioned previously, I would say that we strived to measure the attractiveness of our products on the markets that we targeted from our practice in Paris. Regarding the client focus, we were guided by the principle that we should definitely avoid covering a client range as wide as the one we have in France.

We first analysed what our strengths were and how we could meet the demands of clients. Drawing on this analysis, we then allocated resources accordingly. The same goes for the product focus since not every financial product in the French range was necessarily suited for international clients. This naturally implies making choices on what we can provide and what is left to do. The creation of a Luxembourg-registered SICAV is good example of this effort. Regarding the geographical aspect, this depends heavily on the need to establish a close relationship with our clients. Clients, cultures, opportunities and regulations will determine whether a local presence is necessary.

Deloitte: Beyond these aspects, how did you structure the implementation of your strategy?

Nicolas Chaput: Our approach was structured according to the analysis of our main strengths. It is very important to realise that Oddo AM was almost unknown outside of France. When you are knocking on the door of someone who does not know you, you better have strong arguments and what I call legitimacy. As an asset manager, this means a pretty solid track record, a stable team, a significant volume of AUM and consistent performance over a long period of time. Since it fulfilled all of these conditions, we first pushed our European mid-cap range. We then continued with our range of convertible bonds.

The second aspect of our strategy is inherent to the need for higher levels of professionalism. It means being able to offer all our skills in the local language, regulatory environment and currency where applicable. The more you can make clear what and who you are, the more it helps when no one knows you. The GIPS certification is an integral part of this process, as it means being able to tell a client that they can verify your current asset volumes and performance on a certified basis. It is of course a serious commitment and an additional way of making your practice stand out.

Deloitte: You mentioned the identification of products likely to appeal to targeted markets, what made you sure those products could meet foreign demand?

Nicolas Chaput: Initially, our salespeople based in Paris started to test markets in a defined number of countries in which the addressable AM market was deemed to be of sufficient size. In order to gain more credibility with potential institutional clients, we sometimes had to use global and local consultants. We worked on the global clients segment as we would with clients (rating of our investment strategies by the global consultants, beauty contests, etc.).

Deloitte: What were the obstacles to implementing your strategy?

Nicolas Chaput: The first challenge that we had – and which is, in my view, often overlooked – is the uncomfortable truth that you may be completely unknown to foreign clients. International development is in that sense a tremendously humbling experience. When you embark on this incredible adventure for the first time, you have to face the reality that no-one may know you. And what this means is that you have to prove your worth once again. It also means being able to take an objective look in the mirror.

On top of all this, going international requires a lot of patience. This is really something you will need. No one really understands how much time is needed when you plan on having a fund registered abroad. Another issue is that of technical constraints. For instance, it is totally inconceivable to think for one second that a fund can be traded in euros in the Middle East or in Asia. Structures created under French law are clearly losing favor compared to entities incorporated in Luxembourg when it comes to selling abroad. The success of the operation is not based solely on the asset manager; it is a value chain with the valuation agent and the custodian being other essential links. You need those people to have a significant experience abroad; otherwise you run the risk of things going wrong.

> It is absolutely necessary to take the time to step back, look at all your options and analyse your strengths and weaknesses. Do not seek to replicate your domestic business model. Humility is probably the best quality you can have

Deloitte: Did all this require some cultural adaptation in-house? How did you address it?

Nicolas Chaput: I will give you an example that illustrates the situation quite well. Five years ago, French investors accounted for 90% of our annual asset inflows. Today, 65% of our net asset inflows come from abroad. There are two key ideas to keep in mind: the first is that even if you are convinced that going international is the right path, it takes some serious convincing when only a small fraction of your total asset inflows come from abroad. Believe me, you need nerves of steel to do that. The second is that you must first reassure management that you are not abandoning your domestic market – because it still is important to you – but that you are starting to allocate additional resources to your activities abroad because that is where the company needs to look to find new growth drivers.

This organisational renewal requires hiring profiles that make it both possible for you to go global and that somehow act as catalysts for change. This means having salespeople who can speak several foreign languages – or at least English – fluently, and that have good knowledge of the cultural contexts in your target countries. But the commercial division is not the only department to be affected by this process.

Going abroad dramatically changes the way the risk and compliance department operates. Whereas it was only focused on ensuring compliance with French laws and regulation, it has now to take applicable foreign laws into account. Going international will impact the company as a whole, including client service, which guarantees the quality and the sustainability of the relationship with your clients. As you are going to enter new territories, you will need either local salespeople or people that have the skills to speak local languages and understand cultural differences.

Another adaptation we had to face was the need for wider diversification of the geographical profiles of our managers to enhance our credibility among international clients.

Deloitte: What kind of measures have you taken to assert your position in countries in which you were not established before? How did you raise awareness of your brand, your expertise and your product offering?

Nicolas Chaput: Operational marketing and press relations are an integral part of the chain I mentioned above. We are currently focusing our efforts on three main areas: press relations, events and our website. Through our PR activities we are trying to raise awareness of our expertise in the local media. The organisation of local events is also very important when it comes to bringing our services closer to clients. A close relationship with our clients is a fundamental aspect of our strategy.

Deloitte: Looking at where you stand today and drawing on your experience, what would be your advice to those willing to expand into international markets? Are there any necessary steps and pitfalls to be avoided?

Nicolas Chaput: Probably the best advice I could give to someone is to avoid attempting to deliver everything, everywhere. It is absolutely necessary to take the time to step back, look at all your options and analyse your strengths and weaknesses. Do not seek to replicate your domestic business model. Humility is probably the best quality you can have.

I would also say that you need to have your product offering ready. Nothing is more disastrous than talking about your investment products to a client and not being able to offer them locally. From the appropriate legal structure to local registration of your fund and the choice of currency, everything must be ready to hit the ground running. And you better not disappoint on all of those key elements.

Some strategic markets turn out to be less accessible. For this reason it is useful to be able to serve markets that are closer to you and for which you are almost certain to benefit from rapid returns on investment. These markets will allow you to finance markets that are both geographically and culturally more distant but are also more promising.

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Investment Funds Introduction

- Introduction to IFRS for Investment Funds - *11 SEP*
- Introduction to Hedge Funds - *14 AUG*
- Introduction to Private Equity - *28 AUG*

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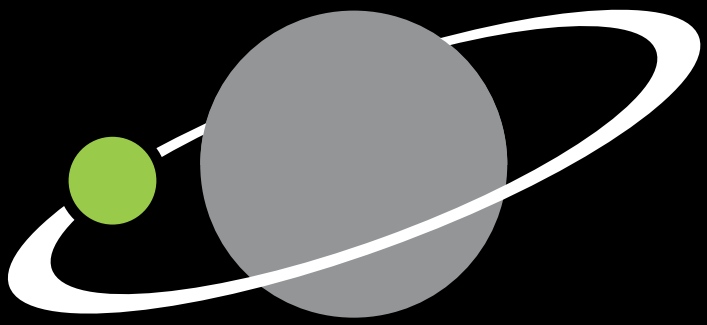

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