Optimisation of the trade management cycle in the investment industry

Jordy Miggelbrink
Senior Consultant
Advisory & Consulting
Deloitte

The world of the investment management industry is in full motion: new and increasing regulations, enhanced perspectives in the market environment and new technologies are the only constants in today's world. These developments follow each other rapidly, in shorter cycles, with new continuously changing requirements for investment managers to deal with.

Their current operating models, core processes and supporting software are in many cases insufficient, disorganised and not exploited to the full, and will prevent them from achieving operational outperformance. The capacity of today's investment managers to cope with these challenges will determine whether or not they survive the next decade.

Inefficiently organised operational processes will lead to inaccurate internal records on trading and settlement activity. Organisations are exposed to uncertainty in their trading position, affecting the accurate prediction of settlements, and weakness in verifying securities and cash held with custodians. Operational costs arising from activities such as reconciliation, accounting and reporting will consequently be excessive, resulting in a direct negative impact on overall company profits. Therefore investment managers' success can not depend solely on their investment expertise but also on the organisational capacity to adapt to their environmental service needs, without losing sight of the primary defined investment goals and profitability.

Environmental developments

It is generally expected that the industry will have to face massive changes in the economic and investment landscape. Numerous opportunities are anticipated in emerging markets and major challenges will arise in existing developed markets. Increased market volatility and aging societies (and outflows from pensions and life insurance funds) in diverse parts of the Western world will test if investment managers are capable of tackling these changes in an efficient manner.

Besides these market driven challenges, there are also considerable changes taking place from a regulatory point of view. For example, regulations such as the Foreign Account Tax Compliance Act (FATCA), Alternative Investment Fund Managers Directive (AIFMD), European Market Infrastructure Regulation (EMIR) and Dodd-Frank Act all affect an investment manager's execution costs and margins.

All these 'revolutions' will have an impact on investment managers' ability to transform their business models, investment strategies, (risk) policies and procedures and accounting with the aim of creating an increasingly agile and requirement-fulfilling operational organisation.

Back to the 'roots'

Given these enormous shifts, the market belief is that investment managers have to return to their roots—their primary investment objectives—by rethinking their strategies. These 'new' defined strategies will be focused on absolute returns, accepting minimal risk with an extended investment horizon in a quest for long-term results.

To cope with these changes on a strategic level, investment managers will have to reconsider their fund structures, fee models, asset allocations, valuation cycles and organisational structure, bringing these in line with each other.

Dealing on a practical operational level, we can introduce the 'trade management cycle', covering the core process of an investment manager. The 'trade management cycle' basically embraces the entire (automated) operational process, enabling investment managers to remain in full control of cash and investment positions at all times.

This requires up-to-date internal records on portfolio modelling, trading activity, confirmation, settlement, reconciliation, valuation, accounting, NAV calculation, reporting, performance management and risk management. Operational processes should be fully aligned with the newly defined investment strategies, current market standards and best practices. In this way, expected future developments can easily be followed as challenges are experienced market-wide instead of by a specific investment manager. By making use of best-in-class market systems in the original design and related usage of data, investment managers will be able to improve efficiency and agility in order to meet all environmental demands: delivering operational outperformance towards clients and regulators at optimised costs.

Market initiatives for market standards

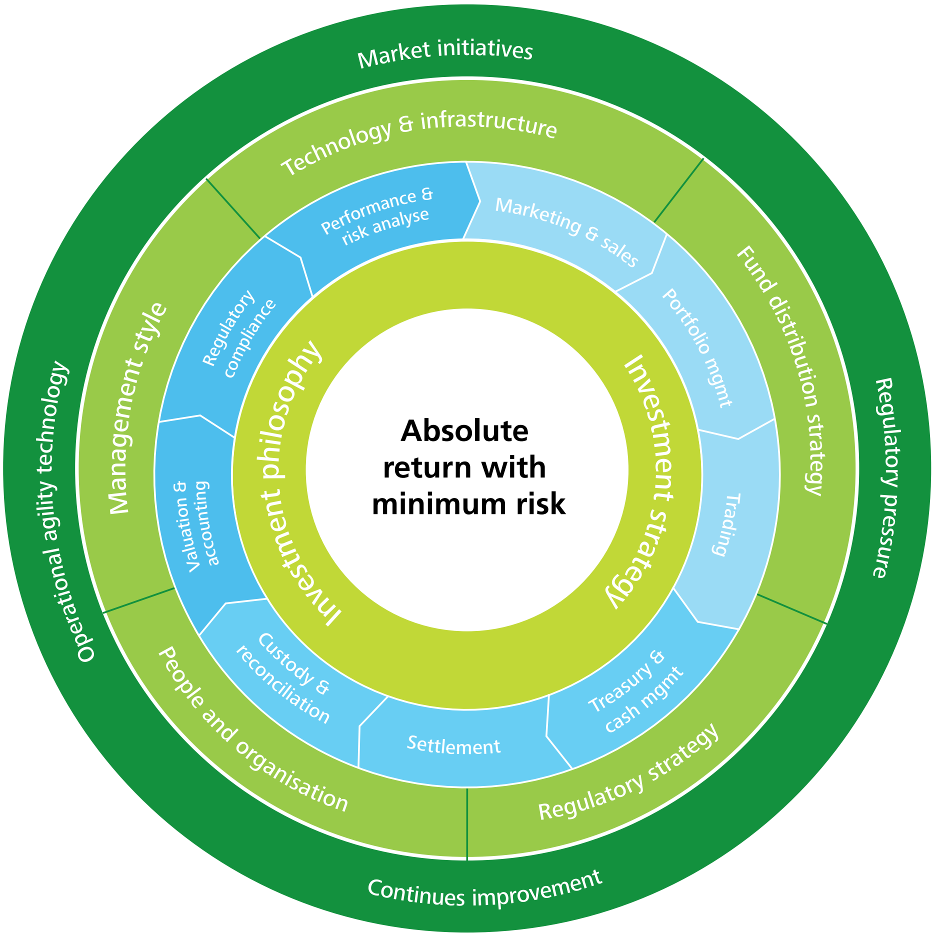
The redefined strategies, initiated by various market developments, have a direct impact on the 'trade management cycle' and processes of investment managers. Historically developed structures are not able to deal with these new developments. Perspectives have been changed drastically—for example, the front, middle and back offices are no longer considered as separate departments when discussing the operating model. Increasingly, order and trading staff are aware of downstream processing, avoiding trade exceptions and settlement or reconciliation failures.

Worldwide initiatives addressing best practices and related market standards have already been launched. These are focused on improving and standardising the industry's operational infrastructure for investment managers and other types of financial institutions. Examples are the International Securities Association for Institutional Trade Communication (ISITC)', Securities Industry and Financial Markets Association (SIFMA) and International Swaps and Derivatives Association (ISDA).

These associations are mainly focused on removing bottlenecks by building robust, stable market standards enabling increased transparency, flexibility and simplicity within the benefits of facilitating Straight-Through-Processing (STP) among investment managers. These market best practices should therefore be the starting point for changes based on processing, organisational structure and other supporting areas within the investment manager's organisation.

Optimising the trade management cycle

Investment managers capable of implementing an optimised, fully automated 'trade management cycle' supported by market best practices will have the greatest chance of survival in the long term. Despite the fact that market conditions, regulations and financial frameworks are 'in principle' similar, it will be a different 'journey' for every investment manager. As mentioned before, the investment philosophy, investment strategy, organisational culture and long-term vision will influence the exact steps taken by each investment manager.



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The expectation is that one of the following strategic approaches will be pursued:

Collaboration with an innovative (software) partner
Investment managers will investigate possibilities and solutions which are currently not available on the market but will lead to significantly higher efficiency in the 'trade management cycle'. These systems are consequently in line with current market best practices and expected new protocols.

This strategic approach is characterised by intensive collaboration with an innovative software vendor which has an in-depth knowledge of the specific and complex market developments. The advantage is that both parties, with their own background perspective and specialties, investigate and analyse the market and combine their results into one solution. A possible drawback may arise if the collaborating parties do not agree with the overall solution based on their own analyses: an unclear direction may eventually lead to the investment manager adopting an inefficient operational process.

Investment managers must be prepared to adapt to structural shifts in the markets, regulations and investment landscape while focusing on their investment philosophy and strategies

Innovation by internal developments

Another possibility is that investment managers push to change the structure by establishing an internal software department or platform charged with redesigning and rebuilding the required functions into the 'trade management cycle'. The challenge for this department is to stay in line with current and future market developments and standards: where standards and best practices are identified too late, these must then be reverse engineered into the solution which has already been chosen and designed. This can lead to unforeseen and increased organisational expenditure, especially in this constantly changing and complex market. Another challenge for this strategic approach is that operational departments should focus on their key operational objectives and not be distracted by redefining the solution's business requirements.

Standardised software

Currently a more common strategic approach is the implementation of business-specific applications which support the 'trade management cycle', known as off-the-shelf solutions. These business solutions, often offered by well-known vendors, are specialised in a part of the operational process of the complex investment management market. The advantage is that the software vendor will follow market developments based on their specialised experience and a wide range of clients' requirements. However, there may also be disadvantages, such as if the software vendor is overly specialised in one (small) part of the 'trade management cycle' and therefore cannot foresee the challenges on the complete process level. Furthermore, when discrepancies between software packages and protocols appear, specialist vendors will be reluctant to change their own structure or processing and are likely to advise other vendors to do so.

Outsourcing

The last and increasingly used strategic approach is to outsource secondary organisational processes, thereby allowing organisations to focus exclusively on their primary objectives and processes. In the case of an investment manager, the primary process functionalities are portfolio modelling, trading activity, confirmation, settlement, reconciliation, valuation, performance management and risk management. The supporting processes, such as transaction and security processing, NAV calculation, accounting and reporting, are not directly part of the primary processes of an investment manager. These secondary processes in the 'trade management cycle' will generally not differentiate an investment manager from competitors. Outsourcing could lead to operational efficiencies and reduce costs associated with technology, staff and real estate. When new instrument classes, products or services are requested in the future, these must be enabled by the service provider without any extra implementation costs in terms of the outsourced processes. However, with this strategic approach, it is in the best interest of both parties to have a close partnership based on mutual collaboration so that possible (transition) problems can be tackled successfully should they arise.

Conclusion

The past few years have proven to be turbulent times for investment managers. These financial service organisations were not fully equipped to respond effectively to highly volatile financial markets while simultaneously achieving the investment objectives agreed with their clients under difficult circumstances. Investment managers should be prepared to adapt to structural shifts in the markets, regulations and investment landscape while focusing on their investment philosophy and strategies. In order to effectively support these primary processes, the 'trade management cycle' should be aligned with both current and future market standards and best practices.

Two strategic approaches are advisable in order to optimise the 'trade management cycle'. Given the significant developments in environmental and technological areas, it is the expectation that the investment management sector will be strengthened by intensive long-term mutual collaboration with innovative software partners or outsourcing parties. This enables the optimal implementation of solutions which are technologically and functionally best-in-class. Intensive mutual collaboration ensures that both parties are committed for the long term, improving the delivered quality of the 'trade management cycle'. Realising an operational investment management process, which is based on accurate, timely and fully accessible financial positions, facilitates the right investment decisions and the achievement of absolute returns benefiting clients in the long term.

To the **point**:

- The investment management organisations that will be best equipped to survive are those that can quickly react and adapt to the environmental, regulatory and technological developments of the next decade
- Well-developed investment strategies and philosophies are essential but investment managers should also focus on improving their trade management cycle; optimising operational efficiencies to deliver sustainable cost savings reduces overheads and pressure on the investment portfolio's absolute returns
- There are two suitable strategies for optimising the trade management cycle; both focus on developing long-term mutual collaboration with specialised and enhanced partners. The first option is collaboration with an up-to-date software vendor which can support the optimal trade management cycle by implementation of 'best of breed' software. The second option is collaboration with a specialised outsourcing partner who has experience across the sector in resolving the complex challenges presented