New Opportunities in Alternative Mutual Funds

New alternative investment strategies for the Canadian mutual fund industry - Finding tools and techniques to create attractive, competitive investor offerings and enable best execution financing.

Canadian Mutual Funds

ENSO

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Foreword

In a global investment management landscape characterized by changing investor behaviors and preferences, squeezed margins, ongoing and asynchronous regulatory reform across markets and rapid technology innovation, 2019 is set to be a year in which allocation to liquid alternatives will be an increasingly important tool.

In the US, for example, liquid alts or alternative mutual funds have become increasingly attractive to retail investors. In Canada, investment managers have been permitted to launch and market non-traditional funds to retail investors since January 3, 2019 (Canadian Securities Administration legislation NI 81-102). This opens up the $1.3 trillion Canadian mutual fund industry to alternative investment strategies for distribution to the public for the first time. In Europe and beyond, alternative UCITS became more prominent in around 2009 as retail investors sought access to hedge fund-like strategies. Today there are c. 1,400 alternative UCITS funds globally managing over EUR 500bn AUM.

Expanding into new asset and investor classes brings new opportunities but also new challenges, not least changing portfolio dynamics, risks and regulatory requirements. Consequently, asset managers of all sizes are seeking the tools and techniques to create attractive, competitive investor offerings and enable best execution financing.

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1. Introduction

Alternative mutual funds permit investment strategies that extend beyond traditional long-only cash, bond and equity investment, enabling investors to diversify their investments, limit their downside risk and potentially increase returns. This includes private equity investments, hedge funds, commodities, derivatives, managed futures and real estate. At the same time, investors in liquid alts maintain a high degree of liquidity (e.g. same day access) and a diversified risk profile.

Traditionally, alternative mutual funds (previously known as commodity pools) were the domain of institutional investors; however, since January 3, 2019 (Canadian Securities Administration legislation NI 81-102), investment managers have received permission to launch and market non-traditional funds to retail investors. Alternative mutual funds can be appealing to retail investors for a variety of reasons. In particular, retail investors can benefit from diversification and access to new, previously inaccessible markets whilst maintaining access to same day liquidity.

For asset managers, the ability to tap into a new investor base and expand both assets under management and profitability is a powerful incentive. In some cases, they are expanding their existing retail portfolio to incorporate non-traditional mutual funds, while others are extending existing offerings to the retail investment community for the first time. In both cases, asset managers need to understand the changes required to their own business to manage these new business strategies and the associated regulatory and reporting obligations. For example, many managers will employ leverage, stock lend and borrow, and manage collateral for the first time, depending on their investment objectives and principal investment strategies. Rehypothecation of securities may now be possible to collateralize short sales or variation margin on OTC derivatives, allowing for more efficient cost of funding these strategies. This creates significant additional complexity for treasury, particularly in the middle and back office.

By accessing a software-as-a-service (SaaS) treasury solution supported by a vendor with a track record, financial stability and combination of technical and industry expertise to continue investing in solutions and services, asset managers can make the transition to new audiences and fund types whilst managing their risks, reporting and operational burden.

2. Oversight and regulatory compliance

One of the biggest challenges facing many asset managers, particularly when expanding into new asset classes and markets, is to comply with regulatory requirements. Using the right technology can be a valuable enabler to achieve this.

Securities regulations continue to change in every market, and as each regulator's priorities may differ, these changes are often asynchronous and create different obligations. As a result, asset managers operating in multiple markets can find it particularly challenging to navigate and comply with the regulations in each market in which they operate. Whether operating in one or multiple jurisdictions, asset managers need the flexibility, functionality and data transparency to comply with changing regulations over time in a cost-effective manner and without comprising operational efficiency.

While the use of technology in itself does not lead to regulatory compliance, asset managers' use of a treasury solution with a considerable degree of transparency, rich data and comprehensive metrics is a valuable way of supporting the assessment of compliance, monitor limits and support price discovery, etc. that is required to achieve regulatory compliance in the relevant markets. The need to comply with relevant securities regulations also creates specific functional requirements. For example, asset managers need to comply with strict conditions on leverage levels for compliance purposes, so these need to be monitored and managed. In some cases, fund managers will rehypothecate client collateral which again needs to be managed carefully. Counterparty exposure and net asset value (NAV) limits need to be calculated in line with policy, utilization monitored and reported, and breaches alerted. In many cases, asset managers have been accustomed to reporting NAV on a monthly or periodic basis, but alternative or active mutual funds need to provide daily NAV calculations, creating new operational requirements.

Equally importantly, effective use of the right treasury solution demonstrates to investors that their managers are employing the necessary oversight and control over their operations and decision-making.

3. Optimizing an alternative investment strategy

Effective treasury solutions deliver significant value beyond compliance, however. The right treasury technology plays a key role in creating operational efficiencies, implementing effective controls and achieving scalability both in the breadth and volume of an asset manager's activities. It also allows managers to harness traditional and alternative data sets to create insights, inform decision-making, achieve best execution financing, thereby enhancing the overall investor experience.

While these objectives may be common to investment managers across all asset classes and investor types, there are some specific considerations for those offering alternative mutual funds. For example, some will be engaged in activities such as managing collateral and securities financing requirements for the first time, creating specific functionality requirements from the treasury solution.

A SaaS-based treasury solution from a well-established provider such as ENSO enables treasurers to harness data, make informed decisions and act on insights across the full spectrum of both traditional and alternative asset classes, including:

Harness data Collect, collate, standardize and track data from both traditional and alternative sources to create a rich, harmonized data set for reporting and analytics	Portfolio Finance	Track all securities lending activities post-trade and settlement date Create a central repository of all relevant securities finance information Access re-rate tracking, community benchmarking and analytics Track financing alpha post-execution Facilitate the stock locate process across multiple regions and brokers.
	Data Insights	Using signals that can drive investment decision making processes Observe industry trends Understand the cost of financing when deploying alternative strategies.
Optimize decision making and operations Use data to model scenarios, provide 'what if' analysis and optimize asset allocation, stock lending and rehypothecation	Best execution	Financing Cost Opportunity Analysis Short position life cycle community benchmarking Margin and Exposure Limits tracking
	Portfolio management	Highlight opportunities to long lend, and optimize inventory Stream prime broker inventory axes and identify opportunities Allocate costs to portfolio manager/ strategy/ fund automatically Perform wallet targeting and tracking
	Cash & collateral management	Replicate prime broker financing rules to reconcile and identify cost reduction opportunities Highlight inefficiencies within a portfolio to reduce cost or risk and optimize collateral allocation Consolidate all margin statements to identify and analyze capital drivers
	Balance sheet & wallet optimization	Assess balance sheet impact by individual prime broker, including calculating return on assets (ROA) to drive decisions

Governance and compliance oversight Support the assessment of compliance with internal audit and external regulatory requirements	Reporting and Auditability	Provide full auditability of system actions and point-in-time positions to demonstrate decision-making
		Support a comprehensive and flexible reporting suite.
	Counterparty Risk Management	Calculate and report on counterparty exposure daily or on demand, including limit utilization and breach notifications
		Manage broker consumption and compute, manage and track execution and financing wallets to complete broker assessment reports (e.g. RTS 28 Article 2).

4. Leveraging technology for competitive advantage

Implementing and making effective use of the right treasury technology is essential to leverage the opportunities that liquid alternatives offer whilst addressing the compliance, operational and decision-making challenges. Many small and mid-sized investment managers lack the necessary resources to build these capabilities in-house or to acquire, host and maintain large-scale technology solutions. Larger asset managers too find it difficult to justify channelling resources into development, implementation and maintenance of middle and back office solutions instead of client-facing activities and systems. As a result, we are seeing a growing number of asset managers of all sizes acquiring third party SaaS solutions and migrating their operations to the cloud.

Today, the quality, depth, scalability and affordability of third-party solutions now vastly exceeds what a fund manager could create independently. Upfront and ongoing costs are far lower and time to market significantly shorter, a key issue for fund managers in today's fast-changing environment. Furthermore, the use of SaaS solutions allows asset managers to de-risk and accelerate adoption of new treasury technology, and enables them to expand into alternative asset classes and new investor groups more easily than on-premise solutions:

***Implementation and maintenance cost and risk**. SaaS solutions enable rapid deployment without substantial upfront and ongoing investment and without diverting resources from the company's core purpose. The solution is maintained over time in line with evolving market, investor, technology and regulatory requirements, providing asset managers with agility, operational scalability and lower fixed costs.*

***Functionality and scalability to support changing business needs.** Fund managers extending their reach of activities into alternative funds and/ or targeting a new investor audience can support new requirements, such as collateral management, quickly and scale their operations as their business expands and new regulatory requirements emerge.*

***Data-driven approach to insights and decision-making.** A SaaS solution such as ENSO provides fund managers with on-demand storage and processing capabilities, enabling a far more agile and sophisticated approach to data and techniques such as advanced analytics.*

Access to expertise, experience and best practices. *By working with a supplier with a commitment and ability to invest in solutions over time, expertise developed over many years, and a diverse community of clients facing similar challenges, asset managers embarking on new strategies can tap into a wealth of experience, insights and best practices.*

5. Meeting the strategic imperative in liquid alternatives

The use of liquid alternatives offers significant potential for asset managers to build their investor community, client satisfaction, assets under management (AUM) and profitability. To leverage this potential, however, requires agility, human and technology resources and strategic vision to anticipate and respond to changes in investor behavior, regulatory changes and market volatility. Ultimately, asset managers' success in doing this is measured in investor value. Investment in technology is one way to achieve outperformance in financing alpha (the combination of quantifiable savings and revenue uplift) against industry peers, and free up resources for more value-added activities. Asset managers should ensure that their chosen treasury solution has a track record of meeting new functional requirements and delivering financing alpha to its clients through efficiency savings, improved risk management, best execution financing, better-informed decision-making and enhanced returns.

To find out more about how your treasury can harness data, make informed decisions and act on insights, please contact sales@ensofinancial.com

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