



The Search For Higher Returns

REQUIRES HIGHER LEVELS OF EXPERTISE AND VIGILANCE

There is growing demand from both institutional and, increasingly, retail investors for transparent products offering prudent investment styles, within familiar regulatory frameworks—such as those provided by mutual funds—but involving exposure to enhanced investment strategies.

Pension fund managers are also looking at ways to both enhance returns and diversify risk. They are looking at alternative investment classes—physical assets (real estate, commodities) as well as private equity, hedge funds and structured products.

Investing in these instruments brings a number of administration challenges that do not occur with more traditional investment portfolios. Failure to properly account for these issues can have serious consequences:

- Lower returns
- Additional costs
- Regulatory infringement
- Covenant risks
- Reputation risk

As alternative investments are becoming part of the mainstream, fund managers and institutional investors need to answer a number of questions:

- What are the true values of underlying investments?
- Do investors/trustees really understand the nature of their exposure?
- Have operational and performance idiosyncrasies been properly identified?
- How can additional risks that arise be mitigated?

SOME ALTERNATIVE INSTRUMENTS CAN BE DIFFICULT TO VALUE

Valuing nontraditional asset classes can be problematic. Take the case of investing in hedge funds or a fund of hedge funds—many contain clauses allowing them to close funds or strike valuations at intervals that suit the manager. For the institutional investor, this may not be frequent enough (e.g., in the UCITS world, the NAV needs to be struck on a daily basis).

Investing in these instruments brings a number of administration challenges that do not occur with more traditional investment portfolios.

Many long/short funds achieve their “short” investment through swap baskets—contracts for difference (CFDs). However, valuing the instruments properly requires “looking-through” to the underlying instruments. To complicate things further, some of these may be over-the-counter derivatives. Lack of benchmarking information means valuations will have to be calculated using a valuation model (so called “mark to model” valuation)—and valuation models vary across the market.

MANAGING EXPOSURES CAN BE TRICKY

Similar problems arise when monitoring and managing counterparty or credit exposure. While measuring these may be relatively straightforward in the traditional long-only world, using alternative strategies adds complications. Take the example of a long/short fund using a CFD. To fully understand exposure risk, the manager must understand the underlying elements within the basket in order to aggregate (or net) these with other exposures to that issuer.

In respect to counterparty exposure, total exposure may be affected by the collateral to be provided to, or received from, the counterparty to a derivative trade.

Collateral fluctuates on a daily basis dependent on the value of the instrument. In the case of OTC derivatives, two issues arise: the administrative burden of managing and tracking collateral, and the risk that the valuation process may be inaccurate.

Furthermore, many alternative investments are much more

illiquid than traditional investments—whether physical assets such as property or commodities or hedge funds with lock-in clauses. So even if an exposure has been identified as excessive or in breach of the fund’s investment strategy, it is often impossible to quickly unwind the position.

OPERATIONS BECOME MORE CHALLENGING

Numerous operational issues arise from an enhanced investment strategy. A manager may decide to engage the services of a prime broker for both trading and asset servicing. However, not all prime brokers support SWIFT standards, so a scalable proprietary reconciliation system will be required to capture inputs and carry out reconciliations.

Fund managers may choose to manage their own swap portfolios. As the size of a synthetic portfolio grows and the types and complexity of the instruments increase, administration problems surface. With 50 open positions, it may be possible to keep control via a spreadsheet alone. But once the number rises to around 500, things are not so simple. OTC derivatives are instruments with as distinctive a trade life cycle

as any cash market instrument, and are subject to a series of events which must be managed continuously. Fund accountants will find that to accurately record transactions, monitor them through their life cycles and provide valuations based on sophisticated modelling, is an expensive proposition—both in terms of systems and resources.

Managers must also ensure they have sufficient cash to meet the collateral and margin calls required for physical short positions and derivatives contracts. To ensure cash is available, managers may find they are obliged to hold substantial long balances of cash in a fund ostensibly set up as equities only.

Demands on pension funds to analyse performance are accelerating. Liability-driven investments, funding shortfalls and other challenges mean performance is key. At the same time, the move toward alternative investment strategies means monitoring that performance is becoming increasingly complex, requiring the use of sophisticated modelling and systems.

HOW CAN THESE ADDITIONAL RISKS BE MITIGATED?

Many fund managers and institutional investors

considering such strategies have one major drawback: their back- and middle-office systems were designed for the more traditional long-only equities and bonds. Consequently, fund administrators and pension fund trustees need to look carefully at their in-house systems, processes and staff and consider if they are up to the job.

The risks and administration challenges in this new world can be substantial, particularly taking into account the highly regulated framework within which they operate. If their systems are not appropriate, then they will either need to buy more in-house expertise and systems or outsource part or all of their back- and middle-office functions to a third-party provider.

JPMorgan has been working with clients to structure multi-product solutions to meet the specific needs of its investor clients. We have built a set of solutions which we believe to be unique in the industry and address the issues outlined above.

For more information about our products and services and how we can help you meet the challenges of these new investment strategies, please contact your JPMorgan representative. ○

