Speaking of Alpha

Accurate, Enterprise-Wide Cash and Positions with an Investment Book of Record

A conversation with Dick Taggart

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A scalable, unified platform of software, data and services that produces a single, consistent, enterprise-wide "source of truth" is increasingly essential for asset managers.

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Our *Speaking of Alpha* series features insights and commentary from State Street Alpha platform experts on data, operations, technology and services.

In this article, Dick Taggart, head of State Street Alpha℠ Platform Solutions, discusses the challenges of generating and disseminating real-time cash and positions, and how Alpha is helping firms tackle this issue and build a more resilient infrastructure that is better aligned with emerging regulatory requirements and the complexity of next-gen investment products.

Against a backdrop of fierce margin compression and competition for assets, investment firms looking to differentiate are launching increasingly sophisticated investment products, including multi-asset funds, direct indexing strategies and volatility-capped funds.

But cost-effectively managing these new offerings creates a number of operational challenges for firms constrained by legacy technologies that are ill-suited to handling such products' inherent complexity. New regulations around liquidity risk management and collateralization of OTC derivatives can add another layer of difficulty.

These challenges share a common thread: without the ability to see a timely and accurate view of cash and positions across the enterprise, managers will struggle to meet new demands.

Why have cash and position management traditionally proven difficult for asset managers?

Buy-side firms have long been organized as investment teams, middle-office operations and fund administration which oversee outsourced fund accounting and custody. Investment teams need timely and accurate cash balances and projections for the portfolios they are managing regardless of whether they are comingled funds at their designated custodian or separate accounts held at a custodian selected by the account owner.

Maintaining and reconciling cash and position information across multiple custodians is a major operational task for many firms, requiring manual processing and often resulting in stale or inaccurate data being provided to portfolio managers and traders. This is because some cash flows are known and expected such as dividends, income and transfer agency subscriptions and redemptions. Others, including client instructed contributions/withdrawals and custodian FX are less automated, requiring reconciliation and research before posting to accounting systems. Even known cash flows can be subject to potential reconciliation or functionality issues like tax withholding. Subscriptions and redemptions can also be subject to revisions. All in all, cash and position management requires careful orchestration on a timely basis across multiple data sources in order to provide accurate data to the front office.

How can the middle office use technology and a global service model to deliver timely, accurate, independent cash and position data to investment teams for portfolio decision-making?

Technology vendors designed the investment book of record (IBOR) to address this need. IBOR serves as the "single source of truth" for portfolio cash, positions, valuations, profit and loss, and performance and risk. An accurate and independent IBOR is updated in real time, and reconciled daily against all custodians to deliver an actionable view of current positions and investable cash. IBOR acts as a translation layer between the front and back offices, allowing investment professionals to view and act on cash and position data.

Data accuracy is crucial, but it also needs to be made available in a timely fashion. Unlike end-of-day batch processes that deliver potentially stale data, IBOR can provide portfolio managers with near real-time data before and throughout the trading day, facilitating better informed investment decisions.

In essence, IBOR provides the front office with an investment-centric view of their portfolios, in contrast to the less useful custody/accounting-centric view delivered by back-office systems.

Massive subscriptions and redemptions during the market volatility in early 2020 were problematic for many fund managers. Did this experience highlight the role that cash and position management play in helping firms keep track of their investable cash?

Absolutely. Uninvested cash can be a significant source of tracking error for both actively managed funds and index funds that aim to replicate a fully invested benchmark. IBOR cash balances and projections, sourced from transfer agency transaction data and digitally pre-advised client movements, help portfolio managers make informed investment decisions based on expected cash rather than waiting for custodians to report actual cash balances a day or two later.

Eliminating “cash drag” is a top priority for portfolio managers. New subscriptions are only part of the picture. Cash flows, swap contract payments and maturities, free receipts, deliveries and corporate events also impact investable cash balances. By maintaining a timely and properly controlled record, an IBOR provides cash balances and forecasts that better inform a portfolio manager’s investment decisions.

One aspect of industry consolidation is that as firms grow, they increasingly expand their footprint by opening offices in new geographies. How does an IBOR support global asset managers?

Firms with trading desks across multiple time zones and geographies require fast and flexible reconciliation as they “pass the book” from region to region. IBOR controls and reconciliations can be configured in granular detail by portfolio or sleeve at specified times to prepare for trading in different regions. An IBOR must also be “regionally aware,” handling corporate actions, market holidays, fixed-income valuations and other regional nuances appropriately. Also, as there will always be some level of custodian breaks, it is important to recognize that the best IBOR control and reconciliation teams are able to research, resolve, and communicate those breaks quickly and effectively.

By maintaining a timely and properly controlled record of these events, an IBOR provides cash balances and forecasts that better inform a portfolio manager’s investment decisions.

What role does holistic cash and position management play in helping firms mitigate trading and compliance risk?

Trading errors resulting from stale or inaccurate start of day and intraday position data can trigger compliance violations, fines and potential investment losses. By ensuring that desks are trading on timely, accurate and complete information, IBOR can help prevent these errors.

Compliance teams need the ability to retrieve and/or reconstruct historic positions for faster, better informed responses to regulatory inquiries. Many back-office systems are unable to do this, which forces firms to perform time-intensive manual position reconstruction. An IBOR can help middle-office teams investigate and respond to regulatory inquiries and compliance violations faster by capturing and storing historic position snapshots that can be easily retrieved.

Operational resilience was top-of-mind for COOs as the pandemic created spikes in trading volumes and volatility just as firms globally were shifting en-masse to a remote workforce. How can an IBOR support resilience?

A robust IBOR provides a centralized and controlled view of cash and positions held at multiple custodians reducing the potential for data discrepancies and delivering higher quality data to portfolio managers.

Most providers of outsourced middle-office services deliver an automated and integrated independent IBOR, especially those providers who are GSIFIs operating under far higher resiliency standards than most investment managers. This has proven to be especially valuable during the pandemic as IBOR systems and control teams have performed very well, successfully handling material volume and volatility spikes while also shifting to a 100% "work-from-home" environment over a short period of time.

Adoption of the BSBC/IOSCO margin framework for uncleared OTC derivatives and FINRA Rule 4210 for TBA securities have significantly increased buy-side collateral and margin requirements.[1] What role does an IBOR play in helping firms meet these new industry standards?

These regulations are placing significant demands on asset managers to identify available cash and securities for collateral, and determine the most cost-effective collateral to deliver to satisfy counterparty requirements.

As a repository of position and cash data, an IBOR provides portfolio managers and operations teams with visibility into eligible collateral inventory and position updates of pledged securities. This minimizes internal communication errors which can be costly and time-consuming to remediate and enables firms to quickly identify cheapest-to-deliver securities.

[1] https://derivsource.com/2018/11/13/collateral-management-why-2019-is-the-year-to-build-a-long-term-strategy/

Growing adoption of new investment instruments and derivative-based yield enhancement strategies by fund managers requires that positions incorporating these instruments are valued correctly and in real time. Most legacy accounting systems can't support complex derivatives such as total return swaps and credit default swaptions. In contrast, an IBOR supports accurate valuations across the entire asset class spectrum. Exposures also need to be transparent across asset classes. An IBOR provides a critical safety check for flagging naked or uncovered exposures.

Securities must be correctly classified and valued and corporate actions must be applied. Fixed-income and derivative cash flows introduce further complexity. An IBOR's ability to feed performance measurement and risk reporting systems with accurate and enriched cash and position data in near real time allows managers to satisfy institutional clients' demands for greater visibility into portfolio and fund performance on an intraday basis. Accurate and consistent security master data is a critical input to the valuation process.

Liquidity risk is once again on the radar for both regulators and investment managers, given the recent pandemic-driven dislocations in fixed-income markets. How does position and cash management support the buy-side risk function?

Traditional silo-based views of individual asset classes burden operations staff with manual risk aggregation tasks that rarely present a current or realistic view of exposures. By maintaining a consolidated view of positions across asset classes, portfolios and funds, IBOR provides a firm-wide view of risk exposures. Importantly, this consolidated view respects portfolio sleeves required for allocating the management responsibilities among portfolio managers. Effective hedge construction and accurate risk analysis also require current position data as inputs. Properly enriched position data is also central to realistic performance measurement and attribution.

Final thoughts?

Firms are under relentless pressure to more efficiently and effectively support complex investment styles, asset classes, and account structures. We don't believe the pace of change will subside as firms continue to design differentiated products in response to investor preferences, competitor pressure, and regulatory requirements. Collateral management will also grow in importance for firms that make heavy use of OTC instruments for yield enhancement and risk management.

Challenges around cash and position management, accuracy, timing, and reconciliation will also persist. We believe that delivering a scalable, unified platform of software, data, and services that produces a single, consistent, enterprise-wide "source of truth" is absolutely essential for asset managers navigating these uncharted waters.

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