

Investment Performance Analysis

Market Practices and Industry Trends

Published January 2015
PK Consulting Ltd

Sponsored by



© PK Consulting Ltd 2015

Contents

1	Introduction	3
2	Measuring the Effectiveness of Business Functions	3
3	The BI-SAM Performance Best Practice Framework	5
4	Market Survey of Performance Practices	6
5	Survey Overview	8
6	Fixed Income Attribution	9
7	Manual Processing	10
8	Operational Scale	11
9	Conclusions	12
	Summary of Survey Findings	12
	Next Steps	12

1

Introduction

This paper describes the work completed to date as part of a program of research focused on the working practices of Performance functions operating within the global asset management community. The research programme was initiated in Q2 2014 and it will continue into Q1 and Q2 2015. This report describes the findings and conclusions of the work completed in phases 1 and 2 of the research program, and outlines the areas in which further investigations and analyses will be carried out in the next phase of the work.

The research was carried out by PK Consulting Ltd and was sponsored by BI-SAM.

2

Measuring the Effectiveness of Business Functions

A key question for any business is: How do you measure the effectiveness of your business functions? This question has become increasingly important for asset management firms over the past five years as 1) their clients have become more demanding and 2) the pressure on their profit margins has intensified.

The business functions in asset management organizations are usually divided into three groups:

- 1 The Front Office includes business functions such as investment management, investment risk, and research.**
- 2 The Back Office includes business functions such as investment operations (trade confirmation trade settlement, etc.), fund administration, and transfer agency.**
- 3 The Middle Office includes business functions such as Performance, Compliance, and Client Reporting.**

Measuring the effectiveness of Front Office business functions is straightforward. These functions are directly involved in creating value for the firm's clients. If these functions fail to meet the clients' expectations and objectives for investment returns, then the clients will take their business elsewhere.

Measuring the effectiveness of Back Office business functions is also straightforward. These functions have to operate within constraints and conform to rules defined by markets and regulators. Failure to do so will result in fines, compensation for clients, and in extreme cases the revoking of licences to operate.

Measuring the effectiveness of Middle Office functions is, however, less straightforward. These functions are not directly involved in value-creating processes and some, like Performance, are not subject to operational constraints defined by markets and regulators.

In fact, the situation is particularly difficult in the case of Performance functions because the measurement and analysis of investment performance is an inexact discipline. There are different ways to calculate the performance return for a portfolio (e.g. internal rate of return, modified-Dietz, daily time-weighted) which will usually deliver different results. It is not the case that one of these different results is correct and the others wrong. It is just that there are different ways of measuring and describing investment performance. Similarly, there are different techniques that can be used to calculate performance attribution.

In other words, not only is there a lack of an external framework for measuring the effectiveness of Performance functions, there is a lack of consistency in how they operate. Performance functions in different organizations use different techniques to calculate the same metrics. And this is perfectly acceptable business practice.

So, referring back to the key question we posed at the start of this question: How do asset management organizations measure the effectiveness of their Performance functions?

In Q2 2014 BI-SAM, as part of its industry research program, initiated a project to investigate this question. This research project had two objectives:

- 1 To define a best practice framework for Performance functions in asset management organizations.**
- 2 To establish whether this framework could be used as the basis for an independent, objective method for assessing the capability of Performance functions.**



Not only is there a lack of an external framework for measuring the effectiveness of Performance functions, there is a lack of consistency in how they operate.



3

The BI-SAM Performance Best Practice Framework

In the first phase of the project a best practice framework for performance measurement and analysis was designed.

The BI-SAM framework contains five capability 'areas':

- 1 Calculation of Audited Results – the calculation of results using audited source data.
- 2 Calculation of Indicative Results – the calculation of indicative results using unaudited source data.
- 3 Distributing Performance Information – how well performance teams can distribute performance information to internal and external clients.
- 4 Operational Integration – the degree to which performance teams are integrated with the upstream business teams and processes that provide source data.
- 5 Production Robustness – the strength of the operating platform and of governance and management control procedures.

Two benchmarks are defined for each capability area:

- **Standard Practice**
The minimum service level Performance functions should achieve.
- **Best Practice**
The best level of service that they should be expected to achieve.

The capability of a Performance function can then be assessed relative to these two benchmarks.

Further details of the Performance Best Practice Framework can be found in a white paper published by BI-SAM, *Achieving Best Practice in Performance Measurement and Analysis*, which can be downloaded here: www.bi-sam.com/achieving-best-practice-in-performance-measurement-and-analysis

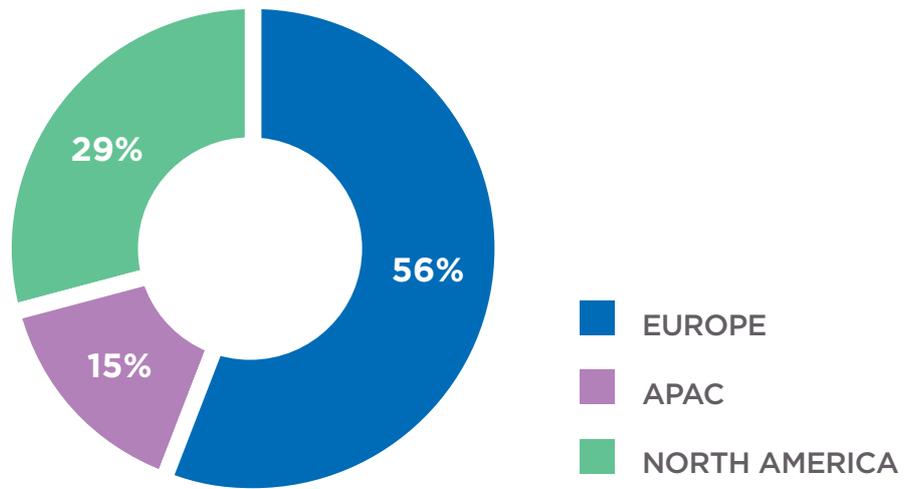
4

Market Survey of Performance Practices

In the second phase of the project a market survey was carried out to collect information about current working practices in Performance functions. This information could then be used to investigate whether it is possible to define an industry practice for Performance functions.

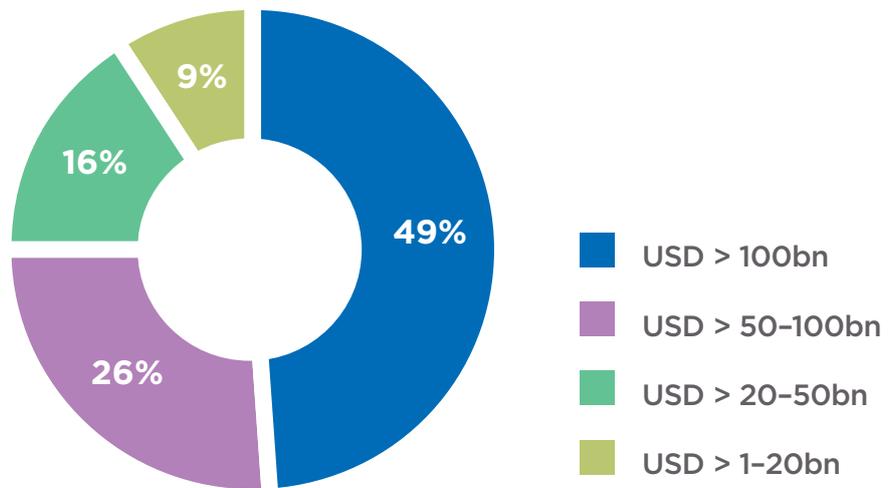
A total of 55 asset management organizations participated in the survey. Chart 1 shows how the organizations were distributed geographically.

Chart 1
Geographical distribution of respondents



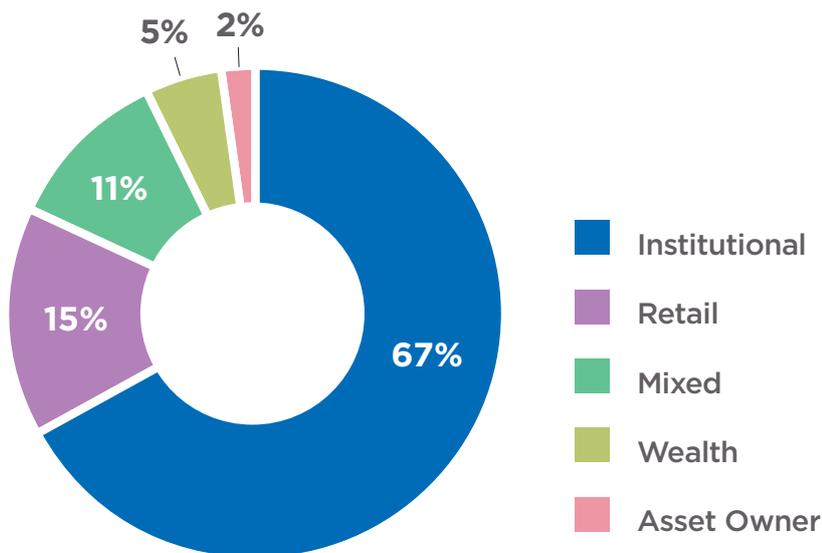
The total AUM of the organizations in the survey universe was USD 12Trn. Chart 2 shows how the survey universe was distributed across four AUM bands.

Chart 2
Respondents by AUM



The survey focused on investment management firms but the participants represented different types of organizations. Chart 3 shows the type of organizations that participated in the survey. Investment managers with an equal mix of institutional and retail businesses were categorised as **Mixed**. Investment managers with a dominant focus were categorised according to the dominant focus. For example, an investment manager with a business mix of 70% institutional, 20% retail, and 10% wealth was categorised as an institutional organization.

Chart 3
Respondents by
business type



“
55 organizations
took part in the
survey with a
combined AUM
of USD 12Trn
”

5

Survey Overview

In this section we describe some of the main highlights from the survey findings for each of the five capability areas described in Section 3. Higher-level analysis and commentary is then provided in the following sections:

- Section 6 – fixed income attribution.
- Section 7 – the degree of manual processing.
- Section 8 – operational scale.

Calculating official results with audited source data:

- A wide range of methods are used to calculate performance returns with almost 50% of Performance functions using three or more different methods.
- Brinson models (95%) are the most widely used equity attribution models.
- Duration Analysis Method (47%) is the most widely used fixed income attribution model.
- 73% of Performance functions are GIPS compliant and have been verified.

Calculating indicative results:

- There are wide differences in the provision of indicative performance returns. About 75% of Performance functions are either 1) delivering them to portfolio managers by 12.00 on the following day or 2) not delivering them at all. And there is an equal split between these two extremes.

Distributing performance information:

- The most widely used channel for distributing performance information is still reports, either in paper or PDF format.
- Manual processing still features strongly in the distribution of performance information: 60% of teams are transferring data manually into Excel before distributing it.
- Performance functions are customising a significant quantity of performance information before it is distributed.
- Performance functions are achieving well at processing requests for performance information.
- On average, 60% of the total effort expended by Performance functions on providing support performance reporting is expended on scheduled reports. And they expend more effort on supporting the reports for internal clients than for external clients.

Operational integration with upstream and downstream business functions:

- The supply of portfolio data in the correct format is an issue.
- The completeness of the portfolio data that is supplied to performance teams is also an issue.
- The major data issues faced by performance teams relate to the consistency of portfolio and market data. 76% of teams experience issues with portfolio data because it is independently maintained in multiple systems. And 80% of them experience issues because their organizations do not maintain a Golden Copy of market data.

Robustness of production environments:

- Performance teams are facing a major issue with the scalability of their system platforms.
- Manual processing is still an issue for performance teams.
- Source data issues are also a drag on the scalability of performance functions.

6

Fixed Income Attribution

Chart 4
Challenges faced by Performance functions

In the survey, respondents were given six different challenges and were asked to rank them in order, from least challenging to most. Chart 4 shows the proportion of respondents that selected each of the challenges as the highest ranking one.

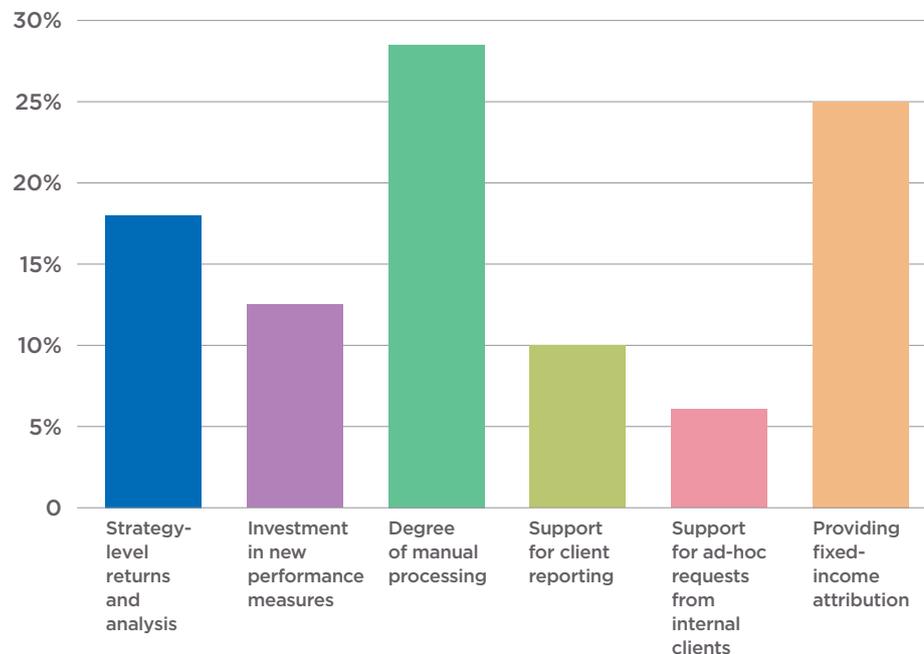


Table 1
Comparison of fixed income and equity attribution

Service characteristic	Fixed income attribution	Equity attribution
Proportion of functions using the dominant attribution model	49%	98%
Proportion of functions using two or more different attribution models	21%	55%
Proportion of functions using custom or proprietary attribution models	23%	6%
Proportion of functions providing no attribution (excluding those organizations with no mandates for this asset type)	13%	0%

Two challenges were ranked by 54% of the respondents as the greatest ones facing their Performance function at this point. One of these, chosen by 25% of the universe, was the provision of fixed income attribution.

It is clear from the survey that the provision of fixed income attribution is a less established service than the provision of equity attribution. This is shown in Table 1, where we summarize the different findings emerging from the survey for fixed income attribution and equity attribution.

The detailed findings from the survey show that this lack of maturity in the provision of fixed income attribution is an industry-wide issue. It is one of the areas in which the performance ‘industry’ needs to work harder to achieve a higher level of service capability and maturity. The key question is where should this effort be directed?

There was a time when very few performance systems could support fixed income attribution, but this is no longer the case. There is now a range of vendor systems providing this support. So why is the provision of fixed income attribution still relatively immature?

- Is the problem with the attribution models themselves? Do they simply fail to provide the level of insight that Performance functions and their clients require? Is there more ‘academic’ research that should be carried out to develop industry models with the same status as the Brinson equity attribution models?
- Is the problem with the level of data integrity that is required for the attribution models to produce meaningful results? Is there more work that needs to be done outside Performance functions to ensure that operational functions can provide source data at the right level of completeness, correctness, and consistency?

This survey was not designed to investigate these questions and so we are not able to offer any answers in this paper. However, it is clear from this survey that the industry is still some way from being able to offer the same level of transparency into fixed income investment processes as it is able to offer into equity ones.

7 Manual Processing

The other major challenge that was highlighted in Chart 4 was the degree of manual processing, which was chosen by 29% of respondents as the greatest challenge facing their Performance function. Furthermore, only 12% of respondents ranked this as the lowest of the six challenges they are facing, and none of the other challenges attracted a lower proportion of votes. So, as with fixed income attribution, the degree of manual processing is an industry-wide issue.

A key question arising from the survey then is why do Performance functions still perceive manual processing as a significant challenge? Systems have been available for many years now that can automate much of the processing that has to be carried out by performance analysts. The reasons for this widely-held perception can be found in the detail of the survey findings, which show that Performance functions are actually still reliant on manual processing, despite advances in system technology. There are three areas of capability in which the degree of manual processing is high:

- **The loading and validation of source data used to calculate performance results.**
- **The identification and resolution of source data issues before performance results are calculated.**
- **The distribution of performance results to internal and external clients.**

What is interesting about this finding is that these areas represent the interfaces with the upstream and downstream business functions with which Performance functions have to be operationally integrated. Historically, Performance functions have focused a lot of energy on the techniques used to calculate performance returns, attribution effects, and ex-post risk statistics. At the same time, they found it difficult to obtain high-integrity source data in time for them to calculate, check and deliver performance results. These factors resulted in an internal focus that left Performance functions a little disconnected from upstream processes and systems.

Another factor is the extensive use of Excel within Performance functions because of the flexibility that it provides for analysing sets of data, calculating results and charting. This resulted in a higher level of tolerance for manual processing within Performance functions than in other business functions, where this tolerance has been eroded over the past ten years. Until recently, the reliance on manual processing within Performance functions was not seen as a major issue for asset management organizations. But this is no longer the case. Significant changes in the demands and expectations of investors is creating pressure to deliver more performance information, in more detail and in less time than ever before. And the reliance on manual processing has become a major issue for Performance functions as they struggle to adapt in the more demanding world in which they must now deliver.



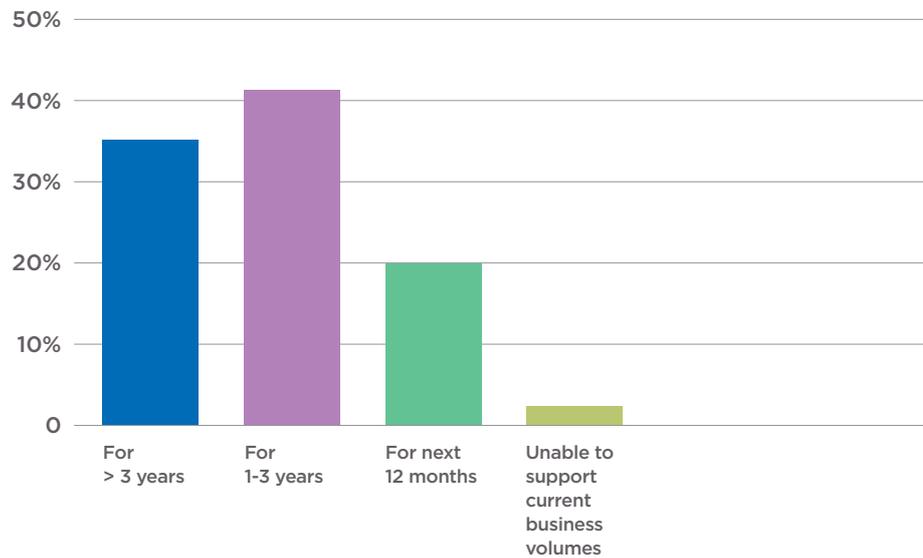
8

Operational Scale

One of the main issues with a high degree of manual processing within a business function is a lack of operational scale. It makes it hard for business functions to respond effectively to temporary peaks in workload, and to maintain service levels as business volumes increase. One of the key survey findings was the level of concern within Performance functions about the ability of their systems to support expected business volumes.

Respondents were asked how long their performance system would be able to support expected business volumes. Chart 5 shows the proportion of respondents that selected each of the four time periods that were provided.

Chart 5
The ability of performance systems to support expected business volumes



What this chart shows is that 64% of Performance functions do not expect their systems to be able to support business volumes for more than three years. What is even more of a concern, is that 22% of them do not expect their systems to be able to cope for more than one year.

It is not clear from our survey whether these concerns are shared by the organizations in which the Performance functions are operating. However, it does not appear that lack of budget is the issue. Chart 4 shows that only 12% of respondents ranked investment in new performance systems as their greatest challenge. Perhaps even more significant is that 25% ranked it as their lowest challenge, which is more than for any of the other challenges.

9

Conclusions

Summary of Survey Findings

The findings of the market survey paint a picture of a performance 'industry' that is coping reasonably well with the pressures of delivering services to internal and external clients. However, there are areas that should raise concerns for the asset management industry as a whole. Many Performance functions are concerned about the scalability of their systems and, more specifically, about the length of time that their systems can continue to support expected business volumes. At the same time, many Performance functions are still reliant on manual processing, especially in those areas in which they interface with upstream and downstream business functions. And the provision of fixed income attribution is still an industry-wide issue, with Performance functions unable to match the maturity and service level provided for equity attribution.

When these issues are viewed together it is clear that asset management organizations need to be asking themselves a key question: How well positioned are we to cope with the increased demand from (and higher expectations of) investors, with the increased complexity of investment processes and asset types, and with the increased business volumes that these trends are generating?

Given the length of time taken to complete the selection and implementation of systems in key business functions such as Performance, asset management organizations really need to know the answer to that question today.

Next Steps

As noted in the Introduction, this paper describes the work completed to date as part of an on-going research project. In the next phase of the research, we will complete further detailed analysis of the data collected in the survey.

In particular, we will investigate the possibility of defining an Industry Practice for Performance functions. Currently, we have to rely on individual views and opinions, and on anecdotal evidence, as to what Performance functions should be doing and how they should be doing it. What the industry needs is an independent mechanism for assessing the capability of Performance functions relative to industry benchmarks and peer groups.

We will also slice and dice the data we collected in the survey by regions, by type of organization, and by size. Our objective is to investigate whether industry practice varies across these different populations. Our initial analysis indicates that it does.

Where is your firm's performance function positioned within the BI-SAM Performance Best Practice Framework?

Contact BI-SAM at feedback@bi-sam.com to start an assessment.

Contact details

Americas

usa@bi-sam.com

UK

uk@bi-sam.com

EMEA

france@bi-sam.com

Asia

asia@bi-sam.com

Peter Ellis

peter@pkconsultingltd.co.uk



With more than 35 years of experience in insurance, engineering, software development, and investment management, Peter is a knowledge leader in performance measurement and analysis. Prior to setting up PK Consulting Ltd, Peter was a member of BI-SAM's Executive Management team, holding first the position of Chief Operating Officer for EMEA and then Managing Director - Strategy, Marketing, and Alliances. Prior to BI-SAM, he was Managing Director of Investit. He also spent 8 years at Deutsche Asset Management, where he held a number of roles in IT and in the business. In his last role at Deutsche Asset Management, he was Managing Director, Performance and Client Services. Peter has extensive project management experience on a wide range of projects, and has directed many complex strategic projects, both from within IT as a project manager and as a business sponsor.

Investment Performance Analysis

Market Practices and Industry Trends

January 2015

PK Consulting Ltd

PK Consulting Ltd is a specialist consulting firm operating in the investment management industry. The company provides a wide range of services from thought leadership and research, through strategic advice, to system selection.

Founded in 2000, **BI-SAM** is a leading provider of software and services to the global Asset Management industry. With its unique combination of best-in-class product capabilities and staff expertise, BI-SAM is a de facto market solution for performance, attribution, risk, GIPS compliance and reporting. Many of the world's largest asset managers use BI-SAM to enhance their business strategies while maintaining high levels of security, risk management, process control and operational scale.