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North of the OMS

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Now more than ever, Investment Managers are seeking strategies that not only generate benchmark-aligned returns, but also manage investment risk and protect clients against market downturns and doomsday scenarios in the global economy. The art of managing risk while producing returns requires robust capabilities to view the portfolio, generate models, and apply increasing complex investment vehicles. The platforms and data required to efficiently implement these strategies have put the focus on technology spend 'North of the OMS' where the secret sauce of Investment Management exists.

We have previously shared our thoughts on the shrinking software market (Honey, I shrunk the Software Market) and the risks of vendor consolidation vs. the speed and complexity at which requirements of investment managers are evolving. Fortunately for the investment community, vendors North of the OMS have largely resisted the overtures of the large Wall Street technology conglomerates. What this means for investment managers is that there is exciting innovation occurring and opportunities to partner with independent vendors in mutually beneficial ways. On the downside, while they offer best of class capabilities for specific needs, independent vendors may not be positioned to solve the enterprise multi-functional needs of global multi asset managers.

Adapt to Survive

Today, the investment manager can no longer market and survive solely on performance returns, as they are facing significant pressures from low-cost passive investment options and ETF managers who can deliver against a benchmark at a significantly reduced cost. In order to reset the value proposition of the active management fee, managers are evolving investment strategies that do not focus solely on rate of return in up markets, but also manage risk in down markets. With periods of volatility dominating the headlines more frequently, managers are adopting alternative, liquidity, and risk management strategies and are leveraging complex derivative vehicles to achieve their objectives.

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Achieving that ever-more elusive alpha begs the question: how does the smart money stay ahead of the industry? By adopting strategies in front offices using new and varied tools. Today, managers are marketing their risk in such a way that even in the harsh light of negative publicity toward active strategies, they can still go to investors and present risk adjusted numbers for their portfolios. They are adding these risk dimensions to the traditional views of performance versus the benchmarks. The new objective is to present risk profile, illustrating to investors their margin of outperformance when the markets go down, but hedging on the upside, where they will continue to manage assets to meet benchmark objectives.

We believe the current stress on technologies in the front office, especially with those functions North of the OMS, is driven by two primary factors; 1) the proliferation of products available to investment managers, especially derivative-based vehicles; and 2) the migration by investment managers to strategies that are more risk-based, similar to those in the hedge fund world.

What we have experienced of late is nothing short of remarkable insomuch that it is affecting managers and vendors alike, and it is occurring at a rapid pace. The pressure to achieve alpha in a responsible manner using an influx of new investment products is causing systems long used by managers to show their age and limited functionality. Many fall short in portfolio management construction, asset allocation, and in providing adequate risk management tools in response to these new products. This has opened the door for new vendors who are innovating both the functionality and data services available to managers.

Changes Afoot

The changing landscape of vendors North of the OMS requires firms to reassess their usage of these systems, and solve for the new mandate of today's active investment strategies. The complexity needed to support these strategies also mandates a look at best of breed rather than broad-brush platforms. Further, the adoption of powerful development tools such as MATLAB and R programming along with business intelligence platforms means systems North of the OMS need to exist within a robust architecture with open data sets. These systems and development tools in aggregate are increasingly important in allowing managers to analyze key data, model prospective investments, and understand their impact prior to making investment decisions that will affect the entire portfolio.

Where is this happening now? On the Investments side, capabilities traditionally built internally by the hedge fund industry are becoming increasingly relevant to traditional buy side managers. This functionality includes the ability to focus on short and long term risk analytics, optimizing portfolios to risk rather than return objectives, and managing risk budgets and profitability at a more granular level than ever before. On the product side, new vendors North of the OMS are filling gaps with respect to hedge fund data acquisition and analytics along with multi-asset capabilities and broader modeling capabilities.

Although risk is becoming a much larger consideration around investment decisions, that's not to say it is entirely new, only more heavily weighted. On the sell side, we see it as more of a regulatory and capital-adequacy driven function. On the buy side, institutional managers are becoming comfortable with risk metrics of various sorts, so value at risk is a more complicated proposition than traditional alpha or beta. These managers are now more knowledgeable about risk and analytics, and therefore these metrics are quickly becoming the standard expectation for their clients. Regardless of whether they are being used to make active investment decisions, these metrics are vital for reporting and demonstrating credibility that the manager is thinking across all spectrums. Other managers may embrace risk analytics from an investment decision point of view, especially those that are more quantitatively styled and minded, taking advantage of the tools and analytics to point their thinking in the right direction.

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Specifically, we are seeing use of analytics and correlation, essentially calculating the blended volatility of a portfolio, derived at multiple levels from the trade, strategy, asset-class, sector, portfolio, and even at a portfolio or client composite such that managers who are using it can determine and evaluate risk through any lens. Managers want to interrogate Value at Risk (VaR) and its variants, Expected Tail Loss (ETL), and other models to ensure confidence in the investments while managing how much they are willing to risk losing if markets turn south.

Finally, we believe the pace of change in investment strategies and vendors providing solutions North of the OMS is only beginning and will continue to increase. Whereas buy side technology is traditionally slow to evolve and mature, the vendor community must keep pace and evolve proactively to the changing investment landscape North of the OMS. This change is providing opportunity for new, upstart, and unexpected vendors to make an impact. Innovation is coming in pockets from traditional players, unexpected new entrants (e.g. Silicon Valley), and a commoditization of hedge fund technologies previously not available to traditional buy side firms.

Conclusion

Investment Managers must evaluate and align the needs of the investment strategy to their technical architecture, and consider the cost and benefits of multi-use platforms against the unique capabilities provided by best of breed. Investment managers faced with changing strategies can look to third-party partners experienced implementing multiple risk-based solutions North of the OMS to contend with both the influx of new products and help fulfill their investment mandate.

Contact Us

North America

Paul Migliore
paul.migliore@citisoft.com
1 (617) 428 9582

Tom Secaur
thomas.secaur@citisoft.com
1 (617) 428 9584

Peter O'Toole
peter.otoole@citisoft.com
1 (617) 428 9381

David Bates
david.bates@citisoft.com
1 (617) 428 9583

Beth Cavanagh
beth.cavanagh@citisoft.com
1 (860) 558 4708

Europe

Jonathan Clark
jonathan.clark@citisoft.com
+44 (0) 207 236 4219

Steve Young
steve.young@citisoft.com
+44 (0) 207 236 0430

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