Controlling Costs: The Investment Manager's Dilemma

At a time when delivering alpha has become a major challenge, alternative investment managers around the world are faced with a different sort of test: controlling costs. Moreover, reducing costs has been two-fold; investment managers are focused on reducing the costs of their own management company, but also reducing fund expenses to appease and attract investors. Much has been made of the increasing costs being faced by investment managers in an already difficult environment, but fortunately there are useful solutions.

One of the major trends, and one of the best ways to manage costs for an investment manager, is through outsourcing various operational tasks to a third-party service provider. Given a fund manager's pre-existing relationships, this has most typically been with a fund administrator, but also can include specialist organizations. Fund administrators are a natural choice for this outsourcing, as the vast majority of investment managers already used a fund administrator for independent NAV reporting to their investors.

Where this situation has evolved is with respect to what tasks are now being handled by a fund administrator on behalf of an investment manager. It was quite usual for back office work, such as NAV calculation and investor servicing, to be handled by a fund administrator, but more than ever the same firms are now handling middle office tasks. This can include daily reporting and reconciliations, cash and collateral management, daily NAV estimates, confirmation and affirmation of OTC assets and trades, transparency reporting, and a host of other items.

Many of these tend to be manual and laborious tasks, meaning that previously an investment manager had to have sufficient internal staff to perform this work. However, by utilizing a capable fund administrator, these tasks can be performed outside of the investment manager's office, obviously meaning direct financial savings in terms of personnel but also reducing indirect costs such as office space requirements, infrastructure needs, and HR necessities.

A second area where savings can be realized is through an increased and more efficient use of technology. For example, many front-end order and portfolio management systems have been upgraded in recent years to have additional features and benefits, such a risk reporting, real-time P&L capabilities, auto-reconciliation tools, and more. Utilizing these features can decrease the internal hours spent performing the same tasks or can supplant an existing external service provider, both of which result in direct cost savings for the investment manager.

Also, investment managers are using new technology tools to lower their costs, especially on the trading side. For equity long/short managers, for instance, even smaller investment managers are starting to employ tools that handle calculations and aggregations of fees and rebates across the various brokers, allowing the fund to locate the best

terms on a daily basis for their various strategies. Over the course of a year, these technology tools often pay for themselves many, many times over as they allow the fund to execute trades in the most cost-effective fashion. As a fund expense, decreasing the trade execution costs and increasing their short rebates will increase returns, clearly music to investor's ears.

Speaking more generally, cloud computing has become a popular choice as a cost-saving measure. Working in the cloud allows for a more scalable, professional technology infrastructure that is housed outside of the investment manager's firm, taking advantage of the third-party provider's economies of scale to lower costs. While concerns would remain surrounding security, an always-present fear to be sure, the cloud can offer enormous cost savings on the technology and IT personnel side of the business.

More and more investment managers are also merging their existing funds into combined platforms to decrease audit, legal, regulatory, and operational costs. Many investment managers have multiple investment vehicles that have opportunistically been created over years, leading to what can sometimes be a dizzying array of legal entities. Since each of these products has its own set of costs, fund managers have been putting these vehicles together where possible to reduce their footprint and streamline operations, leading to lower costs.

Alternative investment managers are getting increasingly creative with their cost savings in an effort to gain any advantage in a difficult market environment. A particularly imaginative example would be the increasingly popularity of investment managers purchasing exchange seats in order to bypass broker costs. While it would not apply to many funds, some of the larger investment managers, and especially high-frequency traders, have found that purchasing exchange seats in New York and Chicago can offer savings that are so significant that the exchange seats are paid for in a matter of months. The side benefit here is that many of these funds trade black box strategies, meaning that by-passing the broker keeps their trade secrets even more secretive.

To be sure, fee pressure is no longer a trend but rather is simply a matter of successfully conducting business for investment managers. While it is relatively easy to bemoan such cost increases, it is far more difficult to tackle these problems head on and drive real solutions in practice. The above items, as well as countless more, can help an investment manager not only stay profitable and competitive, but actually increase their business. More than ever, investors are looking for investment managers who run their firms like institutional-grade businesses and a part of any successful business is controlling costs. Firms that can adapt to this new world order should be able to attract capital more effectively in the future.