The market crash that occurred two years ago has left many private and institutional investors scrambling to stay afloat and searching for a path to recover from the ravages of the market downturn.
Global Custody Services... In A Changing Market

Gurmeet Ahluwalia
Head of CIBC’s Securities and Fund Services (SFS) Business in Canada

Canadian pension plans were no exception. In 2008, the Canadian pension market lost $150 billion in value and demonstrated a zero growth rate over the previous year! Solvency levels of pension plans have also deteriorated to record lows hovering around and even falling below 70%.²

It should not, therefore, come as a surprise that institutional investors have been looking for ways to recoup their losses, as well as to obtain an edge over the pack. This has led many investors to look for exotic and somewhat unconventional investment options, or even venturing into new geographic locations and market segments. To be successful, these types of investments often require on-the-ground support and close supervision to navigate a path through different regulatory environments and tax systems.

Most global custodians have a network of subcustodians around the world and real benefit comes to the client from partnering with a local manager in the market itself. The example of the benefits of a global partner: providing clients with such investments.

Local Access
As unconventional investments in FX transactions and hedge funds become commonplace, so too do the managers’ requirements from custodians. With FX transactions, for example, investors are increasingly seeking custodians who are able to provide local access to FX transactions on a global basis and offer greater transparency on each transaction. Such transparency can and should be provided by the custodian offering to tie the transaction to a wide variety of benchmarks (beyond the Bank of Canada noon rate), as well as time stamp each transaction. If your custodian is not willing to provide this service, you should insist on it. Localized benchmarking gives the investor comfort in gaining fixed competitive rates based upon interbank dealing rates. This is achieved without the operational burden and added cost of continuous negotiation in the pursuit of best execution to maximize returns to the fund.

As with FX investments, some large pension funds have tested the waters with other alternatives – such as hedge funds – in order to improve yields. Historically, these fund managers chose to funnel investments into many of the large well-known hedge funds. However, nowadays investors are looking for a customized experience with an institutional separate account. Research conducted by Prequin¹ found 16% of institutional investors already have allocations to institutional separate accounts, with another one in four contemplating this solution for their hedge fund investments. Under this type of investment, custody and administration services are provided by the client’s preferred custodian(s), rather than by the hedge fund manager. Hence, when a hedge fund manager wishes to execute a transaction, trade instructions are first routed to the custodian. This level of service provides plan sponsors and investors with an unprecedented degree of flexibility and transparency:

• The custodian can offer the client full transparency of the portfolio, even in real time.
• The client, via predetermined rules or ad hoc alerts, can direct the custodian to reject an individual trade which is not in line with the investor’s investment policy guidelines.

The need for transparency, risk mitigation and clarity on financial positions in such an environment is paramount. Today’s funds are often held in multiple accounts and geographic locations, recorded on incommensurable reporting systems, and use multiple accounting methodologies. A global custodian can bring this data together to provide an accurate, minute-by-minute snapshot of the state of play of the fund.

Acting as custodian to some of the largest institutional investors and with a physical custody presence in 60 markets around the world, we see first-hand the issues of risk management and the requirement for timeliness of information. Some of these challenges include:

• Access to timely and relevant credit rating data – Today, market events are often outpacing the frequency in which investment information is updated and available to fund managers and treasurers for effective and prudent risk management. For example, daily incidences of credit rating changes that may be fragmented across multiple accounts and asset allocations make it a challenge to stay current and properly support downstream processes such as accounting.

• Cash visibility and cash flow forecasting – As cash is typically held in multiple accounts and managed using various bank-provided systems, data is compiled from many different sources and may not always provide up-to-the-minute accurate visibility over positions. This may lead to a delay in deal determination and execution. Additionally, the lack of immediate and accurate cash visibility also hinders the ability of portfolio managers to properly assess and anticipate future cash flow for proper planning.

The search for alpha has also driven institutional investors, even those considered conservative, to broaden their portfolios with other exotic investments.
• **Issuer concentration management** – In the post-Lehman era, it becomes a standard practice to limit exposure to any single issuer. However, with organizations merging or being acquired at a growing pace, changes in issuer exposure become more frequent and difficult to track.

• Another common challenge faced by institutional investors is the need to benchmark risk and performance against multiple markets, strategies and/or indices. Investors are required to do so while maintaining accurate accounting across regions, platforms and portfolios, while ensuring compliance with investment policies.

Responding to these challenges by providing firm-wide solutions that address an investors’ need for timely and accurate data is becoming the gold standard of custodian services. Granting additional administration and operational responsibilities to custodians – along with the use of automated reporting and analytical tools – enables asset managers and plan sponsors to concentrate on managing their portfolios, gain strategic insights into their asset allocations, and execute their investment strategies while effectively managing risk.

**Cost Containment**

Today some of the major costs for asset managers include custody services, fund and portfolio valuation, trade execution, and technology and infrastructure enhancements. By outsourcing these back- and middle-office services to a third-party administrator, asset managers can change these costs from fixed to variable. When outsourcing services, asset managers can increase cost savings through utilization of the administrator’s network and scale.

Beyond geography, custodians can provide cost savings through additional services that move up the value chain. While numerous asset managers outsource custody, and many outsource other “back-office” functions such as portfolio valuation and pensioner/unitholder record keeping, incremental savings can be gained through outsourcing “middle-office” services. For example, Citi’s “Execution-to-Custody” service allows portfolio managers, once they have decided which assets they want to buy or sell, to enter the trade only once with the administrative burden (including finding the best price for execution, confirming the trade and liaising with the custodians) all falling on the custodian. Additionally, this service is custodian-agnostic, meaning even if (and especially if) the client is using multiple custodians and execution partners, the client gets value from reducing their administrative burden. By relying on their partner to perform these non-core functions, managers can eliminate the need for continual investment in technology and infrastructure, remove a significant amount of fixed costs and align variable revenues with variable costs.

By building and growing a partnership with their custodian and administrator, asset managers can focus on their core business and provide better returns, risk management and transparency to their clients.