An Investment Process for a New Reality

THREE TRENDS SHAPING THE BUY-SIDE IN 2021 AND BEYOND
Executive Summary

Although the world has changed in ways nobody could have predicted at the start of 2020, COVID-19 and its attendant changes to the global economy and the future of work have not completely overturned the global investment industry. They have, however, exacerbated and accelerated disruptive forces that were already at work.

Asset owners and investment managers were grappling with long-term structural shifts, stemming from trends such as digital innovation reshaping operating models and business strategy, the democratization of data, and the hunt for yield requiring suitable tools and infrastructure to find new sources of return.

Yet the effect of the pandemic has reinforced the urgency for buy-side leaders to build a future-proof investment process. From investment strategies to operational processes, all aspects of how investors make portfolio decisions today face ever-acute challenges.

These include:
• Muted interest rates putting pressure on yields
• Prolonged volatility and unpredictability in markets
• Heightened concerns over liquidity and correlation in mainstream assets
• Investors’ increased expectations related to transparency and user experience
• The need to adapt to frequent regulatory changes across geographies
• Escalating geopolitical instability, trade tensions and de-globalization
• Uncertainty over how long the impact of the pandemic will endure

“The economic and market shockwaves from COVID-19 have left institutional investors at the intersection of a systemic change, technological upheaval and a roller-coaster investment landscape. Digitizing every process and interaction and improving both the client and end-investor experience has shifted from being about differentiation to being essential for survival.”

Roman Regelman
Chief Executive of Asset Servicing and Head of Digital BNY Mellon
Getting Ready for a New Tomorrow

The latest World Economic Outlook from the International Monetary Fund (IMF), in October 2020, highlights the importance of preparing for what the Fund predicts will be a “long, uneven and uncertain” recovery – on the back of projections that the global economy will contract by 4.4% in 2020.¹

Against this backdrop, asset owners and investment managers must adapt by developing the right capabilities and infrastructure across their front, middle and back offices to help them secure positive and sustainable growth.

We had already pinpointed the need for this type of transformation amid the key themes shaping the future of the global investment industry in “2020 and Beyond: A New Era of Transformation for Buy-side Leaders”.

20 key trends in 2020

SHAPING THE FUTURE OF THE GLOBAL INVESTMENT INDUSTRY

Digitization: REDEFINING ‘BUSINESS AS USUAL’

1. Artificial Intelligence rewriting the future of the investment industry
2. Blockchain moving from hype to reality
3. APIs forming the cornerstone of the client experience
4. Open architecture is defining the future-state operating model

Data Management: THE DEMOCRATIZATION OF DATA

5. Democratized data empowering strategy and decision-making
6. Client journey reimagined with data-driven innovations
7. Faster growth for investment domains with open data ecosystems
8. Formalized data usage frameworks giving access to broader datasets

Alternative Investments: COMING TO THE FOREFRONT

9. Role of private equity to grow
10. Real estate ripe for greater digitization
11. Emerging Asia to become a hot spot for alternatives
12. Private credit heading for new levels of transparency

ESG Integration: A SEISMIC SHIFT BEGINS

13. Climate change transforming the investment industry
14. Impact investing redefining the role of capital
15. Material ESG factors driving positive financial returns

Opportunities Untapped: CHINA OPENS ITS DOORS

16. Foreign participation will increase
17. Greater harmonization of access schemes
18. Rising influence of the RMB
19. Broadening of the investor base
20. Expansion of investment scope

Now, in the wake of COVID-19, not only have these trends endured, three of them have accelerated significantly:

1. The development of digital-first strategies and mindsets that align with the acceleration of digitalized economies, and with more open and connected information ecosystems.

2. The role of data and analytics as a key differentiator in driving solutions, reporting and insights, as well as enhancing efficiency, cutting costs and reducing risk.

3. The search for yield via greater allocations to alternative investments and emerging markets, and the need for infrastructure to support this shift.

“These three trends align with three consistent goals we are hearing from our asset owner and investment manager clients: customers, risk-return trade-off and resiliency.”

James Slater
Head of Client Coverage for Asset Servicing
BNY Mellon
Trend 1: Driving a Digital-First Approach

For the buy-side, COVID-19 has further thrust the need for technology-led transformation to the foreground. For example, some investment institutions had to replicate trading environments in living rooms on extremely short notice. New communication and workflow systems quickly became the norm and business continuity and cybersecurity practices were tested like never before.

The need for greater digital evolution became clear very quickly when the pandemic began. In March and April 2020 alone, BNY Mellon migrated 57 clients to digital solutions to process 400,000 transactions that had previously been manual. Various processes have had to adjust to accept digital signatures on many tax-related forms to support remote processing. This has led to expectations that regulators around the world will expand – and make permanent – the use of digital signatures in areas where ‘wet’ signatures are required today. In BNY Mellon’s business alone, digitizing such processes will help around 200,000 clients, and remove roughly 3 million physical documents per year.

Infusing a digital mindset in this way is even more pressing given that more asset owners are insourcing investment functions and activities. Others are outsourcing middle- and back-office functions, in a quest for value, scale and timely solutions. Benefits to this approach include support in navigating changing regulatory regimes, as well as reducing the high costs and burdens of the required infrastructure and human capital.

“Yet more work needs to be done to leverage the vast benefits digital can offer. Culture and mindset are some of the most critical elements of successful digital change. And part of that is a recognition of the benefits of taking an open-architecture stance.”

Janelle Prevost
Head of Strategy and Digital for Asset Servicing, BNY Mellon

Partnerships can offer an effective approach to building and enhancing digital processes and infrastructure. Strategic sourcing is an increasingly viable way to implement an efficient, resilient and adaptable operating model, based on front-to-back technology integration. This is aligned with the fast-growing concept of openness via application programming interfaces (APIs), adds Prevost. This enables integration with multiple service providers to make the infrastructure and operating model more robust, while leveraging support in navigating changing regulatory regimes, and in managing the high costs of infrastructure and human capital.

Part of this involves making more meaningful investments in custody solutions. Typically, asset owners and investment managers allocate the equivalent of only a few basis points of overall AUM to this aspect – compared with between 30 and 40 basis points to the front office. Rather than a quick-fix to plug this gap, open architecture paves the way to future-proof a business by using solution-agnostic integration of best-of-breed tools – in conjunction with the required migration, training and onboarding for IT and operations teams as well as business units, so that legacy systems can make way for new solutions.

The industry is increasingly aware of this need to evolve towards a more open architecture model to meet clients’ needs. BNY Mellon OMNI™, for example, shows the importance of an end-to-end approach that allows clients to customize or plug into legacy systems.

While such extreme circumstances as those of 2020 will hopefully not be repeated in the foreseeable future, they have accelerated the role of digitization in all parts of the investment process. This includes faster implementation of products, streamlining and aggregation of the investment model, and greater efficiencies to lower costs and minimize investment risk. Several technologies are making this possible. Artificial intelligence allows asset owners and investment managers to streamline operations and use predictive capabilities for investment decisions, while blockchain increases transparency in operations and distribution.
Trend 2: Unlocking the Value of Data

Just as the power of digitization can transform investment processes and enhance operational efficiency, the power of data can help leaders make better decisions to drive the business. Distribution analytics, for instance, can determine decisions around products and sales. But the industry is faced with a deluge of data in terms of volume, velocity and variety. As a result, investment management organizations face challenges achieving the promise that data offers. A recent survey of 100 heads of investment operations from firms across Europe showed that analyzing data is by far their biggest current challenge.3
That’s hardly surprising, as many asset owners and investment managers try to wrest insights from data stored in legacy systems. It’s difficult to identify and discover data in their own enterprise, much less in their wider ecosystem. They have learned that the underlying framework and tools for acquiring, analyzing and managing data matter.

Previously, organizations tried to centralize their data to simplify analysis. Now, however, data lives in their own systems, in their vendors’ systems and in the cloud. What they need are solutions capable of ingesting, tagging, and fingerprinting multi-format, multi-sourced data – essentially, a horizontal capability that can look across all of these verticals of data.

“Data should be managed as an asset in its own right and treated as a competitive differentiator.”

Charles Teschner
Head of Data and Analytics Solutions, BNY Mellon

What’s more, users across functions must be able to engage with and collaborate on data in real time – requiring not just effective data platforms but a shift in the industry’s skill sets. In short, asset owners and investment managers need to be able to respond to market realities with skill and agility.

One area where the challenges and benefits of consistent, readily available data have been on display is in environmental, social and governance (ESG) considerations. The pandemic has created tremendous interest around sustainable investing and ESG. But these are frontier data sets: they’re large, they change often, they’re maturing quickly and they need to be brought together. Combining customization with accepted practices and standards, as a result of aggregating rich data sets from multiple ESG data sources, is the top choice for the growing number of investors looking to incorporate ESG criteria and preferences into their investment process.

“There are more transparency, flexibility and responsiveness to investor needs will yield tremendous gains in advancing ESG standards in a post-pandemic world.”

Corinne Neale
Head of Business Applications, Data and Analytics Solutions, BNY Mellon

Recently investment managers have followed one of two paths as they digitize and evolve their technical capabilities. They have either evolved into high-tech firms by hiring programmers, data scientists, and data engineers, or they have preferred to outsource technology and analytics to third-party providers. Ultimately, to ensure data capabilities can contribute to future-proofing the investment process, asset owners and investment managers should:
- Harness cloud technology to remove any constraints of managing data internally
- Apply machine learning and artificial intelligence to drive quality decisions via better insights
- Manage data governance to control the flow and use of data within organizations

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Trend 3: Finding Alternative Sources of Return

The continued lower-for-longer rates environment has accentuated the importance for investors of achieving performance via two approaches: greater investment in alternative asset classes and greater investment in emerging markets.

The combination of these opportunities bodes well for buy-side institutions seeking higher risk-adjusted returns. However, this requires asset owners and investment managers to review their existing infrastructure and processes for investing in alternatives, and to manage administrative and regulatory challenges within emerging markets.
ALTERNATIVE ASSETS

Data from Preqin, released in November 2020, forecasts alternative assets globally to hit more than US$17 trillion in AUM by 2025, up from US$10.74 trillion as of December 2020. Asia Pacific will likely drive the pace of this growth, with its AUM set to increase from US$1.62 trillion to US$4.97 trillion over the next five years.

Among the notable trends, private equity is the fastest-growing asset, expected to account for more than half of the 2025 total at US$9.11 trillion.

But it is not without some hurdles for investors.

“We are seeing increasing complexity of fund structures; evergreen with liquidity structures and queuing mechanisms; challenged by dry powder and valuations. In addition, asset owners are seeking greater transparency and larger roles in their private equity portfolios.”

Mick Murphy
Head of Alternatives, BNY Mellon

In terms of private debt, Preqin data shows it is growing at 11.4% annually, to US$1.46 trillion in five years’ time. Part of the appeal is the diversification the asset class offers in terms of the format (liquid, private, direct and fund) and across the product set (real estate, infrastructure, distressed assets and mortgages). “We are seeing demand for capabilities to measure performance and risk in private debt,” adds Murphy.

Preqin data suggests that real estate and hedge funds will see more gradual rises from 2020 to 2025 – from US$1.05 trillion to US$1.24 trillion, and from US$3.58 trillion to US$4.28 trillion, respectively. For real estate funds, outsourcing continues, often due to regulatory and technology burdens. And for both real estate and hedge funds, there is greater investor interest in bespoke products, such as dedicated managed accounts and co-investments, a pre-existing trend that accelerated due to COVID-19.

For investors looking at adding more portfolio exposure in the alternatives space, this brings with it a need for more visibility over assets – from portfolio company investments to ESG factors to accounting information on co-investment and direct holdings. In such rapidly evolving and competitive market landscapes, buy-side leaders need to assess whether their existing technology needs to be replaced or updated to manage investments in alternatives. With growing portfolio exposure to such new and, potentially, less liquid assets, specialized tools are essential to monitor them on an ongoing basis.

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5 https://www.preqin.com/future
In line with this, institutions are seeing greater innovation from alternative asset managers. They have looked to plug the gaps caused by the pandemic in terms of relationship building, communication and due diligence, for example, and have invested in technology across the board that will reshape processes such as investment decision-making, fund reporting, compliance and legal, making them more efficient going forward.

And as more industry players develop their digital offering – including data analytics, automation, blockchain and artificial intelligence – the potential for the buy-side to outsource new activities becomes more viable.

This enables these investors to focus on their areas of expertise and improve understanding of underlying positions, risks and opportunities, rather than tackling new and burdensome operational and cybersecurity challenges.

### Alternative assets under management ($bn), 2020 vs. 2025

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<th>Category</th>
<th>2020</th>
<th>2025</th>
<th>%</th>
<th>2020</th>
<th>2025</th>
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2020 figure is annualized based on data to October. 2021-2025 are Preqin’s forecasted figures. Source: Preqin
EMERGING MARKETS

Investments in emerging markets are another potential route for generating alpha. China and India, among the top markets by size globally, increasingly attract international participation with their continued efforts to introduce new economic reforms and ease market access.

The Indian government has set a target to become a US$5 trillion economy by 2024. To achieve that, the country has been making efforts to liberalize its capital markets to welcome foreign inflows. For example, it has created two new accessible routes for Foreign Portfolio Investors to channel funds into a wider range of domestic securities – the General Route under the Medium-Term Framework, and the Full Accessible Route. Bond index inclusion opportunities also exist in the country, whose investment-grade debt is valued at close to US$1 trillion.

China, meanwhile, which is home to the world’s second-largest bond and equity markets, is too big to ignore. Regulators are making it easier for foreign investors to tap into domestic capital markets by simplifying regulations and expanding investment scope. China may face a more measured outlook for 2021 amid bond market volatility, stricter oversight on initial public offerings and the uncertain nature of its bilateral relationships, such as the U.S. executive order. It’s worth noting that China’s latest five-year plan is focused on technology innovation to help create jobs and transform its economy. Much of this innovation may be funded through the capital markets, with new stock listings and bond offerings.

To capture some of the opportunities in these markets, understanding and keeping pace with the slew of new regulations, as well as managing the administration involved with making investments and managing them going forward, are crucial but often overwhelming tasks.

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10 https://www.scmp.com/comment/opinion/article/3103528/china-simplifying-access-its-bond-market-its-about-time-too
Adapting Quickly to a New Landscape

As buy-side leaders assess how best to respond and reposition themselves amid today’s challenging market environment, it is clear that a new approach is needed to business models, investment strategies and operational processes.

To future-proof investment processes, asset owners and investment managers must embrace:

1. **Digital-first** strategies and mindsets in all aspects of how they operate
2. Greater use and application of data and analytics to drive insights, enhance efficiency, cut costs and reduce risk
3. Tools and infrastructure to find new sources of return via alternatives and emerging markets

While these trends are pervasive, buy-side institutions – supported by their service providers – are rising to these challenges, and we expect continued innovation in 2021.