BNY MELLON

Bouncing Back

HOW COVID-19 IS ADVANCING ALTERNATIVE FUND OPERATIONS

PART 2: *A LOOK AT THE FUTURE*

The world has changed and each week seems to bring a “new normal.” Featuring exclusive interviews with industry experts, BNY Mellon examines operational change for the alternative asset management industry in a time of pandemic and how the working environment could change post COVID-19.

Part 2
A Cautious New World

In the second part of our report on how the alternative asset industry is dealing with the pandemic, we explore the challenges and opportunities that transformation can bring. We also examine what the future may look like for the industry and how the environment could change post COVID-19.

The past few months have been a large-scale test of operational agility for alternative asset managers. Leadership teams have faced significant challenges to keep their firms running, their staff connected, and investors informed.

Technology transformation

The advances in technology over the past decade certainly assisted the transition to remote working. However, many parts of the industry were still relying on at least some manual, paper-based processes before the pandemic. The EY 2019 alternative asset management survey[1] found that private equity lagged hedge funds significantly in investing in technology to improve their operations: just over half of hedge funds (51%) said they had been successful in enhancing middle and back office processes and technology, yet just 26% of private equity fund managers said the same. The report says that, for private equity funds, the "focus on these areas has been diverted as they deal with the enviable issue of deploying capital…Hedge funds, meanwhile, have taken the opportunity of slower growth to analyze and right-size their operations."

However, the experience of the past few months has provided the impetus required to make new investments or speed up planned investments to do things like remove paper from the system and automate more processes. "We've accelerated a few things," says Robyn Grew, chief operating officer of Man Group. "Electronic signatures, for example. The need for these was previously limited because it was easy for us to provide wet signatures. Now it's not, so that will be a thing of the future. But overall, the outcome of this is that the more electronic we can be, the more systematic we can be and the less manual, the better."

[1] https://assets.ey.com/content/dam/ey-sites/ey-com/en_gl/topics/wealth-and-asset-management/ey-global-alts-fund-survey-final.pdf

A more rapid adoption of digital technologies, such as data and analytics and automation, is also likely. Digital adoption will mean either a significant investment in in-house and potentially bespoke systems, or outsourcing for a range of activities.

Roman Regelman, BNY Mellon's CEO of Asset Servicing and Head of Digital, emphasizes the acceleration of digital adoption in a recent article on asset servicing transformation[2]:

"If COVID-19 reinforced anything, it is the critical need to digitize every process and interaction," Regelman says.

He continues, "It happened in custody years ago, and it happened in accounting. We see digitization transforming administration today. Going forward, we'll see just about every part of what was once in the realm of bespoke client service become automated."

And while greater digital adoption will lead to improved resilience to future black swan events, this also creates significant opportunities in terms of efficiency gains, plus the potential to spot untapped investment themes or identify hidden targets and risks.

[2] https://www.bnymellon.com/us/en/what-we-do/business-insights/leading-the-transformation-of-asset-servicing.jsp

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We believe the learnings from the health crisis will serve to advance and accelerate the hardening of IT infrastructure and automation to create a more flexible workplace and work force,” says Francis Idehen, chief operating officer at GCM Grosvenor.

Capital raising cuts

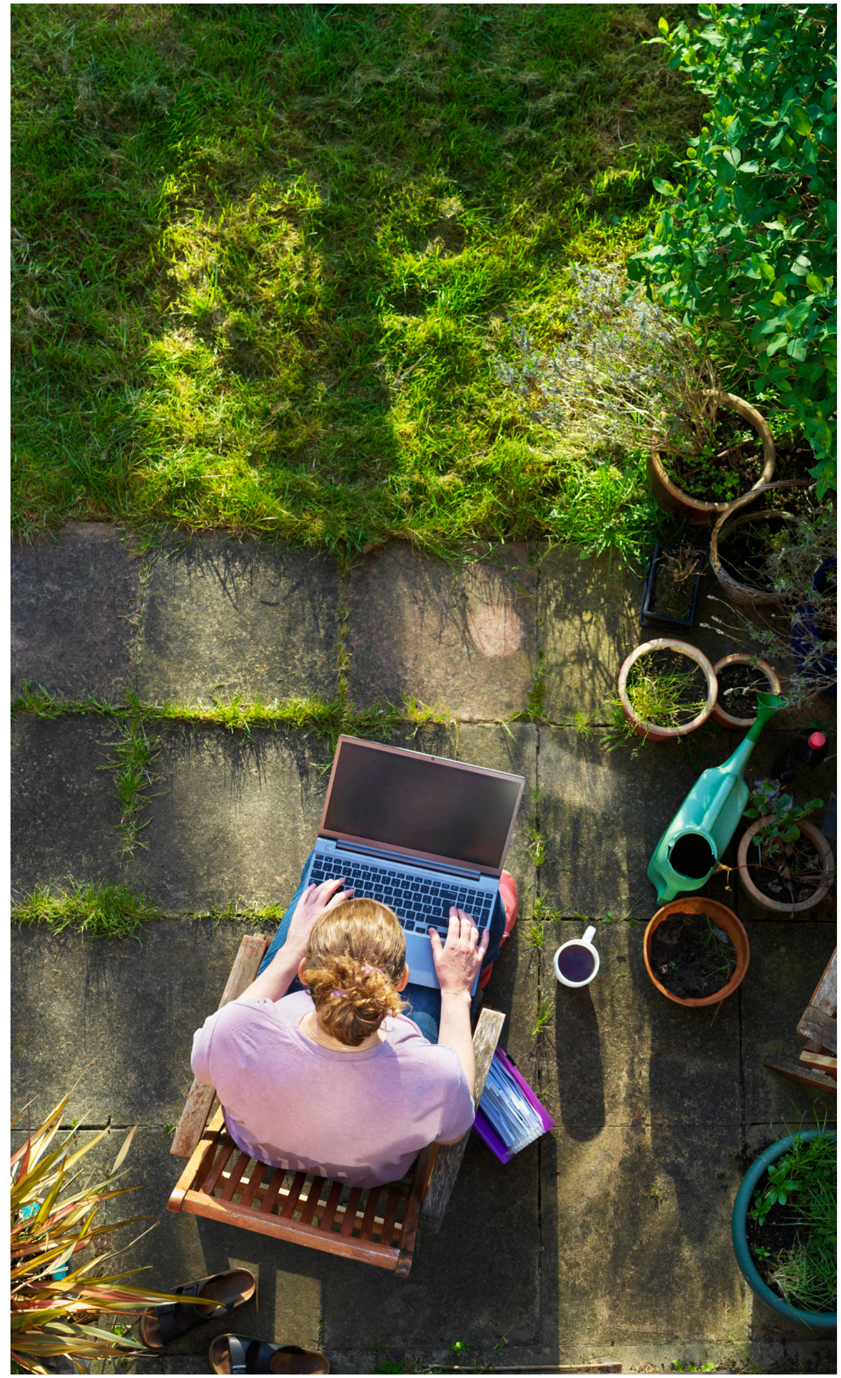
Nevertheless, COVID-19 looks set to have a negative impact on capital raising overall. Over half (58%) of investors in alternative assets said they would decrease the number of commitments they will make in 2020 and a similar proportion will decrease their size, according to Preqin[3]. Recognizing this, 55% of fund managers with funds open to investment have opted to slow their capital raising process, and 69% of fund managers overall say the pandemic has negatively affected capital raising, the Preqin survey found. Just 225 private equity funds reached a close globally in Q2 2020, the lowest number in five years.

It is difficult to untangle how much of this is the result of operational challenges in due diligence and how much is to do with issues such as the denominator effect and performance concerns. However, many investors will remain wary about making new investments in an uncertain environment without the kind of rigorous analysis and relationship-building to which they are accustomed.

[3] https://www.preqin.com/Portals/0/Documents/About/press-release/2020/may/COVID-Surveys-May-20.pdf?ver=2020-05-11-155901-027

The same can be said for new investments being made by many fund managers. New deal activity was down significantly in Q2 2020 as firms were unable to carry out usual due diligence in a highly uncertain environment. Infrastructure deals were down 39% by volume and 74% by value compared with the same period in 2019[4], while in private equity, Q2 2020 buyout activity registered only half the value and volume seen in the second quarter of 2019[5].

Given the nature of their investment activity, hedge funds, by contrast, have been more resilient. "Traditionally, traders have had to be in an office for security reasons and because regulators have insisted that market-making has had to be done in an office at one time," says Grew. "Ordinarily, I'd also be insisting that traders don't work from home. And some firms have had their traders continue to be office-based, but that is likely to be down to not having strong technology infrastructure. Every one of our traders has been at home."



[4] https://www.preqin.com/Portals/0/Documents/About/press-release/2020/July/INF-Q2-2020.pdf?ver=2020-07-15-081224-887

[5] https://www.preqin.com/Portals/0/Documents/About/press-release/2020/July/PEVC-Q2-2020.pdf?ver=2020-07-08-154129-593

Out with the old

The switch from office to remote working has been largely successful. This is prompting alternative investment managers to review their entire operation and even consider ripping up old ways of working. Done right, these changes have significant potential to improve efficiency, attract and retain talented staff while also increasing business resilience to future black swan events.

New working practices will lead to more flexible – and potentially more individual-led – working dynamics. It's likely that firms will still need office space and require staff to use it, but the future looks set to be more of a blended remote-office way of working. "We have all learned that we can be more flexible with our workplace and workforces," says Idehen. "Coupled with what we've learned on social distancing, this would suggest that you will not have the same office density we have been accustomed to."

Some may be looking to cut operational cost by reducing real estate footprint, but successful firms will be those that look far beyond the bottom line. The most effective organizations will recognize that this will require a shift in management styles to take account of individual circumstances – for example, considering staff who are unable to work from home as well as those whose circumstances make it more difficult to commute – and to be more intentional in the way they build teams and encourage collaboration. Organizational technology tools are part of this, but so is a change in mindset.

"When you are all in an office, it's very easy to raise a question over the desk. You can't do that remotely, so you need to plan more and visualize deadlines more clearly. It will become also much more apparent who is performing and who isn't, particularly in larger teams."

– Lars Tell

Chief Operating Officer, *Sector Asset Management*

Greater flexibility could also engender a more inclusive workplace as organizations may be able to bring in more diverse talent than would be possible under more traditional working patterns. “There is a real opportunity for this to develop and grow,” says Grew. “We can start to abandon some of the more old-fashioned and perhaps risk-averse practices to give us access to talent and creativity – that’s a massive upside and smart organizations will take advantage of that.”

Assessing investments

It’s clear that human relationships will remain important when it comes to investment decisions and portfolio management – both at fund investor and portfolio company levels. Yet the past few months has called into question the travel schedules many professionals believed were essential. With business travel set to be disrupted for some time to come, innovative solutions will emerge.

We’ve already seen some investors remove restrictions on operational due diligence to allow video conferencing and it seems likely that in-person meetings may no longer always be expected. “There will always be a place and need for face-to-face contact, both internally and with clients,” comments Idehen. “That said, it is likely remote interaction will become more widely accepted.”

In addition, some alternative asset managers have been experimenting with technologies such as drones or body cameras to conduct part of the due diligence in manufacturing plants, for example. In some cases, this may even be more effective than a visit in person as it offers the opportunity to re-wind footage, focus in on areas of interest and allow more individuals the chance to analyze by viewing footage.

Overall, less travel has a significant impact on firms’ cost and the efficiency of teams, while also reducing their carbon footprint at a time when climate change looks set to offer up new black swan events in the future. Yet it could also bring in a more objective view of investments. “We need to work more on developing virtual diligence rooms,” says Grew. “And there may be an advantage of looking even more closely at quantitative measures. Investors may find they can really get to the nub of issues outside the fact that they had lunch with the fund manager last week.”

The Future: *How agility will create resilience*

The industry's response to the pandemic has been the ultimate test of its business continuity planning and, to a large extent, those plans have held up well under some extreme circumstances.

Behind much of the success has been the increased spending on technology solutions that enable staff to work and collaborate remotely, with processes increasingly automated across the firm's operations.

This will give rise to even greater efficiencies enabling firms to meet individual investor requests and to improve their understanding of underlying positions, risks and opportunities. But it does come with added cybersecurity risk. As a result, firms will increasingly invest in intelligent cybersecurity systems. "We remain focused on cybersecurity as we operate with a more distributed workforce and expect this to be an area of focus across the industry," says Idehen.

Yet cybersecurity is just one of the risks firms will need to manage. As we've seen, a more connected world means that black swan events can up-end entire global systems. Those who can best adapt to new technological demands will have an advantage in not only delivering better quality service to their clients but also in attracting talent.

Tomorrow's star performers will be those that plan effectively for future pandemics, the effects of climate change, market disruptions, social unrest, geopolitical flare-ups and even other, unknown disruptive forces.

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