

How Fund Look-through Improves Buy-side Risk Monitoring and Performance Evaluation

Charles
River

bobs guide

The leading web resource for financial technology

Asset managers and owners increasingly implement their investment strategy by buying funds from a number of providers. These funds can represent a significant portion of the firm's portfolio, and complicate their ability to manage risk, measure performance and comply with

global shareholder disclosure regulations.

Managing fund holdings requires the ability to "look through" the underlying securities held in the funds in order to identify and aggregate exposures at any level of direct or indirect ownership. For large institutional portfolios, this can involve multiple levels of constituent holdings across a range of pooled investment vehicles, including ETFs, ETNs, Fund of Funds (FoF) and Investment Trusts. While ETFs comprise the bulk of these holdings, firms also manage internal funds for strategy implementation, such as balanced funds.

By purchasing funds and related products, asset managers can gain broad diversification across alpha sources, and access to risk drivers with low correlations to core holdings. Funds can also provide exposure to differentiated strategies or new geographies. Some fund structures such as ETFs offer the opportunity to invest in a portfolio of securities that provide the same diversification benefits of mutual funds, with the liquidity and trading flexibility of stocks.

Given their wide acceptance, investors are reevaluating how they manage, measure and ultimately hedge risks with these portfolio structures – from asset allocation and manager selection to portfolio construction and exposure monitoring. This article discusses how look-through enables more informed risk management and performance attribution, the challenges of implementing and automating fund look-through for asset managers, and technology evaluation considerations.

Risk Management

Fund look-through allows portfolio and risk managers to understand portfolio exposure from multiple perspectives. This enables timelier exposure monitoring and more responsive hedging and de-risking decisions. Equity funds can be disaggregated to the individual security level and issuer, while bond funds can be analyzed by credit rating, country, bond type, maturity and currency. The impact of derivatives on their underlying instruments must also be reflected. Additionally, look-through provides richer historical data of a manager's risk exposures and adherence/deviation to/from a fund's stated investment policies.

By providing a more granular view of exposures, look-through enhances both risk and portfolio management:

- Portfolio stress testing** can better predict outcomes when using a complete view of portfolio constituents than with 80% coverage
- Historical scenario analysis and strategy back testing** can be conducted using previously unavailable data to check model accuracy
- Awareness of current fund-of-fund exposures**, aggregated by concentration or counterparty, geography, sector or asset class result in more informed asset allocation decisions
- Smarter portfolio construction and optimization decisions** based on accurate covariance matrices for collective investment vehicles.

Performance attribution

The Fund of Funds industry has seen enormous asset growth, largely driven by strong institutional interest. For investors, plan sponsors and clients that hire multiple managers to optimally manage their portfolios, it is important to see a portfolio's look-through performance in terms of the key decisions made:

- Strategic allocation to broad asset classes
- Tactical deviations from these asset classes
- Benchmark risk taken by assigning benchmarks different from those at the fund level to those assigned to managers
- Manager selection
- Manager allocation

Look-through capabilities are also critical for accurately attributing performance in pooled structures. For example, real-time ETF prices can deviate from the fund's NAV (the exchanged-traded price of an ETF can be above or below its NAV). This may present an arbitrage opportunity wherein an investor could purchase ETF shares, redeem them for the underlying assets at NAV and realize a gain. By supporting the right level of data granularity, look-through provides visibility into direct and indirect holdings, uncovers potential pricing differences, and enables conflicting attribution figures to be reconciled. Additionally, look-through enables:

- A consolidated view of performance for collective structures
- Identification of discrepancies in fund-of-fund and ETF pricing
- Accurate reporting of position and sector concentrations

Challenges with managing pooled investment vehicles

The growing importance of funds in institutional portfolios managed by banks, pensions and insurers has invited global regulatory scrutiny. Tasked with preventing a future Lehman-like failure, regulators have implemented sweeping regulations including Solvency II and Basel III that highlight the importance of look-through capabilities for banks and asset owners. Asset managers are also drawing the attention of regulators, given the rapid rise of passive, index-based investing and the growing complexity and size of institutional portfolios.

It is critical for portfolio managers and risk officers to be able to 'look through' their portfolios, measure and aggregate underlying exposures, and roll them up to the portfolio level. A granular view of exposures enables more informed investment decisions.

Traditionally, gaining transparency into constituent level holdings proved difficult or impossible to attain on a timely basis, since monthly or quarterly reporting was considered acceptable. These backward-looking views of exposures might satisfy regulatory risk reporting requirements, but provide little value for portfolio and risk managers looking to rebalance or hedge current holdings.

Pooled investment vehicles provide varying degrees of transparency into their constituents. The inability to disaggregate opaque holdings can make it impossible to aggregate exposure at the ISIN or CUSIP level. Regulators are incentivizing transparency by boosting capital requirements for investments in funds with non-transparent holdings.

Technology considerations

The scale and depth of data required to support look-through presents significant logistical and technical challenges that must be resolved in order to provide complete, timely and accurate information to asset managers. Look-through has multiple impacts across the front and middle office, and technology vendors need to provide holistic solutions that effectively address the challenges discussed earlier. At a minimum, technology must support pooled structures across asset classes, appropriate fund disaggregation capabilities (down to any level), and daily reporting.

Automated capture of look-through data is critical. Large firms hold potentially hundreds of individual funds across dozens of fund distributors and managers. Attempting to source and manage this data manually quickly becomes impossible. Having a single, consistent data format across fund managers and instruments streamlines data capture, eliminates manual data entry, and enables daily exposure aggregation and reporting. Equally critical is the comprehensiveness of the underlying security master: it needs to cover every instrument in every fund that the manager may be invested in. Assembling and maintaining an up to date security master is resource intensive, requiring data from multiple internal and external sources.

Summary

The popularity and utility of pooled investment vehicles to implement buy-side investment strategies is well established. Using funds to gain low fee exposure to new geographies and uncorrelated asset classes is a clear benefit, but one that must be balanced with the requirements of timely and accurate exposure monitoring and management.

Investment managers, banks, third-party administrators and asset owners all benefit from timely and granular look-through capabilities. Firms working from a complete and current view of exposures can reduce the potential for shareholder disclosure breaches. Banks can lower risk capital reserves, allowing these funds to be reinvested. Asset owners have a clear view of fund performance across their investment universe and can make data-driven allocation and manager selection decisions.

Asset managers capable of providing clients and regulators with current, accurate and detailed exposure data have a clear advantage over firms lacking the requisite look-through and aggregation capabilities. Having the correct technology in place can position firms to retain and even grow AUM during a time of declining management fees and front and middle office headcount reductions. Streamlined look-through is a key capability, supported by a comprehensive security master and solid data management infrastructure.

Charles River enables sound and efficient investing across all asset classes. Over 350 firms worldwide use Charles River IMS to manage more than US\$25 Trillion in assets in the institutional investment, wealth management and hedge fund industries. Our Software as a Service-based solution automates and simplifies investment management on a single platform – from portfolio management and risk analytics through trading and post-trade settlement, with integrated compliance and managed data throughout. Headquartered in Burlington, Massachusetts, we support clients globally with more than 750 employees in 11 regional offices. WWW.CRD.COM

