Operational Alpha

- a key to staying competitive in funds management

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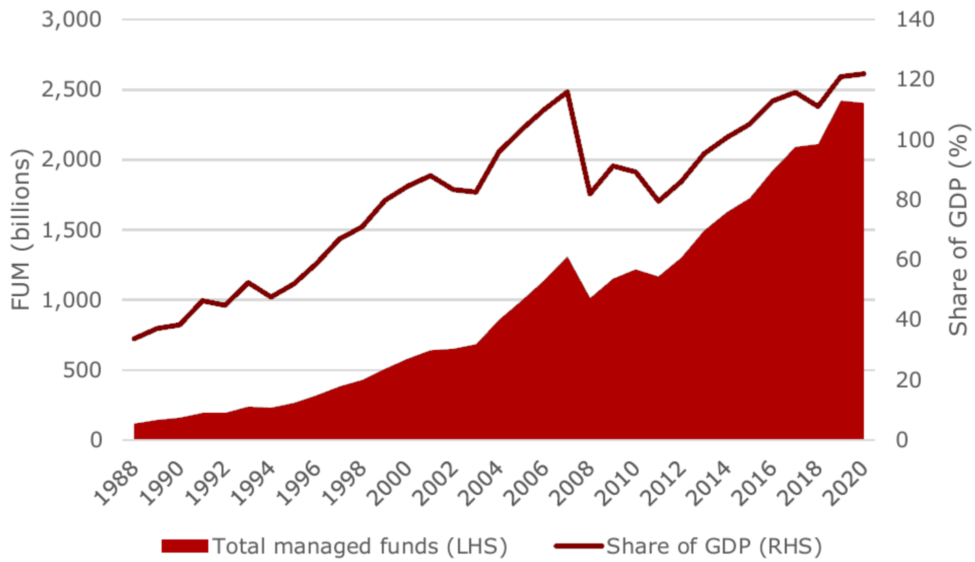
GROWING DEMAND: demand for managed funds is growing faster than GDP.

In the last 10 years or more, the Australian managed funds industry has undergone considerable change, with demand for funds management services growing steadily and total Funds Under Management (**FUM**) growing significantly over the past 30 years, from 34% of Gross Domestic Product (**GDP**) to 122% at the end of 2020 according to the Australian Bureau of Statistics (**ABS**). In dollar value of FUM, this has seen an increase from $144 billion to almost $2.5 trillion. To put this number into context, as at March 2023, the total money supply in Australia is $2.87 trillion.

Total funds under management in Australia (1988 – 2020)



Source: ABS (2011)

The recent publication of Competition in Funds Management by the Australian Securities & Investments Commission (**ASIC**) and Deloitte, concludes that investors ultimately make investment decisions based on a range of factors, not just absolute returns. Within each investor type (e.g. retail, wholesale), fund managers compete within and across some or all of three main competitive dimensions[1]:

> **Dimension 1: fund characteristics –** for example, asset class, listed status and investment style (active or passive)
> **Dimension 2: fund manager characteristics –** for example, customer service and brand
> **Dimension 3: historical returns, fees and discounts**

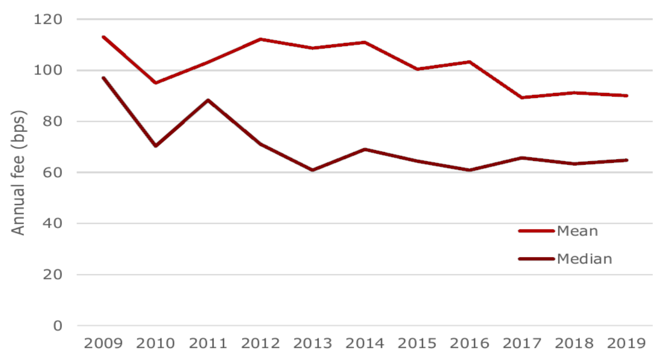
[1] *Competition in Funds Management, Australian Securities & Investments Commission, Deloitte Access Economics, September 2021*

FEE COMPRESSION: a trend you might already be aware of.

The funds management industry in Australia is highly competitive, with the same ASIC and Deloitte report showing that many small fund managers found that they had limited control over prices and tend to operate as price takers rather than price makers[2].

Other than fund characteristics (Dimension 1) and fund manager characteristics (Dimension 2), many fund managers have been trying to compete on fees and discounts, driving fees charged by fund managers to steadily declining over the last few decades, in both the retail, wholesale and institutional investor markets, domestically and overseas. In the survey conducted for this ASIC and Deloitte report, 93% of respondents (including fund managers, platforms and other groups) said that fund manager fees had fallen in the last ten years.

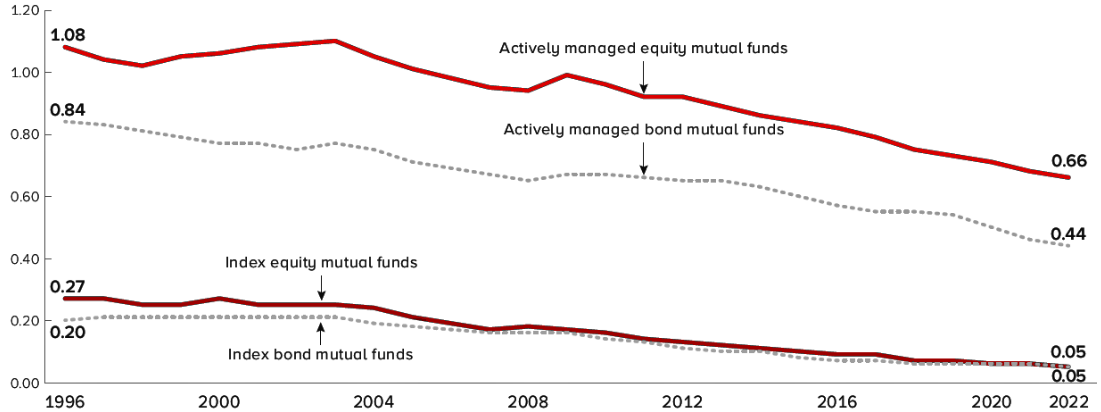
Fees charged over time – total expenses by funds under management - Australia, 2009 – 2019, basis points (bps)



Source: Deloitte Access Economics (2021) and ASIC 388 forms.

In the midst of the rise of low-cost index funds, increase of regulation and compliance requirements, and investors demanding higher return and more transparency – ***how can funds management firms stay relevant and competitive in today's world?***

Actively managed funds and index funds fee trends - United States, 1996-2020, percentage (%)



Source: Investment Company Institute, Lipper and Morningstar

[2]Competition in Funds Management, Australian Securities & Investments Commission, Deloitte Access Economics, September 2021

RUNNING A BUSINESS: scarcity breeds efficiency.

Before we start searching for ways to "stay competitive in funds management", let's take a few steps back to understand how businesses operate.

Business operations and human behaviour are closely intertwined, both are fundamentally driven by the actions and decisions of individuals. Motivated by this connection, the field of behavioural economics (a subset of behaviour science) was developed in the 1980s which studies the effects of psychological, cognitive, emotional, cultural and social factors on the decisions of individuals or businesses / institutions.

There are numerous research papers showing that almost every human activity that takes place in the world is restricted/subject to scarcity[3], including running a business.

To this end, let's take a look at the definition of scarcity and efficiency:

- **Scarcity** is an economics concept rooted in one of the most basic facts of life: we live in a world of limited resources that requires choices about how they are allocated.[4]
- **Efficiency** is the quality of achieving the largest amount of useful work using as little energy, fuel, effort, etc. as possible.[5]

In a world of scarcity (which we live in now), it is essential to use resources efficiently in order to maximise their value. If a company has limited resources, such as time or money, it needs to carefully allocate its resources to activities that will generate the most value, while minimising waste and inefficiency. In other words, efficiency can help mitigate the effects of scarcity by allowing organisations to get more output from limited resources, and thus help companies to achieve their goals with fewer resources and increased profitability.

"Scarcity: A basic economic problem - the gap between limited resources and theoretically limitess eants" - Investopedia (2023)

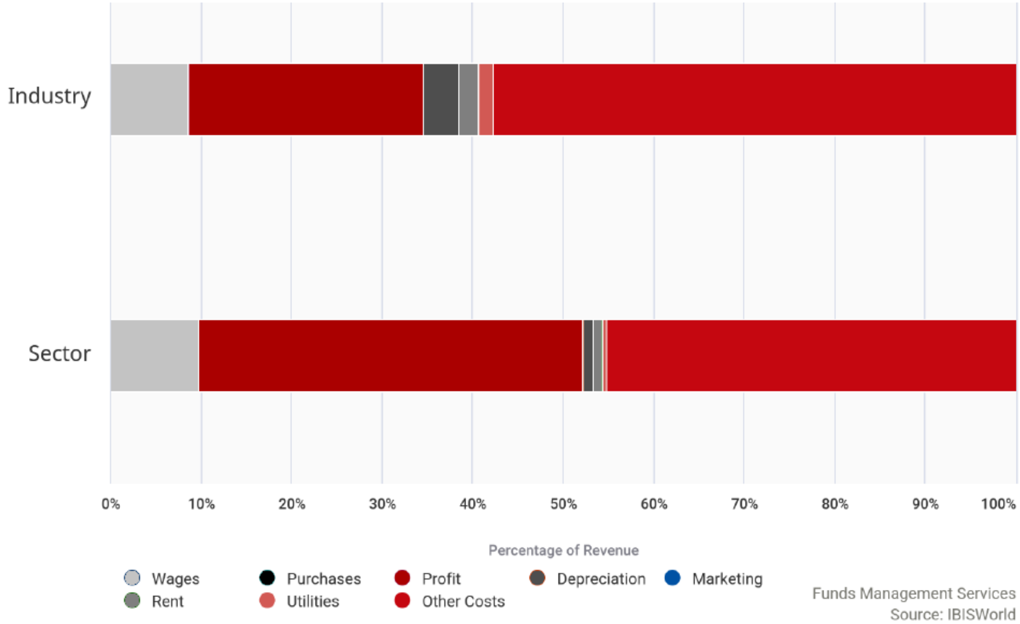
[3] Does scarcity make you dumb? A behavioral understanding of how scarcity diminishes our decision making and control, Deloitte University Press, 2016
[4] Scarcity: What It Means in Economics and What Causes It, Investopedia
[5] Cambridge Dictionary

RESOURCE ALLOCATION: funds management industry overview.

In the context of funds management, scarcity relates to the limited resources available to manage the fund, such as time, personnel and capital. The demand for high-quality investment management services is significant, especially when operating in an environment such as Australia with a financial system that is highly regulated and competitive. Fund managers need to be able to maximise the use of their limited resources to achieve their investment goals and deliver outperformance (alpha) to their investors versus their peers or benchmark.

Funds management industry profitability is derived primarily from management and performance fees, minus wages, administration expenses and other general costs. Typically as FUM increases, industry operators benefit from greater economies of scale and rising profit margins. However, rising competition as shown above has placed downward pressure on fees, which has constrained growth in profitability.

Cost structure breakdown, funds management industry and financial sector in Australia[6]
2022, as measured by percentage of Revenue



Source: IBISWorld, Funds Management in Australia Industry Report Feb 2022

Wages is a key cost for fund managers, and arguably the most important. Funds management industry employees are highly skilled and generally have significant experience working in the industry and are hired to run the core value-adding activities of investment analysis, portfolio construction and management.

[6]Funds Management Services in Australia Industry Report, Manageable: Revenue has risen, despite the COVID-19 pandemic heightening volatility, IBISWorld, James Thomson, February 2022

RESOURCE ALLOCATION: continued.

Outside wages, fund managers incur numerous other costs (whether directly from its own cashflow or indirectly through the fund, thereby eroding its own fees), including those related to custodial services, unit pricing, registry, fund accounting and other professional services. Fund management firms also incur marketing, corporate administrative, rent, utilities and other general costs.

Counterintuitively, as shown by the diagram above, other costs outweigh the wages cost – consuming over 50% of the revenue within the funds management industry!

> *"With the rising popularity of low-cost index funds such as exchange traded funds (ETFs), there is increasing pressure for all players including Alternative asset managers to lower their fees and cut costs. Although Alternative funds may not be able to reduce their fees as low as those ETFs issued by Vanguard, BlackRock, or StateStreet, we believe the evolution of fee reduction and broad diversification via a single vehicle is inevitable. It will take time, and Ekam Capital is at the forefront of this evolution. By replicating the framework of a broadly diversified stock market ETF and continuing to strive for operational efficiency, Ekam Capital aims to bring investors an institutional grade portfolio, unparalleled diversification, for one low fee. "* - **Ekam Capital**

In general, the costs associated with a fund can be categorised into five main components:

1. **Investment Management Fee**: Fees associated with investment management such as expenses that contribute to investment analysis and portfolio construction and management (similar to R&D and input costs in other industries).
2. **Performance Fee**: Fees associated with the investment manager achieving returns that are in-excess of a given benchmark or huddle, and providing a strong incentive for the investment manager to generate investment alpha for the investors.
3. **Placement Fee**: Fees associated with undertaking or outsourcing the role of capital introductions and raising for the fund which includes the development of the marketing collateral, establishment of a data-room to undertake the bookbuild, roadshows and client communications initially and ongoing.
4. **Trustee Fee:** Fees associated with governance and compliance to protect the interests of investors such as all expenses spent on ensuring adherence to government regulations and terms of investment.
5. **Administration Fee**: Fees associated with administration (similar corporate overheads in other industries) includes:
    - *accounting* to ensure the value of investor's holdings are reflective of their underlying investment assets;
    - *registry* to ensure the investors interests are correctly recorded; and
    - *custody* to ensure the safekeeping of the fund's investment assets.

While it is important that fees are kept as low as possible for investors, it is also in investors' interest that the fund management firms are able to cover their costs. These costs include salaries and incentive structures for high quality staff in order to align interests with investors by continuing to deliver strong returns while being adequately incentivised.

OPERATIONAL ALPHA: harnessing operational efficiency.

Alpha (α) or Investment Alpha is a term used to describe an investment strategy's ability to outperform the market, or the value added that comes from active investment decisions[7]. Operational Alpha is the value added from everything other than the actual decision process of investment, including the adoption of new processes and procedures that permanently reduce costs and boost efficiency.[8]

Logically, cost reduction and outperformance of the same magnitude should have identical impact on net returns to investors. But why do fund managers tend to focus on Investment Alpha when reporting performance but leave out on Operational Alpha?

In the context of overall funds management industry in Australia ($25 trillion):
1bp *Operational Alpha* (cost reduction) = 1bp *Investment Alpha* (outperformance) = *$250m*

Optimising processes, embracing technology, automating tasks, outsourcing selective functions and maintaining a culture of continuous improvement, allows fund managers to better allocate their limited resources to improve operational efficiency, reduce risks, deliver better returns to investors, and ultimately free up resources for more value-adding work, such as strategic decision making so that the firms can remain competitive and meet the evolving needs of investors.

In other words, improving Operational Alpha does not only reduce costs and thus improve return (Dimension 3), more importantly, at the business level, it allows for existing resources to focus on gaining ground in fund characteristics (Dimension 1) and manager characteristics (Dimension 2).

"Operational efficiency is more than just a buzzword, it is shaping the funds management industry today as the guiding ethos, especially with the tough economic environment over the horizon, in which investment managers have to continue to provide positive returns to investors and raise capital for exclusive investment opportunities to be successful." - **MAI Capital**

[7]*Alpha: What It Means in Investing, Investopedia*
[8]*The search for operational alpha, Seamus Collins, June 2015*

OPERATIONAL ALPHA: continued.

By operating efficiently, funds management firms can focus more on their core competencies. Below are some relevant tools for fund managers to consider, which can contribute positively to the goal of operational efficiency:

1. **Process Optimisation:** The workflows and processes within a funds management firm can often be complex and time-consuming. Embracing the learnings from other industries, one effective approach can be to adopt Lean methodology (to be introduced below) that focuses on identifying and eliminating waste in processes. This involves identifying areas where processes can be streamlined or automated, analysing how non-value-added activities can be eliminated, and reducing cycle times.

   Fortunately for businesses operating in 2023, the concept of process optimisation and improvement is not new, in fact, it has been around for centuries, with evidence of its use dating back to ancient civilisations such as the Greeks and Romans. However, it was not until the 20th century that process improvement became a formal discipline, with the introduction of various methodologies and tools. A good starting point would be to study the learnings and smarts of our predecessors (of running business). The list of process improvement methodologies below has continued to evolve and be adopted by organisations globally in some shape or form, including here at The SILC Group.

   Recent History of Process Optimisation

Year	Milestone Event	
1950	**Lean Manufacturing** was developed by Toyota	An original manufacturing philosophy that aims to eliminate waste and achieve the best possible efficiency – what is often called a "lean" or "Just-In-Time" system.
1959	**Critical Path Method** was developed by Remington Road and DuPont	An attempt to find ways to reduce the costs associated with plant shutdowns and restarts that were being caused by inefficient scheduling. By ensuring that the right tasks were performed at the right times, instead of simply saturating the problem with additional labor, they found that excess costs could be avoided.
1986	**Six Sigma** was developed by Motorola	A method named after a statistical concept, Six Sigma process improvement strategy improves output quality by reducing defects. (The most optimised process is set to be the one in which there are 3.4 errors per million opportunities)
1990s	**Six Sigma** was implemented by General Electric	
2000s	**Lean Six Sigma** was introduced, combining the principles and essence of Lean Manufacturing and Six Sigma	A guide for managers of manufacturing plants on how to combine lean manufacturing and Six Sigma to improve quality and cycle time in the plant.
2010s	**Operational Alpha** was introduced by Northern Trust	The positive impact of "data aggregation, historical analysis, custom tagging functionality, and on-demand or real-time data retrieval" on investment strategy and operations and as a result contributing to total alpha of a product.

OPERATIONAL ALPHA: continued.

2. **Embrace Technology and Automation:** All industries are undergoing a significant digital transformation, with technology playing a crucial role in driving operational efficiency, and the funds management industry is no different. There are already many tools available (or in development) including client onboarding software, portfolio management tools, data analytics, artificial intelligence and machine learning to improve decision-making, knowledge management and to reduce low-value manual tasks. For example, implementing a digital platform for client onboarding can automate repetitive and manual tasks, which may significantly reduce the time and resources required to onboard new clients. Or having a digital marketplace for offering financial products that will provide investors access and choice to investment opportunities that may be otherwise unattainable. Or having a digital platform that has a facility which allows investors to apply and redeem their holdings in an investment. We will explore this topic furthermore specifically in our next article later this year titled: Off-Chain Asset Tokensation - Benefits and Barriers.

> *Exciting developments in the utilisation of blockchain technology, in particular tokenisation of 'off-chain assets', offer the potential for reduced intermediation and improved operational efficiency*
> - **James Hill, Head of Digital Solutions at The SILC Group**

3. **Outsourcing:** Outsourcing has become a popular business strategy in recent years. For fund managers, outsourcing is another way to improve efficiency and reduce costs. While it all sounds rosy, if outsourcing is not executed effectively, it may cause more harm than good. As a general rule, effective outsourcing should allow for:

   - *Access to specialised expertise:* Providing access to specialised expertise and resources that may not be available in-house including staying up-to-date with the latest industry trends and regulations, in order to make more informed investment decisions;
   - *Improved risk management by implementing best practices:* Fund managers can improve their operational efficiency by implementing best practices in areas such as risk management, compliance and performance reporting. For example, implementing a robust risk management framework can help fund managers to identify and manage risks effectively, thereby reducing the likelihood of losses. Similarly, adopting a comprehensive compliance program can help to ensure that all regulatory requirements are met, reducing the risk of fines and penalties. In its role as trustee, The SILC Group firmly believes that effective risk management is key to maintaining investor confidence, which is just as important as investment performance.
   - *Increased flexibility:* Outsourcing can give fund managers more flexibility to scale their operations up or down as needed, without incurring significant fixed costs.
   - *Enhanced focus on core competencies:* By outsourcing non-core functions, fund managers can focus more of their time, resources, and attention on their core competencies, such as investment analysis and portfolio management.

CONCLUSION: opportunities await.

"In the midst of every crisis lies great opportunity." - **Albert Einstein**

The fast-growing Australian funds management industry is as competitive ever. This coupled with the uncertain and ever changing global economic landscape, presents opportunities for those fund managers who:

- Understand the driving forces in the industry;
- Manage scarcity and resources effectively; and
- Continue to improve Operational Alpha

These factors allow the fund managers to achieve improved performance, better outcomes for investors, and builds a sustainable business model which helps the firm remain competitive and flourish.

First order of business in setting up and enhancing Operational Alpha is the assessment of the landscape of service providers by fund managers. Appropriate due diligence is imperative to ensure business and goal alignment.

Some questions to consider when conducting due diligence on service providers:

- Organisational structure and resources:
  - What is the organisational structure and financial standing?
  - Are key staff based in relevant jurisdictions or are they all offshore?
  - Medium to long term corporate strategy – are they running the business for long term or are preparing to sell the business or publicly list?
  - Does the provider have capacity to grow with the fund/business?

- Personnel track-record and experience:
  - Have you met the key staff members that you expect to be interacting with?
  - Is there a high turnover of staff?
  - Is there culture and value alignment to facilitate stakeholder collaboration?
  - Does the organisation have experience in servicing the needs to similar fund managers?
  - Are client references available?

- Risk management and compliance:
  - Are there relevant policies, procedures and processes in place to appropriately manage risk?
  - What is their knowledge and attitude towards compliance and regulation?
  - Is appropriate professional indemnity insurance in place in the event of professional negligence, breach of confidentiality and other errors?

CONCLUSION: continued.

- Clarity and transparency:
    - ¤ Are all parties clear what is required to ensure pricing proposals are clear and complete to avoid any surprises?
    - ¤ How does the pricing compare to others? If the pricing is too expensive it may be uneconomical for the fund manager, but if it is too cheap it may not be sustainable for the service provider.

- Other:
    - ¤ Does the provider offer any other value-added services that would be relevant or useful in the future?

"At the end of the day a funds management business is about serving the needs of investors. For fund managers, operational efficiency is a core source of alpha and goes way beyond cost reduction which is a key to remain competitive and is a critical component of success.

Having launched multiple managed funds, feeder funds and discrete funds across all major alternative asset classes as well as in traditional assets, The SILC Group is in a unique position to understand the requirements, constraints, risks and rewards of collaborating with strategic stakeholders in delivering operational excellence to support the efficiency, velocity and scalability of the fund managers."

- Koby Jones, Group Managing Director at The SILC Group

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ABOUT THE SILC GROUP

The SILC Group is an alternative assets solutions specialist servicing the unique needs of investment managers, asset sponsors and wholesale investors through our distinct portfolio, digital and capital solutions. Since launching in 2012, The SILC Group has become a leading alternative provider of independent wholesale trustee, security trustee, fund administrator, registry, facility agency and licencing services. Our specialists work alongside our sophisticated clients to understand their business, project or asset requirements to determine the appropriate solutions to support their future growth and funding needs.

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