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Annual Report And Directory Of Global Custodians - Custodians Learn To Deal With Alternatives

Things have changed for **custodians** in Canada.

There was a time when their primary jobs were to settle trades and send out statements at the end of each month showing their clients their holdings.

However, three to 3½ years ago, says David Linds, senior vice-president, business development and client relationship management, at CIBC Mellon Global Securities Services, "we started to see a very distinctive trend" towards the use of more **alternative investments**.

At that time, **institutional investors** were still restricted in the amount of **foreign investment** (30 per cent) that they could hold. Many had no other choice than to use derivatives to enhance **investments** within the limits of the foreign property rule.

Plus, **Defined Benefit pension** plan funds were looking for ways to increase their returns and offset growing **pension** plan liabilities. Again, alternatives attracted them.

Linds says the big plans started the trend to invest in over-the-counter investments, alternative investments, hedge funds, and private placements as well as direct investments in real estate, timber, and private equity.

As well, institutional firms were creating sophisticated instruments such as variance swaps and binary options. Custodians started to see a very distinctive trend away from the standard kinds of investments to "more alternatives, more esoteric hedges, more privates," he says.

Clearly, this move to alternative investments by pension funds is creating new challenges for custodians. Here's how some of Canada's custodians are dealing with these challenges.

David Linds - Senior Vice-president Business Development & Client Relationship Management CIBC Mellon Global Securities Services

"In our role as custodian, we're responsible to safekeep the assets our clients invest in. We also have an obligation to our clients to ensure that we keep pace with the dynamic changes in the marketplace. Here in Canada, what you have is a series of clients – be it pension funds, mutual funds, institutional investors, insurance companies – that are taking us places we frankly never thought we would go. By that I mean, they are investing in a whole range of overthe-counter investments, private placements, and alternative investments – including hedge funds – as well as direct investments in real estate, timber, and private equity," says Linds.

Five years ago, he says, the use of derivatives to deal with the limitation on foreign investing was relatively straightforward. It's when hedge funds and alternative investments started to show up that the marketplace, not just the custodians, was caught a little bit off guard. "For example, we had to go out and find a vendor to price these instruments."

In many cases, custodians rely on third parties to provide those services. "All these derivatives have been engineered, so how do you account for them, literally, from a valuation perspective? How do you price them? What's the formula by which you determine the valuation?"

To do this, custodians have supplemented their teams to include staff who understand these trading strategies and understand the instruments that are being presented. Custodians have dealt with this through "a combination of the people they've hired, the kind of brainpower they've hired, and the continued investment in technology that enables them to account for these instruments on a global basis," says Linds.

Is the industry 100 per cent there? Linds says "No, because there will always be a new item that's engineered, so there will be a little bit of catch-up. Our challenge is to ensure that we're with our clients on the leading edge and participating in their strategy sessions to understand where they're going. It's important we align ourselves with our clients.

"It's a real challenge. Twenty years ago, the challenge was how many markets can you get me into? We were in 40. Nobody's talking about can you get me into that 86th market now. It's a different kind of issue. It's 'can you trade this instrument in that market'?"

José Placido - Chief Executive Officer RBC Dexia Investor Services

"We have definitely seen an increased appetite for alternative investments over the past several years – and this is driving a major shift in asset allocation strategies among clients – including Canada's pension funds," says Placido.

While much of the mainstream media coverage has tended to focus on the high-profile hedge fund sector, institutional investors are seeking opportunities across a much broader range of asset classes as they look to enhance profitability. They're looking at areas such as real estate, infrastructure, private equity, and more.

The shift to these new asset classes brings with it a unique set of challenges for both the investors and the custodian.

From the pension fund's perspective, this shift highlights the need for better transaction, operational, and risk management systems. These new asset classes can potentially add more risk to the portfolio. It's important for them to be able to quantify those risks and manage them appropriately to ensure the best interests of the fund and its beneficiaries are front and centre. Custodians assist clients in monitoring these risks with tools such as compliance monitoring and risk management.

"To add maximum value, providers need to clearly understand their clients' alternative investment strategies, objectives, and business model so that they can develop robust and reliable investment support services," he says.

Placido says "we saw this shift coming and took the appropriate steps to prepare in order to provide our pension clients with the highest level of alternative investment support services possible."

Robert Baillie - President & CEO The Northern Trust Company, Canada

Northern Trust has been very much in tune with the increased allocation to alternative investments by pension funds and is doing a great deal to provide the best solutions for these clients. "While this really is a global phenomenon, the trend clearly has a presence in Canada and we are watching its evolution very closely," says Baillie.

With a trend as dramatic as this one, there are bound to be operational difficulties as fund managers explore new territory at such a rapid pace. Baillie says three major issues come to mind when reflecting on custodian efforts around this shift in asset allocation:

- OTC derivatives processing
- Performance
- Risk measurement and private equity.

OTC derivatives processing is likely the number one issue to emerge from the increased interest in hedge funds, he says. Northern Trust processed more derivatives in the first quarter of 2006 alone than it did in the whole of 2005, and "we've seen 30 per cent average year-over-year growth over the past three years."

In response to this trend, custodians must support a wide range of exchange-traded and over-the-counter (OTC) derivative products. They must perform settlement and processing and offer specialist services for OTC derivatives including independent pricing, and collateral management.

In anticipation of continued growth in this area, custodians must continue to make significant investments towards increasing the automation of OTC derivatives processing. "We've bought specialist derivatives technology which we're integrating with our core accounting and performance measurement systems, and we're participating in the SWIFT FPML (Financial Products Mark-up Language) working group to help achieve STP." Performance and risk measurement is an area where custodians can really add value for pension plan investors," says Baillie.

Private equity is another 'alternative' asset class that is gaining momentum in the global investment community, almost to the point where it has become mainstream. "Our private equity assets under custody have doubled in just two years," he says.

Everyone is struggling with this asset class. Baillie says clients say it is 15 per cent of their portfolio, but takes up 50 per cent of their time. "As a custodian, they come to us for help with automating the process and our efforts in this area are mainly on the front end. We've looked into greater efficiencies for all clients and all asset classes, and private equity is a major part of that undertaking."

Doreen Rigby - Senior Vice-president & Head of State Street Investor Services Business in Canada

"We have clearly seen significant growth in the use of alternative investments throughout the industry. These products are being imbedded in existing investment strategies or mutual funds as well as being used in specific hedge fund structures," says Rigby.

Hedge funds will continue to provide an opportunity for administrators as more pension funds and institutions increase their allocations. Currently, State Street's existing operations that support the investment administration for these funds continue to deal with higher levels of transactions and new OTC instruments. These could be considered challenges, however, "we view them as an opportunity to provide even better service to our existing, and future clients."

She says the year-over-year growth of hedge fund assets is expected to continue at a rate of 15 to 20 per cent.

Adrian Mark Baker - Chief Operating Officer Canadian Western Trust

For Canadian Western Trust (CWT), custody of alternative investment assets is not an issue. Its sweet spot in the institutional custody world is pension plans with assets below $100 million, typically smaller, labour funded plans.

Because it has established a "nice little niche," Baker says it gets asked all the time by consultants if it would issue a proposal on a $300 million portfolio. "It gives us a lot of opportunity to bid on large plans and it's an area we should investigate more."

He says Canadian plan sponsors, if they have more than $500 billion, are served by excellent custodians with very sophisticated systems. However, this comes with a price. For example, the minimum fee is a lot higher.

"Being an alternative, we've focused on the needs of domestic clients. Part of the reason for our success is the fees, but it is also servicing."

The development of CAP guidelines has created another opportunity for CWT. It is giving the custodian a multitude of offerings and "we've been promoting a limited choice or no choice plan."

CWT is also looking to enhance its institutional custody business and offer segregated asset facilities, says Baker. It is working with a sub-custody partner to make an entry into the seg area.

"In 2006, we broke through $1 billion in pension assets and have seen some very good growth from Western Canada. Assets are up 17 per cent." ■

Joe Hornyak is executive editor of Benefits and Pensions Monitor.