The digitization mandate

Increase the pace of transformation in the alternative investment industry

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"From our perspective, digitizing an organization is about creating a strategic, end-to-end process that is intended to benefit the business and, at the same time, offering better customer experiences and innovative products and services.

If the transformation results in better work processes, inevitably there will be a positive impact across the value chain. But, transformation demands consensus, follow-through, and daily commitment from leaders across all functions."

— Jim Suglia, National Practice Leader, Alternative Investments

It's no fad: digital transformation will reshape alternative investments

Digitization is shaping the alternative investment funds industry—but adoption is slow.

Fund businesses that dawdle are missing opportunities to advance in the marketplace by cutting costs, accruing operational benefits, and most of all, satisfying investors (and potential investors) who have shown little patience for businesses that move slowly.

Too harsh of an assessment?

We don't think so.

As we were thinking about digital transformation in the alternative investments industry, we kept in mind operational and cost efficiencies. We also think these tools could offset the potential reduction of income as the result of investors' demands for lower fees.

We believe it is important to illustrate the benefits that accrue to funds that embrace new technologies. Those new ways of working can have a demonstrably positive impact on the industry's value chain. They include:

— Leaner, less costly end-to-end processes

— Better insights into key operations

— Increasing returns and protecting profit margins

— Increased clarity and reliability of regulatory compliance reporting.

We used data from two KPMG surveys that underscore our key points: The pace of change is slower than it needs to be, and many fund managers may not be prepared to go it alone.

And, as we studied the business-model challenges, we also evaluated a large data set in order to understand if funds are actually lowering fees.

Given those factors, and others, we are even more convinced that the need to deploy digital tools and embrace a transformational mind-set in a holistic, strategic matter is essential.

In short, it is time to act.

As always, our aim in this paper is to offer our ideas while inviting your feedback. We look forward to the conversation.

Our method in preparing this report

We relied on a number of sources to form our points of view. By leveraging the daily interactions of our alternative investment practice professionals, we gained a perspective on the drivers of change shaping the industry.

We then analyzed data from several data sources; two from recent KPMG surveys and reports, and a third from a secondary source, Preqin Ltd:

— KPMG's recent Transformation Survey, which polled fund managers and other senior alternative investments (A.I.) executives from more than 19 countries with assets under management (AUM) in excess of $1 trillion.

— A global research project, "*Alternative Investments 3.0 – Digitize or Jeopardize*," sponsored by KPMG International, and coproduced by CREATE-Research, led by its chief executive officer, Prof. Amin Rajan. That report, created from survey data, included responses from A.I. senior leaders from 125 companies around the world with AUM of $2.7 trillion.

— Preqin provided us data on performance and management fees from more than 20,000 alternative funds.

Digitization's purpose

Talking about transforming the alternative investment industry through operational digitization is easy. But talk is cheap. Rolling up one's sleeves and actually doing the job is not.

The work is complex and almost always difficult to explain to those who fear change or might not understand its short- and long-term benefits. Then there is the prickly issue of having no real guarantee of success. Even those concerns should not stand in the way of business and operating model changes, powered by digital technologies. Alternative investment managers became successful by analyzing trends and changes in the marketplace and using that information to their advantage. Adapting their underlying business to a rapidly evolving digital environment should not be looked at any differently.

It is our observation that there generally are two misconceptions about the reason for digital transformation:

First, many mistakenly believe digital transformation is a program conducted by, and undertaken for the benefit of, an organization's information technology team.

It's not.

The benefits can be seen in the front, middle, and back office, and by investors.

Second, alternative fund leaders often do not view digital transformation as a strategic imperative.

It is.

The inability to adapt to a changing environment will hinder a fund's ability to keep pace with competition. The organization that can adapt will be well on the road toward gaining strategic advantage. Successful transformation requires systematic planning, specialists, urgency, and relentless execution.

It is essential for alternative fund managers to instill confidence across their organization that changing traditional ways of working is not only necessary but beneficial for everyone individually and for the business as a whole.

And, there is evidence indicating that relying on certain digital tools, such as artificial intelligence/machine learning (AIML), may already be helping at least some intrepid fund managers attain higher returns that are uncorrelated with other markets.

Changing to a digitally powered enterprise has become a necessity to maintain a strategic advantage in the industry.

Why?

of investors saw an improvement in hedge fund management fees in 2017; however, 64% want to see further improvement in 2018.

Source: Pregin Investor Outlook: Alternative Investments H1 2018, used with permission

One industry tradition provides a telling example for why change is necessary. For example, the days of hedge funds charging investors traditional management fees amounting to 2 percent of assets under management and 20 percent of profits (the so-called 2/20 structure) may be numbered. Already, huge pension funds have publicly and loudly balked at the fee arrangements, and a number of funds have reacted by lowering fees.[1]

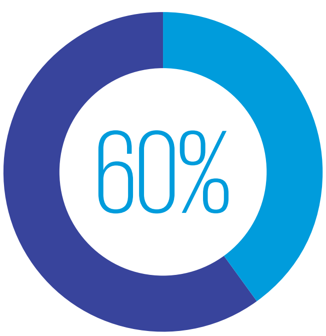
[1] "Inside Texas Teachers' Hedge Fund Power Move," Institutional Investor, March 21, 2017

But that's not all.

A majority of institutional investors remain unconvinced that their interests and their funds' interests are in synch.

Pension plans in some countries have begun initiatives that would require the reporting of all pension-fund costs in "their annual reports, including implicit and explicit investment costs together with estimates of transaction costs."[2]

The *Financial Times* recently reported that hedge fund managers "are being forced to offer lower fees and improve terms to win new business in spite of better performance and a modest rebound in investor inflows in 2017."[3]



The segment of institutional investors in hedge funds who said they felt fund managers' and investors' interests were not properly aligned.

Source: "Preqin Investor Outlook: Alternative Investments H1 2018," used with permission

[2] "Unions Plan Global Campaign on Fund Manager Fee Transparency," The Financial Times, January 2, 2018

[3] "Hedge Funds Forced to Cut Fees to Lure Investors," Financial Times, February 18, 2018,"

Fees Head Downward

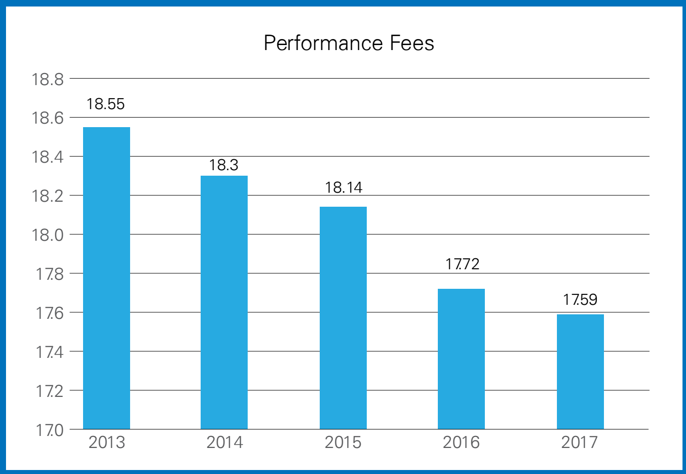
KPMG reviewed 20,000 hedge funds' performance fees, management fees and the traditional 2/20 fee structures from 2013 through 2017. The charts show a clear direction.

Performance fees: When only looking at hedge funds, and excluding outliers, there has been a decrease in performance fees of nearly 1 percentage point.

Management fees: Similarly, these fees have dipped. Further review also shows that more than two times the number of funds have dropped their management fee when compared to those who dropped their performance fee.

The traditional 2/20 fee structure: Only 27.8 percent of hedge funds continue to charge 2/20 or greater.

All raw data supplied by Preqin Ltd; Analysis performed by KPMG alternative investment specialists.



So, why isn't digital transformation happening more quickly?

Some data points to consider
With only a handful of A.I. fund businesses—mostly in the mega-firm category—going full-speed ahead in digitally transforming their businesses, it appears most firms have adopted either a slow-go or a wait-and-see posture.

8% of alternative investment organizations say they are highly capable of capturing value from their own transformation efforts.

KPMG Alternative Industry Digital Transformation Survey, 2017

Some of the firms acting now also are pushing ahead with a goal toward increasing organic growth, and not relying on the AUM to expand due to an increase in asset prices.

They are seeking out underserved markets, such as latching onto up-and-coming Millennials whose penchant for breaking with tradition on many matters (including investment classes) is well known, and taking another look at tapping into defined contribution plans.

While fund managers responding to KPMG's Alternative Investment Industry Digital Transformation Survey in 2017 said cost reduction, enhancing the customer experience, and accelerating growth are their top desired outcomes from transformation efforts. However, nearly six in 10 believe they have underestimated the significance of operating model changes necessary to affect transformation.

One worrisome finding of KPMG's digital transformation survey was that about half of respondents expressed concern about not having sufficient talent and data-management skills required to carry out any transformation.

"Nearly six in 10 alternative fund businesses say they have underestimated the significance of operating model changes necessary to affect transformation."

Source: "KPMG's Alternative Investment Industry Digital Transformation Survey, 2017"

Nevertheless, nearly two thirds of respondents said their organizations were beginning efforts to transform their business models in response to the influence of transformation programs already in their marketplace.

So, are alternative investment firms ready to start the transformation process?

The answers appears to be…maybe.

What may be most troubling about our findings is that nearly half of our respondents say their approach to transformation is ad hoc.

2% of A.I. organizations say they are highly capable of designing customer-centric business and operating models.

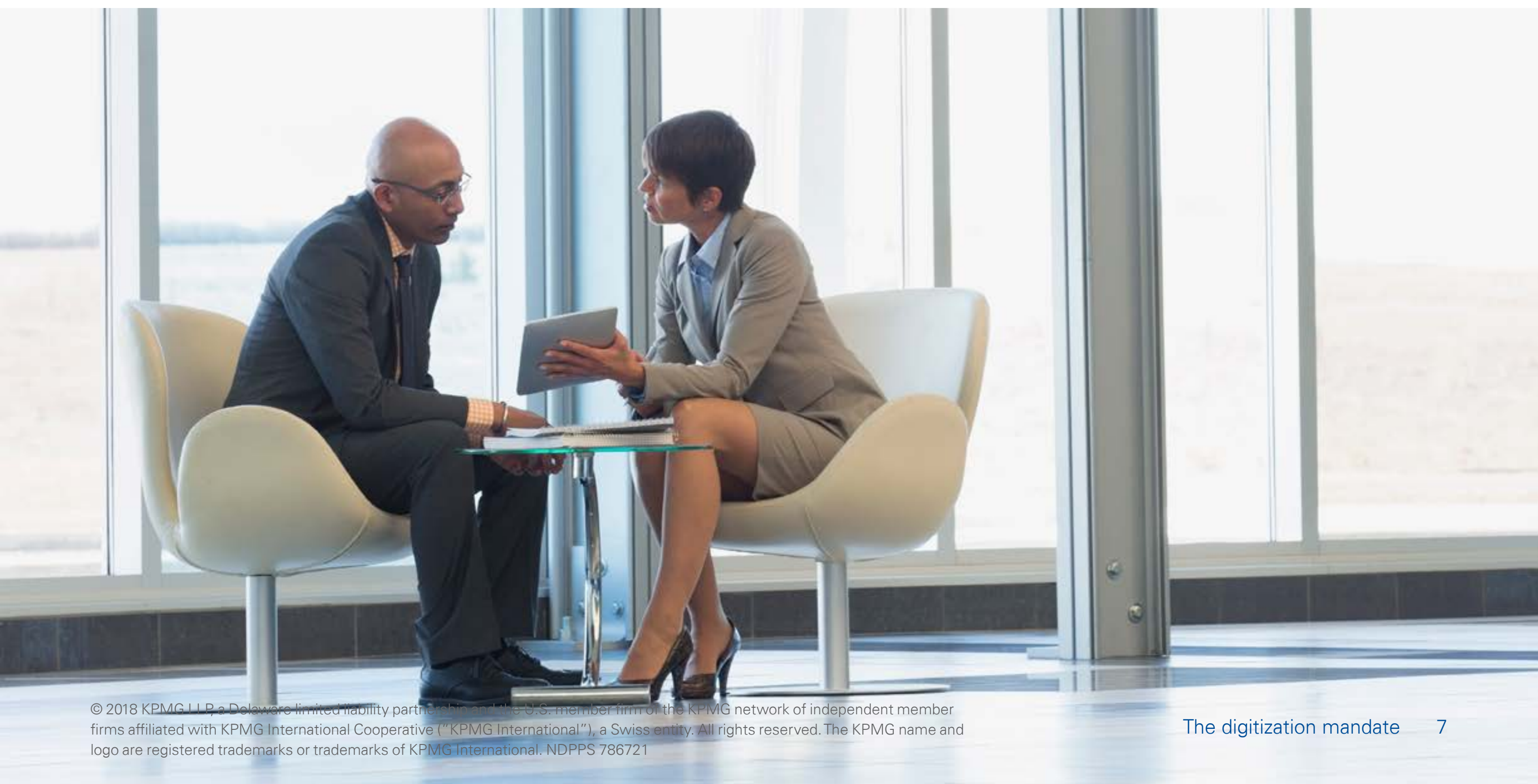
KPMG Alternative Industry Digital Transformation Survey, 2017

Only 14 percent said they are taking a holistic, end-to-end path toward transformation.

In reviewing our findings of both of the KPMG surveys, and in discussions with industry executives, we have learned that funds often wrestle with opposing forces: They recognize the need to be proactive and capitalize on the opportunities presented by digital transformation, but they also say they do not want to take rash steps that could negatively affect their franchises.

The latter response may explain why so few respondents in the KPMG transformation survey characterized their organizations as “very successful” in recent attempts to transform to a digital strategy/data-driven organization, and leverage technology tools to address business issues. The number of respondents who said their organizations were “very successful” in each of those measures was in the single digits.

Consequently, we would expect that, in the months ahead, transformation will be evolutionary instead of revolutionary, despite the alarms sounding from all quarters to pick up the pace of change.



An example of where alternative funds are deploying digitization

While, ideally, digitization processes would be incorporated across all of a fund's businesses, in reality today we are seeing specific areas of implementation.

A particular area ripe for the introduction of digital labor, for example, is in tax, primarily because tax touches so many functions in a firm—and it shows tangible and immediate advantages with clear benefits to end-investors. Digital labor tools, in the form of natural language processing, for example, might be used in extracting information out of various tax forms and related papers, or used for a K-1 footnote reader for client-onboarding purposes. Here are a number of other areas:

Where digital labor tools can speed up elements of the tax function meets escalation for RM Tax.

Policy and execution	Policy documentation, R&D credits, Payroll/withholding tax, measure/monitor tax procedures, post-transaction integration, tax-reserving
Regulatory compliance	Federal/state tax returns, reporting for indirect tax, compliance management, book-to-tax reconciliation, regulatory documentation
Tax accounting	Provisioning, reconciliation, foreign tax accounting and provisioning, estimated tax payments, reduce attribution errors
Transition management and controls	Manage/monitor controls, manage tax plans/transitions, valuation allowance
Risk and dispute management	Monitor/track disputes, dispute analysis, SOX testing, control documentation, tax authority inquiries
Tax business planning	Calculate effective tax rate, prepare K-1 documents, M&A tax due diligence, M&A modeling, transfer pricing, cross-border transaction documentation

The tax-department example merely provides a detailed illustration of how a single internal department in an organization may accrue benefits by heading purposefully down the path to greater digitization.

We are witnessing digitization move into a number of other areas: "Tax is a great example of where digital efforts are paying dividends, but when we have discussions with funds, especially some of the large, more mature businesses, the discussion about digital transformation typically focuses on investments, investors, and regulatory compliance reporting," says Jim Suglia, KPMG's National Practice Leader in Alternative Investments, and a member of the firm's Global Investment Management Executive Leadership Team.

In investments, as a number of firms leverage AIML in their quest to create alpha, among the key areas of focus are quickly and accurately leveraging the best possible data during the analysis process. Many of these firms are hiring top-level computer and data scientists to assist them turn a proven investment thesis into an even more effective and long-lasting strategy.

In using digital tools to benefit investors (beyond picking the right investments options at the right time), many funds are getting better at meeting customer demands for increased communication, transparency, and flexibility. Funds leverage big data tools to provide investors more flexibility with reporting and are using communications tools, such as social media for alerts that direct customers to digital dashboards that can be accessed on mobile devices, in place of e-mailed and mailed documents for account activities.

Many investors increasingly are demanding these types of digital experiences, which will be compounded by the next big wave of investors—after Baby Boomers—who will make up the majority of funds' investor base. And, finally, a major area of digital deployment is in the regulatory compliance area. So-called "reg-tech" tools, which are designed to house the most up-to-date jurisdictional information and hasten the response time to multijurisdictional regulatory bodies, have found increasing usage in the alternative investment industry—and elsewhere in the overall financial services industry. We expect such tools to be used even more as the cost of regulatory compliance continues to rise and complexity increases.

Business case

A multinational organization with alternative investments in real estate, private equity, hedge funds, and infrastructure is working with KPMG on a digital transformation program. While the fund has increased its use of digital tools in a number of operational regulatory areas, it is placing most of its focus in its investment function.

In addition to using data and analytical tools such as machine learning to pick investments, it is helping its investment professionals become more comfortable with the tools.

"In some cases, there are pockets of resistance among some of the traditional investment managers who do not totally trust the tools," says KPMG's Suglia. "We recognize that some veteran professionals may not be entirely convinced that a machine can find worthy investments better than they can."

We believe fund managers need to stress that "bots" working with humans are the future.

"That is a point that gets lost quite a bit," says Adam DePanfilis, a KPMG director specializing in alternative investment organizations. "When there is a discussion about using artificial intelligence and machine learning to help with picking investments, we see that, in some quarters, there is a push-back because they are worried about their jobs going away." DePanfilis says the message that needs to be delivered is that machine learning in this industry will enhance results. It is not intended to replace the investment specialists. The idea is to use the technology to work along with the professionals. "Investors want to see humans maximizing their potential by leveraging every possible tool at their disposal," DePanfilis says.

Digital tools offering leverage

Big data: Extracting valuable operational process, customer, and product insights from vast amounts of data available inside and outside an organization

Robotic process automation: Software tools that automate labor-intensive processes

Cognitive technology and machine learning: Tools that reduce reliance on humans and offer faster means to perform both mundane and complex work

Blockchain: Distributed ledgers that disintermediate payments and settlements

Application programming interfaces: Generators of new business capabilities by leveraging apps and the cloud instead of investing in more IT hardware

Robo-advisors: Algorithms that disintermediate fund distributors and facilitate direct-to-customer business

Digital platforms: Software or hardware that can reconfigure the producer-distributor-client relationship

Ready, set, push the start button

No one is entirely ready for radical change, but we believe the writing is on the wall: It's time to get going full throttle on digitization.

In our view, before any work on transformation begins, it is important to deliver a straightforward explanation for the purposes of the transformation.

Many people simply may not understand the benefits of transformation through digitization. It may help to explain that the point of the effort is to move well beyond cost saving via automation.

While some manual jobs would be eliminated, the fear of headcount being significantly reduced may be overblown.

Consider this recently published comment from Kyle McEnery, an investment analyst at the Scotland-based fund house, Bailee Gifford: "The first very positive thing I would say is anything that we automate will only mean investors have more time doing much more valuable tasks and coming up with new ideas…In investment in particular, I think this would be mainly welcomed by our human investors."[4]

We agree.

Digitization done well can also help funds to tap into underserved customer segments (think Millennials). Furthermore, Millennials are expected to be the recipients of the greatest wealth transfer in the years ahead (estimated at about $30 trillion), as their Baby Boomer parents leave significant inheritances.

When we mention digitization adding value we are referring to the benefits of positioning a business to become much more investor-centric—through targeting the mining and management of rich investor data—rather than being a predominantly product-centric organization.

The reason we advocate for more emphasis on the investor is simple: They expect it.

[4] "Fund Managers Deny Artificial Intelligence Threatens Jobs," Financial Times, August 13, 2017

KPMG's digital transformation steps for alternative funds

A fund's success in making its transformation work will hinge on how disciplined an organization can be in carrying out the details of the plan.

In offering these 10 recommendations, we recognize that for firms, some of the steps will have different impacts based on a fund's scope, size, and complexity. Not all funds will carry out each of these steps in exactly the same way.

Still, each of the steps offers ideas for funds of all sizes.

Here, we offer our point of view on steps that would be useful for fund teams evolving their businesses into a new age.

We have taken these 10 steps and organized them into three categories designed to provide focus and clarity.

Motivate	Ignite	Execute
1. Form a long-term multiyear vision and roadmap for your transformation, with a focus in the near term of areas with tangible impact such as tax and investor reporting.	4. Create an enterprise-wide educational program that helps everyone in the business understand how digital transformation will make their work meaningful while positioning the organization to grow.	8. At long last, knock down the cultural barriers and silos that have only served to thwart past attempts at change. Transformation is impossible if resistance to change persists.
2. Accept that the transformation to become a digitally enabled alternative investment organization requires an enterprise-wide, holistic, strategic approach tightly aligned to a business model.	5. Set expectations for everyone in the organization with a specific role in the transformation—and, hold them accountable. Ensure that senior, functional, and department leaders are digital champions, and that they understand the future vision.	9. Align with fintechs that have shown this industry that they can offer faster, cheaper, and leaner solutions to help organizations grow. We expect the pace of fintech partnerships to speed up in the near future.
3. Recognize that transformation is a process with no end, adjusted constantly, and accepted across the enterprise as a process that must adapt to market conditions.	6. Relentlessly pursue computer and data management scientists. Concurrently, demand that portfolio managers, risk specialists, and client-service teams have continuous interactions with the tech talent to foster cross-learning opportunities.	10. Outsource manual, noncore activities in the middle and back office, thus reducing costs while freeing up fund employees to focus on making faster, smarter decisions in their pursuit in the creation of alpha.
	7. Emphasize an understanding of how machine learning can benefit the organization. It makes sense for fund managers to study how this tool can inform and influence human judgement in the industry.	

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