ISChronicle

Investment Solutions Consultants

Summer 2008

A Chronicle of the Investment Management Industry

Investment Solutions Consultants LLP

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Inside this issue:

Welcome to the First Issue of the ISChronicle

Welcome to the inaugural edition of the ISChronicle. This regular newsletter is brought to you by Investment Solutions Consultants LLP, the independent consultancy dedicated the investment management community.

The ISChronicle is our regular newsletter discussing pertinent trends and issues affecting the buy-side investment management industry.

It draws on the unrivalled pool of experience and expertise that we have here at ISC, giving you a unique perspective on the market as a whole and an informed focus on those issues that matter the most.

In the current stygian economic gloom investment managers and their service providers are all tightening their belts. Management of risk and operational efficiency are of paramount importance in a market haunted by the spectre of inflation and cowed by the fear of redemptions.

This newsletter will I hope shed some light on some of the hurdles the industry is facing and some of the new directions that it is taking.

There are exciting times ahead of us. We may all be in for bumpy ride, but we at ISC believe that quality shines through in dark times and we therefore hope to be able to assist and inform you over the coming months in these newsletters,

Regards

Sean Sprackling
Editor
ISC LLP

Collateral Management—Buy, Build or Bounce?

The last few years have seen something of a quiet revolution in the world of investment management as managers have begun, slowly at first but with rapid acceleration to get involved in the hitherto esoteric world of OTC derivatives.

Increasing liberalisation in regulation of pooled vehicles as well as pressure on managers to deliver returns to ever more demanding and savvy clients have led to managers seeking to access the asymmetry of return which derivatives can provide.

The front office has in many cases been in the box seat of this change. Quite naturally, resources tended to be concentrated on providing systems and controls to enable the investment professionals to make decisions and monitor OTC positions. The flip side of this approach has often been that volumes have in many cases been limited due to the constraints required to ensure control over new operational processes necessary to support OTC trading.

With the advent of the chill winds of the credit crunch, the fall out from the collapse of Wall Street giants Bear Stearns and pressure on Fannie Mae and Freddie Mac, Asset Managers have placed a renewed emphasis on the operational side with a focus on credit risk mitigation. As managers increase their trading in OTC's, many of which are long term commitments, they tie themselves into credit relationships with the organisations at the eye of the storm to a far greater extent than ever before. Arguably we have reached the paradoxical position of the investment managers having to worry more about counterparties' credit risk than vice versa.

As the situation has developed, there has been a growing realisation of the value of a well defined, robust and scalable collateral management process as part of the credit risk mitigation strategy. In many cases, the collateral management function among the investment management community is far less well developed than on the sell-side and for very good reason. They have had 20 years or more to perfect the operating model. They have developed or bought systems that remove volume constraints, so important when relying on

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ISC Announces Launch of Derivatives Health Check Service

Press Release 30 July 2008

Investment Solutions Consultants (ISC), the leading Investment Management focused consultancy, today announced the launch of their Derivatives Health Check service. The service will provide a review of existing derivative operations, systems and processes from front through middle to back office with a view to providing pragmatic advice designed to expedite the delivery of the robust and scalable operating model required to manage derivatives.

Sean Sprackling, ISC Partner explains, "Derivatives within Investment Managers are moving inexorably from being regarded as state of the art, esoteric instruments to becoming sine qua non. As a result, it is becoming more important to develop an operating platform providing on the one hand the freedom for investment professionals to deliver the returns they seek while at the same time delivering the control and risk mitigation to satisfy regulators, investors and trustees. We aim to bring to bear the considerable experience in derivatives built up within ISC to assist our clients in developing the platform to empower them to manage the increased complexity inherent in trading these instruments. "

Julian Manfredi, ISC Partner, adds "Our emphasis is on providing pragmatic advice and solutions which spring from derivatives experience stretching back over 15 years. We recognise that the current systems and resourcing landscape presents investment managers with some thorny issues. In many cases, the application of sell-side technology, people and process is not of itself sufficient to take account of the requirements of the buyside. Our experience assists our clients in finding the most suitable solution from perspectives of cost, control and investment flexibility."

For further information, please contact Sean Sprackling at sean.sprackling@i-s-c.co.uk or Julian Manfredi at Julian.manfredi@i-s-c.co.uk

Collateral Management—Buy, Build or Bounce?

high-volume, low-margin trading, and they have organised themselves operationally in such a way that they have in-house talent pools with depth of understanding of the products and processes required to provide controlled environments around their trading, systems and processes.

Impact on the Operating Model

So how can Investment Managers build up there collateral management function so as rapidly to provide the support for higher volume OTC trading while ensuring that control and process counterbalance increased operational and credit risk?

Firstly they can look to their ISDA agreements and particularly the economic terms of the agreements enshrined within the CSA's. In the initial phase of agreements, both managers and their counterparties tended to be happy to engage in contracts in which the resultant collateral management activity was limited. Hence thresholds and MTA's tended to be high and the frequency of calls tended to be low. Quite simply, the complexity of managing multi-client, multi-portfolio collateral agreements placed limitations on the effectiveness of the credit risk mitigation undertaken by the organisation.

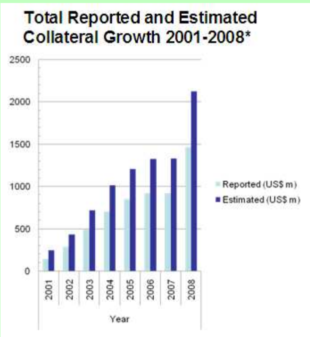
Increasingly, best market practice is beginning to converge on the end of the spectrum at which thresholds and MTAS's are reduced to the lowest level possible – zero. At the same time, Managers are increasingly coming to the realisation that, as markets and sentiment continue to be volatile, the periodicity with which collateral positions are calculated and mitigated ought to be aligned more closely. Again, best market practice is tending towards the paragon of prudence – daily collateral calculation. At the same time, as OTC trading volumes increase, the tendency to limit eligible collateral to cash begins to become less attractive. Many fund managers have a ready pool of bonds which can be used to provide collateral instead of cash which may not always be available to cover collateral calls. Further, being delivered cash can present the thorny issue of the manager having to achieve a benchmark interest rate. In the case where this is not achieved there is a direct cost to the fund over and above the operational cost of monitoring and reporting on cash returns. As a result, best practice is moving towards the area of bilateral cash and bond collateral.

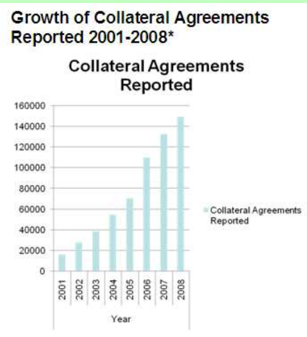
Of course, these changes do come with a price. Reduction of thresholds and increased frequency of calculation is likely to lead to greater incidence of collateral movements. Use of bond collateral requires a means of tracking collateral and facilitating recall where trading activity or coupon payments require. This puts pressure on the people, systems and processes underpinning the collateral management function. Ensuring that all this is managed on a potential multi-client, portfolio and currency basis to a daily deadline while maintaining a picture of existing collateral which may be either delivered or in-transit is clearly a non-trivial task. Add to this the communications chains between the relevant stakeholders including front office, counterparty, custodian and internal management and the complexity represents a considerable operational challenge.

At this point, we need to consider the options available to the investment manager.

Buy

As I have already mentioned, the Investment Banks have had a significant headstart with regard to the OTC derivatives operating model. Having already suffered much of the pain now being encountered by the buy-side, many have opted to support their collateral management programme through the implementation of vendor software. This has over time been developed to provide the complete solution to all collateral management needs and ensures robustness, scalability and control. However, as with any implementation, the appositeness of vendor CM software for investment managers does need to be considered carefully. This software is designed to be able to support the requirements of high-volume, high frequency collateral programmes and as such is industrial strength in the functionality and flexibility of workflow it offers. One corollary of this is that it can take time and hence money to implement. For the small fund manager or manager with simple fund and ISDA structures, this solution may represent a sledgehammer to crack a nut. For the larger organisations with greater complexity, the cost benefits case may revolve around potential savings over time from a reduction in collateral management resourcing requirement brought about by the implementation. Given that OTC derivatives are here to stay in the IM world, this may well be a solution for those managers who will be looking to maximise OTC trading volumes and want to maintain local control over their operational and credit risk.





*Source: ISDA 2008

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Collateral Management—Buy, Build or Bounce?

Build

Typically IM organisations engaged in OTC derivative trading in an ordered, step by step approach, limiting the volumes to what were considered by front offices to be fairly Draconian levels. This facilitated a considered and controlled approach to building up internal competencies required to manage the new risks from an operational perspective. Typically, the collateral management approach was MS Excel based with support from investment accounting systems around reporting. Needless to say, manual input was also very much to the fore as indeed it was throughout the rest of the OTC operational model.

This configuration does tend to create issues as managers look to move to the next level of complexity. Increasing the numbers of ISDA's, lowering thresholds, increasing calculation frequency and widening collateral eligibility require development of the spreadsheet based solution to something approaching the level of functionality provided by the system vendors. At this point, the manager may well decide that MS Excel, as versatile and resilient as it is, is not the ideal platform on which to base a key component of the organisation's credit risk mitigation strategy. As a result development may be required on an alternative platform.

While the nature of the development required is relatively straightforward and can be managed through design of a rules based system, the impact on cost, time and resources cannot be dismissed lightly.

At the same time, the requirement for a collateral team to manage aspects of the process such as substitution and management reporting is unlikely to disappear. Further, as the business continues to develop and evolve, there is a very real danger of the road to hell being paved with good intentions as the system and process need to be maintained. The bespoke nature of the homebuilt collateral management system requires that the documentation and practical knowledge of how they are built needs to be kept up to date and available. Key man dependencies on the development side present a real risk and will require management time. The homebuilt solution is certainly a highly practical one for many organisations and there is no reason per se why it should not continue to be used. The questions really are around the breaking point of the system in terms of its ability to provide adequate credit and operational risk control.

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Bounce

The trend for outsourcing of non-core functions continues to have its proponents and detractors. Recently the outsource providers have begun to latch onto the fact that they have sufficient scale and scope to be able to perform the service for the buy-side at a price which makes them competitive with both the buy and build options. Several of the providers have extended to the buy-side the service they already offer to sell-siders and large corporates and they are beginning to gain purchase in the market. This provides several considerable advantages. Firstly, the manager gains access to market leading software providing the organisation with the means swiftly to move towards best practice in terms of thresholds and calculation frequency and providing all-round robustness and scalability to the collateral management process . Secondly, many of the outsourcers provide access to AAA rated cash investment vehicles which mitigate the risk of not achieving the required reinvestment rate on cash collateral balances deposited. Thirdly, the systems will facilitate the extension of eligible collateral beyond cash. As a result the outsourcers will perform collateral substitutions, removing a considerable headache from the investment manager. At the same time, the functionality exists (and is widely used on the sell-side and at the more advanced investment managers) for rehypothecation which can add valuable basis points to the funds returns. Further, the outsourcers will provide a suite of reports to take care of operational and MIS requirements to ensure transparency of service on a daily basis. Moreover, due to the level of collateral management skills built up within the outsourcers and the relatively straightforward client take-on process, the post-contractual implementation timescale can be reduced quite drastically.

It would appear that this solution combines many of the benefits of both buy and build with few of the disadvantages. However, clearly this panoply of benefits is not without cost. On the financial side there will still be costs involved in the implementation. The other cost is that inherent in any outsourcing – loss of ownership of the function.

At a time of increased concern around credit risk, it may well be that a focus on collateral management operations provides considerable "bangs-for-buck"

Julian Manfredi
Partner
ISC LLP

"With the advent of the chill winds of the credit crunch… Asset Managers have placed a renewed emphasis on the operational side with a focus on credit risk mitigation"

Regulatory focus following the credit crunch will be on risk mitigation in general and collateral management in particular

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The Dow Jones Dharma Indices^{SM} are designed to integrate the value system Dharma's religious traditions — especially Hinduism and Buddhism — into the component selection process

"The complexity of integrating…religious doctrine with the issuing of instruments with all the resultant financial requirements incumbent upon them, is a very specialist area and a growing one"

FTSE4Good is an index series for socially responsible investment designed by FTSE, one of the world's leading global index providers. FTSE4Good is a series of benchmark and tradable indices facilitating investment in companies with good records of corporate social responsibility

Faith-Based Indices-A Shelter in Stormy Times?

With uncertainty in global markets and the threat of the "R" word looming over the dinner party conversations of New York and London, there are those investors who may look for a little succour in the form of the raft of ethical and religious based indices now offered by major index vendors. Although these indices are not new to the market, this article will seek to explore some of the more recent product developments, the concepts underpinning them and the ethical issues being faced in the industry.

Dow Jones Dharma Indices^{SM}
The Dow Jones Dharma indices were launched in January this year as analogous religious index set to the existing Islamic Index series. The new series provides an investment framework which is sympathetic to the fundamental principles governing the major religions of South East and East Asia: Hinduism, Buddhism, Jainism and Sikhism. Dharma, itself has a number of interpretations, 'duty', 'law', 'ethics' and 'truth', however the underlying principles which guide the creation and inclusion of securities in the indices are those of non violence and stewardship. These principles thus exclude, for example, companies in defence related industries, food retailing, pharmaceuticals and advertising among others. It is obvious that further and on going analysis will be conducted on the "Dharma – ness" of specific companies which fall in to, for example, the large swathes of the health care industry which is currently excluded from the indices.

The obvious target for this product is the emergent economies of SE and E Asia, but also the large Diasporas in Europe and North America.

Of the 6 criteria for what makes a good benchmark (Investable, Measurable, Appropriate, Reflective of current investment opinions, Specified in advance and Unambiguous), the Dharma set of indices hit all factors well, however, it is a little weak on the ambiguity front. There are three oversight boards governing the interlaced responsibilities required for managing a religious based index, a Religious Council, an Academic Advisory Council and a Supervisory board. Given the involved aspects of interpreting the nature of religious doctrine within the heavily prescriptive monotheist faiths, where set rules on finance and religion are well documented, there may be some apprehension in understanding how to make the indices unambiguous when there does seem to be a greater scope for a range of interpretations within the less prescriptive faiths of SE and E Asia. However, this is a function of degree rather than an absolute. The 3 boards, are stuffed with the good, the brainy and the worthy which also goes some way to counterbalancing the lack of a well defined and transparent inclusion/exclusion methodology.

Dow Jones has created some back history for the world index to back test the methodology which has thrown up some interesting returns 5 Year Total annualised return as at March 31 2008 in USD: 18.54% with a float adjusted market cap of 14.7bn

The other indices in the series are

- Dow Jones Dharma Global Index^{SM}
- Dow Jones Dharma U.S. Index^{SM}
- Dow Jones Dharma U.K. Index^{SM}
- Dow Jones Dharma Japan Index^{SM}
- Dow Jones Dharma India Index^{SM}

FTSE4Good Indices
The FTSE4Good indices were first launched in 2001 to provide a set of indices which would cater for the demands of the socially responsible investor. These demands focus on companies with good standards of corporate responsibility, social accounting, and an avoidance of traditional bugbears of social responsibility: tobacco, defence and nuclear, and a willingness to invest in firms which will minimise the social, environmental and ethical risks within their portfolios. It is these criteria which form the basis for the inclusion of companies into the FTSE4Good index series.

The index series has a comprehensive and robust methodology for the inclusion and exclusion of securities; moreover new criteria have been introduced for climate change. Existing firms must comply with a series of criteria in order to remain eligible for inclusion into the index. Non-compliance will result in exclusion from the index.

One thing about this index set that does stand out at present is the exclusion of companies which are involved in nuclear power generation. It would seem that the tide of opinion is in flux over the ethics of nuclear power generation and the impact of alternate electricity generation technologies on climate change.

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Faith-Based Indices-A Shelter in Stormy Times?

It could be that in the next few years the socially responsible investor may be pro-nuclear and the index inclusion criteria may need to be amended.

From the chart above it looks a though being ethical does have a price when compared against the AW index over the last 5 years.

The indices in the series are:
Benchmarks

- FTSE4Good Europe Benchmark Index
- FTSE4Good UK Benchmark Index
- FTSE4Good US Benchmark Index
  FTSE4Good Global Benchmark Index

Investible Indices

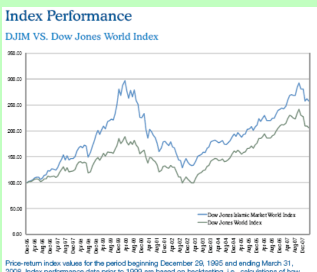
- FTSE4Good Europe 50 Index
- FTSE4Good UK 50 Index
- FTSE4Good US 100 Index
  FTSE4Good Global 100 Index

The distribution of wealth in an era of high and rising oil prices favours the supply side. Given the propensity of the supply side of the oil equation to be geographically centred in the Middle East, over time the growth in the importance of investment strategies which take into consideration the religious-economic aspects of Islam will increase.

Dow Jones Islamic Market Indices
The Dow Jones Islamic Market indices were launched in 1999. The index series security universe covers 95% of the market cap across 46 countries (float adjusted). There are currently more than 70 indices. The index series filters securities based on the following criteria:
Companies engaged in alcohol, tobacco, pork related products, financial services, defence and entertainment.
In addition, companies are excluded from the index series which

- Total debt divided by trailing 12-month average market capitalization is 33% or more.
- Cash plus interest-bearing securities divided by trailing 12-month average market capitalization is 33% or more.

Accounts receivables divided by 12-month average market capitalization is 33% or more.
The method governing the eligibility criteria of securities is overseen by a supervisory board. It is the task of this board to interpret Shari'ah law in order to define the parameters and boundaries within which the index can include/exclude securities, sectors and industries. As with the supervisory boards of the Dow Jones Dharma indices, the board of the Dow Jones Islamic Market Indices is made up of the good and the brainy, however there is only one supervisory board on the DJ Islamic Market Indices as opposed to 3 for the Dharma Indices. This divergence in the number of inputs into the structure and process provides us with some insight on the relative structure of financial principles which underpins Islamic religious thought as opposed to the more fluid interpretations of the SE Asian religions which form the basis of the Dharma Indices
Looking at the data provided by DJ (31 Mar 2008) on the country allocation the spread of the Islamic Market Index there is no allocation to Israel. Despite this fact there is a probable selection of Israeli securities based on the fact that many Israeli companies do not list on the Tel Aviv Stock Exchange but list directly and only on the NASDAQ. Despite this, according to many Shari'ah legal authorities there is no prohibition on investing in Israel. Looking at the graph below, there seems to be some evidence that investing according to Islamic orthodoxy does pay dividends (Although the price indices in the graphs below excludes them).



Price-return index values for the period beginning December 29, 1995 and ending March 31, 2008. Index performance data prior to 1999 are based on backtesting, i.e., calculations of how the index might have performed prior to launch if it had existed using the same index methodology employed by Dow Jones today. See the disclaimer at the end of this document for more information on backtested data.

Faith and ethical based index products fill a void in the market for investors who heed the call for investing according to their convictions. Without a doubt, this market segment will grow and expand over the coming years. Indeed, recent developments has expanded index provision across asset classes with the establishment of the Dow Jones Citigroup Sukuk index series which provides fixed income index data for investment grade bonds or 'Sukuk' which are Shari'ah compliant.
The complexity of integrating Islamic religious doctrine which prohibits the charging or paying of interest, (which has its roots in the understanding of the function of money: acting as an intermediary for the exchange of assets) with the issuing of fixed income instruments with all the resultant financial requirements incumbent upon them, is a very specialist area and a growing one.
These indices merely provide a flavour of the evolving financial landscape which now encompasses god as well as mammon.

Simon Haque
Partner
ISC LLP

Summer 2008

ISC Announces Appointment of Anna Harris

Press Release 26 June 2008

Investment Solutions Consultants LLP (ISC), the leading consultancy dedicated to the Investment Management community, is delighted to announce the addition of Anna Harris to its staff today. Ms. Harris joins as a Senior Consultant.

Mark Andrews, ISC Talent Partner, said, "We at ISC believe that a key to our success will be to secure top-quartile performers. As everyone in the industry is aware, this is an incredibly difficult task. Anna undoubtedly fits into this category and we are delighted that she has agreed to join ISC. She has a fantastic mix of experience and consulting skills and we are looking forward to the contribution she can make to our fast-growing company."

Ms. Harris added, "ISC is a dynamic young company with an outlook offering support at the same time as considerable scope for responsibility. I am greatly looking forward to playing a role in taking the company to the next level."

The Dow Jones Islamic Market Indexes are monitored to ensure their continued compliance with Shari`ah Law. The independent Shari`ah Supervisory Board supports index integrity by conducting periodic reviews.

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4th Annual Optimising OTC Derivative Operations Conference

ISC would like to announce that they will be presenting on both days at the 4th Annual OTC Derivative Operations in Fund Management conference, hosted by Osney Media.

As the Knowledge Partner for the conference we are being represented both by Julian Manfredi, who will be moderating a discussion on STP in OTC Derivatives, and by Sean Sprackling, who will be chairing day two of the conference.

The conference has an impressive set of speakers lined up from within the industry and should be attended by anyone who wishes to:

- Explore how to form an operational strategy that allows for optimal risk in volatile markets
- Learn how the buy-side can achieve a fluent STP settling process by revamping its front-to-back architecture
- Find out how to utilise FpML efficiently within existing operational structures
- Examine strategies that will allow for effective collateral management

Some of the other speakers at this conference include representatives from:

- General Motors Asset Management
- JP Morgan Asset Management
- Barclays Global Investors
- M & G Investments
- Fortis Investments/ ABN AMRO Asset
- Baring Asset Management
- Natixis Asset
- AllianceBernstein Fixed Income
- Cantor Fitzgerald
- FH International Asset Management
- IDS GmbH
- MEAG Munich Ergo Asset Management
- JP Morgan Worldwide Securities Services
- Lehman Brothers
- Pictet & Cie
- State Street Bank & Trust Company
- Citigroup
- Bank of New York Mellon
- Field Fisher Waterhouse LLP
- Investment Solutions Consultants
- Cutter Associates

The full agenda can be seen, and places booked, at

www.otc-derivative-operations.com

Tuesday 25th November 2008 to Wednesday 26th November 2008
London, 09:00 - 17:30

Next Edition:

In upcoming editions of the ISChronicle we will be looking at other issues in the Investment Management world, including:

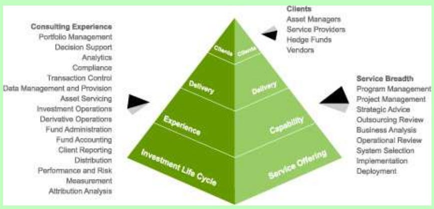
- The integration of risk management practices into the front office
- Client reporting
- The governance of OTC derivatives
- A white paper on the importance of positions in data management
- Running a successful front office implementation
- Current trends in the outsourcing market

ISC
Investment Solutions Consultants

Delivering market leading change for Investment Managers

ISC Profile

ISC is a Limited Liability Partnership exclusively serving the investment management community. ISC work with some of the largest global and UK investment managers, product vendors and niche asset managers. We aim to partner with you to maximise the value of the systems and processes underpinning your business. ISC recognises that your business is about meeting the challenge of managing change. The successful investment manager seeks the balance between systems, people and processes to deliver value to its clients. The successful investment manager manages financial and operational risks robustly and transparently while maintaining focus on operational and financial efficiency.



ISC provides consulting skills and experience across the spectrum of investment management solutions - from system selection and implementation to operating model review and design; from programme and project management to business analysis; from front to middle and back offices; from investment managers to service providers. ISC is driven by the belief that the investment management community demands its consulting partners give value through providing quality resource able to grasp quickly the challenges and assist in delivering solutions

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