



***Active Investment Management:  
Smart Beta, and Factor Investing:  
Impact of Niche FinTech Data Management Solutions...***

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## ***Active Investment Management, Smart Beta, and Factor Investing:***

### ***The Impact of Niche FinTech Data Management Solutions...***

#### **Introduction:**

Welcome to FinTech Navigator's maiden voyage!

This white paper is the first of a series of articles that consider the business and technical impact of niche FinTech solutions on mission critical operations for financial services organizations.

Our mission is to uncover the hidden gems of the niche FinTech industry and to highlight their unique approaches, value add, and compelling benefits!

The first series of articles shall focus on Active Investment Management, as well as Smart Beta and Factor Investing.

In fact, we will also focus on buy side organizations, namely investment management firms and their operations in this context.

Also, in the world of infrastructure technology, there are typically two important considerations – data and process management; and we will key on the *former*, as the Big Data and related subjects are attracting a great deal of attention and investment from the venture capital community and within financial companies these days (and for good reason!).

Prominent buy side IT professionals claim repeatedly, that they do not have access to enough data and in a timely fashion to execute their Active Investment Management goals to gain the Alpha edge.

While many would think that the turnkey all-inclusive OMS providers solutions and managed services would cover all requirements to facilitate efficient trade processing, portfolio management, risk management, performance attribution, Investor Book of Records (IBOR), and the rest of the trading lifecycle; many buy side IT and business professionals feel that these vendors applications fall short in certain critical use cases and objectives in their quest for the Alpha edge.

This article will detail such use cases and common technical short falls – and possible solutions.

According to *ValueWalk*, since 2010, there has been \$11.4B of private investments in the FinTech targeting the investment management space, plus about \$2B in during the early part of 2016 for FinTech asset management firms.

This begs the question – if there are adequate capabilities available from the large OMS providers, then why would all these investments be pouring into for the buy side community for new FinTech solutions?

### **Investment Management – Stark Realities:**

According to InvestOps from the TradeTech Forum, the following were stated as the top three operational challenges in the front office:

- “An overwhelming 89% of operations stated the provision of timely and accurate start of day positions and cash, as their top challenge in supporting front office staff.
- 80% cited difficulties in the creation of options to trade new asset classes and strategies in a timely manner.
- 67% struggle with accurately measuring firm-wide limits and counterparty exposures.”

Additional Findings:

- **“Regulation: 75% of the North American buy side stated implementing new data management processes as their top challenge, when complying with new regulations.**
- **Investment Strategy: 77% of participants are employing active management either primarily, or as part of a hybrid strategy [meaning with Factor Investing and/or Smart Beta approaches].**
- Asset Class Support: Alternatives (34%) and Private Debt (28%) are the most costly and challenging asset classes to administrate.
- **50% of Asset Managers felt their current technological capabilities were just functional, with a further 19% stating their capabilities, as lagging the curve.”**

Thus, if you consider the studies and findings above, Active Investment Management remains highly relevant, and there are clearly issues with technology, with data management being a key component of this conundrum for the buy side.

Since Active Investment Management has been mentioned here with Smart Beta and Factor Investing, it would be worth the time to distinguish between these investment approaches.

### **Active Investment Management, Smart Beta, Factor Investing – Defined...**

To level set, Active Investment Management entails the fund manager's involvement, who assigns weighting based on strong fundamentals, whereas Passive Investment entails indexing; allowing market participants to rank securities based on price. Consequently, Active Investment Management provides the opportunity to generate Alpha, as the ROI is not the result of the general movement of the greater marketplace.

Regarding Passive Investment Management, the investments are designed to track broad market indices (capitalization-weighted – meaning assigned percentage of an index weight to each component of the investment vehicle); and while these types of investments are certainly appropriate for portfolios – they experience volatility or systemic risk (as measured by Beta).

To contrast, Smart Beta avoids weighting indices according to price, and instead weighs securities based on risk and fundamentals or a combination of the two. Additionally, Smart Beta further includes quality metrics, such as earnings growth and quarterly earnings information.

The goal of Smart Beta is to obtain Alpha, while lowering risk and increasing diversification at a lower cost basis than Active Investment Management; but somewhat higher at Passive Investment Management.

This investment approach seeks the construction of the optimally-balanced portfolio by leveraging a combination of efficient market hypothesis and value investment management.

Smart Beta captures market inefficiencies in a transparent manner with the investment approach being connected to portfolio management, risk management, and factor-dimensions diversification; with the goal of attaining risk-adjusted returns above the cap-weighted indices.

Proponents of Smart Beta assert that this investment approach yields the benefits of Active Investment Management with reduced costs and risk associated with Passive Investment Management.

As it pertains to Factor Investing, this is an investment strategy whereby securities are chosen based on two primary characteristics such as style factors (capturing broad risks across asset factors) and macroeconomic factors (explaining returns and risks within the asset classes).

### **On now [drumroll...] Active Investment Management Use Cases...**

In terms of use cases, as it pertains to Alpha generation as part of the Active Investment Management, Smart Beta, and Factor Investing processes, let's consider the following examples below; which highlight the need for efficient data management.

The important aspect below is not necessarily whether a trading strategy, quant risk model, or investment philosophy is better than another; but, how does an investment management firm execute in real-time intraday on their Active Investment Management, Smart Beta, and Factor Investing without the right data management platform?

Here are the use cases/examples:

1. Alpha Strategy # Case A:
  - a. Price to Book Ratio < 1.5
  - b. 3 years of return on equity
  - c. 7 years of positive operating margin
  - d. Lowest 20% of growth adjusted free cash flow multiples
  - e. Above average operating and net margins within market segments
  - f. Below average debt to equity
  - g. Positive cash flow
  - h. ROA growth
  - i. D/E decline
  - j. Current ratio, gross margin, asset turnover growth
  - k. Cash flow > net income
  - l. Consistent earnings growth
  - m. Momentum parameters
2. Equity Alpha Case B – return of a stock is equal to Alpha plus some broad market sensitivities plus risk free rate plus company specific idiosyncratic risk, balancing short term risk either absolute (“risk of ruin”) with relative risk (risk of underperformance of benchmark(s)).
3. Fixed Income Case C - How would the performance of a domestic corporate bond behave with a yield curve position given a “twist effect” as portfolio weight, proportional rate, benchmark twist return, asset class twist return, and portfolio twist return all need to be calculated?
4. How would an open-ended rolling repurchase agreement’s valuation be determined in a real-time trading operation?

When you consider the dizzying array of investment models, derivatives, calculations like VaR, CVA, and other variations, the challenge of attaining the Alpha edge in Active Management, is surely not an easy undertaking!

The availability of data and data management solutions is absolutely crucial as auxiliary technologies to support active investment management.

FinTech Navigator shall now introduce a host of niche FinTech data management technologies in a series of articles to empower by side firm to meet their investment goals and to maximize their investments in their other key systems such as OMS, risk management, portfolio management, and others!

About Verrazano Consulting Solutions LLC – [www.verrazano-consulting.com](http://www.verrazano-consulting.com)

Verrazano Consulting Solutions LLC is a business advisory and systems implementation global consultancy, with deep subject matter expertise in niche financial services applications and key standards and industry mandates.

Our firm provides a unique methodology called “ISOTOPE” to ensure business and IT unified solutions are delivered to our Customers.

Our subject matter experts have a unique combination of extensive lines of business functional domain knowledge, across various market segments involving key business processes and niche financial services applications and standards-based expertise to provide the maximum value to our Customers.

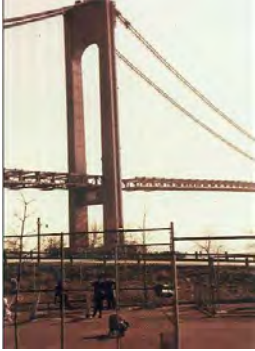
Our global Customers include Tier 1 and Tier 2 financial services organizations and the treasury departments of Fortune 100 and Fortune 500 corporations.

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***“Strategically Bridging Your Business and IT Operations...”***

***The Niche Financial Services Applications Experts...***

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Triborough Bridge and Tunnel Authority	
RECEIVED ONE TOLL PUNCHED	
for PASSAGE of ONE VEHICLE	
AT TIME STAMPED ON BACK	
.10	.75
.15	1.00
.25	1.25
.35	1.35
.40	1.50
.50	1.60
.60	2.00
DOUBLE TOLLS	PREPAID TICKETS
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