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# Ben Franklin Joins the Backoffice

## Equity Finance and the Alpha Equation

***By Marshall Saffer, Chief Operating Officer***

## ***Q. How can Debt be “Thrifty”? A. Everything in the firm is about ROI.***

Today’s hedge fund and traditional asset managers are faced with a great deal of uncertainty: in markets, in regulation, in investment strategy and style. Getting to alpha, always difficult, is as challenging as it has ever been. Taking an approach where each and every function and process in the firm becomes an opportunity to generate alpha means that the entire enterprise is seen in terms of ROI rather than cost. This approach is rarely taken with the backoffice, but using equity finance as an example, it is one which can payoff substantially both immediately and over time.

It comes as no surprise that Ben Franklin was the aphorism king (though he certainly would resent the “king” idea as he was opposed to monarchy). That said, his aphorism, like all aphorisms, contains a grain of truth. And, his diligent practice of aphorisms, combined with his ability to see new ways of doing things and innovative approaches to implementation led him to become one of the wealthiest men in the colonies.

One aphorism which applies to the backoffice is “a penny saved is a penny earned.” This is because the backoffice is typically viewed as a cost center, and any reduction of cost (the penny saved) goes to the bottom line (the penny earned). This is a legitimate, though not complete view of the complexity of backoffice contributions to a firm.

Franklin’s aphorism is based in thrift. And let’s face it, thrift is not about borrowing. But suppose we were to apply the aphorism to the stock lending equation – particularly short term borrowing. Paradoxically, when applied to the stock lending equation, we move beyond passive thrift to actually deploying the back office as an active mechanism to increase returns. Here, the backoffice is seen as an opportunity for ROI, shifting the prism from shedding light on saving pennies to earning them.

How exactly does the thrift aphorism apply to stock lending? It’s fairly simple (and elegant). The cost structure for financing as between stock lenders in equity finance varies (both within lenders over time and between lenders at all times). The fact is that if the various rate structures between lenders could be arbitraged and optimized in real time, firms would benefit from the taking advantage of the spreads.

And the ability to execute on such an approach resides completely in the backoffice. If a firm begins to save pennies in stock lending over time, the back office effectively becomes not solely a cost center but a means to liberate cash. The penny saved (and liberated – Ben loved liberation) is harvested for use by the firm.

It’s a revolution Ben would have loved. The thrifty use of debt is the application of innovative thinking to free cash for application to alpha - kind of an electricity - and Ben had some ideas on that as well.

## ***Is Enterprise-wide ROI Conceivable, Possible, and Probable?***

Aphorisms are easy to say, but to develop a mechanism to actually deliver on a new way of using the equity finance equation itself might be a bit more difficult. This is because it not only requires a change in thinking but a change in behavior, as well as a mechanism to actually get it accomplished.

Which leads to three questions: is the new think about backoffice and equity finance conceptually feasible; is it possible; and is it probable or likely? There are ways to analyze these questions in turn.

## ***What is required conceptually?***

Fundamentally, a view of equity finance beyond mere administration is the first requirement. Secondly, management will need to entrust backoffice personnel and functions with a greater role in the firm (and there may be some risks associated with this). It is an educative and creative exercise for the entire firm – which like many similar exercises can bring rich rewards. This takes a bit of envisioning, which innovators do constantly. In this case the question is: Is my equity financing function being leveraged in ways that benefit the firm beyond securing the financing itself? Is there something that is being left on the table because the function is not being used to the extent possible? If equity finance could produce more, would there be a willingness to take advantage of that opportunity? Essentially managers at this stage must begin to address the "what if" scenarios that will build their businesses, leverage every opportunity, and extract more value at each stage of every process.

## ***What are the Conditions of Possibility?***

Once the conceptual leap has been made (and this may require more than just a top-down mandate, but a broader conversation around how the back office is thought of and thinks of itself) a firm is ready to begin to think through what exactly might be required to build a more robust equity finance engine, designed to benefit both lenders and more importantly the firm itself (as the first beneficiary).

What does an equity finance model look like which deploys the approach articulated here?

The outline detailed below will serve as a guide to what is required. It can also serve as a way to begin to think about how implementing this innovative approach for the benefit of the firm is not as daunting as may be conceived. It also moves beyond the category of "drawing board" to what is actually available.

## *What are the requirements?*

To implement such an approach a firm will want the ability to view financing data across brokers, regions, asset types, portfolio managers, and traders. Managers need to have critical information regarding financing activity and a tool to act on this information. Such a tool would need to validate the accuracy of borrow charges, automate the recording and tracking of stock loan locates and pre-barrows, identify lower borrow rates, and suggest optimization. The application would need to provide detailed reporting, trend charting, alerts and other tangible measures to assist in day-to-day operations.

On a more granular basis, here are the requirements for an effective approach:

1. Automated Equity Finance Data Collection
2. Automated Market Data Source Integration (data on rates, pricing, security mapping, etc.)
3. Incorporate PB/Counterparty position and rate data, billing files, availability files into database
4. Query Function around rates
5. Rate Optimizer – generates the biggest potential savings on a comparative basis, and borrow rates improvement
6. Administration Tools – the engine to take advantage of better rates
7. Security Lending Opportunities
8. Rate Trending
9. Daily Recon
10. MTD Accrual Recon
11. Pay to Holds
12. Alerts
13. Reporting

## *Is it Probable?*

Once the conceptual framework for the alpha approach to the equity equation is accepted, and the behavioral and administrative implications are addressed, the question becomes whether the tool for implementation can be built, or, with some outside help is it already available and ready to deploy?

At MIK we provide software solutions to the largest hedge funds in the world, who constantly seek innovative approaches to all processes in their businesses. We have developed a comprehensive and integrated equity finance tracking and optimization system for hedge funds and asset managers. The application is designed so managers have the opportunity to reduce and optimize borrow costs, improve reporting and attribution of their financing costs, and improve the overall decision making process around equity financing activities.

By deploying the application, MIK clients obtain a sophisticated view into all of their financing interactions with their execution brokers, thereby creating a powerful analytic tool for managers to monitor, measure, and evaluate financing activities across a customized array of categories, defined and chosen by the fund.

Equity finance data capture, finance and borrow information across multiple periods is automatically and easily retrieved. Such data and analysis is essential to financing decision process, and is integral in assessing current and future position allocations.

A cornerstone of MIK's approach is the ability to process a landslide of information contained in the various stock loan data sets from the street. The fully customizable tool ties together all related securities indications from the source files automatically as they become available, and with minimal market data costs incurred by the client using market standard symbology tools.

We have delivered on the possibility of the backoffice to effectively be a revenue center.

## ***Conclusion***

Each and every process in the hedge fund and asset management space must now be seen conceptually as a means for ROI. Firms now demand, as next stage thinking, the ability to use data in a comprehensive and integrated way, to ultimately lower costs around financing and reduce the impact of financing on fund performance. MIK's Equity Finance application works a firm's and brokers data not only to meet basic oversight requirements but to help managers in the entire range of the trading and financing relationships in which they engage. It makes the relationship between firms and their brokers more transparent and provides a means to engage brokers based on concrete analysis and with the ability to eke out cash based on equity finance spreads.