Global Trends in Investment Operations Sourcing

Executive Summary

The Titanic disaster, in which 1,500 people perished, resulted in a change to maritime rules, ensuring a lifeboat seat for every passenger. Extraordinary events beget extraordinary responses. Similarly, the U.S. financial services industry hit the integrity iceberg during the 2008 market implosion that claimed the lives of many firms and bled the markets and economy, as well.

With the global financial market meltdown seared indelibly into asset managers’ memories, the hope is that lessons learned from combating this once-in-a-lifetime crisis will be put to good use. The conditions across the investment management landscape make it ripe for structural changes within the investment operation function – the fulcrum on which investment management is based. Global sourcing offers asset managers a key lever to efficiently redesign their investment operations – front-, middle- and back-office – to bolster their long-run competitive advantage.

Global sourcing offers the lifeboat that asset managers need to:

- **Address the issues of trust and transparency that regulators and institutional investors demand.** Integrity, the non-negotiable asset, is a major challenge these days for asset managers, as well as other players in the financial services business. On the heels of Bernard Madoff’s $50 billion Ponzi scheme, the Rajaratnam scandal reopened the wounds of investor mistrust. With regulators calling for greater transparency and governance, asset managers are reexamining how pricing, auditing and accounting functions are performed.

- **Bolster cost and operational efficiency and effectiveness.** Asset managers across the board have learned how to variabilize their cost structures, following the Great Recession, a long-tailed event that exposed the fault lines of carrying high fixed costs when assets under management (AUM) vaporize.

- **Manage complexity.** Institutional investors demand the engagement of reputable third parties to value complex or non-liquid assets, such as over-the-counter derivatives.

The sharp rally of equity prices since March 2009 (which has boosted assets under management) is unlikely to breed complacency or blunt asset managers’ resolve to redraw the structural contours of investment operations. Instead, asset managers are best positioned to initiate strategic change programs to address the long-term competitive needs of their firms.

To win in the new industry order, asset managers should use the current benign market conditions to partner with reputable service providers and initiate strategic global sourcing programs to anchor their institutions on a sustainable growth path with reliable and efficient operating models.
Global Sourcing 1.0: A Services Evolution

Last decade’s initial wave of global sourcing investment operations was driven by three factors:

- Capacity crunch fueled by rapid growth.
- IT platform integration driven by consolidation.
- Legacy systems upgrades to support global reach.

To comprehend the evolution of global sourcing in investment operations, it is pertinent to understand the investment landscape at the turn of the century. The 2000-2010 time period can be divided into three parts:

1. The recession following the dot.com bust (2000-2002).

These factors laid the foundation for the first wave of investment operations global sourcing. First, the credit-fueled boom led to a dramatic expansion of products (i.e., hedge funds, OTC derivatives, traditional equities and private equity). Second, the creation of the EU and the subsequent UCITS legislation created additional momentum. And third, the material emergence of offshore service centers in Ireland and Luxembourg, thanks to “light touch” regulation, made it easier for firms to transfer work to trusted third parties.

**Credit-fueled boom:** Between 2003-2007, all asset classes and the various derivative instruments registered two- to three-fold growth, thanks to demand pull fueled by loose monetary policy and cheap credit made widely available across markets.

- The World Equity Market capitalization increased by 160%, from $22.8 trillion to $60.8 trillion (see Figure 1).
- Private equity assets under investment increased by 390%, from $79 billion to $308 billion. Private equity funds raised increased by 540%, from $89 billion to $493 billion.
- OTC derivatives outstanding increased by 420%, from $142 billion to $598 billion.
- Hedge funds assets increased by 575%, from $150 billion to $860 billion.

**Creation of EU and UCITS legislation:** This legislation promoted cross-border investing and the global distribution of funds. A wave of M&As across the U.S. and Europe ensued, creating new asset management firms of material scale and complexity.

**Offshore service centers:** Thanks to “light touch” regulations for both marketing and distributing funds, offshore service centers such as Luxembourg and Ireland witnessed rapid growth. Enabled by a well-developed set of laws that facilitate the creation and distribution of cross-border funds, these locations evolved into mainstream investment destinations for both private and retail funds. Regardless of nationality, asset managers use these locations to launch and distribute funds and tap into the global capital pool.

The exponential growth in assets and complexity exposed and accentuated asset management firms’ inefficient IT systems and internal processes. It was the classic case of systems and processes lagging growth. As a result, initial global sourcing arrangements were spawned, primarily to accomplish the following:

- Support systems integration, thanks to rapid consolidation in the industry.
- Upgrade and build on legacy systems. While asset managers were becoming more regional and global in their outlook, their systems were built for country-specific trading, distribution and reporting.
- Address the growing pains in the middle office. Middle-office systems were disparate, and straight-through automation was nonexistent, thanks to multiple interfaces from custodians, brokers, investment managers and other third parties.

**Credit-Fueled Equity Markets Boom**

Credit-Fueled Equity Markets Boom
While many asset managers handed over their back-office operations, as well as pieces of their middle office, to investment services firms (see Figure 2), a few also set up their own captive back-office operations with mixed success. With their proven expertise in back-office functions such as custody and fund accounting, custodial banks became natural partners for asset managers to outsource parts of their middle-office functions. Over time, custodial banks invested in building progressive platforms to support the middle- and front-office needs of asset managers. With proven capability, custodial banks are best positioned to ride the next wave of global sourcing vis-à-vis other service providers and delivery models.

Global Sourcing 2.0
The next wave of middle- and front-office global sourcing will be driven by market and regulatory forces, complex products such as derivatives and asset managers’ need to focus on the hunt for alpha.

In the post-Lehman world, asset managers confront a “new normal” — a tough growth environment, cost discipline, demand for more transparency, stringent regulations and scrutiny of complex products such as derivatives. These forces provide the structural underpinnings for the next wave of global sourcing investment operations.

Thanks to the sharp global rally in equities since March 2009, many leading asset managers have reported robust AUM numbers (see Figure 3). While the AUM phenomenon is cyclical, the 2008 cuts were deep, and the ensuing bleeding nearly hemorrhaged many asset managers.

This experience exposed the anomaly of cyclical revenue and fixed cost structure, and asset managers learned the tough lesson of focusing on cutting expenses, seeking efficiencies and variabilizing the cost structure.

The business priorities for asset managers are to remain competitive and look toward a more realistic return on equity (RoE). The credit crunch and risk aversion have led to a more realistic assessment of what constitutes achievable returns on equity. A recent survey, “Global Fund Manager Survey, February 2011,” clearly highlights the somber mood of asset managers on the RoE front. Of surveyed managers, 59% project an RoE of less than 15% for the industry (see Figure 4).

On the cost-to-income parameter, 24% of asset managers surveyed clearly see an opportunity to bolster efficiency; meanwhile, 36% of asset managers believe their cost per head was higher than the industry average.

Global sourcing of investment operations offers asset managers the best levers available to variabilize their fixed cost structures and drive cost efficiencies. Some examples of this include:

**Growth:** In Europe, consolidation and the increase in pan-European distribution patterns require asset managers to streamline and improve operational effectiveness and efficiency throughout the front-, middle- and back-office. UCITS funds are now distributed globally. This global expansion drives the need for efficient investment operations, underscoring the need for a global sourcing partner.

### Investment Lifecycle Overview

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*Source: State Street*

*Figure 2*
In the U.S., the trend to become global, both in scope of business and distribution of funds, is more pronounced. Today, the U.S. asset management landscape is more complex, encompassing non-U.S. subsidiaries and a global range of assets and investor base. The advantage in global sourcing for U.S. asset managers lies in finding a partner to help them scale and reach new markets and investors to support their global objectives.

Unlike Europe, Asia is a large, fragmented marketplace, and there is no pan-Asian regulation to drive an open market. In such a market, offshore fund structures present the easiest way to distribute funds quickly across the region. Asian asset managers have realized that gaining a pan-Asian footprint fast is best achieved by partnering with global investment servicing providers.

**Sovereign wealth funds**: While traditional asset managers continue to globally source services, entities such as sovereign wealth funds (SWFs) are actively exploring global sourcing opportunities.

Today, SWFs have $4.3 trillion of assets under management. Thanks to the commodities and natural resources price boom, AUMs have grown at a fast clip over the last five years. While the capital pool has expanded quickly, the IT and operations infrastructure has not kept pace and lags the market. This gap can be addressed by global sourcing arrangements.

**The ability to manage complex instruments**: Surging OTC derivatives trade volumes add stress to legacy systems designed to process traditional equity and fixed income products. In many asset management firms, these legacy systems are adapted to handle nontraditional trades, thereby heightening operational risks. Global service providers have built scalable global platforms to fulfill the unique needs of derivative transactions. From valuing complex

### Fund Manager Targeted Equity Returns

![Fund Manager Targeted Equity Returns](image_url)

Source: “Global Fund Manager Survey,” February 2011
Investment Operations Outsourcing Services

![Figure 5](Source: EMC Corp.)

Unlike more commoditized back-office functions such as custody and fund accounting, global sourcing of middle-office operations is not a “cost race to the bottom.” According to the Beacon Consulting Group survey, three service priorities are speed, accuracy and cost (see Figure 6). Eighty-six percent of respondents said accuracy is the most important factor, while only 12% said cost was important. In fact, 50% of respondents clearly said that cost was not an important factor at all when it comes to middle-office outsourcing.

Global service providers have built scalable global platforms to fulfill the unique needs of derivative transactions.

To address these factors, major global services providers such as State Street, Northern Trust, BNY Mellon and JP Morgan are today joined by niche service providers, such as Citi, for hedge funds; established technology solutions

**Key Global Sourcing Trends**

The global sourcing market continues to be dominated by custodial banks, but many technology and business process service providers are challenging the status quo with niche platform-based service offerings.

In this dynamic market, we see increasing competition to the custodial banks from both technology and business process global sourcing services providers. Both competitors are striving to capture the maximum share of the investment operations value curve5 (see Figure 5).

According to a Beacon Consulting Group survey,15 62% of fund managers have completed a formal review of their middle-office operations in the last year to identify cost savings opportunities and improve service quality.

derivatives, to handling associated needs (such as collateral management, data integration and reporting), larger global service providers today offer these services in a variety of operating models.

Institutional investors demand involvement of third parties when it comes to valuations of complex or nonliquid assets, such as OTC derivatives. This further adds heft to the global sourcing argument. As pressure on asset managers grows, the valuation process is shifting to independent third parties to avoid conflicts of interest.

**Madoff fraud**: The resultant call for greater transparency and governance is forcing asset managers to reexamine how pricing, auditing and accounting functions are performed. Globally sourcing these services can help asset managers score on transparency and cost efficiency goals.

**Top Priority: Accuracy**

![Figure 6](Source: “Middle Office Survey” Results, Beacon Consulting Group)

According to a Beacon Consulting Group survey,16 67% of fund managers have completed a formal review of their middle-office operations in the last year to identify cost savings opportunities and improve service quality.
providers like SEI and SS&C Technologies; and many business process outsourcing companies that have built advanced financial analysis and research capabilities.

**Global Sourcing Deal Structures**

Given ongoing trends, we see three kinds of deal structures: The lift-out model, conversions and component-based solutions. While the lift-out model and conversion arrangements are prevalent, the component-based solution is a nascent idea that is just now beginning to play out in the market.

**Lift-outs:** In this arrangement, the global service provider takes over the entire operation, including staff and IT platforms. While the asset manager realizes reduced fixed costs and a fraction of variable costs, the service provider must cautiously tread in dealing with staff, given the human sensitivities involved. However, the benefit for the service provider is the ready availability of an experienced group of human resources.

While technology is part of the lift-out deal, the systems that are “lifted” are more often those that need to be reengineered into a single, efficient platform. With the potential for disparate legacy systems across the industry, this effort will be material.

While this model is comprehensive in scope, it is highly complex to execute.

**Conversion:** The conversion model may or may not take on any of the legacy applications or staff. To put it simply, the existing business is transferred onto new/proprietary systems run by the service provider. Empirical evidence points to a maturing capability of service providers in building scalable yet flexible platforms that have materially reduced the transfer time. Today, deals of this nature are typically completed in less than a year.

The key to success lies in the service provider’s understanding of business needs; moreover, an effective conversion is underpinned by robust and tested technology.

**Component-based model:** In this model, only select portions of the operations are outsourced over time. Component-based global sourcing is a nascent phenomenon. It helps chart the middle path for risk-averse asset managers who may not be comfortable parting with all their operations in a block deal. This option fits in neatly with those asset managers who need third-party support for a specific function or a small set of services. This cautious approach to global sourcing addresses asset managers’ fear of losing control and helps them take measured, calibrated steps in their global sourcing mission.

While this model potentially offers a higher success rate with its calibrated approach, it suits vendors that do not have a mature enterprise platform solution.

**Global Sourcing Drivers and Concerns**

Asset managers view cost reduction as a necessary but insufficient condition in the global sourcing decision calculus. Competition has ensured near-homogenized service provider rate cards across the board, with little or no differentiation. While cost reduction is a given, other factors such as service flexibility, service quality and access to advanced technology will differentiate winning service providers.

Asset managers are striving to variabilize their cost base, and 84% of asset managers in the survey rate flexibility (i.e., the ability of the service providers to scale operations up or down) as a very important driver.

The key anecdotal concerns of asset managers include the following:

- **Reputational risk:** By restricting service providers to only the largest players, asset managers seek to mitigate reputational risk. This factor bestows on custodian banks a formidable competitive advantage vis-à-vis the competition.
- **Increasing complexity:** While service providers have proven capability to deliver services like custody, fund accounting, etc., the same cannot be said of servicing complex instruments such as derivatives.
- **Custom requests:** Most often with their standardized processes, systems and operating models, service providers tend to struggle to cope with custom requests.
- **Price of standardization:** Palpable pricing conflicts are inevitable between service providers with fully automated systems vs. those without such systems. There is a tradeoff between efficiency and flexibility that service providers must handle with utmost caution. For instance, while the service provider with a slick enterprise system will score well on efficiency, it may well be criticized for its inability to process custom requests, eroding its pricing/
bargaining power. And whereas the service provider that bundles basic systems with layers of manual intervention will get knocked for efficiency, it may still price the "manual layers" – an inefficiency – for the sake of the flexible capability to process custom requests.

- **Perceived loss of control:** Many asset managers report this as a key stumbling block, despite an open mind about global sourcing. There is a material need for service providers to build tangible confidence-building measures to enable asset managers to cross the Rubicon.

- **Benefits expectation mismatch:** The "Global Fund Manager Survey" shows asset managers realized cost savings of 20% vs. the expectation of 30%. We believe that cost savings of 30%-plus and material improvement in service quality can only be realized over time – at least over three years – with concerted effort.

**The Next Frontier: Global Sourcing Front-Office Operations**

As sell-side research dries up, asset managers are hard-pressed for adequate research to anchor investment decisions. While the larger fund houses continue to have in-house research teams, the same cannot be said of smaller and medium-size asset managers. Also, hedge funds have always relied on the research expertise and experience of their senior partners for investment bets. However, senior partners are short on time to comprehensively research themes and ideas in-depth to support high-conviction trades.

The time is ripe for asset managers to seriously consider global sourcing as a key lever to plug gaps in their research needs at a fraction of the cost. In this model, while the onshore seniors will be responsible for securities selection, they will be better equipped to take investment calls with well-resourced support. Custody banks can shape and lead this trend with their investment management expertise, global footprint and ability to partner with knowledge process outsourcing (KPO) firms that have a proven niche in financial, market and strategic research support capabilities.

Today, service providers have mature capabilities to offer offshore support for equity, credit, quantitative, market and business research. Also, service providers have created scalable capabilities to help the front office with marketing strategy and support services.

As sales and distribution is the second largest cost item, asset managers can look at global sourcing functions such as funds marketing presentations; production of shareholder reports; sales support activities, such as RFP completion, replies to sales queries and performance tracking; marketing strategy support, such as market size assessment and new market entry strategy; and marketing support, such as production of presentations, marketing brochures and editorial support.

**Key Success Factors**

Global sourcing arrangements are like a marriage, except that getting a divorce is harder. There are lessons for both asset managers and service providers to underpin rational decisions with reasonable expectations to make this relationship work. These include:

- Be prepared for a long sales and negotiation process.
- Do not underestimate the complexity of migration, whatever the deal structure.
- Key leadership stakeholder commitment, engagement and sponsorship is vital.
- Define deliverables and metrics to assess service excellence, from day one.
- Be honest to set reasonable expectations on the benefits of global sourcing.
- Have a well-defined operational, risk and governance mechanism, from the beginning.
- Remember, cost benefits are a given. Asset managers are looking for service providers that can offer a high degree of standardized yet custom services. Flexibility is the name of the game and an attribute winners will share.
- Ensure that the individuals who are already familiar with the business manage the transition. Invest upfront to retain talent and ensure continuity.
- Invest in a consultative, partnership-based and asset manager-centric business model focused on harnessing sustained success. Shed your world view – technology, custody or business process services – and instead adopt the asset manager's view of the world.

**Global Sourcing Outlook**

While global sourcing back-office functions such as custody and fund accounting is a proven business proposition, global sourcing of middle- and some front-office functions are gaining traction. Today,
we see a clearly defined set of services that are appropriate and ready-made for global sourcing across the front-, middle- and back offices (see Figure 7). Increasing service provider maturity, technology sophistication, regulatory scrutiny and the asset managers’ hunt for alpha and efficiency will constantly push and widen the perimeter of “outsource-able” functions across the investment operations’ value curve.

Regulators, boards, institutional and retail investors want to see strong, reputable firms providing checks-and-balances to the asset manager. The Madoff and Rajaratnam scandals have underscored the need and the benefits of using a third-party for investment operations. Additionally, the use of a third-party, independent entity to value assets helps to bridge the trust deficit gap.

Global sourcing offers asset managers a strategic lever to drive greater efficiency, enhance transparency to redeem lost trust and lay the foundation for future growth and success.

Footnotes
1 Sri Lankan-born American Raj Rajaratnam – the co-founder of New York-based hedge fund management firm Galleon Group – was arrested by the FBI in October 2009 on charges of earning about $45 million through insider trading in shares of several public traded companies, including IBM, Intel and Google. Rajaratnam was found guilty in May 2011 on all 14 counts against him.
2 Undertakings for Collective Investment in Transferable Securities (UCITS) legislation led to free marketing of investment funds across the European Union once registered in one EU member country.
3 World Federation of Exchanges, Market Highlights.
4 TheCityUK estimates based on PEREP Analytics, Thomson Reuters, European Private Equity & Venture Capital Association (EVCA), PricewaterhouseCoopers and Asian Venture Capital Journal data.
5 Bank for International Settlements
6 International Financial Services London estimates.
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