

# THE NEXT GENERATION OF OUTSOURCING

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## IS COMPONENT OUTSOURCING THE WAVE OF THE FUTURE?

### The Changing Market Landscape

The financial crisis has prompted some asset managers to outsource at least part of their operations to save money. In today's world of outsourcing, most fund managers are taking a cautious approach to outsourcing their operations. They are deciding to test the waters with one or two functions before moving to outsourcing all of their operations. Despite the potential allure of cost-savings, outsourcing does come with some risks. It is still the fund manager's reputation on the line and liabilities for errors cannot be transferred to the outsourcing provider. Despite these risks, this will become the trend of the future as more asset managers choose to focus on their core competencies of managing money and client relationships.

Today, many asset managers are exploring component outsourcing in an effort to boost their bottom line. This has changed dramatically from a few years ago when asset managers demanded much more customization in outsourcing deals - they wanted providers to replicate all of their in-house technology and operations. The main strategies were lift-out or full conversion outsourcing. The shift today is a move from a fixed cost structure to a variable cost structure that rises and falls with assets or transaction volumes. Component outsourcing is an increasingly more common option for firms to be able to align costs with their overall revenues.

The "re-evaluation" of middle to back office functions is a direct result of the recent financial crisis and has shifted the way asset managers look at their investment operations. Those functions that are perceived to be "commodity" functions are the ones that are highly automated and are most likely to be outsourced. In this new financial landscape, alliances will be critical and partnering with the right firm will be necessary. With component outsourcing, the asset manager can focus on higher-value activities while transferring the commodity functions to experts who can do them more economically.

**The question for most asset managers today, is which in-house operations to outsource and which ones to keep in-house?**

### Return on Investment

The cost benefit from outsourcing is largely determined by the scope of services an asset manager decides to outsource. Creating efficiencies goes beyond just the cost savings, it eliminates a great deal of risk by providing product maintenance and upgrades, maximizing internal resources, and should ultimately increase a firms' profitability. Not only do vendors maintain the latest in technology, they also provide a "virtual staff" eliminating the risk an employer faces of finding talented professionals. They lower the asset managers' technical and operational overhead costs by focusing on IT advances and all product innovation. It enables firms to leverage economies of scale since they can provide the service for multiple firms at a lower cost.

ROI is a key consideration when asset managers choose to decide whether or not to outsource their middle to back office operations. The traditional ROI equation is based on the subtraction of net costs from net benefits. The impact of component outsourcing should ultimately lead to improved top-line and bottom-line performance while reducing operating inputs. The savings should come from the amount of time spend on the component outsourced, the time spent on managing the system and the data. The provider should be able to do it more cost effectively and accurately that the asset manager.

According to Finix, while most initial analysis and proposals estimate a cost savings of 25-40% from investment management outsourcing, a 15% realized savings is considered a success

**"Most outsourcing initiatives begin as a cost savings exercise, but in the end, investment managers outsource commodity components of their technology and operations to allow them to focus on their core competencies," says Jeff Musgrove, a Partner with Finix Business Strategies.**

If implemented correctly, outsourcing is generally less costly than an in-house application. As more functions become outsourced and it becomes more and more strategic (as opposed to transaction-based) the risks also increase.

The same way that several custody and accounting services have matured and become commoditized products, middle and back office functions are also evolving. There are already many functions that are highly automated like reconciliation and performance reporting that are real “value add” outsourced functions. Many asset managers start the process with a focus on a specific area and then add additional services and increase the scope of the arrangement.

#### Factors to consider when calculating ROI:

- Cost Benefit of redeployment of capital no longer used for outsourced components
- Cost benefit of leveraging vendor’s ability to bring new products and enhancements to market faster
- Factor in reasonable growth rates into the variable cost model to ensure an accurate cost calculation
- Staffing needs to manage vendor relationship
- SLAs and invoices

#### Component Outsourcing Benefits

Component outsourcing offers cost savings, scalability and efficiency. In some situations, it allows asset managers to trial outsourcing in stages to increase their comfort levels. Many asset managers today are more comfortable with the reduced risks of outsourcing a single component of their middle to back office operations. Because of this, there is an increased demand for component outsourcing.

There are a number of benefits associated with component outsourcing.

**Cost Savings** – better alignment between cost structure and revenues

**Focus on Core Business** – increased focus on clients and managing assets

**Adoption of New Business Lines** – more flexibility to introduce new products without having to build out the technology and infrastructure

**Adherence to New Regulations** – greater ability to keep pace with changing regulations and markets

**Increased Scalability** – faster time to market and the ability to expand into new geographies

**Competitive advantage** – more innovative in middle to back office investment structures and access to new technology

**Risk Management** – managed risk through specific requirements mandated by well defined SLAs to ensure quality and control

#### Component Outsourcing Risks

Outsourcing has proven to be effective, but it brings significant risks that must be recognized and managed. In component outsourcing, an asset manager is relying on a vendor to run a specific business function or a small set of business functions. Risks depends on several factors, but are most clearly measured by the size, nature and criticality of the outsourced activity.

If risks are managed appropriately, outsourcing can be an efficient operational risk mitigation tool. It is likely that more asset managers will turn to outsourcing as a source of flexibility in developing their businesses, reducing cost, and aligning their core competencies. If the outsourcing risks are not properly managed, they may negatively affect companies' operations and customers.

Some of the potential negative risks include:

**Lack of control** – perceived loss of control of operations and decreased customization

**Unanticipated costs** – shift to variable costs based on volumes could end up costing more if the firm realizes significant growth

**Delivery of Performance** - responsiveness and end-customer satisfaction levels may not be adequate

**Lack of innovation** – depending on the relationship, introduction of new products may be subject to vendor provider’s prioritization

**Hard to turn back** – it is very difficult to bring back a function in-house as the asset manager loses most of their in-house expertise

The main objective of component outsourcing is to reduce costs, focus on core competencies, improve operational efficiency, reduce risk, and keep technology current

**Financial Viability of Vendor** – if the provider is not financially viable or stable, there may be real risk to the asset manager

“With the maturity of the outsourcing industry over the last few years, asset managers are acknowledging that outsource providers can provide commodity technology and operations functions at a reduced cost with same, if not better, service levels.” says Jeff Musgrove, a Partner with Finix Business Strategies.

### Component Outsourcing Areas

The key to determining what areas should be outsourced can usually be determined by answering the following question: Which functions are commodities within the industry and which functions are considered strategic?

**Strategic considerations** are competitive differentiators, proprietary processing, high level of risk associated with loss of service, high level of oversight, and regulatory restrictions.

**Commoditized considerations** are mature functions with defined industry standards, repetitive, rules base, transactional functions, low level of hands on control required, and availability of vendors.

According to Finix Consulting, the areas most commonly considered for outsourcing include:

<b>Commonly Outsourced</b>	<ul style="list-style-type: none"> <li>• Portfolio Accounting</li> <li>• Reconciliation</li> <li>• Performance &amp; Attribution</li> </ul>
<b>Increasingly Outsourced</b>	<ul style="list-style-type: none"> <li>• Client &amp; Regulatory Reporting</li> <li>• Corporate Actions</li> <li>• Trade Notification &amp; Settlement</li> <li>• OTC Derivatives</li> </ul>
<b>Rarely Outsourced</b>	<ul style="list-style-type: none"> <li>• Order Management</li> <li>• Fee Billing</li> </ul>

### Trade Notification and Settlement

Trade notification and settlement encompasses the notification, matching, instruction and settlement of trade data from external and internal sources.

Matching is done at the block and allocation level and the current trend is towards central matching. External 3rd party vendors play a large role within the function and often include SWIFT, Omgeo, and the DTC.

Increased regulation around the confirmation and settlement of alternative asset types have required many investment managers to look at outsourcing options to ensure regulatory compliance. Trade notification and settlement is often described as a “middle office” function and represents the point in the asset management life cycle where firms see the function as a commodity and start to consider outsourced alternatives.

### Portfolio Accounting

Portfolio accounting involves all core accounting functions performed on a variety of data inputs. Historically, an investment manager’s books & records were considered the heart of the business. The investment management landscape has changed quite a bit over the past few years and portfolio accounting is now considered a commodity and is regularly outsourced.

The complexity of managing several external data feeds; the migration to centralized business intelligence strategy, as well as, the move to real time processing has shifted the focus from accounting to true data management.

### Reconciliation

Reconciliation occurs at multiple levels including reconciliation between order management systems and accounting systems and reconciliation between custodian records and internal books & records. There are several systems that can provide automated reconciliation of holdings, cash balances, cash transactions and securities transactions daily.

Reconciliation is one of the most common functions outsourced to 3rd parties. Very few firms can achieve the economies of scale required to make reconciliation a viable internal function. Recon can be performed from any physical location easily.

### Performance & Attribution

Performance and attribution activities include calculations at the account level, for mutual funds, composites, as well as, risk measurement, attribution, GIPS compliance, benchmarks, and reporting.

### Corporate Actions

Corporate action processing is often one of the most manual and challenging parts of investment management operations. High volumes and the

“Gone are the days of only outsourcing accounting and reconciliation. Today, asset managers are moving away from the one-size fits all approach and looking more towards specialized, component outsourcing.” says Mike VanderVat, a Partner with Finix Business Strategies.

complexity of conversions, tender offers, mergers, rights and other corporate actions, along with the lack of industry standards cause the processing of corporate actions to be a high risk and high cost burden to money managers. Add in the management of proxy voting and it is easy to see why asset managers are looking to outsource this function.

### Client Reporting

With all of the recent fraud and bad press in and around the investment management industry, clients are demanding full disclosure and client reporting is the latest hot spot for outsourcing. Gone are the days of quarterly reports, clients are now demanding real-time access to their accounts and activity.

Clients require graphs, trend analysis and easy to access and easy to read reports. The format and content of client reports may vary, but themes are constant and typically include Holdings, Performance, Gain/Loss, and Transaction information.

Some of the growth areas in outsourcing of the middle-to-back office operational functions: are over-the-counter derivatives processing, corporate actions processing, and collateral management.

By outsourcing infrastructure and services, costs relating to installation, integration, maintenance and support can be significantly reduced. Hosting has also become a popular way to reduce overhead as it allows asset managers to select a software provider and everything else is handled by the provider. It also means having a solid business continuity plan since everything is available on the intranet.

### Finding the Right Vendor

Choosing a partner that can provide the scalability and flexibility needed can be a challenge. A vendor must have a global presence and be able to adapt as their business evolves over time. An outsourcer is also a partner of the asset manager - as both parties evolve, so must the relationship.

Some of the criteria for choosing the right partner are as follows:

**Delivers Economies of Scale.** The primary reason to outsource is to reduce costs. A good provider will have a proven track record and multiple clients that will allow the firm to deliver economies of scale.

**Forms a True Partnership.** For the asset manager, the outsourced partner is an extension of their business. The provider must work very closely with the asset managers' people, processes and systems.

**Proven Technology.** Find a provider who invests regularly in their technology efforts and continually upgrades and enhances the product. A system should be comprehensive, multicurrency and able to handle all security types.

**Reliable Transition Plan.** A good outsource provider will develop a customized implementation plan complete with milestones and progress checkpoints. Choose a vendor with significant Implementation experience.

**Low Staff Turnover.** In today's marketplace it's essential to quality to have an experienced Leadership (BPO team).

**Green SLAs.** Well defined and well managed service level agreements are the life blood of any outsourcing relationships. Asset managers must obtain the providers documentation for all outsourced processes.

**Fair Pricing Model.** Most managers tend to opt for a variable cost structure that rises and falls with assets or transaction volumes.

**The Right Cultural Fit.** Make sure that your provider has a similar vision about the outsourcing arrangement and shares the same work ethic, sense of purpose and responsiveness to address issues that may arise.

“Outsourcing is a partnership and as with every good partnership, in an outsourcing relationship both parties must gain from it.” says Mike VanderVat, a Partner with Finix Business Strategies.

### No “All or Nothing” Approach

Thomson Reuters Outsourced Services offers asset managers a choice in outsourcing – clients have the option to choose the components of the middle to back office they want to outsource whether it's their infrastructure or just the reconciliation function. Asset managers can operate with a 'business as usual' and continue to benefit from the flexible service approach that evolves with clients' needs over time. Thomson Reuters consistently demonstrates economies of scale by having a standard set of processes and proven implementation methodologies in place. The ability to leverage PORTIA, the industry's leading investment accounting platform which supports 300 clients in 45 countries providing deep support across all asset classes. Thomson Reuters PORTIA offers world class global functionality across the middle-to-back office, and has been a proven solution for over 25 years.

## **A True Partnership**

Thomson Reuters partners with each client to understand their unique needs and defines a service offering that meets those specific needs. Each client has access to the tenured staff and dedicated account team so that clients' have the knowledge they need and the skills required meeting all of operational functions of the middle-to-back office. Thomson Reuters is continually investing in innovative new enhancements and services to provide to our clients, a significant advantage in today's market.

## **About Thomson Reuters**

Thomson Reuters is the world's leading source of intelligent information and workflow solutions for businesses and professionals. Used by more than 300 investment managers in 45 countries managing assets worth more than US\$15 Trillion, Thomson Reuters PORTIA is a highly scalable solution which boasts flexible deployment options. Thomson Reuters PORTIA provides investment operations outsourcing for asset managers across a full array of post trade execution activities. The solution is tailored to meet each client's individual requirements. With headquarters in New York and major operations in London and Eagan, Minnesota, Thomson Reuters employs more than 50,000 people and operates in over 100 countries. For more information, go to [www.thomsonreuters.com](http://www.thomsonreuters.com).

## **About Finix Business Strategies**

Finix Business Strategies, LLC is a Baltimore based management consulting company specializing in technology and operations for the Financial Services industry. Finix provides clients with advisory, strategic planning, project planning, project management and implementation services. For more information, go to [www.finixbs.com](http://www.finixbs.com)

