

EMC PERSPECTIVE



**Strategic Considerations for
Investment-Management
Outsourcing**

In a new, post-financial-crisis era, investment-management firms are facing intense cost-cutting pressure, increased competition, and greater demand for operational excellence. Outsourcing has regained its popularity as an answer to some of these challenges, as well as a means by which many financial companies are able to continue to focus on their core competencies and business objectives. However, determining the appropriate strategy, scope, and outsourcing partnership—as well as overcoming the complexities, duration, and resource commitments that ensure a successful conversion—make outsourcing a challenging endeavor.

In August 2009, EMC® Consulting surveyed 16 leading investment-management firms and four major service providers on the topics of investment-management operations and technology outsourcing. The responses to this survey, as well as the observations of EMC consultants working with these organizations, provide valuable insights to guide organizations in their outsourcing journeys.

Dynamically changing the outsourcing services landscape

In a rapidly growing market, there is increasing competition in the marketplace from both technology and services providers. Major outsourcing services providers like State Street, Northern Trust, and Bank of NY Mellon, have been joined by several niche players, like Citi for hedge funds; established technology solution vendors, like SEI and SS&C Technologies; and business-process outsourcing providers like Patni. All of the custodial banks are working on the “unification” of their investment-operation outsourcing and asset servicing platforms to bring added economies, consistency, and efficiencies to their overall operations. Traditional technology solution vendors such as SEI, SS&C, SunGard, and even some BPO providers have made significant investments to expand into the outsourcing market.

Investment-management operations outsourcing services encompass all asset management activities following trade execution through portfolio management and client reporting, and integrated with the full spectrum of traditional back-office (i.e., accounting, custody, and fund administration) services that major custodians have been providing to investment managers for years. See Figure 1.

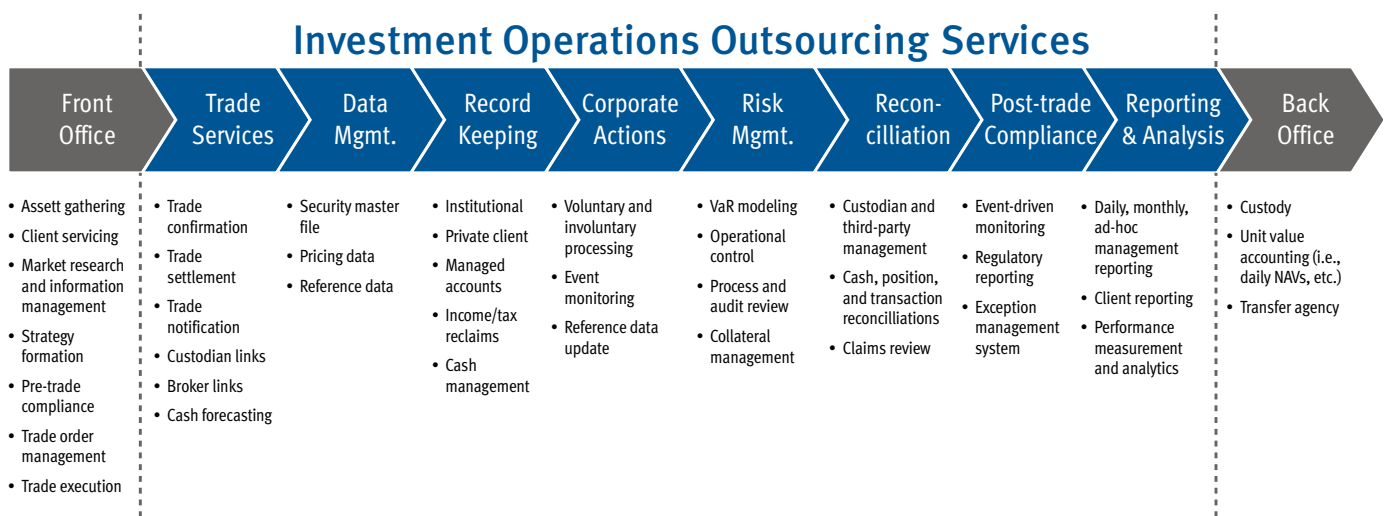


Figure.1 Investment-management overview

The current outsourcing deal structure models vary in structure, risk, and cost. There are three major forms taking shape in the recent years:

- **Lift-out model:** In this outsourcing model, the outsource provider takes over the entire operation, including staff and IT platforms. The provider is interested in creating a foundation on which to build its business since it can’t achieve economies of scale by maintaining client legacy environments. The conversion processes are initially delayed until the provider builds-out its strategic platforms.
- **Component-based model:** With this outsourcing model, only select portions of the operations are outsourced over time. This model has a high likelihood of reducing the risk of conversion. This is a very good strategy if the preferred vendor does not have a mature, more-holistic, enterprise platform solution.

- **Entire investment-operations model:** The last model has the entire middle-office operations outsourced at the same time. Due to the larger scope, this can increase risk of conversion, particularly if the conversion involves challenging and testing the provider's new platform with high-volume levels, a range of security types, application modules, etc. It is a good strategy if the preferred provider has a mature platform. Complete savings should be realized faster.

There is an outsourcing services supply-side squeeze anticipated in the next few years as providers are busy digesting the initial "lift-out" deals they have established. Over the past couple of years, these major deals have been in Europe. Outsourcing middle-office functions has been slower to catch on in the U.S. Many fund managers have held back from completing outsourcing deals because of a lack of competitive providers with tried and tested platforms, and both investment-management organizations and outsource providers have underestimated the complexity, duration, and resource commitments necessary for this complete conversion.

The lift-out approach is reaching the end as outsource providers build-out enterprise solutions with integrated IT infrastructures. Migrations to these new environments will slow their ability to take on too much new business until transitions are completed. Less than one-third of announced deals have fully migrated to the outsource provider's enterprise platforms. Also, after absorbing the initial set of clients, providers may not be as price competitive as those for the first movers. The major challenge for outsourcing service providers is to successfully demonstrate they can effectively absorb the initial clients they acquired, while they continue to build-out their enterprise solutions.

It is anticipated that the business in the U.S. will begin to mature. Vendors will likely structure more favorable deals when a client outsources both the traditional back-office functions—like custody and fund accounting—along with middle-office functions. The middle-office aspects will likely become commoditized as did custody and fund accounting. New deals will leverage the service provider's common solutions and produce incremental efficiencies for the outsourcer with the development of more standardized, repeatable service models. Over the next five years, we will see financial services outsourcing grow with various destinations around the world competing for business.

Investment-operations outsourcing motivations

There are several hot spots for global outsourcing initiatives within investment-management firms, including middle-office component solutions, cash and collateral management, reporting, compliance and risk management, and hedge fund administration.

Asset managers from most midsize and large businesses have recently considered outsourcing some, if not all, of their investment-operations functions for the following reasons:

- **Cost savings:** Improve operational efficiencies in areas that don't differentiate the business, and reduce costs associated with technology, staffing, and/or real estate
- **Focus on core competencies:** Partner with an outsource services provider who has the core competency in middle-office outsourcing and established services platform
- **Systems-renewal process:** Outsourcing is one viable alternative to building or licensing systems and eliminates large investments in technology
- **Scale/time-to-market:** Ability to more rapidly expand geographically and avoid large upfront investments needed to enter new markets
- **Competitive advantage:** Ability to stay current with innovation as it relates to middle-office processing (i.e., pricing and valuation transparency, derivative process capabilities, etc.)
- **New regulations:** Ability to leverage investments by service providers who have developed efficient and effective tools to meet regulatory requirements in a timely manner
- **Protection from unforeseen events:** Provide assurance against margin-compressing events such as the Euro conversion, STP/Trade Date + 1, etc.
- **New business line:** Adding new instrument classes, products, and services without having to build-out the enabling technology and process if it is already supported by service providers

Investment-management firms are refining their strategies for outsourcing and assessing where they can realize the greatest benefits. In contrast to outsourcing the increasingly commoditized back-office functions, U.S.-based asset managers are far more reserved when it comes to outsourcing their middle-office functions than their European counterparts. European money managers, emerging and boutique asset managers still represent the majority of the investment-operations outsourcing clients. This means many organizations are considering specific functions to outsource as opposed to the entire middle office. These firms will continue to look to the major vendors for broader, comprehensive, and integrated services, and then partner with service providers who have demonstrated—with clear evidence and customer testimonials—that they have successfully delivered the same type of service engagements.

As asset managers continue to rethink their entire investment-operations strategies after recent market turmoil, some have opted to consolidate overlapping and/or siloed investment operations that traditionally serve different lines-of-business within the firm, or as a result of numerous mergers and acquisitions, to lower the cost and increase the operational efficiency. They have started implementing shared services within their organizations and only look to outsource some middle-office functions (e.g., client reporting, cash management) to improve scale and time-to-market.

Investment-management operations outsourcing—benefits and risks

To enhance a firm's competitive advantage, the decision to outsource should enable the organization to:

- Benefit from the strengths of a third-party vendor (whether systems, knowledge, or processing efficiencies)
- Support or enhance future growth (e.g., facilitating new products and services)
- Reduce or eliminate technology and legacy system dependencies
- Implement an integrated global front to middle- and back-office capability
- Contain and/or convert fixed costs into variable costs
- Enhance client reporting and related satisfaction levels
- Meet compliance and regulatory requirements

However, mission-critical business activities make conversion both costly and risky, and there are major outsourcing issues such as:

- Loss of strategic control
- Minimized focus on IT advances
- Minimized continuous innovation
- Unanticipated costs
- Retaining bonuses for valuable employees who process critical institutional knowledge required for a period of time until the conversion is completed
- Challenges associated with vendor relationship management and responsiveness
- Maintaining adequate levels of data access and security
- Service quality problems
- Poorly integrated processes
- Penalties that are difficult to enforce

Making the right outsourcing decisions

Trends aside, investment-management firms must determine if the benefits of outsourcing operations outweigh the risks, costs, and inconvenience associated with converting to a new, offsite environment. EMC Consulting recommends that organizations:

- Consider “component-based” outsourcing, and look for vendors that can demonstrate economies of scale with standardized processes and integrated technologies while achieving with minimal gaps (e.g., pricing, reconciliations)
- Retain mission-critical functions and/or areas where processes tend to be complex with multi-party, high front-office and client interactions and are non-standard or require specialized skill sets (e.g., data management, client reporting)
- Enterprise data provides the foundation for all processes throughout the investment-management value chain. As of today, no third-party provider has the ability or desire to fulfill all data needs, while at the same time assuming the liability for data accuracy. Continued innovation and technology upgrades in data acquisition and integration within the organization should be made a top priority, which will eventually drive value-added services to internal and external clients.
- Look for vendors that have a strong track record in:
 - Client conversion and relationship management
 - Meeting service-level agreements
 - Retaining “initial, middle-office outsource” clients past the first contract renewal period

EMC investment-management outsourcing consulting approach

EMC Consulting has worked with both the supply and demand sides of the outsourcing marketplace to leverage key learning in helping clients develop tailored, optimal sourcing strategies and optimize their investment operations.

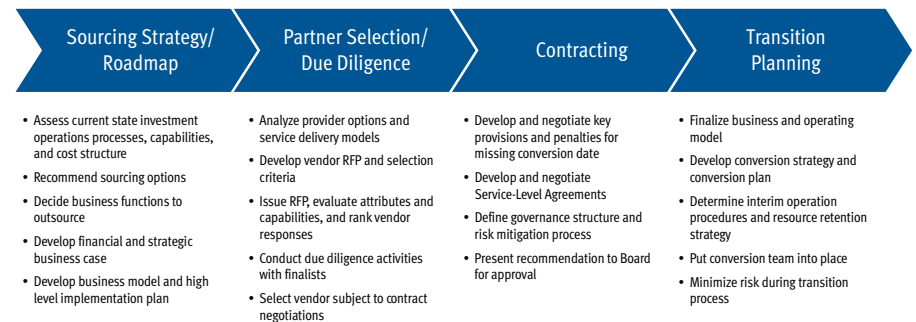


Figure 2. EMC investment-management outsourcing consulting approach

We believe that our knowledge, expertise, and unique credentials can significantly assist your organization in determining a strategy and formulating a plan for your investment for evaluating and enhancing your technology/processing environment. We can formulate a plan that will enable your firm to effectively address challenges in this dynamic landscape.



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