

# Asset Management Component Outsourcing the Next Wave



The economic crisis has resulted in many organisations having to initiate comprehensive reviews of their operating models to drive down costs, increase efficiency and potentially downsize in order to survive. As part of the drive to save costs many companies have reduced their workforces and sought alternative ways to get things done.

One of the options available to management at these times is to consider outsourcing, but where do they start? Firstly they need to understand the drivers behind outsourcing. These can include a desire to focus on core functions, move to a more variable cost model, cost avoidance, risk mitigation or to accommodate volume growth. How do they decide what functions or processes to outsource? Who do they outsource to? When do they do it? How do they manage the outsourced activities?

In the context of an asset management company it is interesting to take a look at the whole organisation and to challenge the “we could never outsource that function ‘sacred cows’”.

Let’s go through an asset manager, function by function, and see what is possible.

## Investment Management

The outsourcing of investment management is now common, as many fund managers understand that they are unable to provide a level of performance and service to their end clients across all

asset classes. They often use other managers to supplement their skills while they focus more on asset allocation. Clients will continue to seek to use best of breed managers for each asset class they wish to invest in and a more open minded, open architecture approach to the use of specialist managers will serve firms well. It is of course vital that appropriate due diligence is carried out on the fund managers who will be performing this function particularly as a result of “Madoff”.

## Research

Fund managers differ regarding their attitude to in-house research departments. In some firms research is done by, or sits within, the fund management teams; in others it is a separate team and some firms merely buy in research from outside parties. This tends to be a sacred cow area and firms can be very protective about how they operate, it is often promoted as a differentiator versus other firms although it is arguable whether this really is the case. Firms which specialise in research should flourish in this environment provided they can demonstrate added value at a reasonable price.

## Dealing

The majority of fund managers manage their dealing in-house with a team which usually sits alongside the fund managers. Typically this team is staffed with quite expensive people and often operates in multiple time zones. It is worth asking that with more and more trading being driven by

systems or algorithms, whether the dealers are actually adding much value in terms of who they deal with and how. A trading system which generates orders from the fund manager’s desk by-passes the dealing desk and is traded on electronic trading platform(s), serves to reduce risk from errors and also reduce the cost of the trade. This is an area where fund managers should really question the reason why they do it themselves as alternatives now exist. Significant value can be lost by poor timing and execution strategy by in house dealing teams.

## Treasury

Many fund managers run their own treasury functions, managing on a daily basis cash balances and foreign exchange positions on multiple accounts in multiple currencies. Depending on the level of automation and systems interconnectivity within the organisation, this process can be very efficient or involve a significant level of manual intervention and therefore risk. Heads of Treasury will often tell you that they get the best rates in the market, they are tremendously efficient and they make great returns for their clients. All of this may be true, but often doesn’t take account of the true costs involved in the process not least being the cost of rectifying errors made to keep clients whole. Inevitably this may occur in any process where people are involved. In addition the cost of back office staff and systems to process the deals has to be taken into account. Most of the major custodian banks will now provide treasury

services at fixed or near fixed spreads, and with judicious contract wording, the liability for operational losses should be moved from the fund manager's balance sheet for errors they do not make. Given that most banks make significant revenue from their treasury and FX operations, it is difficult to see that treasury departments in fund managers are adding significant value on standard transaction types, so why not outsource this work?

### **Stock Lending**

Since the market problems caused by the collapse of Lehman's, several of the main in house players in this area have reduced their capacity or even ceased lending. There are some organisation's which continue to run their own lending desks quite successfully, however care has to be taken regarding the level of risk it puts on the firm's own balance sheet compared to the extra rewards it brings. Outsourcing to a provider the stock lending of the portfolio can, if structured correctly and done with a company with a sufficiently strong balance sheet and under robust contracts, enable a balance between a reasonable rate of return versus the risk being taken. Many fund management companies already outsource their stock lending programme to their custodian banks in this manner and the operating model is very mature.

### **Performance Measurement and Investment Risk**

Typically performance measurement can be split into two sets of tasks. Firstly there is the core processing of data to produce the various reports that are required. As long as the output is produced in an accurate and timely fashion then there is typically no real value-add to be gained from the production of this output. This is something that could be outsourced and typically it should go to the organisation that has easiest access to the data, which in most cases would be the custodian bank or outsourced provider where relevant. The second set of tasks is where value can and should be added. The interpretation of the output produced and how that interpretation is used across the business either by assisting the fund managers, providing information to institutional clients or by enabling the management to make effective and useful business decisions. There is potentially more value to be gained by keeping this latter service in-house, provided the fund managers listen to and act upon the information given to them.

### **Sales/Distribution**

Most organisations have their own sales teams who should understand their products and investment processes intimately. This is certainly not a function a firm should outsource in total. When considering the current environment with fund of fund products and open architecture, many firms already effectively outsource sales of some of their products to other firms. So there is some precedent to outsourcing sales functions in existence, but it will probably be a reflection of the types of business model the organisation is running i.e. predominantly fund products could be outsourced in some way but less likely for discretionary or institutional accounts.

### **Marketing**

A similar situation to sales, however in the case of fund platforms, who is actually doing the marketing of the fund itself to the end client? Usually it is the fund platform, so it is arguable that some outsourcing has already occurred here as well. In this case it is vital that the platform provider has up to date information on the managers products at all times.

### **Investor/Client/Consultant Relationship Management**

At an institutional client level, it is probably sacrosanct that the relationship manager will be in-house to the fund manager. Moreover, given the power of the investment consulting community, it is vital that firms have staff who can relate well with the investment consultants. This relationship weakens when it comes down to dealing with fund products. With some of the major service providers supplying dealing desks for fund managers products, many firms have already outsourced this part of their client management to a third party.

### **Product Development and Management**

Many firms have their own in-house product development team which should link closely to both the sales and marketing teams and the investment managers. The importance of getting the right product at the right time cannot be underestimated however the actual process of establishing the fund is, in most cases a routine process. There is an opportunity for third party specialists to step in and help fund managers with this routine work because once the product idea has been developed in-house, there really is little to stop the development of the fund product itself from

being outsourced and relevant regulatory authorisation gained.

### **Operations**

There is already a maturing market for outsourcing of operational functions from fund accounting and pricing right through the operational value change to trade settlement and matching to client reporting. Typically more and more firms will consider the value add they give by performing these functions in house and generally these functions are becoming quite commodity based and ideal for outsourcing. It is also important to understand that by judicious contract negotiation, some of the financial risks of errors can be defrayed to the service provider by the fund managers to the third party provider.

### **Technology**

Again more firms are outsourcing some or all of their technology requirements. The easiest place to start is the hardware and networks which are best left in the hands of experts and is usually low risk to outsource. Further down the chain the helpdesk is something else which typically gets outsourced, but where things do get more complex is when firms decide to outsource areas such as application management and support etc. These tend to be very client specific and usually the areas which outsource providers find hardest to service, although some firms do outsource these functions.

### **Supplier Management**

Where there are major third party relationships, then these tend to be run in-house. That said, many of these arrangements are multi-functional and require some central coordination which is often not resourced appropriately. The regulatory responsibility for the supplier always rests with the asset manager, i.e. you can outsource the activities but not the responsibility for it. In most instances it is best for the day-to-day functional management to be run by the in-house staff, however it is perfectly feasible and probably sensible, to get help with the overall governance of the arrangement. For this we mean the regular meetings with the supplier, the contractual and fee reviews, the SLA and KPI management and monitoring. In the case of large firms this work could be co-sourced to experts in the field or totally outsourced for smaller firms. This would enable the business as usual to get on with its job and provide professional oversight to the key governance controls. This would be particularly effective for

smaller firms or where headcount controls restrict the ability to resource these roles appropriately or attract the necessary level of expertise and experience.

## Execution of Change

Many companies use outside consultants or contractors to provide the necessary project or program management to their major initiatives, often using people who have worked on a similar project elsewhere. So outsourcing in this area is common, however, the real key is to ensure that each project has the required level of sponsorship within the organisation. This is an area where many companies “under club” what is needed with disastrous consequences in terms of untimely delivery, whether the change meets intended requirements or budget overrun. This is an area where firms quite often outsource the role but forget the overall responsibility for delivery rest with them.

## Business Continuity

A crucial, but in many places an under resourced or underrated department. This is an area which is often part of a job for a member of staff and is really only taken seriously when there is a business continuity incident or when an annual test fails. This is especially true in these current testing times when major shocks are becoming regular events. This role really needs senior sponsorship within an organisation and also someone who cares about it having responsibility. Many organisations would benefit from having outside advice to help them review and update their plans and tests on an ongoing basis, as clients expect companies to continue to function despite any incident that may occur. This outside advice could be on a full time or part time basis as required.

## Risk Management

In light of some of the recent events in financial markets, the role of risk management functions has been subject to criticism in many quarters, as has the way senior risk officers have been ignored by management in certain banks. Some of the criticism should be shouldered by risk departments, however in many circumstances the level of experience of risk staff just hasn't been high enough to cope with and understand what the issues have been. It is important that fund management firms ensure that the level of skills in their risk teams are sufficient and governance structures are such that issues they raise are heard at the appropriate levels within the organisation and

addressed properly. It is entirely appropriate for firms to consider bringing in these professional skills from third parties on a co-sourced basis to compliment the staff they have in-house. Moreover, by utilising skilled and experienced professionals and giving them access to Audit Committees, the firm will be gaining an extra independent level of defence against major risks.

## Legal

Some organisations operate sizeable legal teams and others have a legal coordinator who manages external law firms. Outsourcing of legal work to experts is commonplace within fund managers and will continue to be so as it is unlikely many firms can afford to have sufficient variety of expertise in-house.

## Compliance

The vast majority of fund managers have their own in-house compliance department and will retain such a department, not least because of regulatory requirements to do so. That said, most compliance departments carry out a fairly high level of ongoing compliance monitoring and given the growth in this area in recent years it has become more difficult to hire and retain good staff. This has resulted in monitoring work in many cases being performed by staff without enough experience to really add value and spot risks/issues. Firms should consider co-sourcing some of the more routine compliance monitoring to third parties who have experienced professional staff on their books to carry out the work. This has numerous advantages to the asset manager including having a lower retained headcount on its books, less time spent in staff recruitment and training, more experienced staff performing the monitoring with expertise across multiple organisations and access to market and independent views. In the current and changing regulatory environment this will certainly be of more value and if given access to Audit Committees, an extra line of defence.

## Internal Audit

Internal audit is an area where some firms use an external provider and this will become more common as a result of recent market turmoil. This is because it will become more important for organisations to be seen to have independent professional expertise advising them. It will be more difficult for management to ignore the recommendations of independent auditors than historically they have done with internally staffed teams. Over time,

more niche firms of specialists will be providing these services to ensure the work is carried out by highly experienced and skilled practitioners. In the case of large firms this work could be co-sourced to experts in the field or totally outsourced for smaller firms.

## Policies

All organisations have operating policies to some level or another. In many they are drafted by management as things develop and sometimes there are periods of catch up where an organisation does a full review, often a few months before a regulatory visit for some reason. That said it would be more effective and certainly less time consuming for organisations to utilise experts in the field, with experience of other similar firms, to work with in house teams on the drafting and implementation of policies. This can only be of benefit as it will be quicker, more relevant to the current market environment and implementable with minimum effect on the business but importantly be relevant to the business.

## Facilities

Most large organisations will have a senior member of staff responsible for facilities management and smaller companies will probably have the role split between two or more people. Much of the work is outsourced already from cleaning through electrical maintenance to say, lift repairs. Largely the role of the facilities head is one of being a procurement manager. The key of course is making sure the contractual relationships are sound, in place and effective i.e. good governance over suppliers. A key element to the role in the current environment is to ensure the financial stability of the suppliers in the value chain, particularly those involved in providing added protection in the event of an interruption to business. It is questionable as to whether most organisations have the necessary review processes in place to ensure continuity of supply in the current environment. Outside support could be used to assist in ensuring the financial status and well being of key suppliers.

## Finance

It is not unusual for firms to outsource the basic finance functions such as purchase and sales ledgers and general ledger upkeep. The areas which tend to remain in-house are forecasting, budgeting, cash flow management and strategic planning functions. Again, it's a question of trying to outsource the commodity, low value added

work and keep in-house the more strategic, bespoke to the company work.

## Human Resources

Many organisations retain their HR department in-house and perhaps use a service provider for some processes, for example, payroll processing. However, there are providers available who are able to take more of the HR strain away from an organisation. They can provide services in respect to employment law, drafting of company policies and keeping a client organisation up-to-date with changes in current legislation, through provision of employment contracts to managing the redundancy process on an outsourced basis for a client. In some areas, particularly in case of staff retrenchment, it is often more sensitive to use a qualified outside party to handle the process than use internal HR managers that are often not properly trained or qualified to handle such issues. Typically a larger organisation may co-source some of the skills to supplement their in-house team whereas smaller firms might outsource more because they cannot afford to keep all the skills in-house.

## Procurement

Many companies handle procurement through a centralised point within an organisation but often the people in charge of procurement have been put in these roles by default or they do it alongside another line role. The role of professional procurers is likely to grow as these people get better deals for the companies they work for be it in relation to price, service and efficiency.

## Communications - Internal

Typically this would need to be a function staffed internally as you need people who are full time and connected to the business. The real skill here is to ensure that communication is of the right quantity and relevant. It is surprising how easy for the communications team to lose the trust of staff by in fact over communicating information.

## Communications - External/ Public Relations

This should be run by a full time staff of the company and they would need to buy in certain services to compliment what they do, e.g. PR, advertising etc. It is vital for the head of communications to have a very close and trusting relationship with the CEO and Executive of the company to gain best value out of the department.

## Conclusion

To sum up, it is interesting to see that there are many areas of opportunity for outsourcing various components along the value chain of a fund manager. Historically, there have been many sacred cows that have not been challenged but a combination of more and varied service provision becoming available is challenging their 'untouchable' status. In a turbulent economic environment where cost reduction is a driver, there will be more reasons than before to look at what can be provided by third parties to solve operational complexities.

It is important when considering outsourcing a function or part of a function to ensure that it is working well, the golden

rule of "never attempt to outsource a problem" still applies. It will become a bigger problem later! Whether a firm outsources a whole function or supplements its existing teams by co-sourcing professional expertise will typically depend on the organisations size.

A decision that needs to be made is whether to try to outsource multiple functions to one provider or adopt a best of breed approach. In many ways this is dependent on how good the fund manager thinks they will be at managing their suppliers and the nature and size of their business. If they have a strong process in place then best of breed should give a better result but if new to the process then dealing with one supplier is probably a more sensible place to start. That said the manager also has to weigh up the risks of putting too many outsourcing eggs in the same basket particularly in the current environment.

One need is clear though, and that is getting some help to do the outsourcing project. It is rare for any organisation to have all the skills needed in house. These range from negotiating the contract, legals, project management, transitions, testing, process management, etc.

Outsourcing is a major corporate event and should be treated and managed very seriously by senior management. It is for a long period of time, typically seven years or more, and it needs to work. In sourcing what you have outsourced is expensive, time consuming and distracting to business growth. It is essential to get it right first time.

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