

Extraordinary Times Call for Savvy Outsourcing Solutions

By Robert Donahoe

The numbers are staggering: Over a span of just seven years, two of the worst bear markets of the past century have ravaged the global asset management industry. The latest one has wiped out some \$US15 trillion in asset values, causing havoc in every asset class, market, geography and client segment: 15 years of capital gains wiped out in 15 months.

As a result of the financial crisis, many investment managers are reviewing their product range, their operational model and the infrastructure used to support their business. In this transformed economic landscape, investor demands are shifting to top-quality, low-risk, liquid investments, and investment managers are assessing their opportunities to adapt. While doing so, they are increasingly recognizing the advantages – financial, technological and operational – of outsourcing non-core middle and back-office responsibilities to an independent service provider.

• **Turning fixed costs to variable**

Regionally and globally, declining asset values and record remittances have caused a significant reduction in revenue for investment managers, who are typically paid on a percentage of AUM. This revenue draining scenario is fueled by the fixed costs associated with servicing clients (e.g., operations support, documentation, technology management and infrastructure, etc.), which, despite a decrease in assets, have largely remained the same, or even increased. Infrastructure and operations expenditures now represent a year-over-

year expense-to-revenue ratio that is up 40-60%.

By offloading non-core middle- and back-office support functions to an experienced third-party provider, investment managers can turn fixed costs into variable. Since outsourcing fees are typically based on volume metrics such as AUM, accounts or transactions, investment managers can achieve revenue growth during good times, while weathering declines in turbulent ones.

• **Transferring technology/infrastructure spend**

Through outsourcing, investment managers can reduce the costs required for maintaining a technology infrastructure with assured modernization. For the investment manager not using an outsourcer, current and future capital investments are not embedded in its costs and are an additional financial burden that must compete for limited firm resources. Outsourcing presents investment managers with an opportunity to transfer the current and future technology expenditures to a service provider that already has the capabilities in place and the future development scheduled.

• **Mitigating risk**

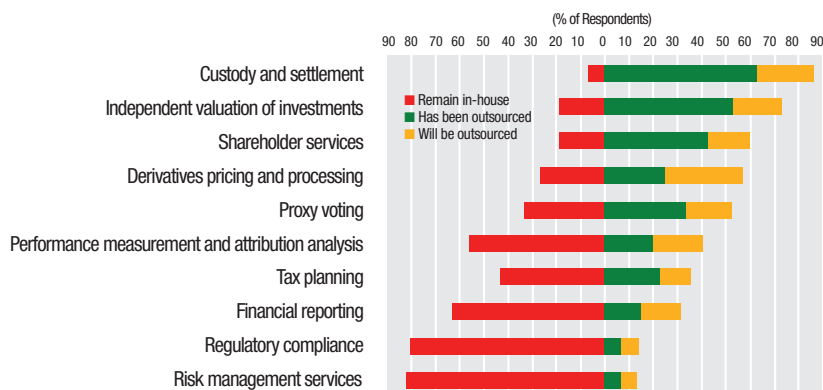
With an outsourcer, liability/financial responsibility is significantly mitigated through mechanisms including defined error policies and service level agreements. However, while some of the daily operational risks get transferred to the service provider, the success of outsourcing any function is dependent on the proper level of oversight. The investment managers that realize the greatest benefits from outsourcing understand that “outsource” does not mean “out of mind.” They still need a strong oversight and governance model in which rigorous controls and an effective reporting structure are in place to manage the vendor.

• **Focusing on core competencies**

When senior managers are forced to focus on operational issues, they are diverted from concentrating on their core competencies. Today, the discussion within investment management firms is shifting to what middle- and back-office support systems and operations can be outsourced and, by so doing, will free up managers to focus on what’s driving their firms’ success – building revenue and meeting the needs of their clients. Strategically aligning with the right outsourcing partner enables investment managers with the flexibility to focus on building underlying value.

What will be the optimal division of back office functions in the next 5 years?

Back office outsourcing has been a major growth phenomenon of this decade, initially covering low value-added activities like custody and settlement and progressing to middle office activities like valuation of assets, derivatives pricing and attribution analysis. As the chart indicates – which reflects data compiled by CREATE Research in its recent survey of 225 asset managers from 30 countries – growth is likely to continue for years to come.



• Securing marketplace intelligence

As investment managers review their business model to incorporate increasingly complex products and fee structures across new markets, they are turning to service providers, not only to deliver specific operational solutions, but also to discuss business opportunities more broadly. More and more, they are regarding vendors as trusted advisors leveraging the providers' experience, product knowledge and market insights. In doing so, they gain industry-wide intelligence and often a global perspective typically unattainable with in-house resources.

A New Toolbox for Hedge Fund Survival

In a post-Lehman, post-Madoff world, hedge funds are under intense scrutiny to meet market, statutory and regulatory demands

“Outsourcing is seen as a tool that allows senior executives to professionalise the business by concentrating on their core manufacturing competencies ... four strategic areas that deliver a vibrant business: deep investment capabilities, strong service proposition, realistic charges and sound business basics.”

Professor Amin Rajin, CREATE Research, 2009 “Future of Investment: the next move?”

while remaining focused on their investment strategies. Attempting to generate alpha, while controlling expenses and ensuring proper risk management and transparency, is a tall order. To succeed, hedge funds need to focus on investor needs and take full advantage of a new class of capabilities being developed and delivered by third-party fund administrators and custodians.

• Blended prime brokerage/custody model

This innovative capability enables a hedge fund to keep margined investments with a prime broker and all long and unencumbered assets in a custodial bank relationship. A flexible service offering is key to ensure the least strain on the funds' operational infrastructure.

• Collateral administration/collateral optimization

Although hedge fund trade strategies have become more sophisticated, the infrastructure to manage operational risk in the back office has not kept pace. Collateral administration offerings deliver both operational solutions to mitigate risk and value-added services to improve the fund managers' return on assets as well as their ability to manage client relationships.

• Hedge fund-specific middle office services

Hedge fund managers looking for savvy outsourcing solutions should weigh the benefits of a total lift-out of middle office services. Typically, these services consist of a portfolio of post-trade and pre-settlement offerings, including daily trade processing, reconciliation and daily P&L reporting, in addition to OTC services, collateral management, corporate actions, cash management and risk reporting.

• Managed account operating platform

Hedge funds are increasingly establishing managed account structures for their underlying investors rather than creating legal vehicles like limited liabilities companies or limited partnerships.

To support this structural shift, third-party administrators are offering operating platforms that provide the robust technology these accounts require. These solutions deliver end-to-end operations support from account management and imbedded compliance and audit control to paperless work flow management and performance reporting.

What Does the Future Hold?

That's a question all of us in the investment management industry have been asking ourselves as we continue to push through the most challenging market conditions in decades. Are recent positive economic events “green shoots” of recovery or only teasing mirages? Has the global financial marketplace – and asset management's role in it – been forever transformed? One thing for certain is that extraordinary times such as these offer opportunities to create businesses of enduring value. Some of today's industry icons, for example, have emerged from the ashes of the 1929-32 debacle.

To succeed in today's transformed marketplace, investment managers need an unwavering commitment to putting the needs and new priorities of their clients first. One way to achieve this client-centric business strategy is to enlist the support of an outsourcing partner – one who can expertly shoulder the operational and administrative functions that drain and divert a firm's people and financial resources.

In much the same way, service providers must recognize the importance of guiding its investment management clientele through all available options. Service providers like Citi, therefore, are likewise adapting their capabilities to the new market dynamics. Evolving our responsibilities as a strategic business partner, Citi's client solutioning approach is to understand each client's unique requirements and develop tailored solutions for the client's middle- and back-office with the goal of enhancing the investment manager's growth.

Citi's Securities and Fund Services infrastructure is defined by the industry's largest proprietary network, with branches now spanning 57 markets worldwide. We are the largest custodian of cross-border assets with approximately \$10 trillion of assets under custody and trust. As a savvy outsourcing partner, Citi has the market expertise and global perspective to support our clients' success as they grasp this unique opportunity to create a business of enduring value. ■



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