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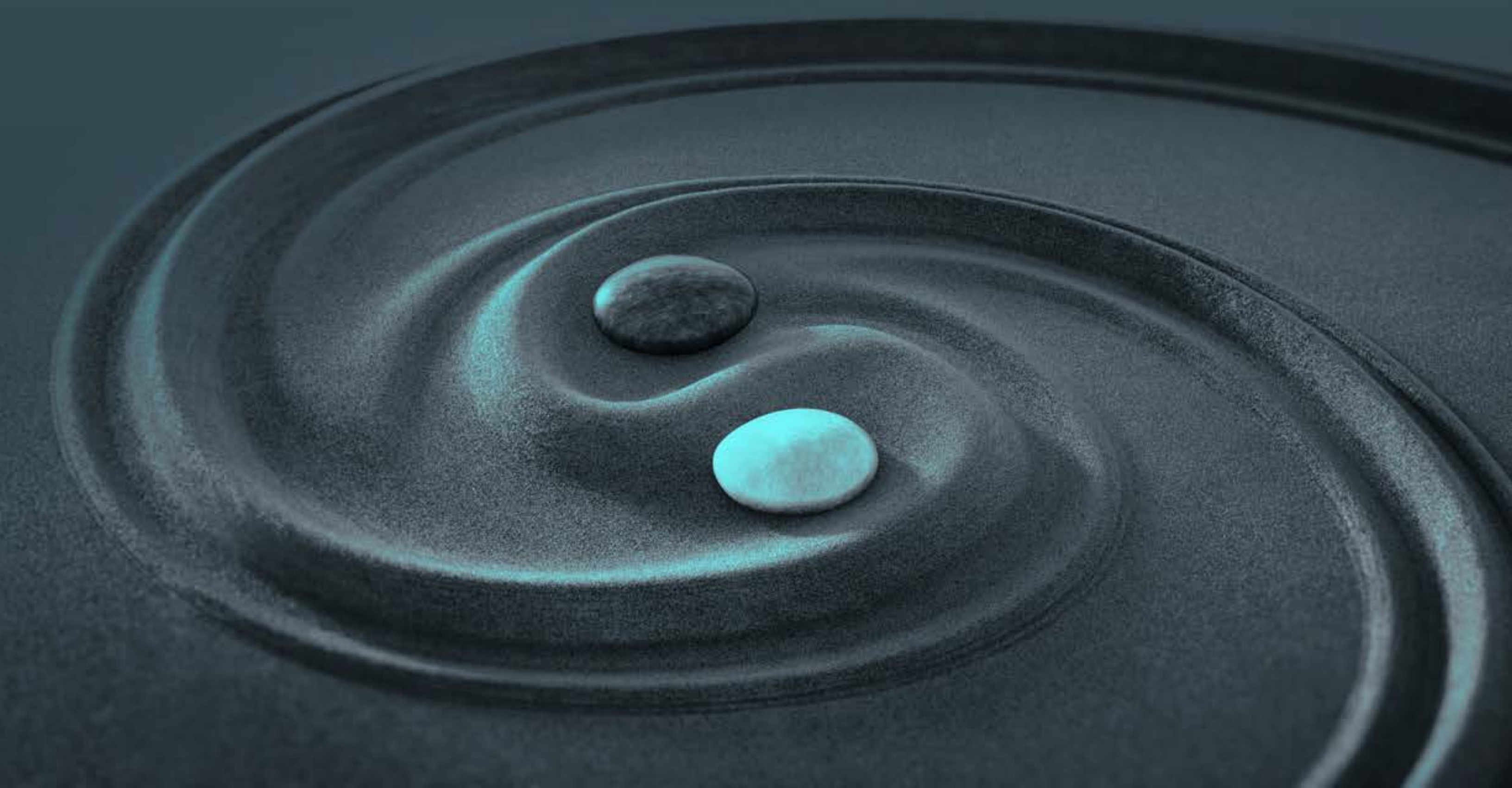
Making Outsourcing Work

Choosing the Right Solution for Investment Managers' Operational Needs



The investment management industry is caught in something of a paradox: between asset growth and expanding global opportunities on one hand and intensifying competition and declining profitability on the other. Throw COVID-19 into the mix, and things get even more complicated. Future success will depend on how well firms can navigate these waters, which in turn will require organizations to maintain a rigorous strategic focus on their competitive strengths and core competencies.

The Future is Bright...

By some measures, this is a golden age for the sector. Despite the crash in March 2020[1], the markets rebounded swiftly, continuing to hit record highs[2].

PwC estimates that global assets under management will climb from US$110 trillion (at the end of 2020) to $147.4 trillion by 2025, with 5.6% per annum growth[3]. While AUM growth in absolute terms would be strongest in North America, such growth would be fastest in Latin America and the Asia-Pacific region. In another report, PwC predicted the industry will manage a greater share of the world's expanding wealth, with the penetration rate rising from 39.6% in 2016 to 42.1% by 2025[4].

Three trends are supporting the global increase in asset management penetration, according to the Boston Consulting Group[5] :

I. Continued flow into pension products to prepare for retirement.

II. The long bull market run (March 2009-February 2020, followed by a swift rebound in April 2020), which has encouraged retail investors to allocate more money to investment funds.

III. Growth of wealth in emerging countries, especially China, where BCG expects assets under management to triple by 2025 (relative to 2017), making it the second-largest market after the United States.

Small niche players, as well as very large asset managers with growth in passive products have been, and are expected to be, the biggest winners from the industry's growth. 71% of large-cap fund managers underperformed the S&P 500[6] over a ten-year period (2009-2019).

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On a similar note, investors have found low cost and efficient methods of investing through ETFs, which in the US market has grown from $2.6 trillion pre-pandemic to $3.9 trillion, as of June 2021[7]. In Europe, the ETF market is set to hit $2.5 trillion in assets under management by 2025, with a compound average annual return (CAGR) of 21%[8]. This rate of growth is faster than that of the United States, which in that same period is predicted to see its ETF market hit $9 trillion, a 16% CAGR.

Similar optimism is felt in State Street Global Advisors' estimate[9] and Investment Company Institute's data[10], which suggest global ETF assets should touch $25 trillion by the end of 2025, up from $4.8 trillion in 2018.

...But Challenging

However, the picture is not universally rosy. Market performance, new wealth from emerging markets and positive net flows may have driven an increase in industry AUM, but management and performance fees across the asset and wealth management sectors will continue to decline through 2025, PwC reckons[11].

Average fees on PE funds are expected to drop to 1.55%.

The continued rise of passives and low-fee products such as smart beta, increased investor and regulatory scrutiny of the value managers provide, and new fee models in the active space that focus on performance will all play a part. PwC predicts that traditional long-only manager revenues per AUM are set to fall as a result, from 0.40% in 2017 to 0.31% by 2025.

And while institutional and retail investors' search for diversification and increased yields will sustain the popularity of alternatives, PwC expects average hedge fund management fees to fall 15% by 2025 to 1.16%, with performance fees drifting down towards 15%. Average fees on PE funds are expected to drop to 1.55%.

COVID-19 doesn't make things any easier. The markets went into freefall at the start of the pandemic, ending a decade-plus long bull market run. Although the markets recovered quickly since, heightened uncertainty remains so long as the virus remains and mutates.

Should COVID cases and hospitalizations rise, potentially prompting new lockdowns, many of the industries hit hard could see losses once again, particularly in restaurants, travel, and entertainment.

With supply chains disrupted due to COVID, the prospect of supply shortages could lead to inflation, putting pressure on those already feeling the pinch financially due to job losses or decreased earnings. These factors would certainly weigh down market performance.

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Onus on Efficiency

The post-2008 financial crisis boom in asset prices has enabled many investment managers to maintain their revenues and margins, despite the progressive industry-wide shift towards lower-fee solutions.

However, any prolonged asset value declines, combined with falling fees and heightened costs, will further squeeze industry margins.

In such an environment, notes PwC, scale and operational efficiency will become far more important, meaning firms "need to integrate technology in all areas of the business and develop a clear strategy for the future[12]." Unless they are "fit for growth," investment managers will either fail or become acquisition targets, PwC warns.

The COVID Factor

When the coronavirus outbreak first started, few businesses had contingency plans for a global pandemic, forcing entire teams to work remotely for an indefinite period.

Fortunately, the industry held up pretty well, in spite of the challenges associated with working at home. Nearly two-thirds of financial services professionals have increased their productivity while working from home during the coronavirus crisis[13]. And according to a Twilio survey, 97% of executives say COVID-19 sped up digital transformation[14], accelerating the trend by as much as 6 years.

This digital transformation acceleration is certainly the case for wealth and asset managers, who have leveraged technology to work remotely, go paper-less, and digitally communicate with colleagues and clients. Though COVID-19 was, in some ways, that much needed push to move the investment industry further into the digital realm, more can be done on the efficiency front.

BCG highlights the importance for investment managers of adopting a strategic response if they are to successfully adapt to the industry's rapidly changing dynamics. Suggested focuses include:

Adopting a Strategic Response

Product Portfolio Management & Innovation

Find fresh opportunities in growth areas through product development initiatives.

M&A or Organic Transformation

Unlocking a sustainable competitive advantage.

Data & Digital

Leveraging new data analysis and decision-making technologies, as well as automation and artificial intelligence (AI).

Cost Reductions

Instituting comprehensive overhauls through:

- Organizational delayering
- Strategic and tactical business transformations e.g. from exiting underperforming business lines and locations, rationalizing product offerings or reviewing service levels.
- Centralizing and automating operations, IT and support functions.
- **Systematic efficiency reviews, especially outsourcing in areas where investment managers are sub-scale.**

The COVID Factor (Continued)

Cost Reductions (Continued)

And cost reductions via digital transformation are not insignificant. The Boston Consulting Group found that "digital transformations" can help wealth managers cut costs across a wide range of variable costs[15], including:

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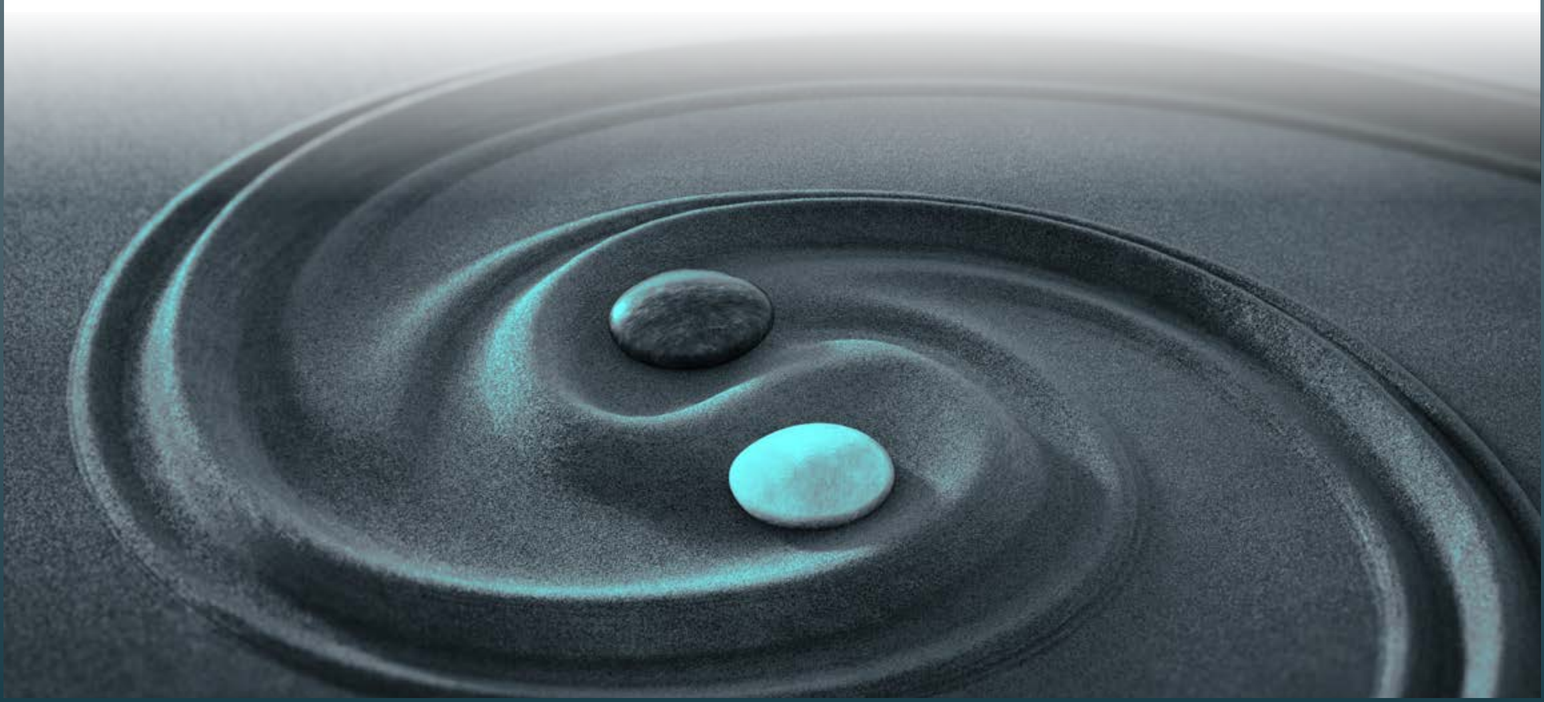
- 5%-10% reduction in customer service costs
- 5%-15% reduction in HR costs
- 10%-20% reduction in office service costs
- 20%-30% reduction in credit review costs
- **20%-40% reduction in operations costs**

Delivering a portfolio of products that satisfy shifting investor demands, along with strong and sustained investment performance, while providing top-notch client service is no easy feat.

Achieving these while maintaining the flexibility to exploit new business opportunities, and keeping a tight grip on costs, will be even tougher. Firms that can't do this will struggle to survive.



The Outsourcing Solution

The largest organizations may have the scale, skill sets, and technology capabilities internally to flourish as the industry evolves.

For many smaller firms though, the answer lies in focusing their limited resources on those core differentiating capabilities where they can add true value (i.e. excellent investment performance and service) – then outsourcing the rest.

Operational activities are prime candidates for outsourcing. PwC observes: "As pressure mounts on firms to reduce costs, they will seek to automate or outsource everything in middle- and back-offices." Outsourcing these activities to a tried and tested provider can deliver a range of benefits.

Focus on Core Competencies

Outsourcing allows investment management firms to concentrate on the areas where they can truly shine: serving their clients, managing assets, and expanding their business through new product and service developments.

For example, it is not uncommon to find portfolio managers spending significant time on operational and reporting tasks. Instead, they should be freed to focus on activities that can add the greatest value.

Outsourcing allows the proper alignment of responsibilities, resulting in improved efficiency and enhanced client servicing. In addition, by delegating operational roles to a quality outsourcing firm, the investment firm's employees can concentrate on the duties they were hired to fill, helping improve job satisfaction and staff retention.

> *"Operational activities are prime candidates for outsourcing."*

Access to Expertise

Staff at small- and mid-sized firms in particular tend to be stretched thin, and they must often undertake tasks with which they are unfamiliar or don't have a high level of competence, resulting in inefficiencies, poor quality control and an increased risk of errors.

As investment firms have firsthand experience with working remotely as result of the pandemic, that means their talent pool is no longer limited by physical proximity. They can partner with experts from virtually anywhere. In that case, partnering with an outsourcing provider has its merits.

Outsourcing firms are specialist providers, with an efficient support infrastructure and highly trained employees dedicated to those specific middle- and back-office functions.

And because outsourcing teams work with many clients, they are exposed to a wider set of operational duties and challenges, resulting in a much broader range of knowledge, skills, and experience.

Improved Client Service

Accuracy and quality are essential to supporting asset managers' end-clients successfully. Manually oriented processes, inefficient systems and inadequate controls can result in trading errors, reconciliation breaks, and late and/or inaccurate client reports.

By entrusting their mission-critical middle- and back-office tasks to a specialist provider, investment managers can improve the quality of their reporting and provide clients with more responsive services.

With accurate reporting and freed up time to focus on client needs, investment managers can strengthen relationships with their clients.

The Outsourcing Solution (Contd.)

Cost Savings and Control

Outsourcing enables investment managers to move from a fixed cost base to a more variable cost environment. That means firms only pay for the operational services they need.

There are also potential direct cost savings. Consider the fully loaded costs of a firm's employees. These include not just their salaries, but any bonuses, payroll taxes, paid vacation time, healthcare, and other benefits. As a rule of thumb, the total staffing cost will amount to approximately 120% to 130% of an employee's base salary. A host of indirect costs – such as training, office supplies, insurance, IT licenses, travel expenses, recruitment fees, etc. – further bump up the overhead. Once all these components are factored in, the real cost of employing staff is often considerably higher than using a third-party provider.

In addition, dedicated staff and investment in high-quality systems enable outsourcing providers to automate and streamline key operational functions, such as portfolio accounting, corporate actions processing, reconciliations, and reporting. The result is a level of operating efficiency that most investment managers are unable to achieve internally.

Plus, there are the opportunity costs to consider. Every minute spent hiring or managing an operational person is a minute not spent supporting clients and growing the firm's business. The resources saved can also be redirected to more profitable areas, such as investing in client-facing digital technologies.

> *... being flexible is more important than ever, and outsourcing allows that flexibility.*

Business Flexibility and Scalability

In the age of COVID, being flexible is more important than ever, and outsourcing allows that flexibility.

Outsourcing also gives firms the scalability to handle any change in workload, allowing them to ramp up – or down – when and wherever their operational needs demand.

Wealth and asset managers no longer have to recruit extra staff to support any growth or diversification into new markets, with all the time and cost that it entails. Instead, outsourcing delivers on-demand capacity, improved controls and consistently high-quality services – giving firms the flexibility to come to market with new products and services faster and more efficiently.

Furthermore, outsourcing needn't be an all-or-nothing proposition. Rather, firms can choose to engage a provider for only a portion of their operation, depending on their current needs.

Reduced Risk

Reduced manual intervention, fewer errors, faster turnaround times, better processing controls, and robust redundancy and disaster recovery all help reduce operational risk.

In addition, outsourcing instantly fixes "key person" risk problems that result when a wealth and asset manager's operations are concentrated in the hands of one or two employees.

Partnering with a strong operations outsourcer ensures the processing knowledge critical to the firm does not walk out the door when an employee leaves, goes on vacation or is off sick.

Making Outsourcing Work

The theoretical benefits of outsourcing are compelling, but they are of little value if they are not realized in practice. Implementing a successful outsourcing project comes down to two key elements:

Know What You Want to Achieve

The first is to clearly identify the project's objectives and how it fits in with the short-, medium-, and long-term business strategy. Evaluating the real financial and operational benefits in terms of an accurate ROI calculation will be a critical component in determining whether or not to outsource.

As the global law firm Norton Rose Fulbright points out: "If there is no clear business case or success criteria for an outsourcing project, the project as a whole is less likely to be successful; or, at least, any success will be harder to measure."[16]

And it is essential asset managers share the business case and success criteria with their suppliers as, "all too often projects fail because suppliers lack an understanding of their customers' objectives."

Find a Flexible, Qualified Partner

The second success element is to choose an outsourcing provider that has not only the capabilities to meet the investment manager's operational requirements, but the willingness and flexibility to work alongside the organization as a true partner. The provider shouldn't force you to fit in one of their boxes. Rather, they should customize their offerings to fit your needs.

Also, do the proper vetting. Make sure the service provider is regularly audited and has the required ISO and SOC certifications. In addition, ask for client references when deep enough into the conversation.

This is a relationship, and the outsourcing provider's skillsets and ethos must be complementary if it is to work effectively.

The provider shouldn't force you to fit in one of their boxes.

Conclusion

The investment management industry is in the midst of profound change. While overall assets are forecast to swell, the rewards for managing those assets are being squeezed inexorably. Disruption from new competition and emerging technologies, complex regulatory demands, and growing client expectations are forcing money managers to re-evaluate their business models in an effort to hone and maintain a meaningful competitive edge.

Focus, expertise, and excellence are the key qualities that will set successful firms apart from the pack.

That means concentrating on their core value proposition and minimizing the cost of delivering it.

Middle- and back-office outsourcing is a powerful enabler to achieving those strategic objectives. It delivers the operational speed, accuracy, flexibility, and responsiveness investment management organizations need in today's environment, while freeing staff to focus on those activities that will have the biggest impact on their profitability and growth. The benefits that outsourcing brings are diverse and well-proven. Wealth and asset managers can ill afford to ignore them.

About Empaxis

Empaxis Data Management is a leading and global provider of middle- and back-office outsourcing for wealth and asset managers, family offices, hedge funds, as well as for banking and financial institutions.

The company's core offerings include reconciliation reporting, performance reporting, and billing, among other services. Learn more about Empaxis outsourcing services.

Founded in 2004 and with over $100 billion in assets under administration, Empaxis delivers a world-class operational experience to firms of all types and sizes, whether they're small startup RIAs or large, well-established organizations.

In addition to middle- and back-office outsourcing, Empaxis offers automation services and a cloud-based turnkey asset management platform (TAMP1) that lets advisors and clients see all data and reports in one place.

With the help of Empaxis, clients enjoy increased efficiency, scalability, and cost savings for their operation.

Empaxis is regularly audited by Ernst and Young and is ISO 22301-certified, further validating clients' trust in their outsourcing provider.

Want to learn more?

Wondering if outsourcing is right for your firm?

Unsure about what exactly can or should be outsourced?

Ready to get started or just seeking more information on the topic?

Whatever your reasons and no matter what stage you're at, Empaxis is happy to have a conversation. There's no cost to you, and our goal is to help you stay most informed in your decision-making process.

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