Buy-side outsourcing grows up

Contracting a specialist service provider to manage certain business processes or IT requirements strikes a chord with many buy-side firms. But that only holds true if both firms have an explicit understanding of what the relationship entails, and the outsource provider has the necessary IT flexibility and extensibility to grow with the firms it is partnering with. By Stewart Eisenhart and Victor Anderson

With a track record less extensive than that of the sell side or banking sectors, buy-side and hedge fund outsourcing initiatives nonetheless appear beset by proverbial growing pains. While business process and IT outsourcing has increasingly become a fact of life for more and more investment and hedge fund managers, a recent string of cancelled agreements such as those between JPMorgan and Schroders and Mellon and F&C Asset Management may demonstrate the need for more formalised, transparent processes between managers and providers.

Industry officials and observers alike have long warned against establishing outsourcing agreements without well-defined parameters of responsibility and clear communication channels, but nothing drives these points home like real-world examples.

Beyond the need for more thorough service level agreements, however, recent buy-side outsourcing failures also illustrate an evolving playing field in terms of what managers expect to gain from these arrangements and how far providers are willing to go to keep their clients' business. Reduced operating costs and improved efficiency still drive outsourcing appetites, but as the asset management arena grows more complex in terms of strategies and products, outsourcing providers must ensure scalable technologies in order to effectively support clients' operations. Of course, this evolving scenario also underscores the issue of capable due diligence: buy-side firms must do everything possible to ensure they select the right outsourcer rather than find out the hard way that their provider cannot accommodate increased trading volumes or more esoteric asset types.

A more technological model

The emerging shift in managers' focus on outsourcing from a primarily cost-saving endeavor to one that also provides robust technology support, if not outright operational advantage, does not necessarily indicate that their fundamental requirements of their outsourcers have changed-instead, this shift reflects the growing operational, regulatory and market complexities in which firms now find themselves.

In the case of F&C and Mellon, the manager opted to disengage from the provider during the due diligence and negotiation phase before any operations were formally outsourced.

Citing an inability to agree on contractual terms with Mellon, F&C director and head of communications Jason Hollands says a robust service level

Dan Houlihan, Citisoft

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agreement, an attractive cost model and a flexible and scalable operational platform are the most crucial factors his firm considers in deciding on any outsourcing arrangement.

"In the European marketplace there have been a number of major operational outsourcing projects that have been scrapped in recent times," Hollands says. "This might suggest that the industry outsourcing model needs to be revisited."

Legacy issues

In terms of amending the traditional outsourcing model, Dan Houlihan, managing director of IT consultancy Citisoft's US operations, observes that the outsourcing withdrawals at F&C, Schroders and other managers came about partially because of legacy issues, which he believes will have to be addressed going forward.

"One of the key things evolving here is the fact that outsourcing providers themselves are recognising more and more that they're being forced to be technology providers, not just business service providers," Houlihan says. "What happened in the early stages was that most providers were offering legacy technology solutions that weren't necessarily geared to building multi-client, scalable architectures upon which they could build standardised or commoditised services."

Houlihan adds that buy-side outsourcers must build scalability into their models to keep them commercially viable; attempting to provide the same level of service managers can get from their internal operations and systems is not realistic, but providers have grown more adept at defining standard levels of outsourcing services and improving transparency.

"There's more transparency now going into an outsourcing deal because it used to be so new to buyers and sellers," he says.

From cost to capability

According to industry observers, due diligence of potential outsourcing providers becomes especially crucial for managers operating in more complex investment or IT environments.

Matt Nelson, analyst at Boston-based financial consultancy TowerGroup, cites technology and complexity of operations as the key factors in buy-side outsourcing failures.

"In terms of maturity of the business, cost and convenience may have originally been the real drivers, but now it's getting to be capability," Nelson says. "One of the biggest traditional criterions for looking at outsourcing is focusing on [many of your] core competencies."

But more often, according to Nelson, issues of new products, compliance and more specific trading and investment strategies have impacted managers' approaches to outsourcing.

"Looking at outsourcing is focusing on core competencies"

Matt Nelson, TowerGroup

Julian Webb, Digiterre

Matt Nelson, TowerGroup

Measurement is the key

Outsourcing of certain business processes in the financial services industry is not a new phenomenon by any stretch of the imagination; it has been around in one guise or another since the early nineties, depending on your definition of course. But one of the crucial aspects of successful outsourcing, which has historically eluded the buy side, is the ability to empirically measure the efficiency and effectiveness of the service being considered for outsourcing, and indeed how that service underpins a buy-side firm's value proposition in the market place.

Addressing the issues of assessment and measurement of buy-side business processes is a growing aspect of Investit's service offering – known as BPA or Business Process Assessment, a dedicated outsourcing-oriented service launched in September this year – although it is more a product driven by reaction to market demands than one established on the back of identifying an acute need in the industry and then addressing it. And so when a number of existing clients approached Investit about tackling the above-mentioned issues, John Robbertshaw and James Hockley knew they were on to a good thing. "This was something that was suggested to us just over a year ago by existing subscribers to our IT Value Survey," Robbertshaw explains. "There was something missing in the market and we felt that we could provide a complementary service to the survey – assessing the value contribution of various business support processes and then benchmarking those processes against industry peers – that fund managers would find extremely valuable."

James Hockley

John Robbertshaw

Hockley adds: "The premise behind BPA is to deliver in a structured, considered way the ability to assess and measure the value that the business support processes deliver to key business areas in asset management."

Benchmarking needs

Robbertshaw is clear about the acute need for buy-side firms to possess a benchmarking methodology against which they can measure the effectiveness of the outsourcing relationship. "What we are hearing from firms that have outsourced and firms that are considering outsourcing is the need to have a baseline measure for the quality of service that is being provided by the business support functions, both before they've outsourced and after," he says. "For example fund managers tend to have short memories and once the back office has been outsourced you typically get comments from the front office along the lines of: 'It wasn't as good as it used to be,' or 'we thought we were going to see a major improvement, but all you've done is lift out the processes, systems and people to a new building'. Without some kind of objective, baseline service the new operating model is fighting in the dark; it hasn't got this measure that it can compare itself against."

Maturity

On the issue of the maturity of outsourcing services and practices available to buy-side firms, Hockley believes the industry has come a long way, although there is some way to go before outsourcing can be considered truly mature. "I don't think we have reached a point of maturity, although I think we are at the point of inflection," he says. "What we are seeing is a combination of the buy side getting a better understanding of the risks associated with outsourcing and providers building more commoditised, scalable platforms in order to package components into areas like trade order management, settlement, and automation. Some buy-side firms have recognised that they would prefer to retain certain aspects [of the back office] in-house, whereas in the earlier days firms might have gone for a total lift out from end to end. For example with client report generation and delivery, they are now happy for the [outsource] provider to do all the number crunching, even though they want the files to be sent back [in-house] so that they can produce and distribute the reports."

Pitfalls

Robbertshaw explains that developing a clear understanding of what constitutes the services that are going to be outsourced and the contribution those services are currently making to the fund management business is crucial to successful outsourcing. But what about those variables specific to each firm that for one reason or another cannot be quantified and expressed in some universally accepted measure, like relationships for instance? Herein lies the rub. "The back office of an investment manager serves a multitude of purposes and a number of those purposes are 'unwritten' practices like the quality of the relationship between the back and front office," Robbertshaw continues. "It's difficult to accurately quantify those services in terms of the scope of the outsourcing. That's where there is the potential for problems to arise in the future where these services are no longer provided or the people who provide these services are not as accessible as they used to be. On the other hand you could argue that those services are being provided on a much more commercialised basis and the commercialities of the previous arrangement were not fully accounted for."

Hockley adds that another potential pitfall lies in an approach to outsourcing that is driven purely by economic and efficiency factors. "There are two problems with that approach," he says. "The firm hasn't established where the real value is in terms of support areas and in the case of a process that provides a lot of value to the front office, do you want to risk outsourcing it instead of focussing on it to increase the value add? The second pitfall deals with firms focussing exclusively on what they are doing today – in other words backward looking – instead of working towards the operating model they will need in five years."

"If you're not with an outsourcing provider who can support those moves from product, IT and operational standpoints, that's an issue for managers and they must approach their outsourcing provider searches with this in mind.

"When outsourcing deals fall through it tends to come down to either technology or complexity of operations or products the manager is trading," Nelson continues. "Really it's a lack of understanding and communication up front, and there are various implications in terms of due diligence."

Flexibility

Alexander Kouperman, former IT director at a billion-dollar New York hedge fund and principal at InfoHedge Technologies, a newly formed hedge fund infrastructure and software provider, contends that managers must also make sure their outsourcers can capably deal with both third-party systems and proprietary technologies to support more complex operations.

"One thing that all IT managers at hedge funds must be cognisant of is the fact that there are very few people out there with the expertise to build customised financial software tools," Kouperman says, adding that as soon as funds begin trading products beyond plain vanilla equities their off-the-shelf systems fall short.

"Then you have to buy the best and build the rest – this is where it's a good idea to outsource to providers who have done this before and have the expertise to do so," he explains.

On a similar note, Citisoft's Houlihan explains that outsourcers that do have experience supporting more complex buy-side operations can prove crucial to managers' efforts to tap into new markets and asset types.

"For an institutional mutual fund manager who wants to introduce a hedge fund product, if they have a strategic outsourcing partner that can provide all these product-specific infrastructures, their ability to move into new products is greatly accelerated by leveraging the infrastructural relationship they have with that provider," Houlihan says.

"It's not just about cost and core competencies anymore; it more and more has to do with speed to market and strategic objectives, as well as strategically difficult positions a given business is in."

Targeted projects

Another indication that buy-side outsourcing approaches are maturing pertains to the types of outsourcing projects managers have increasingly initiated with their providers.

Firms are pursuing more targeted, detailed outsourcing agreements rather than the broad, hazily defined undertakings that often characterised buy-side outsourcing in its nascence.

Alexei Miller, DataArt

Alexei Miller, head of software outsourcing provider DataArt's financial technology practice, observes that there is an increase in the numbers of asset managers looking to proactively manage their outsourced operations.

"I see more targeted, contained outsourcing arrangements, and I think that's a good trend. In the past, many organisations just starting down the outsourcing path initiated blanket outsourcing contracts precisely for the reason that they didn't have outsourcing management expertise in house," Miller says. "They didn't know how to do it and they hoped the vendor would take care of it."

According to Julian Webb, partner at London-based hedge fund software developer Digiterre, even larger hedge fund managers who typically bring outsourced operations back in house once they reach a certain size have started to retain some of these relationships for specific projects.

"At the larger end of the spectrum, managers have grown extensive in-house teams, but now we're having conversations with these players and they're starting to think more like institutions," Webb reports, adding that managers are deliberating whether to continue growing their internal IT staff (and their fixed cost base along with them) or alternatively keep their internal head-count low and look to outsource certain aspects of their IT.

"They're not likely to outsource their whole group, but what they'll look to do is partner with a provider on a selective basis for certain projects… to

Outsourcing relationships that have gone belly up

Schroders and JP Morgan
(Terminated in July 2005)
After what is best euphemistically described as a rocky road since the establishment of the outsourcing agreement between the two parties in early 2000, Schroders and JP Morgan have parted company. How acrimonious the split was is likely only to be fully understood by those privy to the events leading up to the final parting, but suffice to say that JP Morgan Worldwide Securities Services is £20 million worse off due to the termination of the relationship. The official explanation for the break-up cited in the July 1 2005 JP Morgan press release is that "the firms concluded that their individual operating models are no longer sufficiently aligned to continue the investment operations outsourcing project effectively". Unofficial sources beg to differ, however, alleging that it was a blend Schroders' unrealistic RFP and JP Morgan's eagerness to land the deal and by so doing agreeing to terms to which it couldn't adhere, which lead to the termination.

F&C Asset Management and Mellon Global Securities Services
(Terminated in November 2005)
In order to fully appreciate the context in which the contract between F&C and Mellon was terminated, it is important to note that the relationship between the two parties that initially came into effect in November 2003 prior to F&C's acquisition of Isis Asset Management (which lead to the creation of F&C Asset Management) seemed satisfactory. Mellon Global Securities Services had managed F&C's fund administration, trade communication, reconciliation, data services and information delivery. But the Isis acquisition announced in early July 2004 changed all that. In November 2004 F&C and Mellon embarked on ongoing due diligence, which led to contractual negotiations, the upshot of which was (according to a Mellon statement) the failure to agree "satisfactory contractual terms". There is little doubt that the F&C/Isis merger kyboshed the existing outsourcing arrangement, although understandably both parties will not divulge the details thereof.

Merrill Lynch Investment Managers and Bank of New York Europe
(Terminated in October 2005)
This example of the termination of an outsourcing agreement is more a case of inherited problems than one of cultural incompatibility and unrealised outsourcing benefits. Merrill Lynch Investment Managers acquired Mercury Asset Management in Q4 1997, but prior to the merger Mercury sold off its back office to RBS Trust Bank, which in turn was acquired by Bank of New York two years later (November 1999). Effectively BoNY inherited the Mercury back office running on its (Mercury's) proprietary back-office platform. This presented BoNY with a problem inasmuch that its technology platform of choice was its own SmartSource offering, which it had developed at some considerable time and cost. It decided therefore to attempt to migrate Merrill Lynch over to its own platform – RCM is currently on the platform and SG Asset Management is in line to migrate its back office to the platform next year – at which point Merrill decided to 'insource' that aspect of its business and manage it itself.

manage specific gaps in their expertise and provide some flexibility not attainable through their own staff," he says.

But more tactical outsourcing strategies won't prompt managers to forego more established, full-service outsourcing providers for more targeted, niche players.

Citisoft's Houlihan forecasts that managers will ultimately stay with the biggest providers due mainly to the reduced business, regulatory and reputational risks: "A buyer of outsourcing services needs to be able to have confidence that the provider is committed to its business for the long term and has the capital to back its business up," explains Houlihan. "The top-tier providers are moving up the value chain and providing additional levels of service, whereas niche players aren't full-service providers to the same extent."

Salient points

- The outsourcing trend on the buy side has matured somewhat as buy-side firms scrutinise providers' service level agreements, technology flexibility, and scalability.
- Future consolidation among outsource providers is on the cards as buy-side firms look to partner with larger players with a proven track record and financial stability.