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IT OUTSOURCING: Better out than in?

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By Nik Pratt

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As investment managers face up to continuing operational costs, **Nicholas Pratt** looks at the reasons for outsourcing IT operations and the risks involved.

In March 2011, Cazenove Capital Management, the independent investment management firm, adopted an IT managed service from UK-based vendor Advanced 365 (formerly Business Systems Group). Under the terms of the five-year contract, Advanced 365 will provide and manage Cazenove Capital's IT infrastructure. This comprises the use of dual data centres, networks, servers and storage as well as hosting services for the firm's email, disaster recovery and business-specific applications such as Cazenove's trading and settlement systems. The only thing that will remain in-house will be a small IT team that will provide strategy and support for the firm's portfolio management, market data, trading and settlement applications.

According to Steve Norwood, Cazenove Capital's head of IT, the deal with Advanced 365 was both a strategic and economic decision inspired by the firm's demerger from the wider Cazenove Group and the need to move its data centres, networks, servers and storage across to a separate dedicated infrastructure. Outsourcing to a specialist IT provider was considered the best approach.

"An outsourced IT provider can deliver an evolving and flexible service and due to economies of scale, it should also be able to provide high service levels very economically," says Norwood. "Due to the real-time nature of our business, it is vital that we can trust our outsourced partner to provide us with continuous availability and support of the highest levels."

Advanced 365 works with a number of investment managers, the majority of whom prefer to keep their arrangements confidential. According to Neil Cross, Advanced 365 managing director, investment managers are increasingly looking to outsourcing providers to act as their IT department as opposed to a more selective approach to IT outsourcing. The reason for this, he says, is the growing complexity of technology.

"Cazenove Capital was facing more and more requirements to do more sophisticated things with its technology," says Cross. He cites the example of its website which at first requires a firewall. Before long one firewall has become several and then penetration tests are added, followed by intrusion detection software.

"Each stage requires more people and at some point it no longer becomes cost-effective to keep this in-house."

The Cazenove Capital project took nine months to complete, says Cross, during which time Advanced 365 was in communication with all the client's business units and not just confined to a two-man dialogue between the respective heads of IT.

"We had to make sure we understood all the business needs – that was absolutely vital."

The other crucial component in the deal is the governance around the relationship between provider and client, whether it be employees from the provider permanently ensconced within the client's set-up or regular meetings between board members at both firms. Monthly, quarterly and annual reporting are also necessary to ensure the operational and strategic aims of the project are being met.

Outsourcing on the rise
For other investment management firms that may be considering an IT outsourcing arrangement of their own, Cross says it is vitally important to ensure that any prospective provider has a clear understanding of the investment industry.

"You have to work with a partner that understands the market and the specific requirements involved. For example, every firm will have a dealing system. They are sophisticated pieces of kit and the outsourcer not only has to understand how they work and how they can be supported but must also have a relationship with the various vendors that supply these systems."

Jonathan Lindsell is managing partner at Red Skye Partners, an advisory firm that works with investment managers and hedge funds on their technology strategy. For the last ten years and prior to joining Red Skye, Lindsell worked as an IT manager at several investment management firms and has experienced the "trials and tribulations of IT outsourcing".

"Internal clients think that anything IT related works all the time and in any destination where the firm has an office. It is a very challenging experience to meet that expectation, especially for a small firm with a limited IT budget. So IT outsourcing is something that investment managers are looking at, particularly where it involves external infrastructure."

Start-ups are especially interested in outsourcing. They do not have the cultural challenge of switching from insourcing to outsourcing but cost pressures are building for all investment managers. Furthermore, heads of IT are seeing their roles endure seismic changes, says Lindsell. "We were originally valued for our technical expertise but now we are expected to provide more business expertise and not just be responsible for technology."

Part of this business expertise is the ability to sell the benefits of outsourcing to a firm's senior management. In Lindsell's last role as the head of IT at an investment manager, the firm went from hosting all of its IT internally to co-location. "It is about how you portray the story and explain why you are doing it. You have to explain that using a third party does not represent an abdication of duty for achieving technology expertise. And you have to show evidence of due diligence and risk mitigation."

The primary risk in any IT outsourcing involves the loss or compromise of data. "Your data is extremely valuable so you have to look at the outsourcing company's ownership structure, history, longevity and profitability of the company," says Lindsell. "You should also always try to retain a copy of the data that is outsourced, even in its raw format. And if possible try and use more than one vendor – for example, if you are using a live site and a back-up site, it is best to employ a different vendor to host each one so that you are mitigating the counterparty risk."

Three factors
There has been a perfect storm of positive forces that have contributed to the rise in IT outsourcing, says Alexei Miller, executive vice president at IT outsourcing company DataArt. He cites three factors. The first is the pressure from investors for more transparency and data. The second is the improved capability of vendors. "They had been looking at this sector for a long time but not quite understood them."

The third is trust – which has improved dramatically, Miller says. "There is a trust that you could put data outside the firewall that was not always there. Now it is quite different. The risk is better understood. I would also expect more managers to go public about their outsourcing deals. The arrogance of institutions believing that they could do a better job in-house is fading and that is good for the industry."

Can outsourcing be the preferred practice or dominant business model for investment managers? "I think the most we can hope for is that it will become normal," says Miller. "Outsourcing is often seen as providing something that is lacking in the client. Some firms are set up to manage things in-house and I don't think IT outsourcing will replace that approach. IT outsourcing won't become a better approach, just a normal approach."

Cloud computing
It is difficult to discuss outsourcing without reference to the growing influence of cloud computing and 'software as a service' (SaaS), two developments based on the delivery of technology via the internet. Conceivably, investment managers could bypass the use of outsourcing providers altogether and avail themselves of cloud-based services instead for their IT infrastructure needs.

Providers' opinions are divided on the potential impact of cloud computing on the outsourcing market. Lindsell belives it will have a "profound effect" on the outsourcing market to the point where investment managers will look at the cloud first before they consider developing any IT capability internally. Others though are less effusive.

"I don't see cloud computing penetrating the asset management market anywhere near to the extent that is talked about, particularly the use of public clouds such as Salesforce or Amazon," says Miller. "I think cloud computing will leave us with a set of technology to develop tools for flexible computer provisioning but I don't think cloud computing will replace many things that we see today in IT outsourcing."

According to Mark Israel, vice president of business consulting at commodity and capital service provider firm Sapient Global Markets, SaaS will be especially helpful in pushing outsourcing beyond the utility approach of networks, servers and disaster recovery to one based on software and application development. "There are vendors such as Bloomberg that can provide front-office capability on a SaaS basis that include not only data services but trading and fund accounting."

The interesting implication for Israel is the possible combinations of outsourced services that cloud computing and SaaS could create. So instead of contracting with one single outsourcing provider, an asset manager could, for example, rent space within a data centre or a private cloud and have all the third-party vendors manage their own products within that data centre.

As Israel points out, this approach would involve a lot of partner relationships that need to be managed and a lot of information that needs to be shared, creating an operational risk that can only be managed by the most important factor in any outsourcing arrangement – contracts.

"You have to have the appropriate service level agreements to manage the different information that will be outsourced and to manage multiple third-party vendors and make sure they are all working together," he says.