



Service procurement priorities for an asset manager:

identifying a suitable operating model for each part of the business

Noel Fessey, *Global Head of Fund Services at Schroder Investment Management*, outlines how Schrodgers' strategy for meeting its operational commitments has evolved over the past 11 years and factors that will shape its future direction. For Fessey, the key question is not whether Schrodgers should be outsourcing, but how best to obtain the services that it requires to sustain and advance its core business of asset management

Starting Points

The potential benefits of outsourcing investment operations have been widely debated. However, at an early stage in the outsourcing lifecycle 10+ years ago, a number of concerns prevailed: (i) if it went wrong, an outsourcing deal might be problematic to reverse; and (ii) there was little surety about how deals should be priced - with fears that the early round of low-priced deals might not be sustainable in the longer term.

With the benefit of hindsight, how far have these concerns been borne out in practice? And what lessons have been learned from this experience?

Schrodgers entered into several major outsource agreements in the early years of this century, notably custody and portfolio accounting services and IT infrastructure in 2000, UK transfer agency services in 2002, and UK fund accounting services in 2003. Most of those services are still provided on an outsourced basis, albeit some of our service partners have changed. We brought portfolio accounting services back in house in 2005 after a joint review with our service partner, JPMorgan, concluded that our operating models were no longer sufficiently aligned to justify the continuation of the project.

The decision to bring portfolio services back in house was

not unique in our experience. In 1999 we did the same with shareholder services for our Luxembourg funds, in that case from a different service partner. As we see it, the question is not so much a matter of whether we should be outsourcing but how can we best obtain the services that we need to sustain and advance our core business of asset management. Services that are presently in house may be outsourced and vice versa, taking account of factors such as capability, quality, cost control, agency risk etc.

That's why we work with several service partners, even within operating units that outsiders consider to be mostly in-house. We aim to develop relationships with core service partners that adapt as our business develops. In JPMorgan's case, our relation has grown significantly in the past few years and it remains one of our key strategic service partners.

Which elements of the middle office have proven more difficult to support through an outsource relationship than you first anticipated?

I can't answer that question from the perspective of our portfolio accounting services because I wasn't part of Schroders' portfolio outsourcing project. From a fund services perspective, my experience has been that it is important to ensure that an asset manager and its service partner share a common aim of what the service should be – that they reach genuine agreement on what the operating model should be, including how much the asset manager should adapt its operations to take advantage of the service provider's platform. I think that it is important for asset managers to recognise the difference between service requirements that help them to advance their business, particularly where they contribute to competitive advantage of their investment and distribution proposition, and service requirements that they may prefer because they replicate a familiar operating model. The more that the latter prevails, the more likely it is that the outsource decision will deliver service substitution rather than service partnership, and the less fruitful it is likely to be. It is very hard to get this right, which is why I think

that asset managers must take a long-term view when they choose to enter into an outsourced service partnership and they must ensure that they retain people who are commercially, technically and temperamentally able to develop that partnership.

Service requirements and buying strategy

How are your service requirements evolving in the middle and back office?

In asset servicing we have seen significant new demands, particularly with the increase of derivative volumes in the last seven years, in segregated mandates and in mutual funds. We put a great deal of effort into ensuring effective co-operation between our investment desks, legal services, portfolio and fund services, so that for any new OTC derivative we understand the term sheets and that we have set up our operations correctly to facilitate trade capture, valuation, collateral management and exposure monitoring. We pay particular attention to satisfactory independent valuation services and reconciliation between investment manager, counterparty and administrator (which in our case means in-house portfolio services and outsourced fund administrators). We also look to our securities service partners to provide asset service support for derivatives. For example, JPMorgan supports us through its Global Derivatives Hub and its Global Fund Order Routing Service (the latter in our multi-asset business).

Valuation has become much more of a focus point for us in the past few years, particularly in mutual funds if the fund is daily traded and some of its portfolio securities are less liquid or may have stale prices at the time the NAV is struck. We start by building on a foundation of independent valuation provided to us by a service partner according to our Group valuation policy and any relevant product valuation obligations. We may then apply various techniques to ensure that the fund's NAV is appropriate for dealing purposes. This may involve swinging the price depending on the net direction of shareholder dealing, to take account of the underlying portfolio transaction costs arising from the day's business; it

may involve methodical fair valuation using a proxy index to take account of the likely future direction of stale priced securities; it may involve a dilution levy in extraordinary circumstances; it may involve a valuation in good faith in the face of some market event; and it may involve closing the fund for one or more days, preferably on a planned basis, as we might do when the markets in which a fund principally invests are on holiday. We have also “wrapped” our funds with a range of checks to ensure that they are delivering what we expect. For example, we monitor

tor’s wider risk budget. This was historically a specialist interest, typically of the largest institutional investors, and it has always been an important part of our service. However investor demand for transparency has increased since the beginning of the global financial crisis in 2007, waxing and waning with each bout of market distress. Our focus has developed from reporting fund exposure to financial services in 2008 (initially specific names, then generally), to corporate credit in 2009-10, to sovereign credit in 2011 (again, developing from the

We do not operate under a rigid philosophy that in-house or outsource is best and we regularly revisit our assessments to find the most suitable operating model for every part of our business. Clearly, as an asset manager, we would like to allocate as much of our internal capacity to our investment and distribution activities as we can, but we are willing to allocate resources to operations, IT and infrastructure where we see a good business case for it.

the performance of related share classes and analyse the differences, attributing them to several possible causes and investigating any unexpected deviations.

As we have developed an alternative fund range, so we have factored valuation into the fund design. Where necessary and possible, we employ special valuation models for individual portfolio investments. For some funds we have forward priced the fund by more than a day. In others we have adopted a model of “order, settle, trade, value”, in which the time from order cut-off to valuation can be greater than a month. Of course, this model can only support subscriptions through consideration deals.

In all of these cases, we look to one or more service partners to support the operating model and close co-operation from the design stage through to operation is an important signature of our work – which is why we talk about service partnership rather than service provision.

Our client reporting requirements around mutual funds have focused on mitigating agency risk – in helping the investor to understand the portfolio exposure on a standalone basis and as part of the inves-

specific to the general) to, well, pretty much anything now. We expect this to continue with the development of Solvency II reporting services for our insurance clients.

The Key Investor Information Document (KIID) has also been a major project in our client reporting line of service for the past year and the project will continue until our KIIDs enter service in the first half of 2012. In this case, we needed support from several service partners to produce a document that, to observers, appears to be an in-house production. The foundation service partner in this case is Victor Buck Services, whose managed software service provides the basis for our production (it is better to think of the KIID as a production control process rather than a document). Our fund administrators, JPMorgan and Brown Brothers Harriman (BBH), provide us with ongoing charges data, and we source our synthetic risk and reward indicators through a combination of in-house and outsource services. The delivery of the KIID to our fund distribution partners is a key step and we are in the final stages of selecting a service partner to support that activity through a “primary distribution hub”, which must combine an industrial delivery capability with an ability to focus on specific funds (few

distributors will want to receive every one of the 16,000 KIIDs we estimate we will publish every year) and to receive news alerts when we update specific KIIDs. We have also had to design an operating model for the delivery of KIIDs to our direct investors. In the UK, for example, that means working with International Financial Data Services (IFDS), which is our transfer agency service partner, and Innovative Output Solutions (IOS), our printing and fulfilment partner.

An important part of our business in Luxembourg is related to the back office support of fund distribution. We have made significant progress in opening our international fund range to new markets, particularly in Asia, Latin America and the Middle East. Before we open any market, we undertake extensive due diligence to understand what the market is (it may not be as simple as a country), what jurisdiction it falls under, what rules govern sales within it and, if public registration is required, what obligations that imposes on the fund and its management company in terms of filings and any restrictions on the fund's investment and borrowing powers. We will also consider any fiscal obligations, such as fund and investor tax reporting and any other special regimes, such as restrictions on securities lending.

client take-on processes, how orders flow, how the cash moves, and how underlying investors' rights are assured.

Economic cycle

We have seen dramatic peaks and troughs in the global economic cycle over the past 10-12 years. We have also seen an avalanche of regulatory amendments and infrastructure developments laid at the door of the investment funds industry in recent times. Business school orthodoxy tells us that by outsourcing mid- and back-office functions the asset manager will be partially insulated from the technical challenge and cost of keeping pace with this change agenda.

Are you disadvantaged as an asset management house in managing these responsibilities in-house? Or does this provide additional surety that you are technically ready and compliant with these regulatory/infrastructure changes?

I think by now that it's clear that we work a good deal more on an outsourced basis than some might have thought. We don't believe that we are at a disadvantage where we have chosen to provide services in house, precisely because for each such

Over the past few years we have loaded up our principal fund service centre in Luxembourg to deliver substantially greater output per unit of cost, supporting funds in Luxembourg, the UK, Hong Kong, the Cayman Islands, Singapore and Switzerland. The foundations of this success are based on having good technology, strong expertise and recognising how to combine people and systems in order to deliver a high level of operational gearing. These have allowed us to increase our productivity by more than 500 per cent by most measures of activity since 2003 and to develop a cross-border fund platform of remarkable scope and quality which compares favourably with any outsourced service product that we might source from an external provider.

The practical business of selling funds in most countries involves the appointment of local distributors and, in that respect, we have created a separate distributor due diligence team. This performs a detailed legal and operational assessment of each potential distributor, including its ownership and operating model, its AML/KYC and other

service we have identified an advantage in doing so. But we do not operate under a rigid philosophy that in-house or outsource is best and we regularly revisit our assessments to find the most suitable operating model for every part of our business. Clearly, as an asset manager, we would like to allocate as much of our internal capacity

to our investment and distribution activities as we can, but we are willing to allocate resources to operations, IT and infrastructure where we see a good business case for it.

I do not believe that tighter economic circumstances will automatically lead to accelerated outsourcing – or that outsourcing is necessarily the most effective way to deliver greater operational efficiency. It may be a popular belief but I do not think that, by outsourcing, you can truly convert from a fixed cost to a variable cost base – not when you're outsourcing an operation of any meaningful size. More likely, outsourcing may help you to convert from one type of fixed cost model to another, both of which can be varied to a certain degree according to your appetite.

From our own experience, I believe it important not to underestimate the level of cost savings that can be achieved within an in-house operation. In the immediate aftermath of the global financial crisis, for example, we temporarily reduced direct operating costs within one of our business units by more than 25 per cent within 18 months. To achieve these cost savings, we took steps to reduce staff costs, to limit external expenses and to reduce the number of active projects that we were undertaking. It would not have been possible to achieve the same level of cost reduction with the same level of control had that unit been more extensively outsourced.

If you lack operational gearing or critical mass, outsourcing may also help you to reduce your costs, although you ought to be cautious about the size of the opportunity if your in-house operation has any scale and is well run. Even if outsourcing presents you with a significant cost-reduction opportunity, its nature is limited. You cannot transform the profitability of an asset management business simply by stripping out costs. The key is to raise productivity, to ensure that you deliver more value from your cost base, and of course to increase revenues.

This is not to infer that we are insensitive to costs. We expect to run our business at its lowest feasible operating weight – and to ensure that we do not carry fat anywhere in the firm. But over the past few years we

have loaded up our principal fund service centre in Luxembourg to deliver substantially greater output per unit of cost, supporting funds in Luxembourg, the UK, Hong Kong, the Cayman Islands, Singapore and Switzerland. The foundations of this success are based on having good technology, strong expertise and recognising how to combine people and systems in order to deliver a high level of operational gearing. These have allowed us to increase our productivity by more than 500 per cent by most measures of activity since 2003 and to develop a cross-border fund platform of remarkable scope and quality which compares favourably with any outsourced service product that we might source from an external provider.

Pricing and servicing issues

Recognising that outsourcing providers required a 'marquee name' or two on their roster to cement their reputation in this marketplace, some asset management companies drove hard bargains in the early days. How far do you now see a more balanced approach to pricing and service negotiations?

Our approach has always been to negotiate a fair price for service. Naturally, each party to an agreement will have its perspective and criteria for deciding whether a deal is acceptable, and negotiations may be robust. However, a bad deal for one side will be a bad deal for both, and we always aim to reach an agreement that leaves room for both parties to profit from their engagement.

In the past 10 years we have chosen to retain some key services in-house, even to the extent of reversing earlier decisions to outsource them. But we have equally chosen to outsource key services, some for more than 10 years. We therefore don't see ourselves as a firm that is particularly in one camp or the other as far as in-house or outsource provision is concerned, and we don't think that's a helpful way to look at the world. Our sourcing decisions are based upon the best way to meet our service needs and take account of many more factors than cost. As our business and its environment changes, so we will adapt our current operating models and review our assessments of what our future operating models should be. ■