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OUTSOURCING AS A FORCE OF TRANSFORMATION

**How Canadian Asset Management
is Driving Change in the Back
and Middle Office**

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HOW CANADIAN ASSET MANAGEMENT IS DRIVING CHANGE IN THE BACK AND MIDDLE OFFICE

Asset managers are facing a brave new world filled with both opportunities and obstacles. Viewed through a long-term lens, demographic trends indicate continuing high-growth potential, and access to more global business opportunity than ever before. Simultaneously, they face shrinking margins, changing distribution models and regulatory challenges all creating significant pressure.

As the industry addresses these challenges and opportunities, asset managers are increasingly outsourcing their non-core functions. Whatever the coming years bring, this trend toward greater use of outsourcing across asset managers' back and middle office looks to be a game-changer — heralding a new phase of transformational times for asset management in Canada.

BALANCING OPTIMISM AGAINST INDUSTRY PRESSURES

Despite facing a broad set of pressures, asset managers have cause to be optimistic. They are in a unique period of history, with shifts in life expectancy giving rise to more demand for investment products. To give context to our ageing world population, 2018 was the first year in history that adults over 65 outnumbered children under 5. By 2050, there will be more than twice as many adults over 65 than children under 5.¹



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In addition, demand for investment products is becoming truly global, particularly as developing markets mature. China, for example, has relaxed ownership requirements for foreign firms, and citizens are moving from a savings-orientated culture to one more focused on investing. Experts predict that China's asset management market will more than double by 2025.²

But the industry's challenges are a powerful force as well. Fee and cost pressures and eroding margins are having an impact. Morgan Stanley and Oliver Wyman forecast that total asset management industry revenues will grow at a compound annual growth rate of just 1% over the coming five years. And they say it's difficult to see how current fee pressures will abate in either passive or active management.³

Research reveals that operating margins for traditional publicly traded U.S. asset managers have fallen by 20% over the past five years, even as a balmy market environment generated equity returns of nearly 60% over the same period.⁴ Global regulatory obligations have also spiraled in recent years, resulting in rapidly growing compliance costs. In 2018, 21% of financial services executives expected to spend less than 1% of annual revenue on compliance costs. In 2020, only 6% said the same, while 33% now say they plan to spend more than 5%.⁵ In Canada specifically, 64% of asset managers ranked the increasing complexity of regulations and cost of compliance as a top organizational risk.⁶

TECHNOLOGY: DRIVING DISRUPTION AND NEW CLIENT EXPERIENCES

The potential for technology to cause disruption and create opportunity in asset management remains one of the industry's foremost topics. Within the Canadian market, 69% of asset managers are investing in technology innovation for their business model.⁷

As an asset servicer, we see this in our own business, where technological innovation provides an opportunity to make common processes more efficient and reduce costs. For example, machine learning can automate manual tasks to aid accuracy, efficiency and speed, while artificial intelligence can help select the most suitable trading outcomes and identify complex trends to potentially improve investment strategies.

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From our perspective as an asset servicer to investment companies, we see many of the most proactive firms integrating technology into everything they do to gain efficiencies and maintain their competitiveness.



The need for investment management firms to execute their business strategy better, faster, and more predictably has never been more important, nor has it ever been more difficult.

In addition to driving efficiency and enabling cost management, asset managers' technology objectives can also assist in enhancing and developing new client experiences, as mass application of technology to the investment industry creates a new set of challenges and dynamics.

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The same is true for technology expenditure across the entire industry, which explains why leading players are estimated to be outspending their mid-tier rivals on innovation by a ratio of as much as 3 to 1.⁸ Total technology spend is now worth US\$30 billion across the asset management industry, making it 15%-20% of its cost base.⁹

And technology will make all the difference in the future, with one study showing that asset managers are splitting into winners and losers. According to the study, 25% of asset managers are increasing their profits, while another 44% are investing in their businesses but not seeing any returns. Thirty-one percent are simply cutting costs and contracting.¹⁰ The firms that spent heavily on strategic technology to support their investment teams since 2014, however, saw a 44% increase in profits per employee.¹¹

Technology can be a great equalizer for industry players — levelling the playing field and affording smaller, nimbler players the opportunity to disrupt more established firms. If they have not already done so, now is the time to assess their businesses and take action.

THE EVOLUTION OF OUTSOURCING: SUPPORTING CORE COMPETENCIES

Against this backdrop, it is no surprise that asset managers are looking to outsource their non-core services and focus more exclusively on 'core' functions (i.e., portfolio management).

Investment firms first began to outsource in the 1980s, when they shifted their custody operations to independent providers.

The Canadian market is now embracing a new phase of outsourcing. Managers seek to outsource their middle office functions, motivated by more than just saving costs. They want to transform their operating model to meet challenges

posed by the increasing complexity behind investable assets across global markets. Simultaneously, they seek to increase transparency and monitoring capabilities, as well as access to automation, scale and security.

There is no doubt that the latest market cycle has resulted in an even greater demand for middle-office outsourcing. Investment managers have not only faced extreme margin pressure but also the ongoing requirement of doing more with less. Staff reductions and budget limitations continue to increase per capita productivity for operations and technology to all-time highs.

However, while recent volatile market conditions leave many things uncertain, the effects won't change the demand for outsourcing. Cost management will always be critical, but strategic capability is fast becoming the key driver for middle-office outsourcing. The need for investment management firms to execute their business strategy better, faster, and more predictably has never been more important, nor has it ever been more difficult.

The pace and complexity of industry change is accelerating. Whether responding to the demand for more complex, global products and assets or regulatory change, today's investment manager must be able to react faster and more nimbly than ever before. As a result, middle-office outsourcing has evolved from a purely cost-driven processing capability to a strategic platform on and through which an investment manager can execute their business strategy.

When considered in this context, outsourcing providers become more than vendors. The major providers are evolving into "knowledge companies" and are no longer simply processing organizations. Their platforms can help investment managers achieve important strategic objectives. For example:

- A platform for acquisition integration
- Further market expansion (manufacturing, fund domicile, distribution)
- Enhanced focus on distribution
- Improved speed-to-market and diversity of new product capabilities

This concept is particularly important for mid-size and boutique investment managers (in terms of AUM). These firms are at the greatest disadvantage in their ability to execute as they lack scale and access to the real and human

When might outsourcing become a cost — and resource — effective solution for asset managers?

Questions to ask include:

- Is there an operational or technology component your organization does not possess — but will need in the future — that can be supported through outsourcing?
- Might outsourcing help you optimize costs and efficiencies?
- Could outsourcing support your regulatory compliance?
- Is outsourcing likely to support your focus on core competencies?
- Are there opportunity costs of not considering outsourcing?
- What functions are central to your business model?



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capital necessary to keep up with the increasing pace of change. Whether striving to introduce new products faster, globalizing, or changing business models, these firms face steep competition from their larger peers.

ACCELERATION OF MIDDLE OFFICE OUTSOURCING

The need for cost management combined with the increasing pace of change will continue to put pressure on an investment manager's ability to improve capability in functions that are not core to their business. This focus will drive the acceleration of middle office outsourcing.

Outsourcing providers possess not only scale and operating leverage, but also a culture of accounting, control, and risk-based oversight that is critical in today's environment. This will continue to support an acceleration of capability beyond the incremental gains of a typical manager.

Over the past decade, capabilities have evolved far into higher-value functions and capabilities that exceed the average investment manager; services such as complex derivatives processing, sophisticated analytics and highly differentiated client communications and reporting.

LOOKING AHEAD: WHAT'S NEXT FOR OUTSOURCING?

Our industry may exist in both the best and worst of times, but the future of the investment industry will be very different to what we see today. By 2022, at least 20% of managers with US\$50 billion in AUM will outsource at least some of their trading operations.¹²

Larger asset managers will likely automate or outsource everything in the middle and back offices, while boutique managers will outsource to large asset servicing firms or global utilities that could emerge for functions such as transfer agency, trading processing and risk and tax reporting.

With a new era of transformation approaching, it's clear outsourcing is here to stay, and while managers can choose not to make use of it, they should not ignore the trends that are driving this shift — regardless of whether they are experiencing the upsides or the downsides.

ENDNOTES

- ¹ United Nations, World Populations Prospects 2019 Highlights, 2019
- ² Boston Consulting Group, How Global Asset Managers Can Step In as China Opens Up, December 18 2019
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- ⁴ Casey Quirk: Fee Attrition Accelerating at Public Asset Managers as Profit Margins Slide to Median 27%: Casey Quirk Analysis, February 26 2020
- ⁵ Duff & Phelps, Global Regulatory Outlook 2020: The Regulatory Landscape Evolves, January 24 2020
- ⁶ KPMG, It's Decision Time: Canadian asset management opportunities and risks report 2019, September 24 2019
- ⁷ ibid
- ⁸ Morgan Stanley and Oliver Wyman blue paper: Winning Under Pressure, March 2018
- ⁹ ibid
- ¹⁰ Casey Quirk, McLagan: Casey Quirk and McLagan Study Shows Growing Divide Between Winners and Losers in Asset Management, 9 July 2018
- ¹¹ ibid
- ¹² Business Insider: Asset Managers Increasingly Outsource Trading Operations, 19 February 2019

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