CATCHING THE WAVE - GLOBAL OUTSOURCING TRENDS HEADING DOWN UNDER

INTRODUCTION

The next five years will bring significant change to the Australian investment industry and to superannuation funds in particular. Trustees and executives in the AUD2.8 trillion superannuation sector will be subject to the same oversight as bank chiefs, millions of dollars in fees will be abolished, and workers will only be able to be defaulted into an account once – in a once-in-a-generation set of changes recommended by the Banking Royal Commission.

With further pressure coming from the relentless rise of costs, technology investment, high fees and poor performance of some external managers, many super funds want to bring asset management in-house to improve scale, operating efficiencies and bargaining. To do this, however, they will face a number of challenges. For example, setting up trading desks is costly and time consuming, especially now with the greater scrutiny imposed by the regulators. Appropriate reporting procedures and governance structures need to be put in place. Trading expertise and technology must adapt to more specialised and digital forms of execution and cost transparency must be guaranteed. While those with sufficient size and scale may still adopt this route, or build on current capabilities, others might look to outsourced solutions for some or all of their trade execution and processing requirements.

SUPER FUND FACTS

Superannuation is the fastest-growing market in the world:

AUD2.8T

SUPER FUND ASSETS

>AUD70B

AUSTRALIA'S TOP FIVE SUPER FUNDS HAVE ASSETS OVER AUD70 BILLION

SUSTAINING SUCCESS

The superannuation industry serves a critical function for both the public and private sector in Australia, but it is easy to forget that it is less than 30 years old. As the market matures, it is becoming one of the most highly regarded retirement systems globally.[1] With current assets of around AUD2.8 trillion, it is also the fastest growing market in the world , and is anticipated to have the second largest pool of investment capital by 2023 . The country's larger superannuation funds are already globally significant – Australia has approximately 40 funds with assets of more than AUD10 billion and 15 with more than AUD30 billion under management (AUM). The top five have assets over AUD70 billion.[2]

Despite its obvious success, the sector faces an increasing number of challenges. High fees are considered the single biggest drain on the super system. Australians pay more than AUD30 billion each year in super fees according to findings from the Productivity Commission.[3] That's twice what they spend on electricity according to Ben Phillips, Associate Professor at ANU Centre for Social Research and Methods. What's more, a large number of these fees are paid to underperforming funds. The Productivity Commission found that almost 5 million of the nation's 15 million MySuper accounts are in underperforming funds . Other challenges come in the form of rising costs, the relentless march of technology and greater regulatory scrutiny on governance and transparency post the Royal Commission's report. To meet these challenges, many super funds are consolidating and bringing assets back in-house. KPMG believe two-thirds of Australian superannuation funds will insource asset management over the next seven years, which mirrors a wider global trend.[4]

Super funds are anticipated to have the second largest pool of investment capital by 2023

BETTER ASSET ALLOCATION

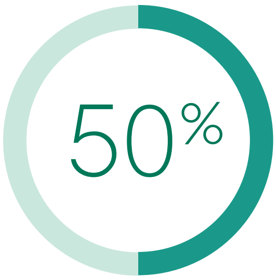
Super funds have realised that in-house management may not only reduce costs and improve margins but can also drive best practice through enhanced risk management and asset allocation. For example, many funds which have historically outsourced investment management are now concerned about the lack of tracking error in their selected funds when looked at in aggregate. Often it's the case that one manager is underweight a stock or sector that another manager might be overweight, effectively neutralising any alpha generation. The result ends in a very passive weighting across a fund's overall portfolio, which is less than ideal, given that the fund is paying active investment management fees, which on average costs about 1.2% per annum.[5] In contrast, some passive funds cost as little as 7bps for domestic equities and 4bps for American ones.[6]

> *Almost 5 million of the nation's 15 million MySuper accounts are in underperforming funds.*
>
> PRODUCTIVITY COMMISSION

As a consequence, super funds are responding by restructuring the way they invest their equity exposure. Instead of allocating to a number of active fund managers, they are reapportioning a heavy weighting to low cost passive strategies. The active component of their investment then comes back in-house. Using the numbers given, the savings from reallocating $1 billion from active to passive funds could be in excess of $9 million. Having the active portion managed in-house can also provide better access to those specialist themes and strategies they want exposure to, greater transparency over their asset allocation, differentiation from their peers and the potential to deliver better results for their members.

BARRIERS TO INSOURCING

Unfortunately, there are plenty of barriers to bringing assets in-house. Rising costs, managing operational efficiency and future-proofing operating models are just some of them. KPMG believe the average super fund experienced a 6.7% increase in total operating costs in 2017, and warn that any funds which remain constrained by budget pressures will continue to fall behind those peers who invest in change and transformation.[7] They predict that half of Australia's super funds will merge with larger funds or exit the system over the next decade as they struggle to become more efficient.[8]



Half of Australia's super funds will merge with larger funds or exit the system over the next decade

A similar story is occurring globally where years of asset growth has masked a lot of cost inflation. Investment industry spending has risen steadily. Between 2007 and 2017, costs for North American asset managers, for example, increased by an average of 5% a year, and 6% in the final 12 months, according to McKinsey, the consultancy.[9] Oliver Wyman believes they rose 8% globally in 2017, limiting any margin improvement in what was a record year for asset growth.[10] If markets were to fall, BCG believes 10% would come off margins.[11] Markets did fall in 2018. In fact, it was the worst for AUMs since 2008: the Global Financial Crisis.[12]

While other factors are at play, namely rampant fee pressure from competition (passive funds) and regulation, it's clear that the competition on fees will favour those very large funds with significant scale advantage. For example, the two biggest, BlackRock and Vanguard together, grabbed more than half of global net new inflows into mutual funds in 2018.[13] The Investment Company Institute reported only the cheapest active domestic US funds – those priced in the lowest 5% of their peer group – attracted positive net inflows in 2017.[14] The other 95% suffered outflows. Without scale to compete, many will be forced to merge or look more seriously at outsourcing large parts of their fixed cost base.

UNDERSTANDING COSTS

Getting to grips with costs will therefore be a critical issue for super funds who are thinking of insourcing in 2019 and beyond. There are four key cost areas that funds have to grapple with:

Implementation costs:

The costs of building and running a trading desk have greatly increased over the past few years. As liquidity has fragmented and trading becomes more electronic, the costs involved to access this liquidity via developing a network of relationships or through technology spend, have materially increased. Regulators have demanded greater transparency which increases reporting requirements. New governance rules requires greater oversight and monitoring, and business continuity is a key consideration for potential investors, not least fund trustees charged with ensuring they act in the best interest of their investors. In addition, funds have apportioned fixed costs, systems costs and disaster recovery costs to consider.

Headcount costs:

Industry consultants believe the fully-loaded costs of a single trader in the UK costs up to USD500,000.[15] But a trading desk is not assembled simply of traders operating in a vacuum. There are front- and middle-office teams, compliance and risk monitoring and oversight departments, and everyone involved in the logistics of portfolio management.

Opportunity costs:

Over the years, it's not been uncommon to see one person perform a multitude of roles; a portfolio manager executing his/her own trades for example. As new regulation focusses on suitability and accountability, the opportunity cost of performing multiple functions is growing. This is especially so in trading and execution where the role now requires a greater degree of specialisation and the demands for reporting, best-execution etc. have grown inexorably.

Transaction costs:

These are often tangible and intangible. Tangible benefits come via lower trading commissions and are immediate and obvious. These are mostly due to scale and deep liquidity pools. Intangible benefits will accrue over time and include the cumulative benefit of having access to state-of-the-art Transaction Cost Analysis (TCA) software, global coverage and local experts working to improve execution quality, always with the clients' interests in mind.

Overall, asset managers and super funds alike need to focus on efficiency and optimisation. It is estimated that asset managers could cut up to 40% of their cost base by outsourcing, automation, and changing organisational/compensation structures.[17]

> *We've certainly seen cases where on paper the cost savings can be 25 percent on the execution side compared to keeping it in house, and significantly more in a few cases.*
>
> **CHRISTIAN EDELMANN, PARTNER, OLIVER WYMAN**[16]

THE ROYAL COMMISSION AND THE COSTS OF CULTURAL CHANGE

Regulators the world over are focussed on trying to rebuild trust in the financial services industry, which still ranks at the bottom of the 2019 Edelman Trust Barometer. The outcome of these efforts is a raft of new regulations aimed to drive cultural change, improve governance and accountability, increase transparency and provide better alignment of interests, to create a fairer system for all. In Australia, the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, which was announced by the government in November 2017, has placed significant scrutiny on the sector and its practices. In February 2019, it was revealed that trustees and executives in the superannuation sector would be subject to significant new oversight via the Banking Executive Accountability Regime, bringing it in line with the Senior Managers and Certification Regime in the UK. This will give regulators the power to curb bonuses, vet appointments and force funds to map out executive responsibilities. Moreover, trustees, not just directors or executives, who fail to act in the best interests of their members, would also be liable for civil penalties in a bid to stamp out misconduct.[18]

Related to this is the Productivity Commission's inquiry into the competitiveness and efficiency of the superannuation system. The findings of the Super Inquiry were released in January 2019 . These called for a change in the 'architecture' of the system - from how defaults work to a 'best in show' shortlist for members to choose products from and weeding out persistent underperformers and prohibiting fees for basic advice. By agreeing to many of these recommendations, not least the default process, millions of dollars will be starved from funds, especially those not on the recommended list.[19] This will in turn, drive the need for consolidation even further.

On top of local regulations, funds will also have to be mindful of global regulations and how they impact the markets they operate in. In Europe, it is the Markets in Financial Instruments Directive (MiFID) II and the European Markets Infrastructure Regulation. Other recent legislation includes the Packaged Retail and Insurance-based Investment Products regulation, the Retail Distribution Review in the UK, the Alternative Investment Fund Managers Directive (AIFMD), and the Dodd-Frank Act in the US.

While it will take time to understand the longer term implications of the new regulations, it will certainly require greater time commitment, governance and oversight, and mean more costs for superannuation funds. It is no wonder then, that compliance costs for financial institutions could more than double by 2022.[20]

BANKING EXECUTIVE ACCOUNTABILITY REGIME

Trustees, not just directors or executives, who fail to act in the best interests of their members, would also be liable for civil penalties in a bid to stamp out misconduct.

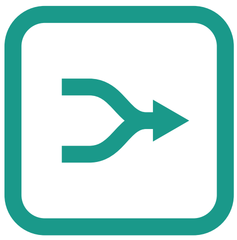
THE RELENTLESS MARCH OF TECHNOLOGY

In addition to compliance costs, super funds are facing increasing technology spends. Whether it is artificial intelligence, the rise in automation and data analytics or the development of scalable platforms, technology has dramatically altered the investment landscape and will continue to do so. While technology will help reduce costs in the future, it is not doing so now. As Morgan Stanley and Oliver Wyman point out, the effectiveness of innovation and technology should be a key focus for competitiveness. It is estimated that leading players are outspending their mid-tier rivals on innovation by a ratio of as much as 3:1.[21] The total technology spend is now worth USD30 billion across the industry, making it 15%-20% of the industry cost base.[22] To save committing to this sort of investment, often hard for sub-scale funds, outsourcing provides a good solution. Northern Trust spends about USD2.5 billion on technology over rolling two-year periods, so clearly the firm recognises its importance. This goes towards not only the development of new platforms and innovations, such as blockchain technology, digital assets and artificial intelligence but also on cyber security; an ever-present and growing threat for any business to consider.[23]

The total technology spend is now worth USD30 billion across the industry, making it 15%-20% of the industry cost base

OUTSOURCED TRADING IS BECOMING MAINSTREAM

As outlined earlier, the asset management industry globally is faced with a perfect storm of regulatory, technological and competitive pressures at a time when asset growth has stalled for many. Costs have become magnified as a consequence and many funds are now reviewing their operating models to see where cost savings can be made.
While outsourced trading was once considered a solution for the very small and/or start-up funds, it's now developed to a scale where it's a viable solution to even very large funds, as Northern Trust can attest to. What's more, it not only delivers immediate cost savings and efficiencies, it also lowers operation risk, enhances transparency and improves governance; critical aspects of the new regulatory environment we operate in.



Having a smaller number of much larger funds brings benefits of scale, improves governance and decision making, makes it easier to attract/ retain high calibre staff, improves bargaining and allows for better asset diversification

INSOURCING VALUE, OUTSOURCING COST - A GLOBAL TREND

Post the Royal Commission's report, Australian superannuation funds will face increased regulatory scrutiny and will be forced to make changes that will be timely and costly to implement. This may also occur as many super funds struggle to demonstrate the clear benefits of having investment management run by external managers. Some are responding by insourcing these funds, indexing a large proportion and running the active portions internally. Interestingly, this is a trend that's happening with asset owners and pension funds elsewhere in the world. Indeed it finds precedent with what's recently happened with the local authority pension schemes in the UK.

In the UK, government intervention has led to the creation of the Local Government Pension Scheme, which consolidated 89 investing entities into eight.[24] The driving logic behind such was having a smaller number of much larger funds brings benefits of scale, improves governance and decision making, makes it easier to attract/retain high calibre staff, improves bargaining and allows for better asset diversification . Northern Trust played an important role in the development of this scheme and provides many of these pools with services, including outsourced trading.

Outsourced trading frees up time and resources allowing fund managers to focus on the critical role of delivering alpha to their investors.

While insourcing has many benefits, it also has its challenges. These include the high costs to build and develop a trading desk, having the proper people and technology in place, implementing new operating procedures and complying with regulation. Outsourced trading helps solve many of these issues. It enables funds to insource the value component of their operating models while outsourcing the costs. It minimises operational complexity and improves efficiencies. It enhances transparency and improves governance. Funds don't have to navigate the changing regulatory regimes on their own. Outsourced trading can help funds access all available market liquidity and provide a single point of contact to manage multiple broker relationships; critical in a liquidity environment that is rapidly fragmenting. With investments in state-of-the-art TCA tools and global expertise in markets around the world outsourced trading can help improve execution performance. Perhaps most importantly, outsourced trading frees up time and resources allowing fund managers to focus more on the critical role of delivering alpha to their investors.

While some outsourced providers claim to offer some or all of these benefits, none can offer them wrapped in a safe, secure, client-centric custody bank with a long history in outsourcing, a global presence and unrivalled access to liquidity. It's these reasons why Northern Trust's Integrated Trading Solutions (ITS) is experiencing the growth that it is in Europe and the US.

INTEGRATED TRADING SOLUTIONS:

Northern Trust launched its ITS services in September 2017. It was developed ahead of MiFID II to help clients navigate the changing operating environment for asset management. The solution has grown rapidly to support multiple clients across the globe, from sophisticated asset owners to boutique funds to USD60 billion global asset managers. In essence, ITS offers asset managers transparent execution with complete alignment to their objectives and a focus on MiFID II best execution* via unrivalled market access and deep internal liquidity pools, wrapped in the security of a client-focused custody bank. The cost savings achieved, both transactional and fixed, can be significant such that Northern Trust expects ITS to grow strongly in 2019 and beyond given the pressures facing the asset management industry, not least those likely to be imposed in Australia following the Commissioner's report.

*Achieving the best possible result for customers when executing their orders via execution venues or over-the-counter.

The reasons this solution has gained rapid adoption in EMEA and the US include:

1. Custody Bank - Not an Investment Bank

Northern Trust Securities (NTS) is a broker-dealer within Northern Trust, a custody bank. This makes NTS an agency broker, with 100% client alignment and executing only on client instruction in a best execution* model. As Northern Trust is not an investment bank, they do not engage in proprietary trading or investment banking, limiting the potential conflicts of interest. Northern Trust's distinctive financial strength underpins its ITS offering and is a key differentiator in the market.

2. Depth of Trading Expertise

NTS has a deep bench of trading experts (150+ years of combined trading experience across large-, mid-, small-cap, programme trading and emerging/frontier markets). With access to more than 80 global markets, Northern Trust has a follow-the-sun model with brokerage offices in London, Chicago and Sydney and provides 24/5 trading desk coverage.

3. Access to Greater Liquidity

As a broker-dealer within a custody bank, NTS has access to liquidity from any market source as directed by the client. For example, USD145 billion of unencumbered agency flow was traded in 2018 - flow that only goes to NTS. Essentially, this means NTS has access to liquidity that other firms may not, which helps to lower the client's footprint in the market and enhances NTS's ability to achieve best execution.

4. Technology and Future Proofing

ITS deploys a "front-to-back" technology, removing the need for manual intervention, thereby creating operational efficiencies for clients. From the moment a trade is executed, Northern Trust's SWIFT middle-office capability employs straight-through processing, sending trades for matching and then settlement – creating a more efficient middle office and thus minimising failed trades. As SWIFT messages are sent every 15 minutes, a client can input an order, have it executed, booked, processed, passed to custody and be back in their investment book of record in under 20 minutes, important for time sensitive net asset value pricing.

5. Managing Cost and Reducing Risk

Underpinned by the scale of Northern Trust, ITS enables clients to reduce their costs and risk by:

- Deploying SWIFT technology to provide a fully automated solution to drive operational efficiencies and reduce risk across the full trade lifecycle - execution, processing and settlement.
- Minimising the cost of ongoing investment in technology and business continuity.
- Reducing headcount costs (traders, middle- and back-office support staff).
- Accessing compliance and regulatory oversight to help control risk.
- Achieving lower commission levels.
- Enhancing overall trading performance.
- Delegating regulatory and compliance reporting.
- Providing integrated reporting functions.

6. Regulatory Oversight

The increasing risk of non-compliance with new regulatory obligations and complexity in achieving best execution* calls for a robust compliance and regulatory framework. Core to the ITS proposition is:

- An embedded but independent compliance team performing oversight, advisory, monitoring, surveillance and reporting activities. This includes compliance control validation, oversight of trade and transaction reporting, and weekly and monthly TCA review and reporting.
- A comprehensive solution to help clients satisfy their best execution* obligations under MIFID II, providing a suite of best execution* reports and analytics which are reviewed directly with clients on a monthly basis.

THE VALUE OF AN INTEGRATED TRADING MODEL

- Has the potential to significantly lower costs and increase returns.
- Increases functionality so funds can provide more services more cost effectively.
- Facilitates compliance, allowing funds to get off the regulatory ‘treadmill’.
- Enables funds to focus on core business, getting best return for their members.
- Helps future proofs business models from technology/regulation.
- Total alignment with clients’ goal
- Avoids significant spend on information technology.
- Removes risks both from an operational and regulatory perspective.
- Improves scale economics and operational efficiencies.
- Provides flexibility - can pick and mix, or fully integrate.

ITS AND THE ROAD AHEAD FOR AUSTRALIAN SUPERANNUATION SECTOR

The issues surrounding fee pressure, performance pressure and cost inflation are not new. They have been a feature of the industry landscape for several years. What is new is the global regulatory environment which is trying to rebuild trust in the industry lost since the Global Financial Crisis. Such a process of cultural change not only adds significant operating costs by way of compliance, governance and oversight, but pressures fees by enforcing transparency, cost disclosure and requiring funds to deliver on value for money.

Australia is not immune to these trends and funds will adopt many of the recommendations made by the Royal Commission. This comes at a time when many are questioning the benefits of having investment management run by external managers. Some super funds who want to optimise their investment performance, embrace best practice and gain scale efficiencies and bargaining are looking to bring their assets in-house – a trend observed globally. Although they are facing several barriers to achieve this, trade execution should not be one of them. To help navigate this route, Northern Trust has expanded on its outsourcing credentials and developed Integrated Trading Solutions, built with this new regulatory context in mind.

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