Outsourcing Goes Holistic: Trade Execution Integrated into Solutions

NORTHERN TRUST

Thought Leadership Studio

INNOVATION CONTENT SPONSORED BY NORTHERN TRUST

Outsourcing Goes Holistic: Trade Execution Integrated into Solutions

Traditional front-office responsibilities are shifting to more cost efficient outside partners

At first glance, 2017 appeared to be a very good year for asset managers in terms of assets under management (AUM), but it was less so from a profitability standpoint. The picture for AUM in 2018 was less of a feel-good story, underscoring the notion that asset managers face serious challenges in terms of buffering their operational expenses. Maintaining technology, supporting regulation and compliance requirements, and keeping talent are time-consuming, costly endeavors. Outsourcing services that are traditionally completed in house — including front office trade execution services — can allow asset managers to more effectively control costs and potentially reduce risk, and can reset the bar for better execution.

To discuss this trend, II spoke with experts **Christian Edelmann (above, center)**, Partner at Oliver Wyman, a global leader in management consulting, where he is Co-Head EMEA Financial Services, and Global Head, Corporate & Institutional Banking, and Wealth & Asset Management; **Guy Gibson (right)**, Head of Institutional Brokerage, EMEA and APAC, Northern Trust Capital Markets; and **Marc Mallett (left)**, Director of Strategy for Asset Servicing Strategy, Americas, Northern Trust.

What are you seeing in terms of flows that points to an expected increase by asset managers in outsourcing services that they typically execute in house?

Christian Edelmann: Based on our current estimate, AUM for asset managers globally is down around 6 percent compared to 2017, with a very modest $3 trillion of flows into the industry. This is the first time since 2008 that AUM has decreased for the industry, and the valuations of asset managers are down, too. When you combine that with pressure on the cost side, we're convinced we'll see more outsourcing transactions happening over 2019 and beyond, and it will accelerate further in the back and the middle office, but we'll increasingly see it in the front office, too.

Back and middle office services seem obvious candidates for outsourcing, but viewing the front office as such is a bit of a new idea, isn't it?

Guy Gibson: Toward the back end of 2018 we started seeing a big increase in the volume of dialogue with our clients globally regarding outsourcing the front office, and that's a real change because traditionally a front office outsourcing solution was very much either for startups or smaller asset managers. Today it's a much wider conversation including asset managers that are quite significant players in the market.

Globally speaking, what potential benefits do asset managers think they might gain from outsourcing front office services?

Gibson: Transparency that aligns with their process from start to finish, better execution if they work with a partner with global presence, and the reporting. Consider a US-based asset manager that's a global fund. They have a US desk, but they trade through the night. Our outsourcing solution at Northern Trust, for example, means they can get their execution at 3:00 AM, but also execute and report the trade cost analysis profile at the same time, with the trade being matched at the custodian level in real time. When the trader begins their workday on US time, it might take five minutes to check on his overnight trades and see they're all matched in the market, rather than taking 30 minutes to go to all his brokers and tidy things up. That's an example of where the ease of the solution can help asset managers streamline their business and give them much more of a global presence.

Edelmann: I would add that there's increased demand for hedging solutions and really understanding the exposure in a portfolio — anything around trade simulation and portfolio analytics. A lot of firms have built these capabilities internally, but they are costly to maintain and there's a realization they don't really achieve competitive differentiation, and that they can access these tools via outsourcing.

How significant are the cost savings that result from front office outsourcing?

Gibson: There are some estimates that the all-in cost of running a three-person trading desk is about $1.5 million. I can't confirm that number, but I don't think it's far off. So, the cost benefits are significant in a holistic context — when you consider the cost of risk management and the value of the global presence — in the current regulatory environment.

Edelmann: It depends to some extent on the nature of the firm, the type of the asset class that they're in, and the type of the market that they invest in, but 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.

Gibson: Objectively speaking, the headcount, costs of running systems, and building and managing trading desks, is fairly self-evident. There is also what we refer to as opportunity cost. An example of that is that some big regional asset managers might still be executing deals, and that's time taken away from their core competency of picking stocks. And then there are transaction costs. Clients want to see the actual cost of what the dealing capabilities might be, and if you are in the market with a bit of scale behind you the transaction cost is quite transparent and also easy for managers to reflect back to their investors.

What's the thought process a firm goes through when considering outsourcing in this context?

Edelmann: When our clients look into it the trigger is usually a cost problem or a new management team challenging the status quo. In most investment organizations, boards tend to be on the conservative side, so a cost-only motivation won't do the trick. Outsourcing firms must demonstrate that they understand the pain points of an asset manager, that they can map them and develop customized solutions that will simplify the workflow and, ultimately, reduce cost and increase transparency. They also must be able to answer questions about operational resiliency — what's the backup solution if the systems go down? What communication channels do you have? What are the services standards? How do you handle cyber risk? Those are things that we see as important to closing any type of outsourcing discussion and get it approved by the board. On the institutional side, particularly in the markets that are heavily intermediated by investment consultants, asset managers often do need to define the strategic rationale of outsourcing relationships, but the concept of outsourcing itself is not questioned at all.

Once a manager decides to outsource some of these functions, what is the integration experience like for them?

Marc Mallet: It differs from client to client depending on their priorities. Some prioritize regulatory compliance, others cost efficiency, and so on. The key to the client experience is making sure we're executing on their strategy, and not just through trade cost analysis and trade protocol, but with monitoring transactions and providing reporting that they see and use to report back to regulators that we're doing what we said we would do. So, there are daily reports, and also monthly meetings on how we've performed and what we might need to improve on.

Edelmann: What we're talking about regarding front-office outsourcing is fundamentally different from traditional off-shored, back-office outsourcing. We're talking about more of a solutions mindset that directly solves clients' challenges through more frequent and direct interaction. Some of the solutions are on open API infrastructure to connect better with clients in their systems, for example.

Mallett: All of this connects very well to the holistic global services we provide at Northern Trust. If we are providing outsource trading for an asset manager we have the ability to provide all the post-trade processing, and act not just as their middle office but also as their accounting book of record. This holistic approach can be far more seamless and transparent than they may have experienced in other outsourcing relationships because it eliminates the communication challenges that emerge when multiple service providers are involved.

When you significantly reduce the number of counterparties that are involved, you're simplifying the overall environment. We've come across some firms in the past year that had looked at outsourcing a few years ago but couldn't find a counterparty to service them because, as a multibillion-dollar fund, they might have $1 billion of flow out in the market at a given time. That's a lot to be accountable for as an outsource service provider if you don't have a full set of solutions and tremendous resources.

From the investor's perspective, does front-office outsourcing eliminate some elements of personal touch?

Mallett: Client service specialists — as opposed to traders — are typically the most directly engaged with clients. With this model, the client service specialists have more time to focus on client and prospect interaction, gathering assets, generating investment ideas, and servicing their clients.

Gibson: Some of the clients who have begun using our platform in the last year have said they don't expect to create or generate alpha out of trading. In that respect, the trading functionality is a commodity — it's a baseline expectation that they will get good, fair prices. That ties back to the opportunity cost we mentioned earlier where instead of trading a portfolio manager can focus on creating more value for the fund.

Edelmann: We're not quite at this stage yet, but if we assume cost pressure will continue to increase, strong relationships with one or a few outsourcing providers could be a differentiator for asset managers in terms of the fees they are able to offer clients.
