NORTHERN
TRUST

FROM NICHE TO NORM

The Accelerated Adoption of Front Office Outsourcing

The last six months have been demanding for asset managers in many ways. Challenges from market volatility, extreme margin pressure, technology resiliency, cyber-risk, and business continuity have all been at the forefront of asset management thinking. Even before the global pandemic, many of these challenges existed. COVID-19 is not necessarily a change agent itself, but more an accelerant of changes already happening. We were already travelling towards a New Normal, COVID-19 simply accelerates the time when we will arrive.

> *There are decades where nothing happens, and there are weeks where decades happen.*

VLADIMIR ULYANOV

FROM NICHE TO NORM

The Accelerated Adoption of Front Office Outsourcing

RECENT GLOBAL EVENTS HAVE ACCELERATED EXISTING TRENDS

COVID-19 has accelerated the challenges faced by firms across the globe, compounding pressure from competition, fees, regulatory and compliance challenges, technology costs and shifting product demand. It has forced an urgent review of entire operating models.

TECHNOLOGY, REGULATION AND GOVERNANCE ARE DRIVING CHANGE

Change is the new constant and firms are under increasing pressure to not only meet performance expectations but also and, increasingly, the environmental, social and governance requirements of regulators and clients. Furthermore, the pandemic has emphasised the fundamental importance of robust business continuity planning and raised questions about whether firms are getting value from their business continuity arrangements.

THE CONVERSATION IS PIVOTING TO THE IMPORTANCE OF VALUE

Until recently, firms had no option but to keep their dealing function in-house. With the development of hyper-scale outsourcing providers – offering enhanced opportunity at lower cost – firms are able to ask the vital question: **do we get value from our dealing desk?**

Outsourced trading is no longer limited to smaller firms as scale and the ability/resources to conduct trading in-house has become irrelevant and large, complex managers seek the diverse benefits of outsourcing.

OUTSOURCED TRADING IS NOW THE “OPTIMAL STATE”

Old assumptions about outsourcing have been challenged (and, during the pandemic, proved incorrect) – a key example being the perceived need for proximity between portfolio manager and trader which work from home protocols have discredited.

More widely, where outsourced trading adoption had been seen as a defensive, reactive strategy, focus has now shifted to the variety of other benefits offered – including supporting risk management, streamlining operations, enhancing governance and improving operational and technological resiliency. Outsourced trading adoption is increasingly a proactive and future-focused decision and, as a result, we’re seeing firms of all sizes, and across all regions, coming to view it as a better way of doing things.

A NEW WAVE IS ON THE HORIZON

There’s no sign of these changes slowing and, with an increasing pursuit of greater efficiency and transparency, new client demands and data analytics technologies look set to drive a “Fourth Wave” of outsourcing.

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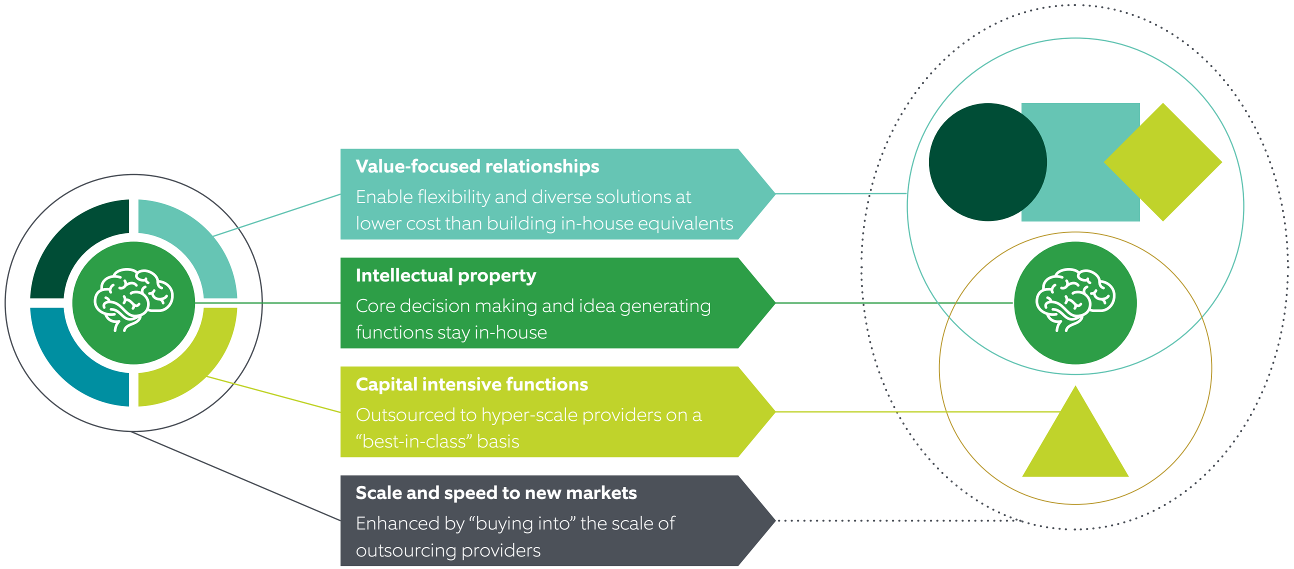
INTRODUCTION

THE THIRD WAVE IN ACTION

Part of the New Normal for the financial services industry has been the arrival of a "Third Wave" of outsourcing. In recent years, asset managers and asset owners have been increasingly outsourcing their front office functions, following the previous distinct cycles of back and middle office outsourcing.[1]

We believe the drivers precipitating this Third Wave of outsourcing are unprecedented, and that many asset managers will undergo significant transformation over the coming years. The future for asset management, we believe, will in time resemble the information technology sector. IT companies in-house their intellectual property (IP), while non-core functions are outsourced to secure hyper-scale providers like Microsoft or Amazon. We anticipate a similar transformation taking place in the investment industry. Asset managers will retain their intellectual property, and the people, systems and technologies informing their decision-making processes (including management and control functions). However, all high-capital intensive functions will be outsourced to hyper-scale providers, the large asset servicers, who are aligned to their interests.

IN-HOUSE VERSUS OUTSOURCED



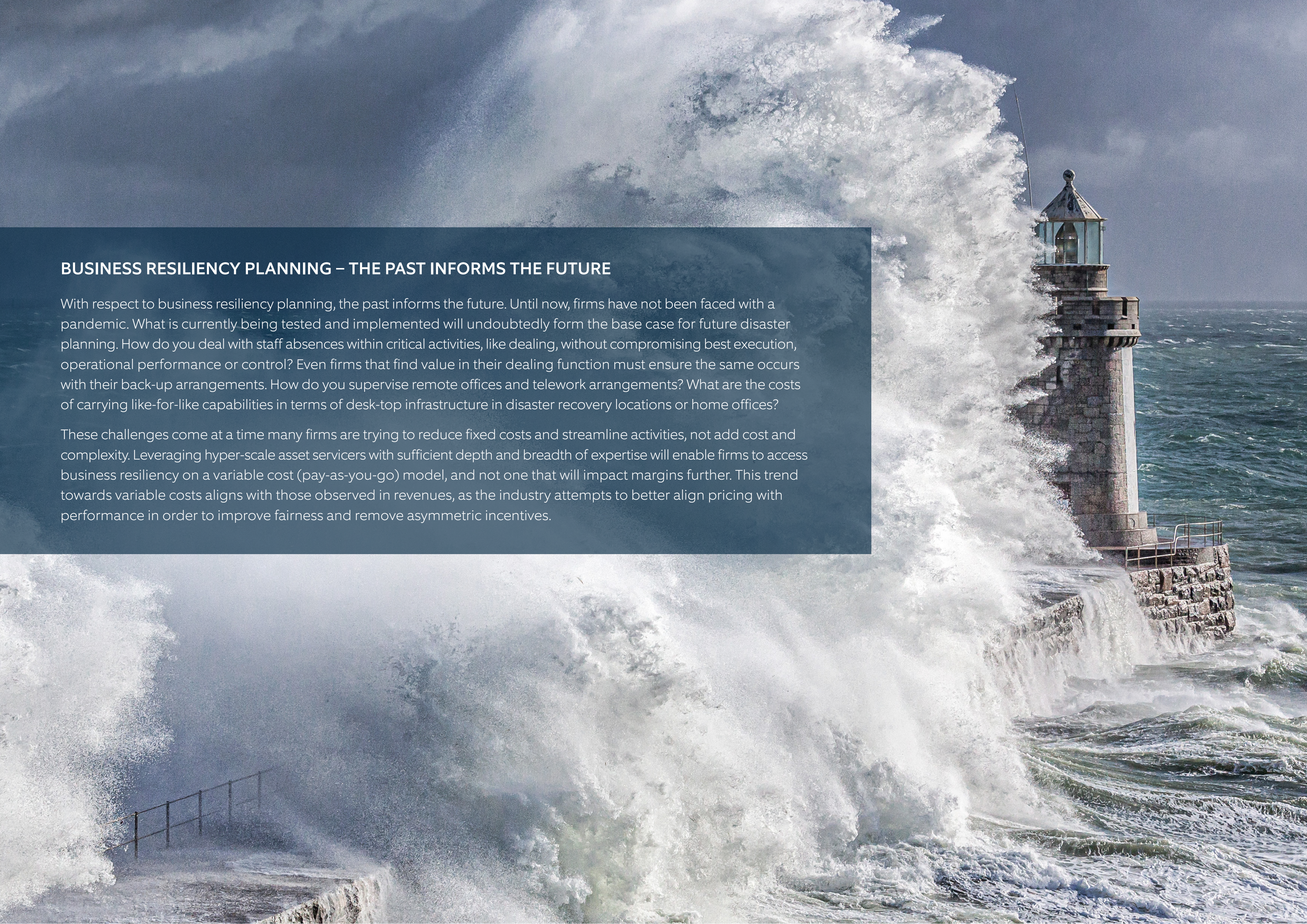
In this context, many front office functions, such as trading desks, foreign exchange, and transition management capabilities, are no longer immune from restructuring or cost-cutting. This is particularly true in the case of dealing. With the advancement of electronic trading, broad fragmentation of liquidity, and the ubiquity and speed of information access, the ability of dealing desks to extract value or find edge has diminished. So too has the perception of dealing as core to the decision-making process of an asset manager. Even the idea of portfolio manager proximity (to the dealing desk) has been questioned, especially during the COVID-19 crisis. In consequence, demand for outsourced trading has grown, and solutions have become increasingly sophisticated. Adoption rates have increased, so too has the size and expertise of managers who are outsourcing their front office functions. These are trends that we expect will continue, and in fact accelerate.

But what started as simply a cost-efficiency endeavour has evolved. The outsourced trading model has moved from being largely a defensive, reactive strategy (to cut costs) to one that resembles an optimal state; a proactive response to margin progression, a way to de-risk and streamline operations and, critically, as a way to enhance governance and operational resiliency. Front office outsourcing is not just a recessionary business – it's becoming, we believe, **a better way of doing things.**

The drivers of change are global, and go far beyond simply margin pressure. They include aspects of competition, the ability to leverage economics of scale, business resilience, changing economic models, variable costs, demographics, technology, and regulation – drivers no longer hidden under the veil of strong markets. Last year marked significant change in the economics of the industry, change that will reverberate for years to come. Margins for many listed asset managers fell despite assets under management going up. Against this backdrop, governance concerns have come to the forefront, with increasing requirements around:

- DISCLOSURE
- REPORTING
- TRANSPARENCY
- CONFLICTS OF INTEREST

The trend towards stronger governance, more regulation, and an increased focus on environmental, social, and governance (ESG) issues has also led to a democratisation of the relationship between asset managers and their clients. While this is a positive development, it requires greater resourcing and adds costs.



BUSINESS RESILIENCY PLANNING – THE PAST INFORMS THE FUTURE

With respect to business resiliency planning, the past informs the future. Until now, firms have not been faced with a pandemic. What is currently being tested and implemented will undoubtedly form the base case for future disaster planning. How do you deal with staff absences within critical activities, like dealing, without compromising best execution, operational performance or control? Even firms that find value in their dealing function must ensure the same occurs with their back-up arrangements. How do you supervise remote offices and telework arrangements? What are the costs of carrying like-for-like capabilities in terms of desk-top infrastructure in disaster recovery locations or home offices?

These challenges come at a time many firms are trying to reduce fixed costs and streamline activities, not add cost and complexity. Leveraging hyper-scale asset servicers with sufficient depth and breadth of expertise will enable firms to access business resiliency on a variable cost (pay-as-you-go) model, and not one that will impact margins further. This trend towards variable costs aligns with those observed in revenues, as the industry attempts to better align pricing with performance in order to improve fairness and remove asymmetric incentives.

1. DRIVERS OF CHANGE

ECONOMICS HAVE CHANGED, SO MUST THE OPERATION

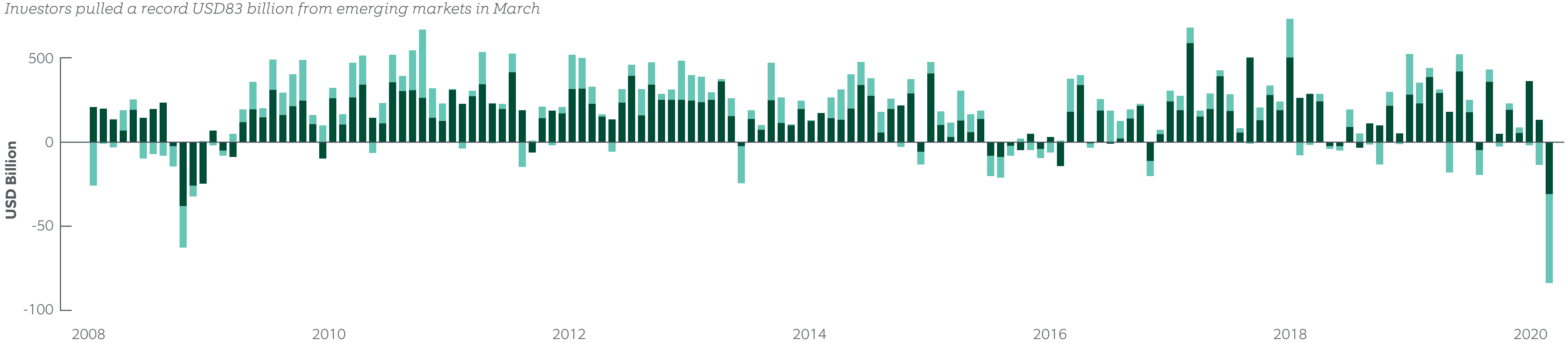
Many observers will reduce the myriad of challenges facing fund management to a single factor: margin pressure. Consequently, their response function will often reflect what's been done in the past: gain scale through increasing the numerator (insourcing or consolidating), decreasing the denominator (cutting fixed costs, automating) or any combination of both. We see these responses being played out in markets through increased deal flow, significant restructurings and increased investment in technology. But what's embedded in this thought process, and why we believe these responses may not deliver the same outcomes as in the past, is the assumption, long proven true, that rising markets will correlate with profitability. In other-words, margin pressure is cyclical and when assets rise, so too will profits. That thought process and the assumptions underlying it are now being tested. Asset management margins remain under pressure **despite** strong markets.

Industry profitability has been waning for some time. For example in 2017, a record year for markets, the incremental margin improvement was only around 1%.[2] When the market fell in 2018, margins correspondingly collapsed. We saw a rebound for assets in 2019, with total AUM growing by 15% to USD89 trillion according to the Boston Consultancy Group (BCG).[3] Yet, even when markets were soaring, active fees continued to decline at a record rate for publicly listed managers in the US[4] and mounting cost pressures lead to a marginal **decrease** in profitability.[3] Worryingly, this occurred **before** the pandemic.

> *If all you have is a hammer, everything looks like a nail.*
>
> ABRAHAM MASLOW

OUTRAGEOUS OUTFLOWS

Investors pulled a record USD83 billion from emerging markets in March



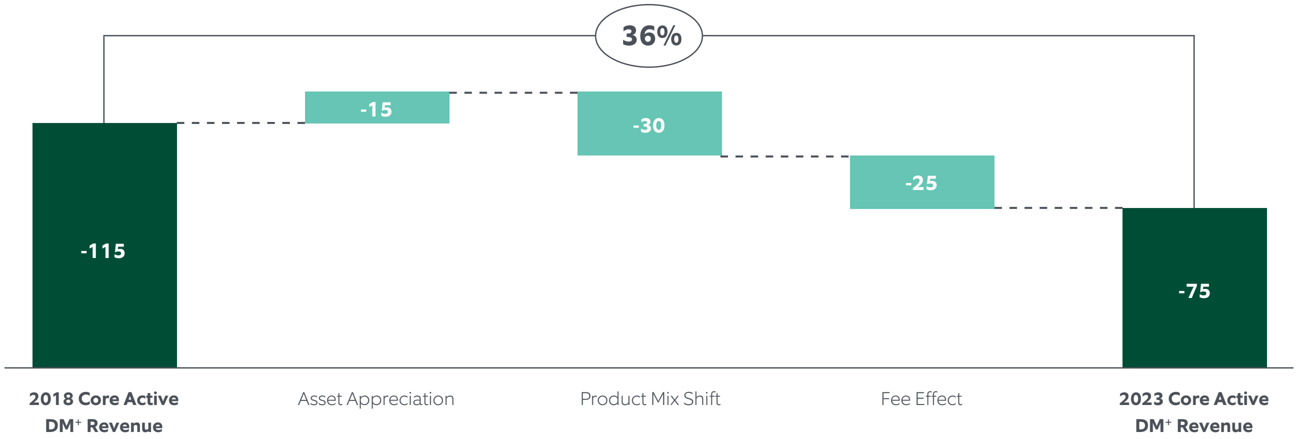
Source: Institute of International Finance

Since the COVID-19 outbreak, asset managers have suffered record withdrawals,[5] and Fitch, the rating agency, expects that traditional asset management firms will lose around a third of their assets under management as a result of the coronavirus pandemic. The ratings agency projected an average decline in assets of between 29.9% and 36.9% for large, publicly traded US firms, due to a combination of declining asset prices, fee pressures, and outflows.[6] It is a perfect storm.

This is consistent with the findings of Oliver Wyman, who expect revenues from active developed market equity funds to fall by -36% by 2024.[7]

REVENUE FROM ACTIVE MANAGERS LIKELY TO FALL BY MORE THAN A THIRD

Compression of traditional active revenue in developed marked (DM), 2018-2023, USD billion



Source: Oliver Wyman

Margins are expected to fall during market corrections. However, they are not expected to fall during a market rally, yet according to Casey Quirk, that is what they did.[8] In other words, the long held assumption that strong market returns correlated with asset manager financial performance, broke down. Strong markets failed to mask the structural drivers underneath. This, we believe, marks a tipping point for the industry.

TIME FOR RADICAL CHANGE

As strong markets have failed to mask the structural drivers underneath, the current cost model may no longer be fit for purpose. As such, it appears the time for tinkering around the edge on cost is over; it's time for a radical re-think of the operating model, as the assumptions that underlie it no longer appear valid. And if economics change, so must operations.

> *It is not the strongest of the species that survives, nor the most intelligent that survives. It is the one that is most adaptable to change.*
>
> CHARLES DARWIN

LOWER AND MORE VARIABLE COSTS

Not only does the industry need to radically adjust its fixed cost base, it appears costs may need to become more variable in order to match trends with revenues. As we discuss in the regulation section below, there is growing pressure to ensure better alignment between investors and asset managers and remove asymmetric incentives. Gone are the days asset managers get paid irrespective of outcomes.

While it's still early days, there appears to be a growing acceptance that alpha is scarce and so should attract a premium, and beta is commoditised and should verge towards marginal costs. This pricing divergence between alpha and beta could be equally framed as between concentrated versus dispersed (or indexed) risk. Traditionally, zero would be the lower bound for beta or indexation, but certain firms have even experimented with negative priced funds.[9] In these scenarios, rebates are offered to grow funds in order to generate alternative, higher margin revenues from the installed base.

One of the industry responses has been to promote the idea of "fulcrum" funds. A fulcrum fund is one where fees rise with returns, and fall to passive levels when they underperform their benchmarks. Several large asset managers offer such products.[10] Meanwhile Westwood Holdings recently launched one of what they call a "Sensible Fees" structure which doesn't attempt to simply remove asymmetry in pay-outs, but to reverse it. Westwood Holdings' clients in this structure only pay fees if they win.[11]

Similar trends are evident in the hedge fund sector. At the core of demands for fee changes is the same "value-for-money" tenet that has become the mantra for active mutual funds. As a consequence, many funds have decided to upend the "two-and-twenty" fee model that's been a fixture for decades to expand, stay competitive, even survive. New structures that better align manager/investor incentives include: waived fixed fees, performance fees paid only when returns hit a key threshold or hurdle rate, higher performance fees in exchange for full loss cover, free access to their internal research, providing for co-investment opportunities on targeted ideas and "1 or 30", a structure developed by consultant Albourne Partners and adopted by a large US public fund in late 2016.

Under this approach, in a good year, fund managers take 30% of returns and no annual fees, while in a bad year, they would still be able to charge a 1% management fee that would be deducted from the following year's performance payout.

This model is gradually gaining wider acceptance. The 2019 JPMorgan Capital Advisory Group survey showed that use of the structure nearly tripled in 2018 to 17% of respondents from 6% in 2017.[12] More recently, Albourne found 63% of managers either already offer or are willing to implement such an arrangement.[13]

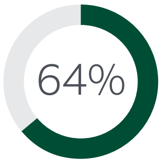
Meanwhile, the Chartered Financial Analyst Society of the UK (CFA UK), the investment membership association, has argued that tiered fees, where managers charge on a sliding scale, are the best way to ensure alignment of interests, and should be introduced on retail funds.[14] Given the growing pressure from investors, consultants, competitors, regulators and even the media, it seems trends towards greater fairness and alignment are here to stay. As revenues become more variable, so too must costs.

> *Asset management is an industry long overdue for disruption. There are currently too many active managers managing too much money. Fixed fees and a lack of real capacity constraints have long incentivised managers to grow assets under management rather than pursue outperformance.*
>
> **PETER KRAUS**
> **CEO, APERTURE INVESTORS**[15]

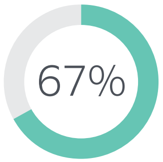
PASSIVE COMPETITION

Another driver of variable costs has been the rise of indexing, which has placed inordinate pressure on active fee premiums. According to Casey Quirk, average active fees for publicly traded US fund managers fell at their **fastest rate on record last year**,[16] suggesting the switch to low-cost passive funds is accelerating. After all, it's mathematically difficult for active managers to outperform a rising market, especially so if they hold cash. However, with recent market volatility, there is growing support for active strategies, which should in theory, perform better in a context where asset volatility rises and correlations fall. The problem is, they haven't. At least they haven't yet…

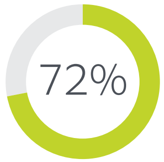
Despite record volatility in March 2020, 64% of domestic US equity funds underperformed the S&P Composite 1500 in the first four months, 67% underperformed in the past two quarters, and 72% have underperformed for the year ending March 2020.[17] It's still early however, and we could yet see a resurgence in performance and in demand for active strategies, which will undoubtedly rally around ESG factors and rising rates (if such were ever to happen).



Underperformed in the first four months



Underperformed in the first two quarters



Underperformed in year ending March 2020

When will it end?

Indexing has grown from humble beginnings. During the Second Wave of outsourcing in 2000, passive funds made up approximately 3% of the market. They now account for more than 50% in the US, according to Morningstar.[18] In the oldest pension market in the world, the Netherlands, passive ownership is at 70% for some pension funds.[19] Could this provide the direction of travel for less mature markets?

The shift to passive is not isolated to equities, but to bond markets as well. According to Greenwich Associates, more than 60% of institutional investors used bond exchange-traded funds (ETFs) in 2019, up from 20% in 2017.[20] Many industry participants expect this trend to accelerate, particularly as investors consider switching from mutual funds to ETFs to avoid capital gains tax.[21] BlackRock, one of the largest providers of index products, suggests it took 17 years for bond ETF assets under management to reach USD1 trillion globally, but it could hit USD2 trillion by 2024.[20]

Needless to say, the pressure on active fees from passive competition looks likely to continue. It also pays to understand some of the secular dynamics at play, for these may yet dominate even if faced with factors that should favour more active strategies.

60%+

INSTITUTIONAL INVESTORS USED BOND ETFS IN 2019

$2T

PROJECTED BOND ETF AUM BY 2024[20]

ECONOMICS

The concentration of profitability in the economy has increased to a small number of very large technology companies, meaning that if an active manager fails to hold these, chances are they will underperform the indices these firms dominate. Compounding matters, the number of quoted US companies has fallen by half over the past 20 years,[22] despite growth in funds, leading to greater crowding and concentration risks.

In contrast, the number of private companies has increased as companies are staying private for longer and funding has improved with the growth in private equity. This trend looks likely to continue as alternatives are expected to capture approximately 50% of industry revenues by 2024. This appears to be mostly at the expense of active equity which is expected to fall to 21% market share, from 24% today.[23]

> Investment "knowledge" is no longer the exclusive domain of the privileged few, but has been democratised.

FAIRNESS AND LEVELLING THE PLAYING FIELD

One of the aims of regulation is to promote fairness. A number of initiatives are bringing about a better alignment of incentives within the investment industry, and democratising fund structures, but they do put further obligations on asset managers, expedite fee compression and/or promote further switching into low-fee passive products.

In the UK, for example, the Financial Conduct Authority (FCA) requires authorised fund managers (AFMs) to have two, or at least 25% of their boards made up of independent directors, and fund managers are required to assess the value for money of each of their funds. They must provide an annual assessment and report publicly on it, taking corrective measures if the fund does not provide value for money.[24]

Meanwhile, the European Securities and Markets Authority (EMSA) has revealed that EU retail investors pay up to 30% of their returns on fund fees, which is 40% more than institutional investors do. ESMA's research also revealed that, net of fees, actively managed UCITS funds failed to outperform passive and ETF UCITS funds.[25]

In the US, mutual funds registered under the Investment Company Act of 1940 are required to publish the factors they considered when entering into or renewing advisory contracts, including factors related to value for money.[26]

INFORMATION TECHNOLOGY (IT)

Finally, and perhaps the most pernicious, is the way technology has made information arbitrage less of an advantage. Having an information edge by being **first** or having better **access to information** – once the bedrock of active managers – is difficult when machines can process more information more often is ubiquitous. Investment "knowledge" is no longer the exclusive domain of a privileged few, but has been democratised. More people than ever before can access this data and knowledge, often for free and without delay. As such, the ability to have an information edge has been eroded, making life difficult for those who rely on it to express an investment opinion.

2. STRUCTURAL DRIVERS: SHAPING AN OPTIMAL STATE

Outsourcing is not a new concept. A First Wave saw investment firms shift their custody operations to independent providers in the 1990s, during another time of margin pressure and focus on costs. At the turn of the century, we saw the Second Wave of outsourcing, when managers began to outsource their middle office functions, not only as a cost-cutting exercise, but also to meet challenges posed by the increasing range and complexity of global investible assets.[1]

While margins play a central role in this third outsourcing wave, there are other underlying structural drivers that are critical to the increased trend in outsourcing.[1]

> *Software is eating the world.*
>
> MARK ANDREESEN
> SOFTWARE ENGINEER AND VENTURE CAPITALIST

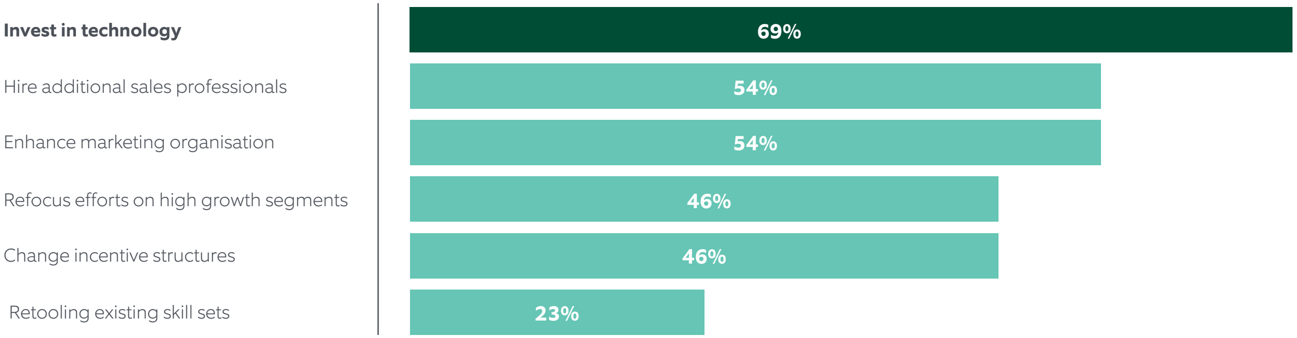
TECHNOLOGICAL DRIVERS

The economic and competitive landscape in asset management has been evolving over many years but, in combination with the accelerating effect of recent events, it is the trifecta of technological development, evolving regulation and a renewed, more broad focus on governance that is at the heart of the Third Wave of outsourcing. These drivers have helped shift outsourced trading from a cost management tool to an optimal state, one which supports greater efficiency, scalability and resiliency.

Technological advances bring innovation and efficiencies, but also increased spending. The costs associated with technology spend are already approximately 15-20% of the industry's cost base.[2] These look likely to increase given the importance most funds place on the need to invest in technology. Survey results by Casey Quirk reveal more than two thirds of funds view technology as their most important area for organic growth.[27] And as we observed with assets under management, when it comes to **data under management**, size and scale clearly matter.

MOST IMPORTANT GOAL FOR ORGANIC GROWTH

US, European Asset Managers, 2019

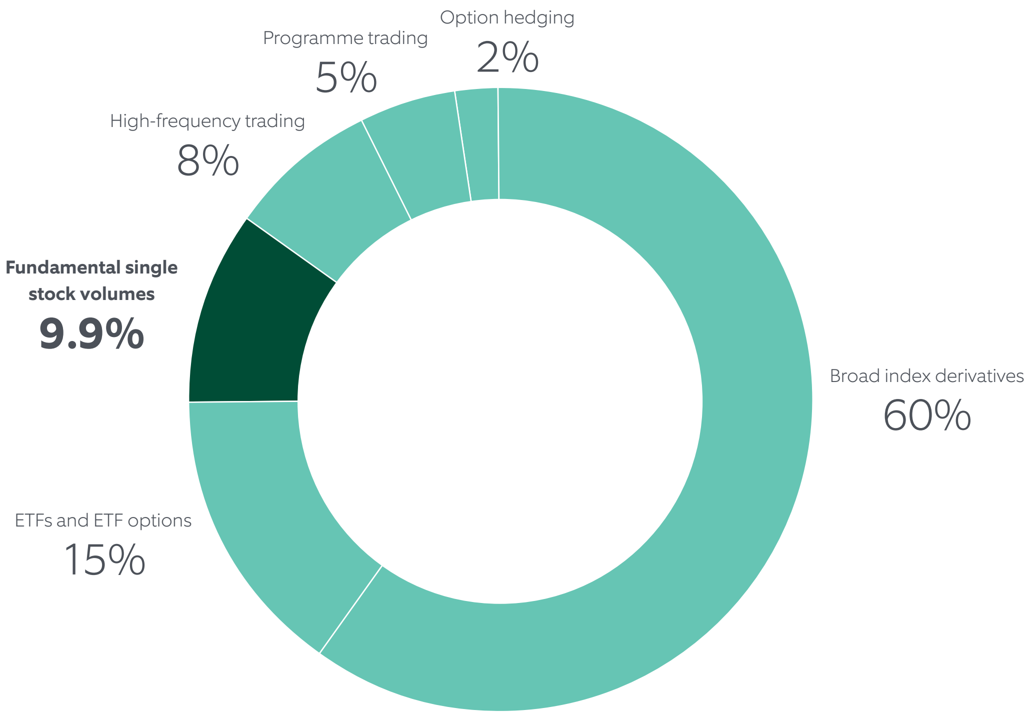


Source: Casey Quick Distribution Benchmarking

While technology can bring innovation and efficiencies, it can also be disruptive. For example, it's principally responsible for displacing the traditional role of the relationship dealer, and is largely to blame for why many firms now struggle to evidence out the value of their dealing functions. Digitisation has substantially decreased the need for physical traders, and what was still being done by humans may now be over thanks to COVID-19.[28] The types of trades have changed too, with more quant-driven, high frequency trades than in the past. Indeed, 80% of daily moves of US stocks are now machine or algo-led.[29] JPMorgan estimates that fundamental discretionary traders account for only about 10% of trading volume.[30] "Sniping races" – where high frequency traders make small profits by taking advantage of the microseconds before stock prices realign following a correlated instrument price shift – are now common. The average FTSE 100 stock is subjected to around 537 latency arbitrage races each day, or one every minute according to the FCA. These races account for a significant 22% of average daily trading volume.[31]

STOCKPICKERS FEEL LIKE AN ENDANGERED SPECIES

Share of total equity trading



Source: JP Morgan estimate

In addition to high frequency trading, technology has enabled increasing numbers of parent/child orders, where a large block of shares is broken into smaller parts when being executed.

As a consequence, trading volumes on traditional exchanges have declined over the years. Traditional exchange volume accounted for 36% of all equities traded in Europe in 2019 according to Rosenblatt Securities, down from 42% in 2018 and 44% in 2017.[32] In thinner markets, the need to move off lit exchanges increases, as many fear showing their hand – the key is to fill orders while minimalising market impact and signalling risk.

Smaller firms that don't have the balance sheet to build their own algorithms, or access to the growing complexity of fragmented venues, will face punitively high costs for accessing the market unless they outsource. Moreover, as remote work becomes more common, security needs to be the first principle of any digital tool. With this in mind, an asset servicing partner offers managers the benefit of plugging into an established, secure and maintained infrastructure, rather than building their own security operations from the ground up. Connecting to platform solutions enables firms to "buy-scale", plug-in greater reach, expertise and technology and removes the in-built advantage of their larger peers, allowing them to compete on alpha, not on cost. This should support a thriving industry.

REGULATION

The scale of regulation the industry faces is unprecedented and is largely in response to the trust that was lost during the 2008 Global Financial Crisis. While transparency, fairness and control are concepts that have been embodied in a range of regulations, most notably in Europe, their reach is far wider than simply where those rules are enacted. For example, MIFID II attempts to replace the opaque way asset managers once paid for research – bundled with dealing services – replacing it with transparency and evidence. By providing full disclosure, customers should be better placed to compare and make more informed choices as to their preferred provider. Despite it being a European regulation, a survey conducted by Liquidnet found that 70% of respondents in the US have chosen to implement a global unbundling policy for better operational management, for example. That has grown from the 50% the study revealed two years earlier.[33]

While there is pressure to loosen the "unbundling rules" to promote greater liquidity and market access, particular from Franco-German regulators, it looks likely that softer restrictions will only apply to fixed income markets and emerging companies with small market capitalisations (i.e. under USD1 billion).[34] For bigger companies, and for regions beyond Europe, current trends may still apply. Greater transparency is, after all, required to improve trust. Exceptions to this, and the way the industry applies these exceptions will need to be considered with this in mind. Moreover, it is still unclear whether there is a direct link between research spend and alpha generation. Some have argued that lower research spend by European managers is the key reason for their under-performance versus US peers.[35]

Great transparency is, after all, required to improve trust.

"

Markets are imperfect. So you need regulation, knowing that the regulators are also human.

GEORGE SOROS

However, to argue for such causality ignores other variables such as style factors and regional biases. European managers (with a home bias) will not have as much exposure, naturally, to US growth or tech, which has been the dominant style factor for most of the decade. European managers do however, outperform in their home market, despite lower research budgets. What's perhaps the bigger and more existential question is why do both regions underperform passives?

Finally, it's too early to say whether these softer rules will benefit the investment managers themselves. Smaller managers may still struggle for access against their larger peers, which seems to run counter to the idea of a competitive and thriving industry. Only time will tell how things play out here and there will undoubtedly be unintended consequences, like there are with many other new regulations. But one thing is clear; with exceptions comes complexity. And with complexity come costs.

A natural consequence of firms focusing on and investing in core competences, especially in the context of ever-increasing importance of good governance, is that they could begin to in-source more of the research function. For many, this could represent a far more efficient use of resources, providing greater transparency and control over the research function. It could be funded by cost-savings via outsourcing non-core functions, like dealing.

EVIDENCE-BASED DECISION-MAKING

As regulators require greater transparency in order to restore trust, and as investors become more digitally conversant (with the fastest growing cohort being digital natives) decision-making is becoming more evidenced-based. The presumption now is that decisions should be based on full information, and not beliefs or preconceptions, for these often blind us to accepting reality, change, or new ideas. The difficulty, as economist John Maynard Keynes put it, "lies not in the new ideas, but in escaping from the old ones". Assumptions can lead to bad outcomes and poor returns.

What does this mean for the activity of dealing?

The assumption that the activity of dealing delivers value to the firm, and to the investment process, must now be evidenced. Sentiment aside, it's no longer acceptable for a firm to in-house the dealing function if they can't demonstrate their reason for doing so. This is especially true in light of a number of service providers who may provide lower cost, and often better dealing services, and can quantify through lower brokerage fees and independent transaction cost analysis. While there will be instances the dealing activity, and those performing it, still add value to an investment strategy, for many others this is no longer the case.

Additionally, as interest and investment in ESG strategies continues to rise, the need to evidence effective decision-making will be reinforced. Governance is not something only regulators care for. Boards and Trustees are expected to implement good stewardship standards, and to ensure that investment strategies consider ESG as an area of concern. If savers demand their money is put into companies with good governance, then the guardians of those savings, the asset managers, must be able to display strong good governance at every stage of their operational process – including the trading desk.

It's no longer acceptable for a firm to in-house the dealing function if they can't demonstrate their reason for doing so.

“

The difficulty lies not in the new ideas, but in escaping from the old ones.

JOHN MAYNARD KEYNES

CONTROL AND OPERATIONAL RESILIENCY

Operational resiliency has been a focus for the industry for some time. Many asset managers were already questioning how to deal with staff absences within critical activities, without compromising operational performance or control. For example, what if the head dealer is off sick, is the cover dealer appropriate to discharge the firm's obligations of best execution and reporting? If not, what are the costs to remedy, hire or retrain?

These issues are compounded when there is a duplication of roles, for example when the portfolio manager is also the dealer. Being such separate and distinct roles, many have concluded the days of improvised practices have past. For most it seems the portfolio manager's role is to formulate strategy, not implement it. It seems likely therefore, these roles will be split in time, adding more cost and complexity to those wishing to in-house these functions.

Another area of concern relates to offshore transactions and whether a fund can maintain sufficient oversight and control of orders placed in a remote market overnight. Does the broker they use have their best interests in mind, and is there sufficient oversight if there is no pass-the-book in-house control function?

These are just some of the issues firms were focused on before the events of this year. Post COVID-19 they become even more of a focus, especially as they relate to business continuity and disaster recovery. The model that became the accepted practice adopted across the globe after 9/11 does not work when a novel coronavirus comes along and imposes social distancing. Where remote offices or work from home (WFH) was once considered an auxiliary function, it's now of primary importance.

What that means for large disaster recovery sites remains to be seen but, as few generals wish to fight the last war, it seems logical that what we are seeing now – this widespread implementation of decentralised working locations – will form the base-case for future scenario planning.

Logically, this means replicating business as usual (BAU) conditions in remote settings, even for some critical functions like dealing. Dealers will need to be able to replicate their physical desk-top set-ups to prevent latency, they must have seamless communication, and be able to access all their systems remotely. The technology enabling this will need added security, all activities will need suitable surveillance and recording and the oversight function must extend to remote locations.

Now, these challenges will bring more cost and complexity at a time many are trying to lower fixed costs and streamline activities. These firms will have a choice – to invest more in their internal operations or outsource the activity to an "appropriate third-party" and be responsible for the oversight of that relationship.

Seen through this lens, outsourced trading evolves from something that is simply a defensive measure to cut costs to a more proactive one, which not only improves margin dynamics by enabling cost-contained growth but by strengthening operational resiliency and control functions.

Does the broker they use have their best interests in mind, and is there sufficient oversight if there is no pass-the-book in-house control function?

ACHIEVING THE OPTIMAL STATE

Asset managers are now re-thinking their assumptions, faced with a myriad of challenges around:

- GOVERNANCE
- COMPLIANCE
- TECHNOLOGY
- DEMOGRAPHICS
- REGULATION
- COMPETITION

We believe that all these factors will be hugely transformational, and continue to accelerate the adoption of outsourcing. But not all will outsource. What is optimal, at least from a governance perspective, is still, arguably, to own and control the direct and back-up resources internally. However, these costs can be prohibitive for all but the very large. For sub-scale funds, outsourcing the activity to an appropriate vendor and being responsible for the oversight of that relationship becomes **their** optimal state.

What's **appropriate** in this sense will depend on a number of factors. But at the very least the vendor chosen should have no conflicts, aligned interests, unique liquidity, significant market access, and expertise in **all** areas the firm trades in. That, and they must be a safe and secure counter-party with robust business continuity plans. This latter point is critical, for firms cannot outsource responsibility and must rely on the security and business continuity planning (BCP) of their vendor in terms of ensuring their own operational resiliency.

THE CASE FOR OUTSOURCING

Let's start with who doesn't need to outsource. Not every fund manager needs to outsource, especially not if:

1. They are delivering sustainable alpha, and/or;
2. They gain value from their dealing function (and this value can be clearly evidenced), and/or;
3. They are of a sufficient size and scale to control the dealing function (people and technology) internally.

Firms that should consider outsourcing are those where:

1. The value proposition from dealing is less obvious.
2. They may not have sufficient reach, scale or expertise to deliver optimal client outcomes.
3. Building comprehensive control and oversight models are proving to be challenging.

Future trends are likely to disrupt their operating models.

CHALLENGING THE STIGMAS

Outsourcing is generally perceived as a recessionary business. It's about cost savings in reaction to the burning platform or firms who are sub-scale. As a consequence, it sometimes attracts bad press; it's associated with the idea of redundancy and that it displaces relationships that have taken years to build. With regard to front office outsourcing however, that stigma is being challenged and indeed disproven.

It's recessionary

Westwood Holdings in the US recently announced their decision to outsource trading. While cost savings were cited, their main motivations were to position their business for future growth. They connected the evolution of technology to that of trading, and see "Trading as a Service" as the best way to future proof operations, streamline efficiencies and enhance returns. They link trading to their investment in technology and see it as a "continuation of that journey" to become "a more efficient and cutting-edge technology firm".[36] Unlike previous technology investments, this one comes with savings.

While outsourced trading **can** address the need for immediate and material cost savings, it comes with the potential to position firms for a more optimal, future state. Looked at in these terms, it can be presented as a positive, showing firms are looking forward to growth and sending a reassuring message to all stakeholders at a time of uncertainty.

> *We've been researching the outsourcing of trading for the past six months and recently made the decision to move forward with this project.*
>
> *We will move to an outsourced trading model later this summer and expect to save more than USD1 million per year, beginning in 2021.*
>
> *We will continue to utlise technology to define our future state to be more efficient wherever possible.*[36]
>
> **BRIAN CASEY**
> **PRESIDENT AND CEO,**
> **WESTWOOD HOLDINGS**

It's only for small firms or start-ups

While smaller firms and start-ups do of course benefit, the question as to what is the right size has evolved. COVID-19 may have had a role to play here as it presented firms with an opportunity to completely re-set and redesign their operations from the perspective of optimal future state. In this regard, many firms, even very large ones, looked at all their operations and asked whether they added value, or not. And if they didn't, they were a cost, and so outsourcing became one factor to consider. When looking at the dealing activity, firms are asking whether the activity itself adds value to the investment decision-making process. For many, it's become hard to say it has, and even harder to evidence. As such, many are turning to the hyper-scale asset servicers which often perform these activities better and cheaper than if they were kept in-house. Some global investors, for example, feel they have sufficient capacity in domestic markets but maybe lack scale or expertise in their overnight desks so to produce the best client outcomes. As such, co-sourcing to supplement their domestic dealing is a growing trend, even for very large managers. It's no longer simply a question of scale, but increasingly one of what's likely to produce the best outcome.

People will lose their jobs

While many firms conclude they get little value from the activity of dealing, they often find they still get value from the people performing those activities, the dealers themselves. In this sense, talent is not being displaced so much as being re-tooled. For example, the head of dealing might find their role is redundant, but then find themselves in another role, as head of dealing oversight. For who better to have in that role but someone who knows it intimately? We believe this will be seen positively by the regulator from a control perspective, by managers from a risk perspective and by owners from a profit and loss perspective.

Losing relationships and connectivity

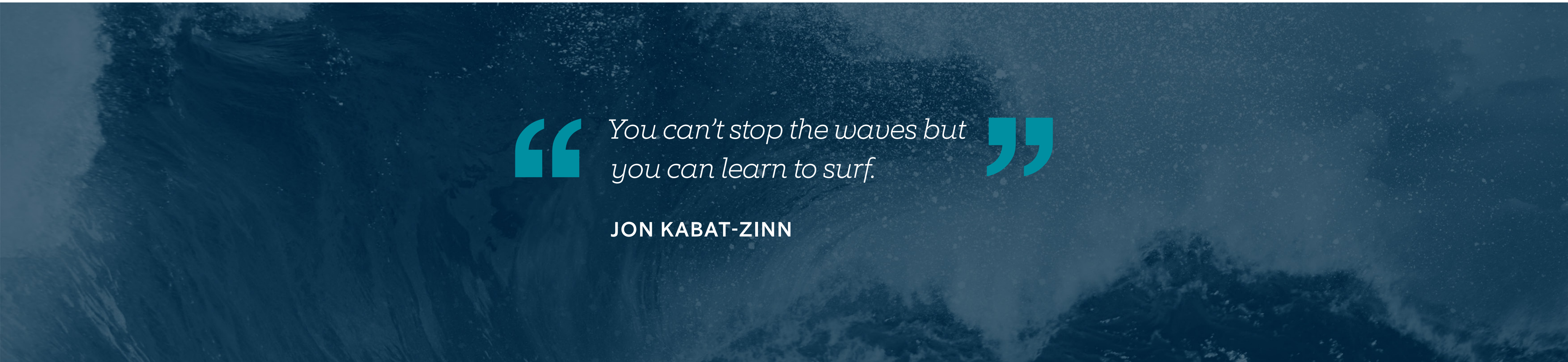
There is a natural tendency for firms to feel they are losing something when they outsource a critical function, like dealing. Many fear the years spent building relationships, know-how and expertise when dealing in particular markets or instruments could be lost, which in turn might negatively impact client outcomes. Many outsourcers are sensitive to this, and so work hard to show clients that far from displacing this connectivity, they augment and often enhance their relationship to the street. This is achieved by clients leveraging global teams of highly experienced traders, many with buy-side experience, and with a broad array of relationships already well established. Added comfort comes from Trade Cost Analysis (TCA) that can measure trading performance.

3. THE FOURTH WAVE

INTEGRATING THE WHOLE OFFICE AND THE FOURTH WAVE

Recently we have observed a growing number of clients wanting to outsource not just back, middle and front office functions, but all post-investment-decision functions to a single (hyper-scale) vendor who can do everything, everywhere. Once the investment manager has come up with a trade idea, and it has passed all required compliance checks, an instruction is sent electronically to the trade desk for execution. From that point onwards, all downstream functions – trade execution, matching, settlement, fund accounting, investment book of record (IBOR), reconciliations and reporting – will be carried out by a single provider of those services. This is likely to lead to the emergence of Whole Office or Platform Solutions outsourcing. In this sense, the investment manager keeps control of the decision-making process, and its intellectual property, whereas all highly capital intensive activities are outsourced to a hyper-scale provider of services. Until now this has not been possible, but the emergence of large, integrated asset servicing specialists that can provide full front-to-back solutions, is helping to increase adoption and we would expect this to also become commonplace in time.

Because the industry is continuously evolving, as the Third Wave becomes increasing prevalent, asset managers will begin to position themselves for the Fourth Wave. We believe the Fourth Wave will focus on alpha – not the decision-making process itself, but on tools to improve and/or measure that process. We expect to see platform providers creating services that allow smaller funds to buy into scale and compete on alpha, not cost. These platform providers will focus on the effective use of data and technology, delivering high-value-services to an installed base – driving operational and investment alpha through the provision of investment tools to enable better data measurement, surveillance, risk management or behavioural analytics. Looking to the future, outsourcing will continue to be key factor for many players as the industry evolves even further.



EMBARKING ON THE NEW NORMAL

A recent survey conducted by Northern Trust of 300 heads of investment operations from global asset management firms, with assets ranging from USD10 billion to USD500 billion, reveals just how quickly operating models are shifting. When asked to express their thoughts on outsourced trading, 85% of respondents said that they were already outsourcing, or were interested in doing so.[37]

But as outsourced trading becomes more normal, there are other considerations. For example, some funds might want to outsource only certain components of their operations, or their international trading book of business only, while retaining their domestic teams. Others may wish to keep their internal functions but outsource cover-dealing for enhanced resiliency. These asset managers would need to ensure that they work with a counterparty who could provide flexible solutions and a modular approach. Any provider must be able to offer seamless integration, and the potential to integrate with other services and functions.

COVID-19 has brought counterparty risk to the forefront in a way that hasn't been seen since the Global Financial Crisis. As with every crisis, there was a flight to quality. More than ever, asset managers need to know that they are working with a well-capitalised outsourced provider with depth of experience and expertise, one that has no conflicts of interest. The asset servicing partner has to work to reduce complexity and cost, not add to it. Moreover, in times of outsized transactional volume like we have just seen, it's important the partner be staffed for their busiest days. This will favour larger partners with enough scale to carry excess capacity to ensure there are no service breaks, even in periods like that witnessed in March 2020.

Finally, the partner must provide transparency, and demonstrate a clear alignment of interests with its asset manager or asset owner partner. In the optimal state, counterparties must be able to bring their wide depth of expertise and experience to all areas. But, when they haven't got expertise in-house, they must be able to fill the gaps by using the expertise of their clients, or finding it elsewhere through specialist providers. They must be able to collaborate, and innovate.

> *So the world has become connected technologically, trading is done technologically, and [outsourced trading] is simply the next rung on the ladder for us in terms of our evolution to becoming a more efficient and cutting edge technological firm.*[36]
>
> **BRIAN CASEY**
> **PRESIDENT AND CEO,**
> **WESTWOOD HOLDINGS**

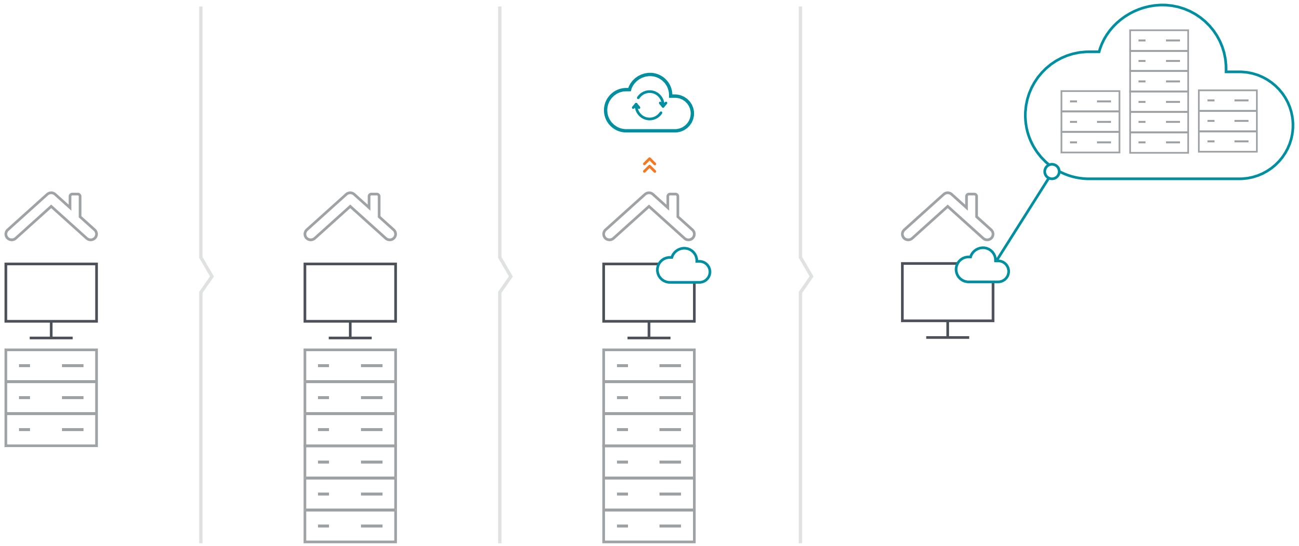
MISSING THE FUTURE

It is hard to believe it now, but it was Blockbuster that first considered streaming video over the internet. Kodak was the first company to invent a digital camera and Nokia once held more than 40% of the global mobile phone market. Despite being visionaries in many ways, these companies all failed because they couldn't (or wouldn't) adapt to the change occurring around them, either due to ignorance or to fear of cannibalising their existing businesses.

The growth of outsourced trading is similar to the growth of cloud computing in the 1990s. At first, the notion of cloud computing was a difficult concept for many people. There were concerns about security, about sharing infrastructure with third party providers, and about losing control. But as technology developed, it became increasingly obvious that cloud-based models would provide scale, reduce complexity, be cost effective, and efficient. In the same way, hyper-scale operational solutions in asset management will provide higher levels of productivity, efficiency, flexibility, resiliency and lower operational costs. Trading in this sense becomes a service, much like Software as a Service. Instead of carrying the cost and complexity of an in-house solution, firms move to an outsourced one, free up capital to invest in growth (or research) and move costs from a fixed to a variable basis in line with the direction of travel for revenues.

> *Lots of companies don't succeed over time. What do they fundamentally do wrong? They usually miss the future. I try to focus on that. What is the future really going to be? And how do we create it?*
>
> LARRY PAGE
> CO-FOUNDER, GOOGLE

THE EVOLUTION OF CLOUD COMPUTING



CHANGING TIMES

The asset management industry is always evolving, and recently, COVID-19 has accelerated some of that evolution. But, even as we embrace a New Normal, it's important to recognise that "normal" is not a constant state in the investment industry. The Third Wave of outsourcing has become increasingly prevalent, moving from being perceived as a niche offering, to one that is mainstream, with the pace of adoption, and the diversity of managers and asset owners outsourcing their dealing desks broadening. Margin pressure will always be an important driver, but so will the requirement for good governance, the need for operational resilience, the demand for technological innovation, and the need to build efficiencies. The Third Wave of outsourcing is increasingly being seen as a proactive action, and not a recessionary or defensive one, and it is here to stay. The "optimal state" is just a better way of doing things. Even as the Third Wave is becoming widely adopted, further evolution will see the consideration of a Fourth Wave, and yet more evolution and innovation in asset management. The times may be changing, but that is the one constant fund managers can all be certain of. Nothing stays the same.

> *Change is inevitable. Growth is optional.*
>
> **JOHN C MAXWELL**

OUTSOURCED TRADING – A ROAD MAP

COSTS

Does the asset manager owner know what its implementation costs are? How are they being measured? Are they transparent, or opaque? How might they change in the future?

- What is the cost of dealing?
- What is the cost of execution?
- What is the cost of research?
- What is the cost of compliance?
- What are the headcount costs?
- What are the ongoing technology costs?
- Are there opportunity costs that occur when the trading function is in-house?
- How do all these costs compare to an outsourced solution?

GOVERNANCE

Asset managers and owners should also consider their governance models, and whether they are fit for purpose:

- Are control and oversight models comprehensive?
- Do they meet obligations under local regulations?
- Will they meet obligations for international best practice, especially as international standards become widely adopted globally?
- Are they part of an integrated ESG framework?
- Does the dealing function meet governance requirements in terms of key person risk, duplicate roles, and overnight orders?

OPERATIONAL RESILIENCE

Asset managers and owners should consider whether their systems will prove to be robust despite margin pressures, economic model shifts, and regulatory obligations:

- Is there enough transparency, not just on operational governance, but also on evidenced-based decision-making, data measurement and analytics?
- Will the fund remain operationally resilient in the future?
- Can remote working/working from home be effectively facilitated?
- Are economies of scale being suitably leveraged?

REVENUE

As there is growing pressure from regulators for greater fairness and revision of fee structures, revenues will become increasingly variable, heightening the requirement for variable costs and "pay as you use" systems. Asset managers should consider:

- How fee structures might change.
- How competition might affect business models.
- How changing market structure might affect business models.

REGULATION

As regulation shifts globally, and is continually adapted, and implemented, asset managers should consider:

- Whether regulatory requirements are being met.
- Whether future regulatory requirements are likely to be met.

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