

# Outsourcing

PERSPECTIVES & OPPORTUNITIES

A JOINT REPORT BY



Global Custodian

## Introduction



Outsourcing of post-trade processes has become a mainstay of the global securities industry, an opportunity for custodians to deepen their client relationships and for fund managers to focus on core competencies.

Shifting regulatory and market practice requirements, client demands for transparency and cost-reduction, and the need to increase performance in challenging markets requires constant juggling of priorities of the fund manager technology investment list. The rise of outsourcing has helped to tackle these problem areas. But is it a suitable long-term business model?

In lieu of inventing an outsourcing crystal ball, Omgeo has teamed up with *Global Custodian* magazine to examine and compare market perspectives of both the outsourcing providers and their fund manager clients. We present the alignments and discrepancies here as assistance in building a more comprehensive understanding of outsourcing as practiced today.

It is our hope that the following summary of results will be useful to all outsourcing participants—and prospects—in evaluating opportunities, challenges, benefits, and risks, in order to foster increased operational efficiency across the industry.

Regards,

A handwritten signature in black ink, appearing to read 'Adam Bryan', with a long horizontal flourish extending to the right.

Adam Bryan  
President and CEO, Omgeo

### Methodology

During June 2005, *Global Custodian* polled fund managers and global custodians via Web-based questionnaires about the industry perceptions of third-party outsourcing. The directionally significant results contained herein are based on responses from 18 fund managers (11% of whom currently have no outsourcing relationship) and 22 global custodians from around the world.

## Executive Summary

Given the critical focus that fund managers must apply to increasing client returns, they may have much to gain by farming out some of their downstream processes to third-party providers. Global custodians are stepping up, leveraging their economies of scale to offer a smorgasbord of outsourcing services. The results of this survey show a continuing business opportunity for outsourcing providers and the need for greater understanding between fund managers and custodians to enhance and expand outsourcing relationships.

- Overall, the future potential for outsourcing service providers focusing on an array of processes is positive. Nearly two-thirds of the fund managers surveyed (65%) would consider outsourcing SSI database maintenance to a third-party provider, followed by interest in outsourcing trade confirmations (59%), transition management (53%) performance measurement and attribution (47%), reconciliations (44%) and fails management (44%). Good growth opportunities exist for custodians not currently offering these services to enter this market.
- Outsourcing service price and value perceptions are not aligned. Thirty-three percent of fund managers surveyed considered the current model's pricing and value unattractive. Only 8% of providers concurred. The groups are more closely aligned on concerns about sustainability; nearly half of each group believes the current model won't work for providers in the long term.
- Both groups recognize that when deciding whether to outsource, fund managers are most motivated by the opportunities to reduce technology costs and to focus on core competency and are most concerned about losing control and the competence of the outsourcing provider.
- Many custodian respondents did not correctly identify what gives certain providers competitive edge—most said primarily cost (39%), then flexibility (35%). However consumers were overwhelmingly looking for flexibility (44%) and specialization in securities services (39%). Cost was tops for only 17% of fund managers.
- Providers are perhaps overly aspirational about the collaborative nature of their relationships. Eighty-three percent of global custodians characterize the relationship as a genuine partnership, while half of all fund managers see it as merely customer/vendor. Indeed, only 67% of fund managers felt comfortable that their outsourcing providers understood the majority of their business.
- On the whole, revenues from outsourcing are on the rise over the past five years, and pass-along costs are down. Ninety percent of the surveyed custodians said revenue on securities lending has been up, as did 79% of fund managers. On cash management, 73% of custodians reported higher revenues, although 86% of fund managers report a decrease, tracking interest rates over the same time period.
- Surveyed fund managers demonstrated commitment to automation. The vast majority reported that 90+% of their trade instructions were at least partially automated. Thirty-three percent of the respondents boasted full automation of 75% to 100% of their trade instructions. This attention to automation could pay off handsomely; the majority claim that repaired equity trades are two to three times as costly, and fixed income trades three to four times as costly, as automated trades.

# Fund Manager Perspective

**EVALUATING** whether or not to outsource some processes is an important decision for a fund manager, and one that nearly everyone seems to be evaluating. Of 19 potential processes to outsource—from investment analytics to SSI maintenance—some survey respondents indicated a willingness to consider outsourcing every single one. However, just as many respondents were inclined not to outsource any of them. Just what causes a fund manager to make the outsourcing leap, and how do they decide which provider is best qualified to catch them?

Business priorities are informing fund managers' decisions. Sixty-two percent of fund managers placed their firm's highest priority on meeting demands from their clients. Close behind were the pressures of improving investment performance and meeting regulators' demands, hardly surprising in today's atmosphere of increasing transparency and regulatory requirements.

Ongoing cost of technology is by far the leading motivator to outsource. Sixty-three percent of fund managers rated technology costs as either their first or second most important consideration, followed by the need to focus on core competence: increasing investment performance. Factors causing pause include loss of control and lack of confidence in providers. (Fifty-five percent of fund managers rated each as one of the top two reasons not to outsource.)

While cost factors highly into the decision whether to outsource, cost is clearly not the driving factor in deciding which provider to employ. Forty-four percent of the respondents tagged flexibility as the most important characteristic, followed by specialization in securities services (29%).

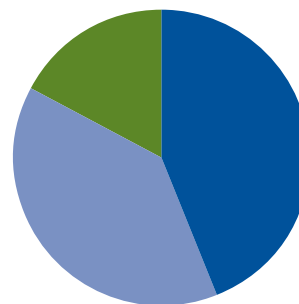
Given the weight put on flexibility and specialization, most providers appear to be rising to the challenge. A large majority of fund managers (72%) said their outsourcing provider was either prepared to adapt some services to their needs or willing/able to adapt all services to their needs. However, only 67% of fund managers said that outsourcing providers understand most aspects of their business, and 11% reported having providers who barely understand their business at all!

Perhaps lack of complete understanding is fueling a difference in relationship depth perception. In sharp contrast to the large majority of outsourcing providers who perceive themselves as partners to their fund management clients, over 50% of fund managers characterized these relationships as customer/vendor. Only 33% see providers as genuine partners. And when asked to score the quality of service they receive from providers, fund managers gave predominantly middle-of-the-road ratings on nearly every service area—from settlement and custody to transfer agency, fund accounting and corporate actions.

In sharp contrast to the large majority of outsourcing providers who perceive themselves as partners to their fund management clients, over 50% of fund managers characterized these relationships as customer/vendor.

## Fund managers' most important factors in choosing an outsourcing provider

● Flexibility	44%
● Specialization in securities services	39%
● Cost	17%
● Existing relationship	0%
● Access to investment banking products	0%
● Access to credit	0%



Cost may be an issue too. Thirty-three percent of fund managers surveyed describe current pricing and value as unattractive. And while the remaining majority finds it attractive, half of them are concerned that it's unsustainable for providers in the long term.

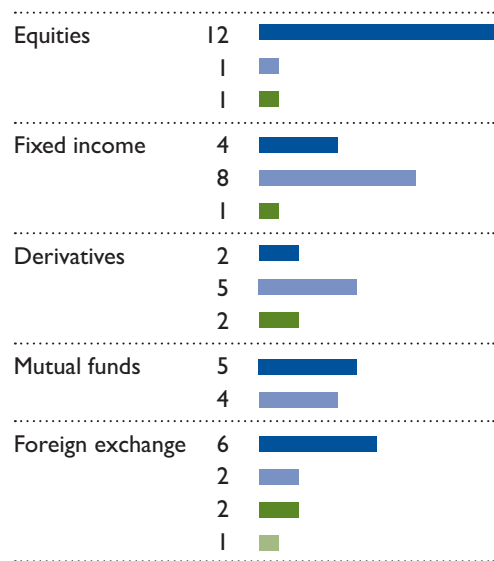
If fund managers aren't thrilled with the level of service, cost, or partnership with their provider, why not plan an exit strategy? Some are, but plenty of challenges stand in the way. Forty-four percent of fund managers said transition costs/resources were the largest obstacle to changing from one provider to another, followed by a lack of standardized interfaces (22%), integration of systems (17%), and operational risk (17%). Notably, only two respondents indicated that they received any transition management service from their provider.

While the fund managers we surveyed may seem to be cool on their outsourcing service level ratings, they are definitely warming to the automation of trade instructions. The vast majority reported no more than 10% of their trade instructions were non-automated or partially automated with manual repair. Thirty-three percent of the respondents boasted full automation of 75-100% of their trade instructions.

This attention to automation could pay off handsomely. Fund managers may see both savings and revenue potential in greater automation. Not surprising, as the cost of repairing failed trades really adds up: The majority found that repaired equity trades are two to three times as costly, and fixed income trades three to four times as costly, as automated trades. In addition, in an era of increased transparency and unraveling soft-dollar arrangements, operational efficiency is primed to be a competitive advantage.

### Estimation of additional cost per trade when repairing failed trades as opposed to processing automated trades

- two to three times as costly
- three to four times as costly
- four to five times as costly
- more than five times as costly



## Global Custodian Perspective

**FUND MANAGERS** have indicated their eagerness to outsource, and global custodians are doing their part to make their offerings attractive. . . maybe too attractive. Nearly all the custodians surveyed (92%) believe the current pricing and value structure is attractive to their clients. However, nearly half of them (44%) consider this to be unsustainable in the long term. This situation does not seem likely to be alleviated soon, particularly as these providers believe the most critical factors on which they must be competitive to be cost (39%) and expensive-to-maintain flexibility (35%). As voiced in other forums, client demands and competitive pressures seem to be placing a squeeze on providers' margins.

Perhaps this helps to explain the intent of global custodians to place greater emphasis on the relationship management aspect of their outsourcing role. The vast majority of respondents (83%) characterized

the nature of their outsourcing relationships as genuine partnerships, and nearly the same number (78%) said that they understood most aspects of their clients' businesses. Global custodians clearly see that the greatest value of outsourcing is in allowing fund managers to focus on their core competence—namely, managing funds—and reduce investment in technology.

This understanding was further evident in that global custodians correctly identified the biggest hurdle in selling an outsourcing service—their clients' perceived loss of control, which 65% of respondents said was of utmost importance. Perhaps reluctantly, 10% also acknowledged fund managers' second-highest strike against choosing to outsource: lack of confidence in the service providers.

Although a minority of fund managers today sees their outsourcing providers as true partners (only 33%), global custodians are trying to do their best to change that perception. Virtually all respondents indicated willingness, ability, and/or preparedness to adapt services to meet client needs. Indeed, nearly half (43%) said they are willing to adapt all services to the needs of their clients. While this is good news for fund managers, it certainly helps to explain the concern among providers that their price/value model is unsustainable.

Maybe savings can be gained from refining their offerings. For instance, within their enormous service suites, most custodians surveyed are providing allocations and regulatory compliance, two services in which only a small minority of fund managers expressed interest.

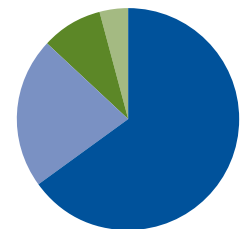
The desire for close collaboration with their clients does not seem to extend beyond custodians' outsourcing service. While outsourcing was clearly viewed as a partnership, global custodians overwhelmingly (70%) characterized their custody services as a customer/vendor relationship. One custodian even owned up to a master/slave relationship with their custody clients!

Much more encouraging is the evident commitment to fostering industry standards. To facilitate communications and data exchanges with multiple outsourcing clients, global custodians primarily (83%) either insist upon or encourage the use of industry standards. Only 9% insist on the use of proprietary protocols.

Despite reportedly declining margins in the outsourcing business, custodians otherwise appear to be thriving, according to their reports on revenues over the past five years in a number of service areas. Nearly all respondents (91%) said revenue on securities lending has been up and 76% claimed increased revenue on cash management. Similar upswings have been witnessed for safekeeping, settlement and foreign exchange—85% report all to be higher.

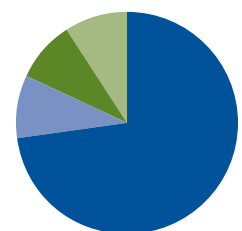
### Custodians' perceptions on the top factor in a fund manager's decision not to outsource

Loss of control	65%
Cost	22%
Lack of confidence in providers	9%
Lack of provider capacity	4%
Difficulty in reversing decision	0%



### Clients' actions in managing communications and data exchange with multiple outsourcing relationships

Encourage the use of industry standards	73%
Work with whatever protocols counterparties prefer	9%
Insist on use of your proprietary protocols	9%
Insist on adherence to industry standards	9%



# Opportunity Assessment

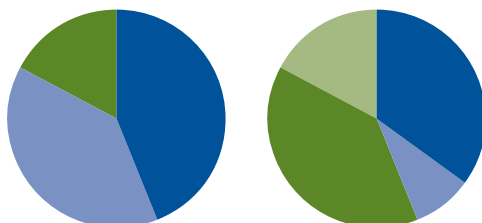
**THE MARKET** for outsourcing securities services seems healthy, with room for growth. However, current industry-wide doubt as to whether outsourcing is a sustainable model is borne out in this research. Whilst the appetite for outsourcing remains strong amongst fund managers, it is clear that the issues surrounding the pricing/value model will need to be addressed if there is to be longer-term sustainability. Showing clearer understanding of their clients' business and outsourcing drivers will be key for custodians gaining fund manager outsourcing contracts and developing true "partnership" relationships. Contrary to global custodians' belief in the importance of operational risk, fund managers are far more driven by meeting demands from clients, regulators, and mitigating investment risk.

Currently outsourcing services such as custody, transfer agency, fund accounting and proxy voting are highly utilized and many additional services offer potential, as the following table shows. However, custodians may be over-providing in other areas. The large majority of fund managers noted that they would never consider outsourcing allocations and regulatory compliance, two services most providers already offer.

Custodians may be missing critical competitive advantages, as they are apparently focusing on cost or relying on up-selling their custody relationships. Forty-four percent fund managers said flexibility was the most important factor, followed by a specialization in securities services (39%).

## Most important factors in choosing an outsourcing provider

	Fund managers	Global custodians
● Flexibility	44%	35%
● Specialization in securities services	39%	9%
● Cost	17%	39%
● Existing relationship with provider	0%	17%



## Top functions fund managers would consider outsourcing

SSI database management	65%
Trade confirmations	59%
Transition management	53%
Performance measurement and attribution	47%
Reconciliations	44%
Fails management	44%

## Top five reasons fund managers consider outsourcing

### Fund managers' responses

1. Meeting demands from clients
2. Improving investment performance
3. Meeting demands from regulators
4. Investment risk management
5. Reducing operational risk

### Global custodians' responses

1. Improving investment performance
2. Reducing operational risk
3. Meeting demands from clients
4. Meeting demands from regulators
5. Reducing cost

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