

# A NEW PHASE OF OUTSOURCING: TRANSFORMATIONAL TIMES FOR ASSET MANAGEMENT?

“It was the best of times, it was the worst of times...”

...While these timeless words were written 160 years ago by Charles Dickens in the novel, *A Tale of Two Cities*, they should nonetheless strike a chord with today’s fund managers.

This is because today, in many ways, asset managers have opportunities to create the *best of times*. Viewed through a long-term lens, demographic trends indicate continuing high-growth potential, and access to more opportunities globally than ever before.

But they are also experiencing some of the *worst of times*, with shrinking margins, changing distribution models and regulatory challenges all creating significant pressures.

As the industry addresses these challenges and opportunities, asset managers are increasingly outsourcing their non-core functions – in what is effectively a ‘third wave’ of outsourcing. Whether the coming years prove to be the *best* or *worst* of times, this trend towards greater use of outsourcing across asset managers’ back, middle and now front office looks set to be a game-changer – heralding a new phase of *transformational times* for our industry.

## **Best of times: the case for optimism**

Despite facing a broad set of pressures, asset managers have cause to be optimistic. They are in a unique period of history. Shifts in life expectancy mean there is more demand for investment products than ever before – between 2015 and 2030, the global population aged 65 or older is projected to grow by more than 60%.<sup>1</sup> And by 2020, for the first time in human history, people aged 65 and over will outnumber children under the age of five.<sup>2</sup>

In addition, demand for investment products is becoming truly global, particularly as developing markets mature. China, for example, has relaxed ownership requirements for foreign firms, and citizens are moving from a savings-orientated culture to one more focused on

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<sup>1</sup> KKR: *What Does Population Aging Mean for Growth and Investments?*, 13 February 2018

<sup>2</sup> *ibid*

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**A ‘new wave’ of outsourcing across asset managers’ back, middle – and increasingly, front office functions – signals transformational times for the investment industry.**

investing. In coming years, China will account for nearly half of the global industry's net new flows, and by 2030, will reach over US\$1 trillion of investable assets under management (AUM) – representing significant opportunity for foreign entrants.<sup>3</sup> In addition, some asset managers are stepping into roles traditionally held by investment banks, such as direct lending, which will yield new avenues of opportunity.<sup>4</sup>

### **Worst of times: managing significant pressures**

But then there are also the *worst* of times to manage. Fee and cost pressures, and eroding margins are all having an impact. In 2017, the industry did not deliver positive operating profits, despite strong AUM growth, because of a rise in absolute costs to 8%.<sup>5</sup>

Then, 2018 saw asset management equity market valuations fall to a 20-year low as concerns increased about the industry's future growth prospects. Morgan Stanley and Oliver Wyman forecast that total asset management industry revenues will grow at a compound annual growth rate of just 1%. And, as they also state, it is difficult to see how current fee pressures will abate in either passive or active management.

Research into the revenues of publicly-traded firms in global asset management also reveals that operating margins are eroding to levels only seen in the aftermath of the 2008 financial crisis – margins shrunk 29% in 2018.<sup>6</sup> Most readers of this article will be keenly aware of global regulatory obligations that have spiraled in recent years. As a direct result of this, compliance costs are expected to more than double by 2022.<sup>7</sup>

### **Technology: driving disruption and new client experiences**

The potential for technology to cause disruption and create opportunity in asset management remains one of the industry's foremost topics.

As an asset servicer, we see this in our own business, where technological innovation is proving to be an opportunity – for example, the use of machine learning to automate manual tasks to aid accuracy, efficiency and speed, or the use of algorithms to select the most suitable trading outcomes from potentially complex options.

Technology similarly represents an opportunity for investment companies using it to adjust traditional processes and everyday activities. Artificial intelligence, for example, holds the promise of helping firms identify complex patterns and trends – potentially improving investment strategies.

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<sup>3</sup> Casey Quirk by Deloitte, *Leadership in Times of Plenty: Future Winners in China's Asset Management Industry*, November 2017

<sup>4</sup> *Financial Times: Fund Houses Pile Into Direct Lending As Banks Retreat*, 6 March 2018

<sup>5</sup> Morgan Stanley and Oliver Wyman blue paper: *Winning Under Pressure*, March 2018

<sup>6</sup> Casey Quirk: *Margins Shrink for Public Asset Managers as Fee Compress, According to Casey Quirk Analysis*, February 7 2019

<sup>7</sup> *Financial News: Compliance Costs to More Than Double by 2022*, 27 April 2017

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And automating functions across fund management can help drive accuracy and speed – across valuations, trading, and reporting, for instance, while reducing execution costs.

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

Managers that are focused on retaining and growing retail investor clients should note a report from Deloitte, which points out that millennials and 'Generation Z' investors will come to hold a significant share of global investing assets, as inter-generational wealth transfers take place across the US and in Europe.<sup>8</sup>

As PwC<sup>9</sup> point out, millennials have preferences that tend to contrast with previous generations. Convenience is highly-valued – driving take-up of mobile applications – and they tend to display more skepticism about established methods of finance. Traditional ways of managing wealth are being disrupted as a result – according to *Investment News*, 66% of children in North America are likely to switch advisers from those used by their parents after they receive their inheritance.<sup>10</sup>

And both millennials and 'Generation Z' name online and mobile channels as their preferred method of business interaction.<sup>11</sup> So asset managers may need to embrace similar types of digitalization just to remain relevant to this next generation of retail investors.

It is likely that many asset managers will need to urgently catch-up with the likes of high-street banks, which have long used online, automated, voice-activated and other technologies to provide customers with greater choice, efficiency and service flexibility.

### **Technology: invest or decline?**

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

The same is true for technology expenditure across the entire industry, which explains why leading players are estimated to be outspending their mid-tier rivals on innovation by a ratio of as much as 3 to 1.<sup>12</sup> Total technology spend is now worth US\$30 billion across the asset management industry, making it 15%-20% of its cost base.<sup>13</sup>

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<sup>8</sup> Deloitte: *2019 Investment Management Outlook 2018: A Mix of Opportunity and Challenge*, November 2018

<sup>9</sup> PwC: *Asset and Wealth Management Revolution: Embracing Exponential Change*, October 2017

<sup>10</sup> Investment News: *Financial firms must attract millennial advisers to serve new generation of clients*, 13 May, 2019

<sup>11</sup> Deloitte: *2019 Investment Management Outlook 2018: A Mix of Opportunity and Challenge*, November 2018

<sup>12</sup> Morgan Stanley and Oliver Wyman blue paper: *Winning Under Pressure*, March 2018

<sup>13</sup> *ibid*

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And technology will make all the difference in the future, with one study showing that asset managers are splitting into winners and losers. According to the study, 25% of asset managers are increasing their profits, while another 44% are investing in their businesses but not seeing any returns. 31% are simply cutting costs and contracting.<sup>14</sup> The firms that spent heavily on strategic technology to support their investment teams since 2014, however, saw a 44% increase in profits per employee.<sup>15</sup>

In addition, changes in market structure and the kind of client generational behavior outlined previously mean that, as Morgan Stanley and Oliver Wyman point out, it will be increasingly costly to catch-up for those firms currently being left-behind, and which face the challenges of defending existing business while allocating precious resources to technology investment.<sup>16</sup>

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

### The evolution of outsourcing: supporting core competencies

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

Investment firms began to first outsource in the 1980s, when they shifted their custody operations to independent providers, and global custodians such as Northern Trust have been evolving their services and skill-sets ever since.<sup>17</sup>

At the turn of the century, there was a 'second wave' of outsourcing. Managers now began outsourcing their middle office functions, not just to save costs, but to meet challenges posed by the increasing range and complexity of investable assets across global markets, and meet requirements to achieve greater transparency and monitoring capabilities, as well as access to automation, scale and security.

### The *third wave* of outsourcing: up the 'value chain'

From our position as global custodian and asset servicer to leading investment companies, we now see signs that the industry is on the cusp of a 'third wave' of outsourcing.

We see some managers outsourcing up the 'value-chain' – including outsourcing functions such as their trading desks, foreign exchange or transition management capabilities – and in some cases, moving towards full outsourcing of all front-office capabilities.

<sup>14</sup> Casey Quirk, McLagan: *Casey Quirk and McLagan Study Shows Growing Divide Between Winners and Losers in Asset Management*, 9 July 2018

<sup>15</sup> *ibid*

<sup>16</sup> Morgan Stanley and Oliver Wyman: *Searching for Growth in an Age of Disruption*, March 2019

<sup>17</sup> Northern Trust: *Custodian 3.0: The Evolution of the Custodian Bank*, October 2018

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

#### Questions to ask include:

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

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In this way, mid-size and smaller firms are able to *buy* scale - once the preserve of only the largest players – potentially eroding the in-built advantages of larger peers, and levelling the playing field. Analysts predict that the investment industry has the potential to cut up to 30% of its current costs through a combination of improved automation, outsourcing, and rationalization.<sup>18</sup>

As well as helping optimize costs, outsourcing is seen as a way for asset managers to gain access to technology and expertise by partnering with organizations offering scale and specialisms.

US institutional investors surveyed by Greenwich Associates, for example, felt that the quality of their sales trader coverage had gotten worse, while brokers have cut costs by replacing senior traders with more junior (and less expensive) ones.<sup>19</sup>

At Northern Trust, we feel this third wave is likely to establish a new 'status quo' across the industry – helping asset managers enhance their resources and focus on specialist skill-sets by drawing on external best-in-class asset servicing and fund operations expertise.

It is also a reflection of the changing skill set of their likely outsourcing partners – the global custodian and asset servicer. When asset managers first outsourced their custody operations, some commentators felt this move would result in extensive consolidation among custodians, and that only a small number would ultimately exist in the long term to handle just a relatively small number of safekeeping and monitoring-related functions.<sup>20</sup>

But this has not proved to be the case. As traditional methods of doing business are changing fast, global custodians (such as Northern Trust) have similarly evolved, and are leveraging their many years of expertise in working with data, security and technology to create innovative solutions for clients.<sup>21</sup>

### **Outsourcing in asset management: *into transformational times***

Our industry may exist in both the *best* and *worst* of times, but moreover, we live in *transformational* times. The future of the investment industry will be very different to what we see today. By 2022, at least 20% of managers with US\$50 billion in AUM will outsource at least some of their trading operations.<sup>22</sup>

Larger asset managers will likely automate or outsource everything in the middle and back offices, while boutique managers will outsource to large asset servicing firms or global utilities that could emerge for

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<sup>18</sup> Morgan Stanley and Oliver Wyman: *Searching for Growth in an Age of Disruption*, March 2019

<sup>19</sup> Greenwich Associates *Outsourced Trading: Helping the Buy Side Improve Execution and Enhance Operational Efficiency*, December 2018

<sup>20</sup> Thomas Murray: *Global Custody – Key drivers, dynamics and future trends*, 2004

<sup>21</sup> Northern Trust: *Custodian 3.0: The Evolution of the Custodian Bank*, October 2018

<sup>22</sup> Business Insider: *Asset Managers Increasingly Outsource Trading Operations*, 19 February 2019

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functions such as know-your-client, transfer agency, trading processing and risk and tax reporting, according to one report.<sup>23</sup>

So what does all this mean? At Northern Trust, we think it means that the new, third wave of outsourcing is only just beginning.

Outsourcing is here to stay, and while managers can choose not to make use of it, they should not ignore the trends that are driving this shift – regardless of whether they are experiencing the best of times or otherwise.

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**This wave of outsourcing will help managers enhance their resources and specialist skill-sets by drawing on external best-in-class asset servicing and fund operations expertise.**

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<sup>23</sup> PwC: *Asset and Wealth Management Revolution: Embracing Exponential Change*, October 2017