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MIDDLE OFFICE OUTSOURCING: A Predictable Evolution

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The Inherent Value Of Outsourcing

Businesses outsource to reduce costs, grow faster, and reduce risk. This is not a new phenomenon, but a "trend" as old as the shifts toward specialization in both the agricultural and industrial revolutions. In financial services, this trend began with common shares and exchanges, and it has developed into widely accepted outsourcing of back office functions such as custody, clearing, and trade communication.

Outsourcing in other industries is the norm. Consider Apple: they design the iPod, iPhone, and iPad, but outsource the manufacturing to select partners. They do so not solely for cost savings, but because their outsourcing partners have highly specialized expertise in materials science and packaging technology. In a way, Apple also outsources the iPhone and iPad content and applications to a willing community of providers, from sophisticated global software companies to amateur programmers. In this model, Apple is able to focus on their core business functions.

As asset management has become more complex and more global, additional specialists have carved out major businesses, from trade execution to custody. These functions are critical to the success of the business, but have been simultaneously specialized and standardized to the point where the practice of outsourcing is almost universally accepted. However, what does that mean for the middle office?

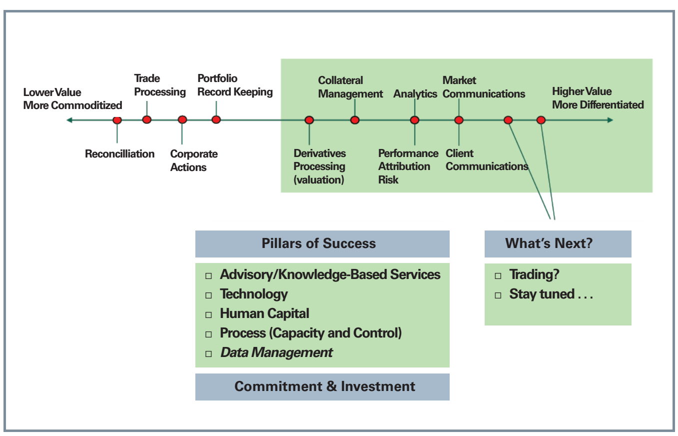
Investment Manager Perspective: Platform For Business Strategy Execution

There is no doubt that the latest market cycle has resulted in an increase in demand for middle-office outsourcing. Investment managers have not only faced extreme margin pressure but also the ongoing requirement of doing more with less. Staff reductions and budget limitations continue to increase per capita productivity for operations and technology to all-time highs. However, while recent market conditions have caused a cyclical increase in demand, sustained demand for outsourcing will be driven by more sophisticated market dynamics.

Cost management will always be critical, but strategic capability is fast becoming the key driver for middle-office outsourcing. The need for investment management firms to execute their business strategy better, faster, and more predictably has never been more important, nor has it ever been more difficult. The pace and complexity of industry change is accelerating. Whether responding to the demand for more complex, global products and assets or regulatory change, today's investment manager must be able to react faster and more nimbly than ever before. As a result, middle-office outsourcing has evolved from a purely cost-driven processing capability to a strategic platform on and through which an investment manager can execute their business strategy.

When considered in this context, the provider shifts from service provider to trusted business advisor. The major providers are evolving into "knowledge companies" and are no longer simply processing organizations. As they continue to develop and harness experience, providers can go beyond best-practice processing to deliver alternative thinking and advice on how to better achieve key objectives. Their platforms can then help investment managers achieve important strategic objectives. For example:

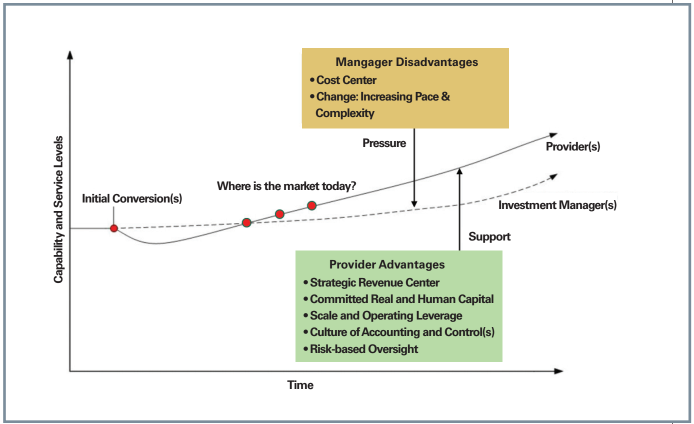
- A platform for acquisition integration
- Further market expansion (manufacturing, fund domicile, distribution)
- Enhanced focus on distribution
- Improved speed-to-market and diversity of new product capabilities



This concept is particularly important for mid-size and boutique investment managers (in terms of AUM). These firms are at the greatest disadvantage in the ability to execute as they lack scale and access to the real and human capital necessary to keep up with the increasing pace of change. Whether striving to introduce new products faster, globalizing, or changing business models, firms in these market segments can be at a disadvantage versus their larger peers

The Acceleration Of Middle-Office Outsourcing

The following chart illustrates the natural progression of the middle-office capability of an outsourcing provider and a standalone investment manager. While generalized, it supports how and why middle office capability and acceptance will not only continue to evolve – but accelerate.



Understanding the market and internal challenges faced by an investment manager, one can assume only incremental improvements in capability over time. The need for cost management combined with the increasing pace of change will continue to put downward pressure on the evolution of an investment manager's middle-office capability. While progress will be made, it will be incremental and in line with the economics of the individual firm.

On the provider side, the initial deals and conversions saw a variable decrease in capabilities and service levels. As the providers continued to invest, learn and specialize, service levels continued to improve. While the purpose of this article is not to debate where the market is today, given continued investment, providers have a marked long-term capability advantage over the typical manager. As a strategic revenue center, providers are committing large investments in capability in both real and relative terms. They possess not only scale and operating leverage, but also a culture of accounting, control, and risk-based oversight that is critical in today's environment. This will continue to support an acceleration of capability beyond the incremental gains of the typical manager. While the triggers and timing for outsourcing differ by firm, market dynamics and the progression of capability will support the accelerating maturity and acceptance of outsourcing.

The Evolution Of Capability

Since the first outsourcing transactions, providers have continued to invest in and improve capabilities across the spectrum of technology, human capital, and process. The early days were a mixed bag of getting lower-level functions and standard service levels right; basics like trade processing, portfolio record keeping and reconciliation. Over the past decade, capabilities have evolved far into higher-value functions and capabilities that exceed the average investment manager; services such as complex derivatives processing, sophisticated analytics and highly differentiated client communications and reporting. Providers are now offering capabilities that can differentiate an investment manager in both strategy execution and servicing.

The Provider Perspective

It is important to understand that for the major custodian providers, middle office outsourcing has become a critically important and strategic growth business. While it is a natural extension of more traditional asset servicing like custody, fund accounting and transfer agency, it has fundamentally changed the value they provide to clients and the ways in which they deliver it. This is by definition innovation, the key to long-term revenue growth. In addition to its positive impact on business growth, outsourcing continues to improve the overall capabilities of these firms in terms of technology, human capital and processing. These enhancements also improve the value and servicing capabilities across all of the businesses in their portfolio; not just middle office outsourcing (ex. derivatives processing)

Recognition of this strategic value has resulted in commitment to and continued investment in what is now a core business for the major providers. To that effect, helping investment managers "reduce costs, grow faster and reduce risk" has become an integral part of a provider's business model.

A Predictable Evolution

While clear that our industry moves by evolution rather than revolution, middle-office outsourcing is maturing in capability and acceptance. Continued investment by the providers and ever changing market dynamics will further prove the strategic value of an outsourced middle-office platform. The ability to execute and differentiate has never been more challenging and the platform through which it is done has never been more important.

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Dan Houlihan is the North American head of Northern Trust's Global Fund Services (GFS) segment, responsible for servicing the firm's North American asset management clients. GFS is responsible for the delivery of all asset servicing including middle-office outsourcing, fund accounting, transfer agency and custody. Dan joined Northern Trust in 2008 as the global head of product and strategy for the investment operations outsourcing (IOO) business.

Prior to joining Northern Trust, Dan spent 19 years in numerous leadership positions for investment management, technology and services companies. Among these, he was President of Citisoft, Inc. where he was responsible for executing their strategy for North America.