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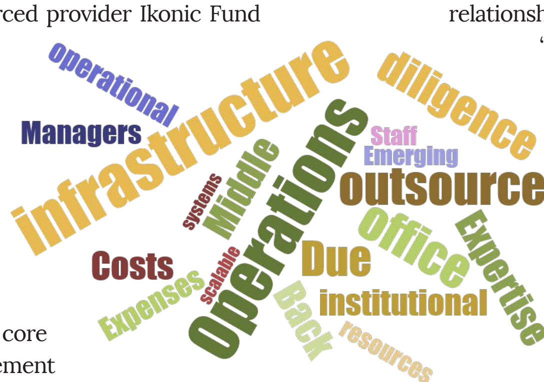
Emerging Mgrs. Increasingly Weigh Costs of Ops Outsourcing

In response to the rising costs of middle and back office structures, an increasing amount of emerging managers are seeking the assistance of outsourced providers to lift the burden off building out those complex operational functions.

While many middle and back office functions are still performed in-house, more than three out of four firms say that they now outsource some functions to external service providers, according to a survey conducted by SEI Investments that was included in a May white paper. Thirty-five percent of respondents in the survey were smaller firms with less than $5 billion in assets under management and represented the majority, according to SEI.

Investors, due diligence firms and asset managers traditionally consider middle and back office functions as responsibilities covered by the manager itself, outsourced provider Ikonic Fund Services said, in a white paper published in May. While there is perceived operational risk associated with outsourcing those functions, there is also perceived value in outsourcing middle and back office functions so that the investment manager can focus on its core competency—portfolio management and optimization, Ikonic said.



Structuring and staffing the middle and back office has proved to be a costly venture for many asset managers, attributed to the rising expenditures of hiring new talent, the pressures brought on by investors with increased regulatory requirements and the significant amounts of data needed for reporting purposes. For emerging managers especially, these obstacles surrounding building a middle and back office can act as a significant hurdle to becoming an institutional-quality firm.

Taking Costs Into Account

More than one quarter of firms now devote 20% or more of total operating expenses to middle office functions, while 37% spend anywhere from 11% to 19%, although diversified asset managers tend to spend slightly more than alternative managers, according to SEI. The growing compliance burden, coupled with more vocal investors and stiffer competition, are resulting in higher costs in middle-offices across the industry.

For emerging managers, a cost-effective solution is to outsource their middle and back office responsibilities to a reputable service provider, Ikonic said.

At STP Investment Services, an outsourced service provider led by President and CEO Patrick Murray, the firm implements a "Grow With You" pricing model for emerging managers. The model offers a pricing schedule with AUM-based fees that will only increase as the firm's AUM increases from one tier to the next, helping emerging and mid-sized asset managers obtain operational expertise at a lower cost, according to the firm. By utilizing the price model, emerging managers can focus on generating alpha and managing client relationships.

"Finding an outsourced partner that offers flexible pricing models is very daunting for some of these managers. This helps them to have a lower initial fee, and as they start growing, we adjust the model," STP's V.P. of Relationship Management and Business Development Dan Schlossberg said.

Murray founded STP in 2008 after witnessing the underservicing of back office capabilities to the small- and mid-sized markets.

"I saw firsthand the challenges associated with the small- and mid-sized managers and the issues around the infrastructure, financial systems and reporting tools. Being able to own all those systems and efficiently run them is a real challenge," Murray said.

STP gives investment managers, wealth managers, banks, plan sponsors and hedge funds the ability to lift out their middle and back office and provides a full end-to-end comprehensive tool kit that allows a client to get up and running quickly, Murray said.

Of the various contributors to the rising costs of middle and back office functions, Murray sees two ways of associating them –

Outsource: Handing Over Back Office Duties Can Alleviate Challenges

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hard costs and soft costs. The hard costs account for how much a firm is paying for items like software, and talent, while soft costs account for the hidden costs that many managers don't consider.

"Maybe there's a portfolio manager who is spending time validating and reconciling data because they don't trust a particular system, which then leads to time and opportunity cost," Murray said.

OCA Consulting, another outsourced provider that was founded last October, has also seen rising costs as a pertinent issue for emerging firms.

"The primary advantage is that we provide an operational infrastructure that allows access to senior personnel that would otherwise be a prohibitive cost for emerging managers," OCA Finance Partner Ken Glynn said.

Glynn founded the firm in 2015 alongside Operations Partner Jon Bartner and Compliance Partner Bob Beinish after the trio departed multi-strategy firm Saiers Capital. Glynn, Bartner and Beinish served as cfo, coo and cco, respectively, at Saiers.

OCA, in which all three have equal ownership, stands for Operations, Compliance and Accounting, and as the name suggests, the firm provides institutional solutions for small and emerging private funds seeking to outsource cfo, coo and cco roles to tenured experts.

Bartner assists private funds in streamlining their processes through optimization of infrastructure and technology with an emphasis on cost reduction and personnel efficiency. "The platform is tailored to emerging managers to help them lower the cost of running and growing a fund by creating a scalable infrastructure that helps institutional investors gain comfort in making an allocation," he said.

International equity manager Strategic Global Advisors is one example of an emerging firm that took on the job of reviewing their middle and back office costs and making the decision to outsource. Ultimately, they made the decision to outsource all of the middle and back office functions to STP, President Cynthia Tusan said, in an e-mail.

As is the case for many managers, the decision to outsource comes from the firm itself growing alongside the assets under management. Since SGA was founded in 2005, the firm's total assets under management have grown from approximately $43 million at the end of 2006, to approximately $154 million at the end of 2010 and finally to approximately $2.7 billion as of June 30, according to eVestment.

"Our strategy as a firm has always been to focus on what we are experts at and work with a partner like STP Investment Services to handle the other functions," Tusan said.

SGA decided to go the external route after analyzing the cost of building out the structure of their firm, and the cost it would take to staff it, according to Tusan. "After that analysis we quickly realized that it was not a feasible and scalable approach. With the right analysis and service plan, no firm is too big or too small to outsource," she said.

Similar to the teams at STP and OCA, Tusan also sees rising costs for middle and back office support, which she attributes to increasing demands from clients for immediate response, timely customized requests, increasing technological demands of constantly changing trading, data and portfolio management platforms and the cost of hiring experienced operational personnel.

Emerging managers often have cost restraints as they enter the space, so it's difficult for them to make the decision to allocate their funds to an outsourced provider. Using STP, that issue was addressed with their fee structure for managers.

Cynthia Tusan

"We were able to have a set monthly fee until we were able to reach a certain threshold. That helped us forecast and plan accordingly," Tusan said.

Operational Due Diligence

The rising costs of middle and back office can also be attributed to an increased regulatory environment, the rising costs of technology, accounting software and people to run those technologies, Schlossberg of STP said. "What's really fueling the cost is that if they are a growing firm, they need to ensure that they have proper staff, especially if they're expanding into new strategies," he said.

Talent has become more expensive and coupled with the increased regulations, that means that there are more things that need to be done, Murray said.

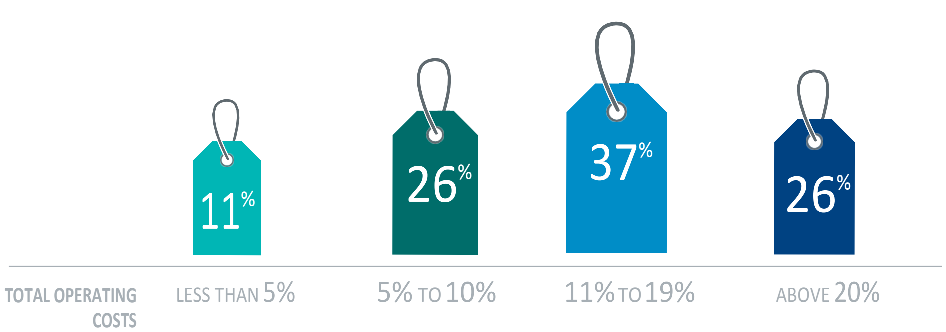
"Most emerging firms don't have backups – they might have only one ops person, so if that person leaves, there's a hole. So now, what's the portfolio manager or client service person doing? Then you're hiring expensive consultants to keep the boat afloat," Murray said.

STP offers what Murray refers to as a "plug and play" solution. Instead of managers paying more to build an internal staff, he offers solutions they can essentially plug into the processes and structure already in place.

Like STP, the OCA team attributes the overall rising costs to the evolution of operational due diligence and regulations.

At OCA, Beinish assists private funds in creating and enforcing compliance policies

Middle Office As Percentage of Operating Total Costs



Regulations, Operational Diligence Are Key Considerations To Outsource

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and procedures designed to meet the demands of regulators. “Savvy investors now have more intense requirements, forcing them to keep pace with that. Additionally, regulatory requirements continue to increase, putting significant burden on the compliance arm, which leads to increased costs,” he said.

The SEI white paper and survey echoes those sentiments, noting that as asset management firms expand their global footprint and their businesses begin to grow, so do regulatory requirements. Firms that partner with outsourced providers to manage compliance functions are likely to be better positioned to quickly adapt to new regulatory schemes in multiple jurisdictions, according to the paper.

“Asset management firms spend significant amounts of resources to ensure compliance instead of focusing on their core competencies and more strategic activities,” SEI said.

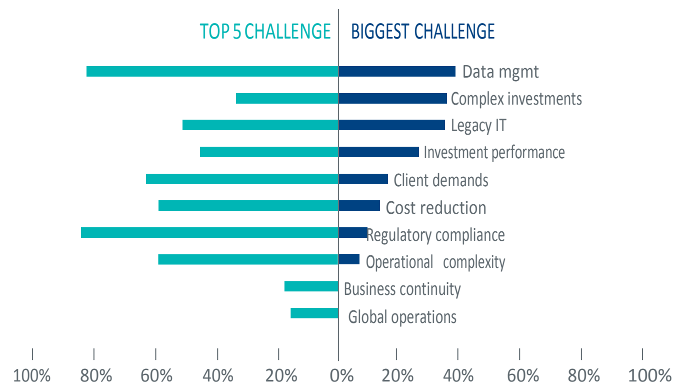
OCA’s Glynn notes that managers don’t tend to think about the time constraints of managing their prime brokers, administrator and auditor as well as satisfying regulatory requirements, so being subject to increasingly sophisticated operational due diligence on behalf of investors requires an institutional infrastructure that will pass operational due diligence and bolster internal efficiency, Glynn said.

“Managers should be focused on alpha generation – it’s their expertise and why they entered the business. We manage the non-investment side of the business. We do so to allow them to generate alpha without unnecessary distraction,” Bartner added.

In a webinar with advisory services firm EisenAmper on Sept. 14, operational due diligence practitioner Michael Merrigan discussed what managers, including emerging firms, can expect when undergoing operational due diligence, and the role that operational due diligence plays in today’s fundraising environment.

Managers that are vetoed during the operational due diligence phase have disproportionately been emerging managers, as they often tend to have a perceived higher degree of operational risk than a more mature manager, Merrigan said. If a manager is “passed up”, the probability to rectify that in the immediate future is not very likely, and it tends to be a year or two or longer before a manager is revisited, he said.

Middle and Back Office Operational Challenges



Source: SEI Investments

For emerging managers, operational due diligence practitioners evaluate the breakeven of a firm in terms of its costs. “The breakeven is different for every manager, but clearly, if there’s a manager that we visit that has 30 employees and is managing $25 million, we have to understand that. Emerging managers need to be able to demonstrate that they’re operating within their breakeven limits,” Merrigan said.

In terms of the use of outsourced service providers, Merrigan said in the webinar that he sees an increased frequency in the use from emerging managers, specifically in the outsourcing of the cfo role.

“People are working with more limited resources then they have in the past and they’re looking for ways to gain operational leverage through experts that are outside at a variable cost, relative to in-house resources. To the extent that you can help investors get comfortable with that, I think it’ll generally be looked favorably upon,” he said.

Data Management

While increasing regulatory demands and the costs of running a middle and back office in-house are on the forefront of managers’ concerns, data management is another component that can be outsourced to lessen pressure on firms.

“It’s often commented that asset managers are lagging behind other industry sectors in leveraging big data and analytics. According to a 2014 survey of broker-dealers, asset managers and hedge funds conducted by Thomson Reuters, 41% of respondents lacked a big data solution,” the SEI paper said.

As a result, managers need to look at providers that not only have expertise in operational functions, but in data gathering and management as well. Data management is constantly evolving, and data fluency will become one of the most important skill sets available to managers, according to SEI.

“Whether they source these skills internally or externally, asset managers that treat data management as an opportunity, rather than a hurdle, are likely to be rewarded with much more productive and efficient middle offices benefiting the entire organization,” the SEI paper said.

Although there has been a reluctance from managers to outsource

►SEI’s back office study can be found here.

►Ikonic’s paper can be found here.

►The EisenAmper webinar is available here.

Data Gathering Cannot Be Ignored When Weighing Outsourcing

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due to perceived operational risk associated with outsourcing middle and back office functions, data management provided by outsourced providers can change those perceptions, according to Ikonic.

"The perceived loss of control by the fund manager over the process and lack of transparency into the process has largely been mitigated through the improvements in technology offered by service providers. Now, the fund manager has a direct portal into the middle office reporting and data allowing him to export the data for further analysis," Ikonic said, in the white paper.

Most asset managers in the survey conducted by SEI cited regulatory compliance as one of their biggest operational challenges, however, it is data management that's most often seen as the single most important challenge, the paper said.

STP advises that before a manager makes the move to outsource to a provider, one of the main things they need to look at are the factors around how they're going to manage and deal with data, which includes looking at what types of products and strategies they may want to grow into. The level of sophistication and the requirements of data management are challenging, so firms can benefit from a strategic partner in that space in particular, Murray said.

"Data management is the one that gets everybody," he said. "It's the reconciliations on the scale basis that become very problematic."

Emerging Manager Considerations

With the trend of outsourcing only continuing to expand, managers have been tasked with reviewing their own middle and back office functions to see if they would truly benefit. For those that are making the consideration, the teams at STP and OCA ask them to look at particular weak spots within their structures.

In the case of emerging firms, STP's Schlossberg said that the decision lies in the strategy and growth plan of the firm – if there is potential for the firm to get into strategies or different products – then that's something they'd want to consider. He also noted that if a firm doesn't have any great technological footprint, then outsourcing is worth investigating, as they may not have the investment in technology to respond to changing market needs.

Managers should also look at what they are forecasting for growth over the next three-to-five years, if their strategies will change and how that will relate to operational expense and budget, Schlossberg added.

Personnel requirements should also be reviewed by emerging managers, as using an outsourced provider can equip the firm with experienced professionals without the cost of hiring them in-house.

"All managers must assess the expertise and experience of the talent they are able to obtain. Firms today have non-investment obligations that span many disciplines, and hiring the necessary staff in-house can be costly. Utilizing external personnel can bring expertise to the table that empowers managers to focus on trading and the raising of assets," Beinish of OCA said.

Patrick Murray

Operational due diligence practitioners often find that when speaking with managers, they don't have a good rationalization for why they chose a specific service provider other than referencing cost or loyalty, according to Merrigan.

"I think using tenure of a relationship alone is probably not the best rationalization for why a relationship should continue to exist and I think it would probably be more helpful to do these operational due diligence reviews if managers speak more about why that specific service provider is a value-added proposition over another one of similar cost."

When searching for a provider, SGA said that there were some requirements that were deemed unnegotiable for the firm. These requirements included finding a provider that not only had a fully-enabled toolkit of technology and services, but also had extensive knowledge to handle the intricacies of the global equity markets, according to Tusan.

SGA ultimately went with STP because they felt like they had found a true partner to not only provide operational support and consultant services, but to also act as a business partner, Tusan said.

When looking at the key functions of the middle and back office that were overly time-consuming, Tusan noted that as the firm began to grow, so did the number of accounts and different reporting needs. With the help of STP, the firm now has the ability to easily add accounts and utilize a flexible client reporting portal to generate reports easily, she said.

Tusan finds that outsourcing has served its purpose in giving her firm the ability to generate alpha without burden.

"Outsourcing has given us the time to focus on our core competencies without the worries of staffing or operations technology," she said.

For emerging managers considering outsourcing, Tusan said that due diligence is a necessity. "Selecting a provider can be an overwhelming decision, so due diligence is a necessity. I truly believe that you need to select a true partner that understands your business."