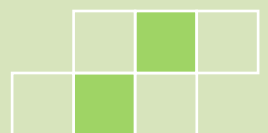




Outsourcing as a Profitability Driver in the Asset Management Industry

Amba White Paper

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Co-founder - Amba Research



Executive summary

The asset management industry has just passed through one of the most testing years in living memory. Investors and regulators are both likely to subject asset managers to much greater scrutiny than they have in the past. Managers cannot rely upon consistent price appreciation in asset markets as the key driver of profitability. It has become imperative for firms to simultaneously achieve improvements in their business models:

1. A cost-effective distribution model that can help grow AuM on a consistent basis

After staff compensation, marketing and distribution is the single-largest cost category in most fund managers' profit and loss accounts. Outsourcers can release onshore staff time that is currently devoted to repetitive tasks and use this time to focus on identifying specific factors that will make the firm's products a compelling solution for each prospective client.

2. A state-of-the-art risk management platform and associated internal and external reporting

Institutional asset managers need to be able to satisfy regulators and potential investors that their reporting systems provide a clear picture of the aggregate exposure and risks undertaken by all operating units within the firm. Outsourcers can help with the heavy lifting required to reconcile reports produced by incompatible legacy systems.

3. Active managers must do everything they can to sustain the majority of their funds in the upper two quartiles

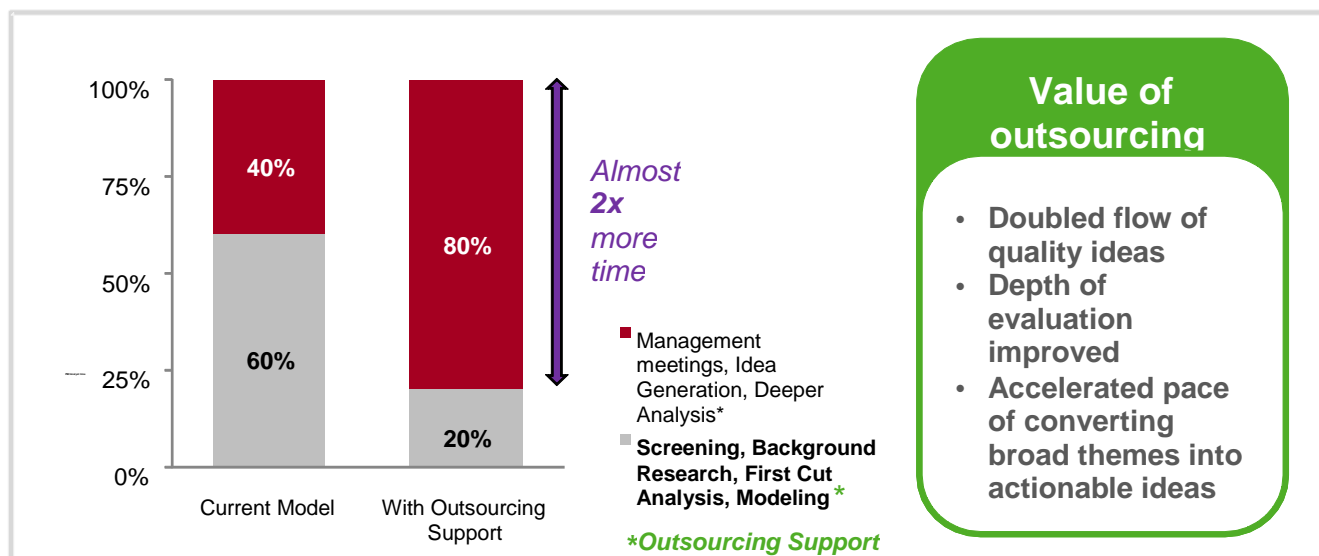
Portfolio managers and buy-side analysts need to be relieved of tasks that are not directly related to the generation of alpha or benchmark out performance. Research outsourcing can deliver the specific bespoke information needed to support an investment decision, as well as ensure that consistent valuation standards and investment methodologies are applied and documented for each investment style.

Managers need to examine how much their daily activities contribute to the delivery of value for the firm. It may be the case that onshore seniors could deliver more value if they outsourced repetitive and lower value added tasks. Identification of investment ideas and exercising judgment based on experience, and consistent application investment method are the key activities of investment seniors.

In addition to reviewing back- and middle-office activities to obtain the optimal in-house vs. outsourced services mix, fund managers should also review **risk management** and front-office activities such as **funds marketing** and **research support** to determine whether or not additional efficiencies can be gained by taking advantage of outsourcing in these areas.

(Figure 1)

Figure 1: Outsourced support doubles time available for security evaluation and selection



– Andrew Houston

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About the Author

Andrew Houston, CFA, is a co-founder of Amba Research. He was previously Head of Asia Regional Research at Jardine Fleming Securities/JPMorgan and Asia Equities Strategist. Andrew has an MBA from London Business School.

Diverse marketplace

A review of the 2008 annual reports of 10 leading listed asset managers (Figure 2) reveals a tremendous variation in performance. Assets under management (AuM) declined at most firms, but at sharply varying rates.

For some firms, poor relative performance led to significant investor redemptions, which compounded the market decline. Other firms were able to attract new subscriptions during the year. At State Street, aggregate net loss of business accounted for 10% of the USD535bn reduction in AuM during the year. By contrast, at Legg Mason, net withdrawals by clients contributed more than 50% to the USD317bn reduction in AuM during the year.

Firms with the highest percentage of retail business, Franklin Resources and Federated, had the highest sales and related distribution costs. Geographic concentration of business varied from 92% of US assets at Janus to 44% at Alliance Bernstein; however, there was no appreciable impact of geographic diversification on their 2008 performance. Other than significant presence in money market funds and cash products which drove Federated's 35% AuM growth in 2008, asset class exposure does not appear to have been a key differentiator of performance. In our sample group, Eaton Vance had the highest percentage of AuM exposure to equities while Legg Mason had the highest exposure to fixed income.

Ability to attract fund inflows and the inclusion of money market products in the product mix, partially offset market declines and withdrawals from equity and credit funds during 2008

Figure 2: A mixed performance by leading asset managers in 2008

	AuM Dec '08 USDbn	AuM YoY change (%)	Operating margins* '08 (%)	Net income YoY change (%)
State Street	1,444	-27	27	49
BlackRock	1,307	-4	32	-23
Legg Mason	632	-33	Loss	NA
Northern Trust	559	-26	45	9
Franklin Resources	507	-22	35	-10
Alliance Bernstein	462	-42	26	-33
Federated Investors	407	35	30	3
Invesco	357	-29	23	-29
T Rowe Price	276	-31	40	64
Janus Capital	124	-40	32	18
Eaton Vance	123	-24	33	37

Source: Company annual reports, 2008

*EBIT

It is worth noting that exceptional expenses in 2007 boosted the 2008 net income growth of Eaton Vance and Janus Capital. Northern Trust and State Street's 2008 earnings were boosted by exceptional gains. Legg Mason's 2008 performance was sullied by a USD1.4bn charge for elimination of securities issued by structured investment vehicles and a USD863m charge for impairment of intangible assets.

Increased focus on risk

The poor performance of a number of leading fund managers in 2008, combined with the Madoff scandal, focused attention on risk management from regulators as well as institutional investors. Asset managers can henceforth expect to face more detailed due diligence by prospective investors.

Managers will also need to do a better job of explaining the trade-offs between the risks and rewards that they are undertaking on behalf of investors. There is likely to be a much greater interest in the way asset managers monitor liquidity and counterparty risk. Investors who had problems withdrawing funds from some managers in 2008 will likely be much more cautious in their approach to manager selection. Retail investors alike will show much greater interest in capital-guaranteed products and be more wary of equity products over at least the next couple of years.

The implications of this for asset managers are significant as firms will need to put in place systems that can monitor real-time risk exposure on a consolidated basis, as well as present regulators and investors with a granular analysis of performance and associated risks undertaken in the course of the business.

Competitive dynamics of the active management industry

In order to attract more assets under management, firms need to demonstrate core competencies that will attract investors. Naturally, all investors in active funds want to see outperformance; therefore, it goes without saying that active managers need to be able to demonstrate that a significant proportion of their funds feature in the top two performance quartiles. Institutional investors and their advisers have a broad focus on the consistency, quality, risk management process, and the delivery cost of the service. Maintaining a stable team of portfolio managers with a consistent investment style and process is an important factor in attracting institutional funds.

Asset managers are also called upon to provide products tailored to the liabilities of institutional investors. Most of the pressure for increased efficiency of asset management services delivery has come from the institutional side of the market.

Required competencies vary according to the investor base that is being tapped. Retail mutual fund investors have historically tended to value absolute performance and do not have a sophisticated risk appreciation. Following the mauling of capital guaranteed funds in 2008, absolute return funds have gained popularity with small investors. Given that investment styles favored by investors change during the economic cycle, larger asset managers with broad product ranges are more likely to be able to attract fund inflows on a consistent basis.

Fund managers need to review their ability to monitor risk on a consolidated basis as well as their fund reporting capabilities

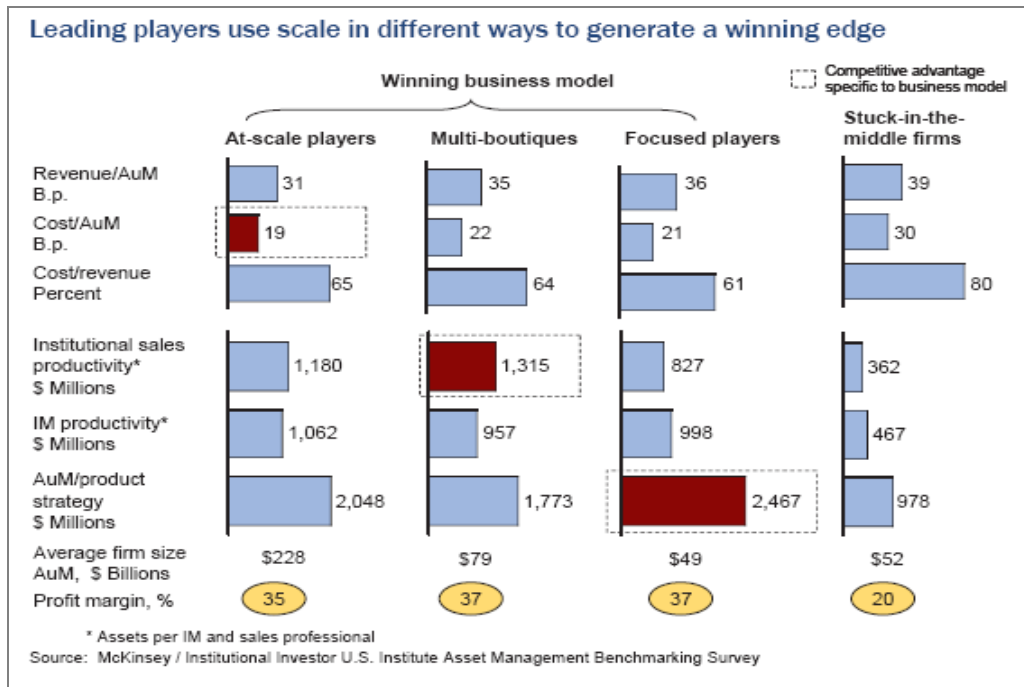
The challenge for larger managers is to maintain cost efficiencies and to create an environment in which portfolio managers can operate without the burden of excessive bureaucracy.

The largest asset managers are widely reported to enjoy scale economies relative to those with lower total AuM. McKinsey Research has suggested that leading players in the asset management industry have used scale in different ways to generate a competitive edge.

The two key fixed costs of an asset manager, employee compensation and sales/marketing expenses, generated significant profitability advantages for the firms that achieved scale. McKinsey's study concluded that global asset management firms with AuM of more than USD100bn and which achieved scale in most of their products enjoyed the lowest overall cost per AuM. The next most profitable group of asset managers are smaller multi-boutiques which are able to pool sales and marketing costs to achieve higher institutional sales productivity. Amongst smaller asset managers, focused players with over USD1bn per investment strategy were more profitable as compared with competitors with broader product ranges.

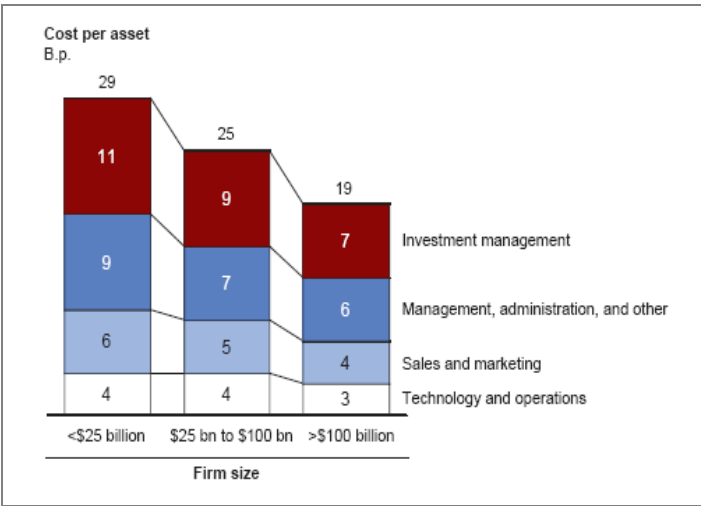
Firms using one of these three business models enjoy c. 75-85% higher profit margins compared with others (Figures 3 and 4).

Figure 3: Scale-based competitive advantage



Source: http://www.McKinsey.com/client/service/bankingsecurities/pdf/a_growing_gap_betweenthewinners_and_also_rans.pdf

Figure 4: Cost per asset



Source:

http://www.McKinsey.com/client/service/bankingsecurities/pdf/a_growing_gap_betweenthewinners_and_also_rans.pdf

Note: **At Scale Players** – At least USD100bn in AuM, **Multi-Boutiques** – Operate as a parent company to a collection of independent money managers, **Focused players** – At least two-thirds of assets in equities, fixed income, or index plus above average AuM per strategy.

Our own less rigorous recent examination of a fund manager’s profitability finds some evidence of performance differentiation between the largest and the mid-sized asset managers during 2006-08. Managers with over USD100bn of AuM were able to deliver around 6% higher average returns on equity and higher average operating margins than smaller managers over the three-year period. However, there was a considerable variation in performance within each group; therefore, although size does matter, it does not guarantee superior financial performance.

Figure 5: Asset managers with over USD100bn AuM

	Operating margins* (3-year average in %)	ROE (3-year average in %)	2008 ROE (%)
T Rowe Price	44	23	19
Franklin Resources	35	22	22
Federated	32	38	45
BlackRock	29	12	7
Eaton Vance	28	47	83
BNY Mellon	23	15	5
Invesco	24	8	8
Janus Capital	22	6	8
State Street	21	15	16

Source: Bloomberg

*EBIT

Figure 6: Asset managers with AuM of USD15-100bn

	Operating margins* (3-year average in %)	ROE (3-year average in %)	2008 ROE (%)
Calamos	41	8	-13
CI Financial	37	28	29
Gamco	33	14	5
Cohen & Steers	26	14	7
Aberdeen	25	8	6
Henderson	22	13	-7
AGF Management	19	13	12
Waddell & Reed	18	28	27
Dundee	13	8	-20

Source: Bloomberg

*EBIT

Figure 7: Size does matter

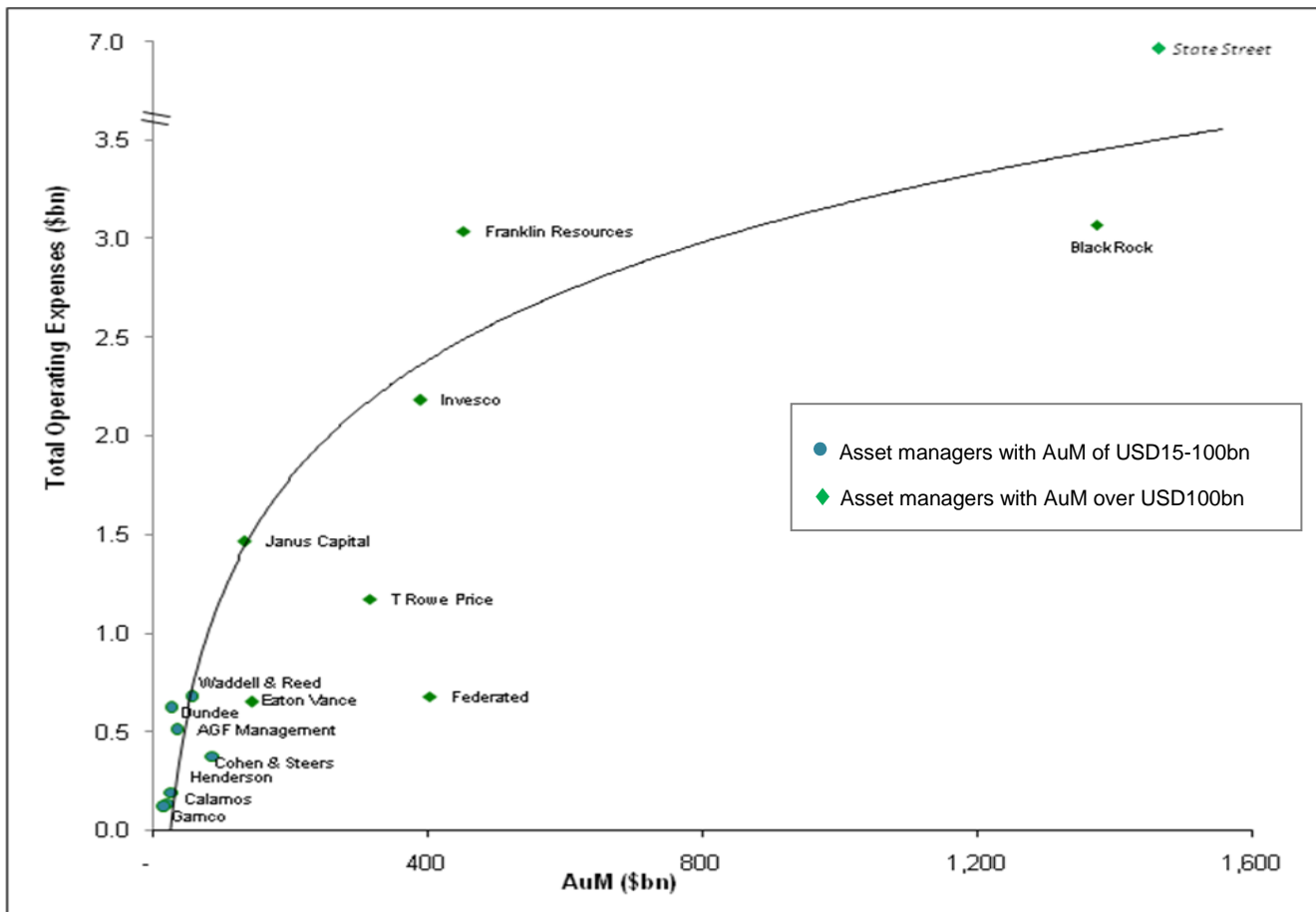


Figure 7 shows total expenses plotted against total assets under management for a sample of large and smaller-sized asset managers. Although this crude measure can be distorted by exceptional items, across the total sample size we believe it gives a clear indication of the relative importance of size to profitability.

Smaller asset managers have a wide range of expenses relative to their assets under management. The most efficient of them can undoubtedly generate profit margins as good as the giants of the industry but on average smaller firms have higher cost ratios than larger firms. Firms with greater exposure to equities and retail business tend to lie above the line of best fit and therefore have above average expenses relative to their assets under management but they also generate commensurately higher revenues. Therefore firms need to measure the cost efficiency of each part of their business against peer group firms in the same asset class and style. Undoubtedly there are economies to scale in this business as witnessed by the higher average profitability of the larger firms but all asset managers of any size should examine whether or not they are carrying an excessive operating expense burden in any part of their business. Any firm that identifies a segment of its business with an operating expenses ratio out of line with peer group should be considering a more comprehensive outsourcing strategy as one of the tools available to restore profitability.

Performance in 2009 reflects lower average AuM

The sharp market falls in 4Q08 had the biggest impact on manager profitability in 1H09. Figure 8 shows 1H09 performance of a sample of asset managers illustrating this point. The S&P 500 declined 12% during the first quarter of 2009; however, a market rally in the second quarter saw the index end the December 2008 to June 2009 period up 2%. Some fund managers were able to grow AuM during the period, but all saw a significant YoY decline in their operating profit.

Figure 8: Performance of asset managers for the six months to June 2009

Asset manager	AuM as of June 2009 (USDbn)	% change since December 2008	Operating profit for past six months (USDm)	% change YoY
State Street Corporation	1,557	8	1,387	(17)
BlackRock Inc	1,373	5	536	(32)
Legg Mason* (Y/E – 31/03/09)	657	(6)	19	(96)
Northern Trust	559	0	748	(12)
Franklin Resources* (Y/E – 31/09/08)	451	8	566	(49)
Alliance Bernstein	447	(3)	167	(72)
Federated Investors	402	(1)	146	(20)
Invesco	389	9	12	(97)
T. Rowe Price Group	316	14	236	(54)
Eaton Vance Corporation (Y/E – 31/10/08)**	144	18	94	(47)
Janus Capital Group	133	7	27	(82)

*Figures are for the December 2008 to June 2009 period in order to be in line with the December year-end companies

**Figures are for the October 2008 to April 2009 period as third-quarter results have still not been released

All other firms have a December year-end

Source: Company reports and accounts

In a world of lower asset price appreciation, efficiency matters much more

We believe that one of the lessons learnt in the past decade is that asset price appreciation can no longer be relied on as the primary driver of asset manager profitability. During the golden years of the 1980s and 1990s, when interest rates steadily declined and globalization delivered a surge in market size, the S&P 500 rose 1,350% between January 1988 and January 2000.

High fiscal deficits in the major industrialized economies will remain a drag on growth over the next few years. Hence, many firms in developed markets are not likely to sustain high growth of revenues and profits in the next decade. In a world of stable or rising interest rates, valuation multiples cannot expand as rapidly as they did in the golden era of the 1980s-90s. It would be foolish to base a business strategy on the basis of a rosy scenario of assumed double-digit market asset price appreciation each year.

In the next few years, asset management firms will therefore need to focus more than ever on their ability to attract incremental funds under management and on the efficiency with which they can deliver their service.

The most important thing for active managers remains the achievement of fund performance in the top two quartiles. However, cost efficiency in delivery of service and raising of new funds will be the key to sustained high levels of profitability.

Outsourcing is part of the solution

Asset managers should consider outsourcing functions where either scale economies are not enjoyed or best-in-class operational efficiencies cannot be achieved due to the absence of a technology platform or a dearth of skills.

Some aspects of asset management outsourcing are well established and we will not address them in this paper. Most senior managers of asset management businesses will be familiar with global custody, securities lending, client servicing, accounting and settlement of trades in complex financial instruments, which are now in the mainstream of outsourced services.

Suffice it to say that there are indications that asset managers are taking a more aggressive approach to mainstream outsourcing. State Street grew its asset servicing business by 11% to a record USD1.66tn in 2008. BlackRock Solutions, with its proprietary leading investment platform and associated risk analytics and advisory services, grew revenues by more than 100% in 2008 and now generates revenues of more than USD100m per quarter. Northern Trust grew its trust investment and other servicing fees by 3% in 2008 as new business offset the lower market valuations. Furthermore, its foreign exchange revenues were up by 75% in the same period.

Outsource whenever you lack significant economy of scale, skill sets or technology relative to the outsourcer

The three major factors influencing decisions taken to outsource are:

1. **Scale:** Revenues associated with a product or geography do not justify fixed costs associated with supplying the product to clients
2. **Skills:** The outsourcer has proprietary skills that deliver a better cost/quality mix than an in-house solution
3. **Technology:** The outsourcer has a technology platform that not only reduces risk and improves quality but also lowers costs compared with an in-house built solution

Most commentators agree that asset management outsourcing started in back-office accounting functions before moving to the more complex, technology dependent middle-office.

Less well known are some of the more recent developments in outsourced services. These include offshore support for front-office services like funds marketing, a costly key to raising AuM, and research support important for maintaining active fund performance. The other hot topic of the day is risk management, an area all fund managers need to review in the current climate.

Therefore, research support, fund sales and marketing, and risk management are the three key areas of focus for outsourcing.

Research outsourcing

Provision of research coverage by the brokerage industry continues to shrink. Yet consultants still expect asset managers to demonstrate rigor and consistency of investment process

As sell-side research has shrunk over the past decade, asset managers have been faced with some hard choices about the provision of adequate research on which to base their investment decisions. Larger asset managers have, until recently, had enough funds available to increase their in-house research capabilities. This has been a less viable option for small- and mid-sized asset managers. Fund management firms, however, need to demonstrate the rigor and consistency of their investment process if they are to find their way on to the consultant's recommended list. Hedge funds have to date relied on the skills and experience of their senior principals and when it fit their strategy, they concentrated commissions on sell-side firms that provided them with the best access to research. However, hedge fund seniors often find themselves with insufficient time to research all their ideas in sufficient depth to support a high-conviction trade.

Independent research has flourished in some niches; however, most firms have struggled to build sufficient revenue streams to support broad coverage with high-quality fundamental research. The independent sector is therefore a mixture of niche providers who focus on larger sectors and data providers which provide more information than in-depth analysis.

Facing a less certain future post 2008, many managers should consider outsourcing as a means of plugging the gaps in their research needs at an acceptable cost. Onshore seniors will always retain ultimate responsibility for

security selection, but they may be able to make better decisions with better resourced support.

Active managers have a wide variety of investment styles, and therefore there can be no 'one size fits all' prescription with respect to offshore research support. Vendor selection should be based on:

1. Domain expertise and the ability to understand the client's investment process and objectives
2. Staff training, employee qualifications and the ability to leverage in-house sector and technical expertise
3. Compliance process plus physical and IT security
4. Transparent delivery process
5. Communications plan, including a clear feedback loop

There are a wide range of services available in the market, some of which are listed below to provide a flavor of the range of services that can be delivered from offshore locations.

Outsourced data gathering, interpretation and organization of information can free up onshore decision makers to spend more time on selection of securities

Equity research services available from the major specialist research outsourcers include:

- Idea validation: Specific investment theses can be researched in depth and supporting data gathered
- Coverage initiation: Coverage initiation and maintenance on sectors not adequately researched by the sell-side
- Portfolio management: Stock news alerts and monitoring can be established to enable managers to stay on top of their portfolios. Screening of broker research, stock universe screens and independent support for company visits

Credit research support can include:

- Fundamental research: Fundamental research on investment grade, high-yield, and cross-over credits. Capital structure analysis and the creation of automated bond screens
- High yield and distressed debt: Cash flow modeling, application of shadow rating models, LBO and M&A modeling, valuation of hybrid instruments, recovery valuations, covenant monitoring, and indenture scanning
- Structured finance: CDO monitoring, CDO constituent analysis, and ABS/RMBS monitoring

Quantitative skills are in scarce supply in the developed world and yet are relatively abundant in a number of offshore locations

Quantitative research is a promising area for outsourcing due to the constrained supply of experienced professionals onshore. The Indian subcontinent has a depth of talent available in computer programming and pure and applied mathematics. Where this expertise is harnessed by an outsourcer with expertise in capital markets processes, the combination can make for compelling value vs. onshore alternatives.

Outsourced services in this space cover a wide range of domains including:

- Equity services: Creation of automated screens, factor selection and back testing, portfolio simulations, and model building
- Index research and data management services: Index construction and maintenance to data validation, and aggregation
- Mathematical modeling services: Monte Carlo simulations, time series econometrics, and statistical analysis
- Technology solutions: Database design and development, customized application development, and process automation

Fund sales and marketing

Sales and distribution is the second-largest cost item for most fund managers. It is an area which cannot be neglected given the link between revenues and AuM. The productivity of onshore employees can be significantly enhanced by a good outsourcing vendor. Most fund managers would do better if they could focus on security selection rather than data gathering to answer questions from investors.

Funds marketing presentations and the production of shareholder reports can largely be automated and thereby generated at significantly lower cost and higher quality offshore.

Other services available from outsourcers in this domain include:

- Sales support: RFP completion, replies to sales queries, and performance tracking
- New product development: New fund structuring, selling strategies, back testing, and development of structure variants
- Marketing strategy support: Media planning, client segmentation, and intelligent data mining
- Marketing support: Production of marketing brochures, editorial support, desktop publishing, and language support

Risk management

The events of 2008 have led to increased regulatory focus on risk management. It is clear that some firms had underinvested in the risk management function and most fund managers must now re-evaluate their systems and processes. This is not only necessary to satisfy regulators in respect of corporate governance and compliance, but also to ensure that every possible step is being taken to avoid exceptional losses in the future. Investors are likely to increase their level of due diligence before committing funds to asset managers, and firms that lack access to world-class risk management systems are likely to be at a significant disadvantage when raising institutional money.

Outsourcing can help to integrate risk management platforms improving the provision of management information and the quality of compliance reporting

Many of the larger asset management firms have grown by acquisition and are plagued by incompatible technology platforms. We believe that it is essential to have a single platform that monitors all the risk exposures of a group on a consolidated basis. This is an investment that many firms have yet to make and augurs well for the business of consultants and service providers like BlackRock.

Outsourcing firms not only handle local regulatory reporting, but they can also monitor fund portfolios to ensure compliance with the investment restrictions defined in the fund's regulations and/or prospectus.

Other outsourced services that can be used to enhance the risk management infrastructure include:

- Risk systems development
- Risk reporting
- Scenario analysis and stress testing
- Risk system identification
- Compliance reporting

Conclusion

The events of the past year have been a wake-up call for many asset management firms. Managers can no longer rely upon consistent growth of the asset markets to offset poor management decisions. The history of outsourcing in the asset management industry dictates that all parts of the business need to be reviewed on a regular basis to confirm that optimal operating efficiencies are achieved. Whenever a lack of scale, skill sets or technology hinders the efficient delivery of the service, outsourcing should be considered.

Whilst size does lend structural advantages to the biggest global asset managers, this does not preclude the generation of attractive financial returns by smaller managers. Mid-sized and smaller asset managers simply have an even greater imperative to deliver cost efficiency from every part of their business.

Back- and middle-office outsourcing are already well-established business strategies; however, outsourcing of front-office functions is now an additional tool by which asset managers can gain a competitive advantage.

To generate alpha, portfolio managers should be freed up to make well supported investment decisions rather than spending time on data gathering and organization and time consuming response to client queries. The risk management platform needs to be comprehensive and robust enough to stand deeper scrutiny from investors and regulators. Marketing and distribution needs to be as cost-effective as possible. Outsourcing can be a cost-effective solution that can contribute to cost and performance improvement in all three of these areas.



About Amba

Amba Research provides investment research and analytics support services to the global capital markets industry. Over 70 companies, including six of the top 15 global asset managers and six of the top 15 global investment banks use Amba to differentiate and outperform. All Amba services are customized, exclusive, and proprietary to each client. Amba was founded in 2003 by senior directors of research from Goldman Sachs, Deutsche Bank, and JPMorgan. Amba has offices in New York, London, Singapore, Bangalore, Colombo, and San José (Costa Rica).

For more information, please visit www.ambaresearch.com.

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