Buy-Side Business Attribution:

Assessing Costs and Quantifying Value

Similar to performance attribution for a portfolio of investments, senior decision makers on the buy side need to be able to assess and understand the revenue contributions made by the component parts of their business. Only by identifying and calculating the relative value of processes, products, vendors, and people can investment management firms truly measure the profitability of their organization.

Having a scalable infrastructure to aggregate revenue and expense data is critically important to the investment management industry, as it strives to grow amidst the countless challenges the industry is facing today. This note considers some of those key challenges, how firms are responding to them in terms of investment prioritization, and what opportunities exist for firms to position themselves for the future.

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Overview

C-suite executives at asset management firms are facing hurdles that present an unprecedented level of complexity to the running of their business. Post-traumatic flashbacks of the 2008 financial crisis and its impact on buy-side budgets continue to plague Chief Financial Officers and other key decision makers. Although the economic environment has improved, the after-shocks — triggered by recent volatility and uncertainty in the global markets —threaten even the best-laid five-year strategic plans. The resulting regulatory reactions layered across multiple geographies and investment strategies require a level of quantitative intelligence to support compliance and strategic business decisions that are difficult to achieve.

Making sense of overwhelming amounts of data in order to gauge the direction of the markets, the industry, and individual firms is now a critical component of success. Knowing how, when, and where to best scale into new products, new distributors, and new geographies are decisions that asset managers are grappling with in today’s environment. Identifying and extracting the greatest value from the scarce resources that remain after meeting mandatory regulatory compliance and technology expenditures is dependent on meaningful quantitative analysis. Every firm is looking to stay profitable, and consequently needs to make precise, quantifiable decisions about how to grow their organization. While they may arrive at the answers in their own unique way, access to business intelligence, metrics, and technology at the enterprise level are essential to supporting their choices.

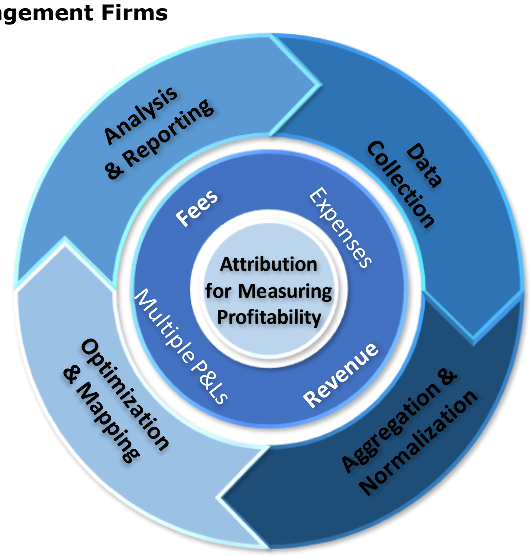
Current Approaches to Strengthening the Business

Every asset management firm we spoke with during Q3 2015 is responding to market challenges in their own unique way. No single approach can meet every requirement, and not every firm admits to maximizing the data they possess in order to make quantifiable business decisions about where to invest, cut, or outsource. However, each firm must have a way to convert data into business intelligence to identify areas of strength and weakness, and to identify successful partnership across business lines and geographies (see Exhibit 1).

P&L Management

How a firm tracks expenses, revenues, and fee outflow across various business units, systems and/or geographies is often based on factors as diverse as a firm's ownership structure or even cultural philosophy. Whether a firm is publically or privately held affects the time horizon for decision-making. Absent the pressures for quarterly reporting to shareholders, privately held companies can often take a longer view of their strategic planning. Hence, there is a much longer period to look at investments and how they go about spend and expansion, versus worrying about the quarterly cycle of earnings.

Exhibit 1: Attributing Profitability at Investment Management Firms



Source: TABB Group

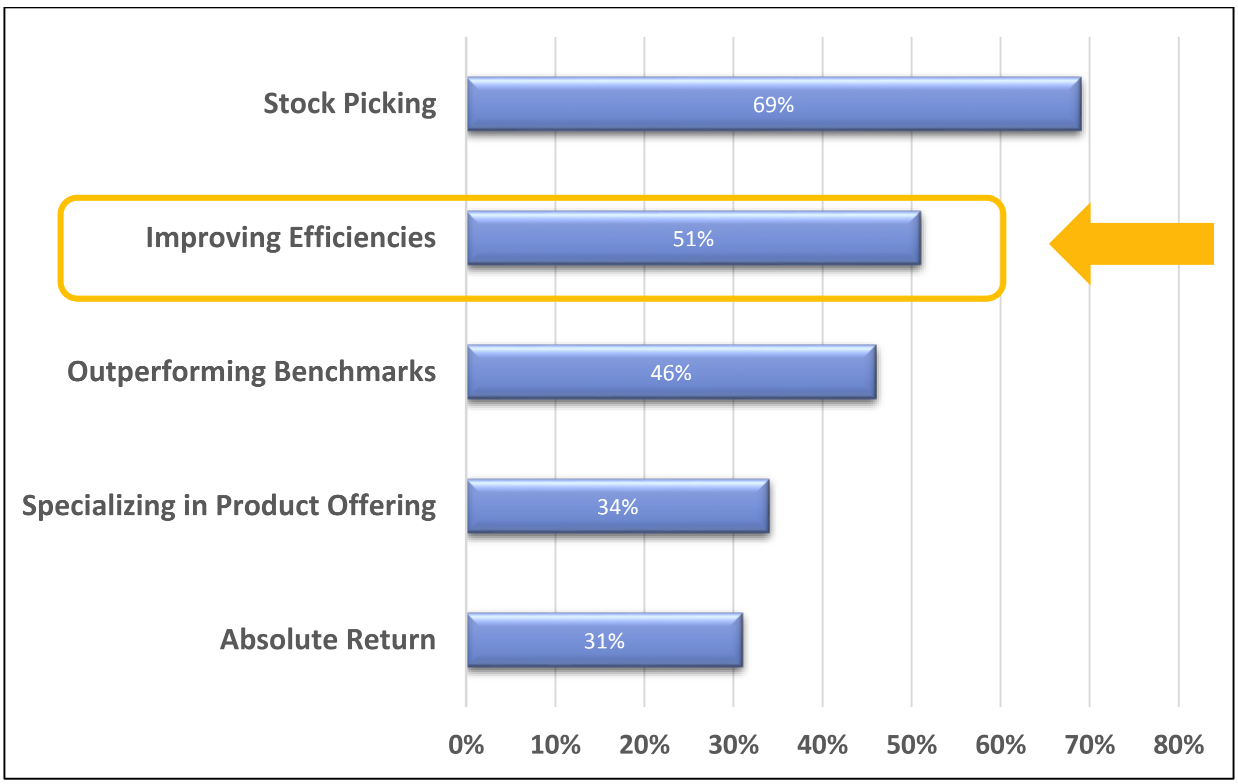
Cultural values can also determine how and where profit and loss (P&L) management takes place. A single view of a firm's P&L — or one that summarizes the revenues, costs, and expenses incurred during a specific period of time, usually a fiscal quarter or year — puts the focus on business decisions that are the best for their clients, not necessarily the firm directly. In this model, there is no product profitability tracking, nor is regional P&L tracked, outside of what is required for regulatory purposes. The philosophy is that if you start to allocate, you are going to shift behavior — and is this really an effective use of, first, finance's time, and secondly, more importantly, management's time? This approach is related to a cultural philosophy that having a single view supports a unified firm, with the ultimate goal being the fulfillment of a fiduciary responsibility to the client.

If firms do not have a way to look at revenue, tie it back to their products, and analyze what is needed to support their products, it is not always easy for firms to evaluate what is quantifiably best for their clients. Many firms have adopted a federated model of individual business line P&L reporting into a centralized finance function. Corporate strategy and finance teams work together to determine general budget guidance, and the businesses take that guidance and work within it. By providing autonomy to department heads to control their expenses, each department is run like a small business. They are free to make their own "value for service" determinations without the corporate finance team's involvement. The business lines know how much revenue they generate, but there is no transfer pricing of services. In this model, the reporting of expenses up to the finance team needs to be consistent, with a standardized reporting process established across the businesses. In either case, managing expenses needs to be a seamless, efficient data=driven process across the enterprise, regardless of geographic location, reporting currencies, or technology platforms. A single consolidated overview of revenues and expenses should be perceived as a vital intelligence tool that can provide insights into the business that would not otherwise be attainable.

Achieving Operational Efficiency

Asset managers are embracing a number of different approaches on how to structure their operations and technology to be more flexible and cost-efficient, and become a top strategy to for growth (see Exhibit 2). Reengineering older technologies and streamlining stale, outdated processes, although a painful process in the short term, absolutely cannot be dodged by firms that wish to stay relevant in the long term. However, there are a few different approaches that we observed asset managers taking to achieve this objective.

Exhibit 2: Growth Strategies at Traditional Asset Managers



Source: TABB Group

Outsourcing Non-Core Competencies. Many of the firms we spoke with do not perform fund accounting, reconciliation, or other operational work in-house. Those functions are often outsourced, while maintaining an internal team to manage those relationships to ensure that everything is working the way it should. In addition to saving on technology systems and infrastructure, an outsourcing model can provide significant cost savings in terms of people, overhead, and the management required for the function. Some of additional benefits of outsourcing these functions is the vendor has the ability to normalize and consolidate data across multiple sources and globally into a single, centralized repository. Finding a provider with the combination of industry-leading technology, people, and operating model can provide your business a more efficient process at a lower price point. Although an outsourcing arrangement certainly requires investment in data and metrics that provide intelligence about how the relationship is working (or not), one senior executive found it amazing that all firms do not use an outsource model.

Shared Services Model: The adoption of shared services or centers of excellence are another way that asset managers are seeking to streamline their operations, reduce costs, and focus on other client or regulatory obligations. Although it is not uncommon to find fund accounting, reconciliations, or even anti-money laundering services centralized, we found that the Chief Finance Office could additionally be run as a shared service. This model deploys an allocated central finance team that embeds people in divisions. There are centralized financial reporting tools that they use to aggregate all the various channel data around product flows, assets, and expense reporting, across client types and geographies. Allocating data and analytics into a centralized platform helps firms to adopt global processing standards enterprise wide.

Streamlining Infrastructure: Investment firms that have been historically "build" shops are becoming more open to vendor solutions, and many others are engaging in the strategic deployment of proprietary and vendor solutions. Vendor solutions decrease the overall cost of ownership and provide a secure, reliable, and flexible infrastructure; but also means a constant re-evaluation of cost and service levels. This is not always a formal process, but it is a discussion that inevitably comes up each year during the budgeting process. Managers gather to talk about whether or not they want to use a particular vendor going forward, whether they are getting the best cost and service, and if there are new and better solutions offered in the marketplace.

Expansion of Product Offerings

Decisions about where to expand into new types of products or asset types are typically driven by the individual business unit advocating for a new strategy. Assessments are based on their understanding of what is currently being offered in the market by competitors, or talking with clients about their particular needs. It is not typically a data driven decision or process. US-based firms are extending into new global jurisdictions such as emerging markets in order to achieve portfolio returns. Knowing where to invest must be based on careful evaluation, with resources deployed outside of the home office in a very measured way. Globalization must be approached in a steady manner in terms of governance, maintaining the existing culture, and making sure that its being done in a very thoughtful manner and not "just doing it for the sake of doing it." The regulatory and compliance implications for a global investment firm are multiplied, and it is challenging to have the technology infrastructure available to manage globalization in an efficient and scalable manner. The right partner must have the functionality to perform in a global market.

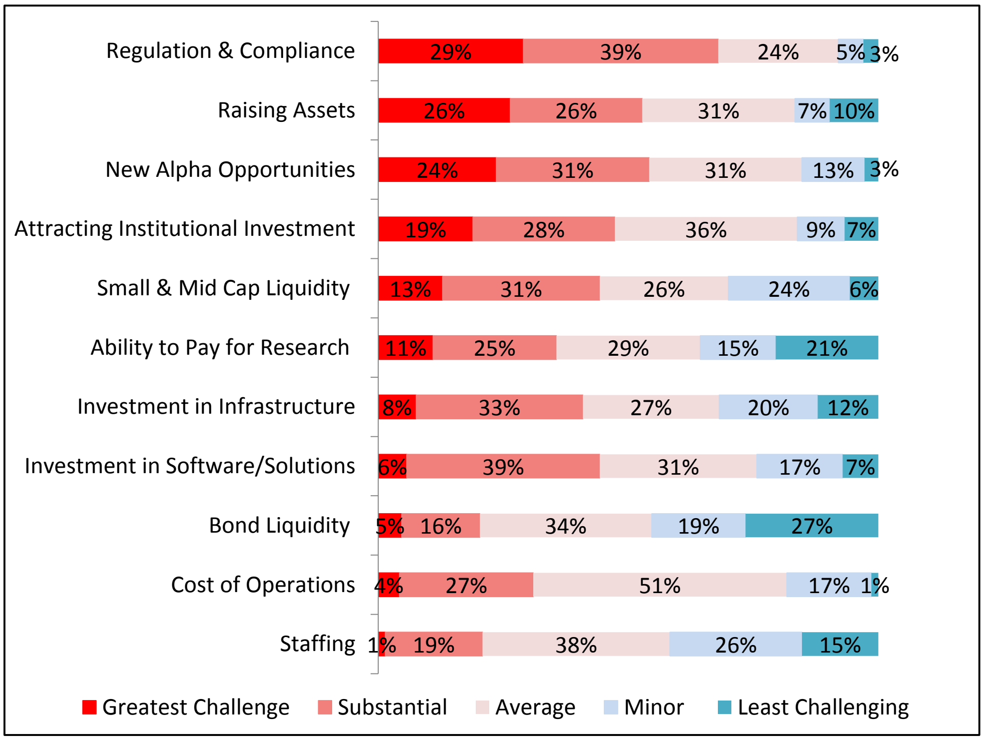
Investing in new instrument types is another strategy for attracting new client assets, but one that inevitably adds complexity to an organization. Product complexity can stand in the way of implementing consistent processes and applications across asset types. For example, many firms may have different technology (and staff) for reconciling derivative positions than they use for traditional security types. However, firms have to change their approach of supporting asset classes separately in order to become agile and cost efficient.

Other course adjustments that investment managers are making include the offering of retail products by institutional managers such as electronically traded funds or 40 Act mutual funds; institutional products such as separately managed portfolios by traditionally retail fund managers; or moving into active fund management by passive shops. Broadening into new strategies may either be organic or through acquisition or partnerships, but in every case adds enormous intricacies to the organization that must be measured and monitored. New fee structures, new regulatory requirements, and new technologies all come into play.

Overcoming Business Challenges

To be able respond to still-evolving regulations, closely monitor expenses, and introduce automation where it will yield the greatest advantage, firms need to leverage existing infrastructure and evolve flexible data and process architectures. How firms approach, monitor, and overcome these business challenges will be paramount to finding profitability and gaining operational efficiency. The list of concerns is long, but regulation and compliance remain the top challenges to overcome along with the annual struggle to increase assets and develop new alpha opportunities. With overlaps in how information is processed and used to promote better business decisions, the ongoing marketplace developments cannot be ignored and only contribute toward the spending on technology required in order to stay in front of these issues (see Exhibit 3).

Exhibit 3: Top Challenges Facing Asset Managers



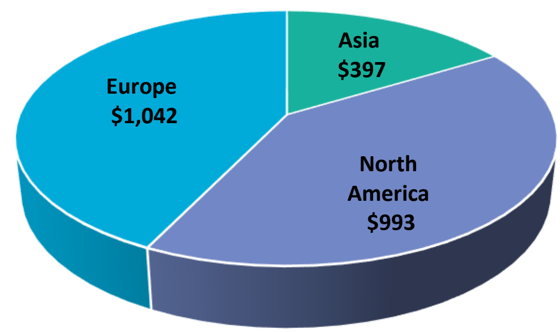
Source: TABB Group

Our discussions with top asset management COOs and CFOs identified a broad range of challenges that they are struggling to address. These challenges originate from many different facets of the industry, with regulation rising to the top as a catalyst of change.

- **Regulatory compliance:** Regulatory compliance is becoming increasingly arduous on a global scale. The costs of compliance are only outweighed by the costs of non-compliance. When providing investment management services in multiple regional jurisdictions, the regulatory cost is magnified in terms of reporting requirements and compliance staffing. Recent TABB Group Research estimates that compliance-market spend will increase by 7.5% to 8% in 2015 and will continue to grow at a similar pace for 2016 (see Exhibit 4)

- **Market Volatility:** Each of the executives that we spoke with mentioned that they learned from the financial crisis that they must constantly be correcting for the ebb and flow of market conditions, particularly in an uncertain interest rate environment. This requires a delicate act of balancing and redeploying staff and technology in order to achieve an equilibrium of a scaled economy.

Exhibit 4: Global Compliance Market Estimates



Source: TABB Group

- **Transparency:** Firms are striving to maintain client confidence and fiduciary trust by meeting their needs both in terms of managing their assets and also by means of superior client service, fee transparency, reporting, and flexible product offerings. Institutional investors in particular are demanding a higher level of insight into their portfolio holdings, the fees and costs of maintaining their account, their exposure to underlying industries — and they want it all aggregated in one place or report. Bringing this data together in a consistent manner to allow for benchmarking is no easy feat. Finding the information in the first place is even more difficult.

- **Cost pressures:** Investment management firms are single-mindedly seeking to wring costs out of their business, particularly in processing and technology operations. Having cut their workforce to the bare minimum, asset managers now face the challenge of finding additional ways to lower costs while maintaining (and in some cases, such as client reporting, increasing) their ability to provide high-quality process execution and service. With the limited discretionary budget remaining after regulatory compliance and client service, any function that can be automated needs to be automated. Processes must be as lean as they possibly can, in terms of human capital, vendor spend, and market data expenses. At this point, firms need business intelligence around what processes are working, and where expenses can be better tracked, allocated, and managed**,** at the enterprise level.

Conclusion

The asset management industry is entering a new phase. The regulatory web is spreading its way across the globe, and producing returns on portfolios is becoming more difficult. As firms continue to expand away from their traditional niche strategies, the technology and processes of 10 years ago are not efficient enough to meet the new requirements and keep them profitable. Our research uncovered ways for asset managers to monitor profitability across the enterprise, to identify areas of inefficiency, and to make corrections when necessary. It is vital that the investment management industry moves to improve data quality, streamline processes, and enhance business analytics in order to measure the relative contribution of a product, partner, or process.

Firms should also acquire data analytics solutions that can help pinpoint their blind spots, weaknesses, areas of profitability, and opportunities for investment. For example, the adoption of a knowledge management framework to capture the relative contribution that intellectual assets, such as portfolio managers, analysts, and traders adds to the strength of the firm and meeting strategic and client objectives. Investment firms should be able to identify the drivers of all changes to their assets under management (AUM), and how they directly lead to changes in revenue. They must be able to tie expenses back to client value, therefore optimizing sales and service personnel. In addition, they need to have the capability to evaluate profitability on a regular basis, not just yearly or even quarterly.

In terms of technology, investment managers must commit to investing in the infrastructure of the firm, whether incrementally or a total refresh. Implementing global platforms, whether proprietary tools or vendor solutions, allow them to gather data and share knowledge across geographies, jurisdictions, and/or divisions. They can only become lean, mean, and agile if they automate functions and processes wherever possible. Alternatively, they should consider outsourcing non-core competencies to specialist firms, and create centers of excellence for professional services across the enterprise. By strategically deploying vendor solutions such as data visualization, workflow, and revenue/expense management tools, firms can perform the detailed analysis needed to evaluate the exact performance of business partners and other service providers. Investment firms that have the ability to tie back revenues and expenses on a granular, attributive basis can protect their profitability, particularly in times of market volatility.

About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of first-person knowledge, TABB Group analyzes and quantifies the investing value chain, from the fiduciary and investment manager to the broker, exchange, and custodian. Our goal is to help senior business leaders gain a clearer understanding of financial markets issues and trends so they can better grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit www.tabbgroup.com.

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Dayle Scher joined TABB Group in August 2015 as a Senior Analyst focused on the technology and equities practices as well as consulting projects. She brings more than 25 years of experience in the capital markets industry, with expertise in the business processes and technologies impacting the institutional securities industry. Prior to joining TABB Group, Scher was a Vice President at State Street Global Exchange, where she supported the development and commercialization of information and analytics solutions, including go-to-market and communications strategies. Scher started her career working in the investment management industry, both at Morgan Stanley Investment Management in London and New York and at MFS Investment Management in Boston. She received her M.B.A. in Finance from Fordham University and a B.A. in Political Science from the State University of New York at Albany. She also spent a year studying at the Centre for Economic and Political Studies in London.

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