



# Maximizing Value in Asset Management: A Closer Look at Insourced Operations

## INVESTMENT OPERATIONS IS AN ASSET, NOT A LIABILITY

What is the role of investment operations in asset management? Should asset managers insource, outsource, or use managed services? The decision is a difficult one. Discussions around modern target operating models and how to utilize investment operations have highlighted the benefits of outsourcing middle and back-office functions. Lowering expenses and limiting the scope of core competencies to portfolio management have driven more asset managers to consider outsourcing. Operations teams are routinely viewed as a liability instead of an asset on the corporate balance sheet, not a core competency. Although outsourcing has many benefits, I discuss an alternative approach in this article. I challenge common perceptions and discuss how an internal investment operation can drive superior performance by providing more organizational control, long-term cost savings, and better-quality data.

## IS SHORT-TERM SAVINGS WORTH THE COST?

***An agile change management process supporting an insourced operation is an effective way to create efficiencies quickly.***

An outsourcing relationship is a partnership and, by its nature, results in less strategic and operational control. When implemented correctly, outsourcing leads to short-term reductions in expenses by reducing staff on both operational and technology teams, saving money from technology/hosting providers, and lowering the firm's financial risk profile. The short-term savings from outsourcing operations come with a trade-off.

Outsource providers are integrated within operational workflows, data, and technology as a critical component of an asset manager's operating model. By doing so, the relationship is expensive and disruptive to unwind. Onboarding a new outsourcing provider requires significant resources to integrate with their systems and, in the case of U.S. mutual funds, possibly changing custodian banks. Asset managers no longer have unilateral day-to-day or strategic control over areas of their business, and the engagement is long-term because of the expense, expertise, and disruption it takes to leave an outsourced provider.

Process improvements, strategic projects, system upgrades, and new data providers may all have to be routed through the outsource provider before getting implemented. Getting a strategic change on two company roadmaps and resourced correctly is much more arduous than doing it yourself. An agile change management process supporting an insourced operation effectively creates efficiencies and navigates strategic initiatives with less friction.

## LONG-TERM CONTROL OVER EXPENSES IS A DIFFERENTIATOR

***It is common for service providers to use a variable cost model by charging fees based on trading volume or assets under administration.***

Margins are tightening, and competition is fierce within asset management. Asset managers are lowering their fees to attract investors. According to an ICI report titled "Trends in the Expenses and Fees of Funds, 2021" (Duvall, James, and Alex Johnson, 2022), equity mutual fund expense ratios are over 50 basis points lower than in 1996 with economies of scale and competition referenced in the report as factors. Lowering operational expenses is a key driver for generating company profit and can be used by asset managers as a competitive advantage through lower expense ratios.

When evaluating whether to outsource investment operations, the cost savings on projected financials can look attractive and explain why many asset managers choose to outsource over insourcing. It is common for service providers to use a variable cost model by charging fees based on trading volume or assets under administration.

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## LONG-TERM CONTROL OVER EXPENSES IS A DIFFERENTIATOR (continued)

This variable cost structure will increase expenses over time as asset managers grow, creating a drag on long-term growth. Firms with a scalable, insourced operating model and the right technological solutions can stabilize their expenses while growing their assets and diversifying product offerings.

Technology is advancing rapidly, and vendors have front-to-back SaaS offerings to support asset managers in a single system. Cloud-based solutions offering interoperability with robust partnership ecosystems provide asset managers with powerful tools for managing their operations at scale. As more firms outsource and providers exercise control over the market, there is an opportunity to differentiate with a vertically integrated operating model. Partnering with the right technology provider and implementing robust investment operations can reduce costs and widen margins while outsourced managers watch their costs rise over time.

## DECISION MAKERS NEED ENRICHED DATA

***There is more traceability and understanding of where data comes from when investment operations are insourced.***

Data is the principal driver for asset management decision-making and generating value for clients. Higher quality data correlates to better investment decisions when deploying effective data management strategies. The best operations teams use service level agreements (SLAs) to set expectations for deliverables and measure KPIs. Outsourcing SLAs tend to be more generic in nature because they fit into the service provider's existing service delivery model. Insourced operations can be more agile and adaptive when establishing SLAs to better align with portfolio manager requirements. SLAs and KPIs are more collaborative when dealing with internal teams with a focus on improving operational processes. When SLAs are contractual between two business partners, it can lead to finger-pointing and a lack of transparency.

Internal communication channels can provide timely commentary on data that an outsource provider cannot compete with, like holdings and cash. Data delivered from an outsource provider tends to be boilerplate and not easily configured to meet asset managers' unique business use cases. There is more traceability and understanding of where data comes from when investment operations are insourced. In some cases, the front office will have access to the same systems as operations and can drill into lower-level detail to understand the why behind their data. For example, a portfolio manager who reviews their cash ladder and identifies an irregular projected inflow could look at the IBOR system to understand the transactions and reference data contributing to the inflow.

## DATA QUALITY IMPACTS CLIENT EXPERIENCE

***Asset managers with efficient insourced investment operations forgo a lower financial risk profile in exchange for better control over their product delivery, lowering their reputational risk.***

Outsource providers typically offer a portal for reporting but do not usually allow asset managers to see behind the curtain. Data quality does not only impact the portfolio management team but also their clients. Incorrect reporting of the NAV, trade matching/settlement errors, and other operational mishaps majorly impact an asset manager's relationship with their clients. Outsourced providers will compensate portfolios for material errors as defined in their contract, but this does not extend to repairing the reputational damage done to the product or asset manager.

Effective insourced operational teams have more knowledge on how a portfolio operates, have better relationships throughout the organization, and have more effective communication channels, contributing to a robust control framework for preemptively catching mistakes before they become errors. Asset managers with efficient insourced investment operations forgo a lower financial risk profile in exchange for better control over their product delivery, lowering their reputational risk.

## HOW MERADIA CAN HELP

Operations and technology teams are often overlooked as drivers of value. It is important to create strategic, forward-looking plans for operations and technology. Understanding business objectives and regularly assessing whether operations and technology align with them is key to achieving future business goals.

Deciding between outsourcing and insourcing investment operations is a watershed moment for an asset management organization. Our team of operations and technology consultants at Meradia has the expertise to assess operations front-to-back and recommend outsourcing partners or strategies to leverage internal operations and modern technology to maximize value for your business.

**Citation:** Duvall, James, and Alex Johnson. 2022. "Trends in the Expenses and Fees of Funds, 2021." ICI Research Perspective 28, no. 2 (March). Available at: [Trends in the Expenses and Fees of Funds, 2021 \(ici.org\)](https://www.ici.org/trends-in-the-expenses-and-fees-of-funds-2021)

**Chris Bodkins, CFA**, brings valuable middle- and back-office transformation expertise to Meradia's client projects. He has worked for leading service providers and management firms to develop a well-rounded view of investment operations. With over a decade of experience, Chris has served as the business lead on multiple implementation and integration projects. Chris has helped firms transition from an insourced to outsourced operating model, including workflows and system changes. Chris has experience across all asset classes, including derivatives, alternatives, private equity, and bonds, and excels with cross-functional project coordination.