WHITE PAPER

Operations Outsourcing and Investment Reporting

A Guide for Investment Advisors

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The Challenge: Controlling Costs Without Compromising Service

In the wake of market turbulence unlike any seen in a generation, investment advisors are under enormous pressure to retain assets and sustain profitability. Rebuilding client trust and containing costs are the two most important goals a firm must meet if it hopes to stay viable as the market recovers.

The challenge is that those two goals are often at odds. Clients expect proactive solutions, fast response, and timely, detailed reports of irreproachable accuracy. Yet the technology needed to deliver first-rate service can be costly. And there's the question of having the time and expertise required to properly manage a portfolio accounting and reporting system in house.

That is why more and more firms are taking a closer look at outsourcing back office operations, portfolio accounting systems, and reporting. For many advisors, particularly growing firms more focused on "high touch" than "high tech," delegating these duties to third-party experts helps reduce time spent on administration in order to devote more attention to clients and investment solutions. And it delivers the advantages of technology while minimizing the investment in hardware, implementation, maintenance, and IT expertise.

This document is intended to explain how outsourcing works, when it makes sense, and some of the tradeoffs involved. Its purpose is to help you make an informed decision as to whether outsourcing is right for your business.

Outsourcing Goes Mainstream

Outsourcing is a common business practice. If you use a law firm for your legal requirements or a CPA firm for your taxes, you are outsourcing—delegating essential functions to professionals that can provide high quality services, while leaving you free to do what you do best. Better still, you don't have them on the payroll, so you don't have to foot the bill for their health care, Social Security or 401(k) contributions. You pay only for what you use.

Many financial institutions are now taking that logic a step further, passing functions that are supplemental to their core business proposition to someone who can do it efficiently and cost effectively. And it is not just large institutions going down this path. The business and economic considerations driving outsourcing decisions apply equally to investment advisory practices of all sizes, especially when it comes to their portfolio accounting, reporting, and performance measurement requirements.

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Understanding Outsourcing Options

The term outsourcing covers a range of alternatives from the software-as-a-service model (SaaS) to full business process outsourcing (BPO). In the SaaS model, the emphasis is exclusively on technology. The provider houses its solution at its own facility and provides all systems, maintenance, and subsequent updates. The client, however, still retains responsibility for conducting all the processing functions that are carried out on those systems. In the BPO model, the service provider typically offers functional expertise as well as the supporting technology on a SaaS basis. There is usually an agreement between the outsource provider and client clearly outlining what services will be performed and how they will be fulfilled.

Outsourced technology and services may be delivered through a shared environment, in which multiple clients are served through a single database, or through a customized environment in which each client has a dedicated server at the provider's site. The spectrum of options might include:

- SaaS only, with the client handling data and operations;
- SaaS combined with limited automation of common tasks such as data management;
- SaaS combined with full operations and data management outsourcing to the provider.

For investment advisors, many outsource providers offer only one or two options. That will prove limiting when your needs change or you outgrow the original solution. If your provider offers the full range of options, you can make the transition from one to another without starting from scratch and disrupting your business.

Why Outsource?
A Question of Time and Money

Time is a precious resource. It's imperative to spend it on the tasks that matter most and at which you are most adept—tasks that generate revenue and strengthen client relationships. So what are your priorities? Do you want to be working with your clients, advising them on how best to meet their financial goals? Do you want to be talking to new prospects? Do you want to be exploring new investment ideas and solutions? Do you need to stay better attuned to the movements of the market for both risks and opportunities?

Most advisors would answer yes to all these questions. But if you are spending a significant portion of each month on administration, rather than on clients and their portfolios, then your business could be paying the price.

Of course, providing accurate portfolio accounting, performance measurement, presentation-quality reports, and daily account reconciliation can also come at a price: the cost of licensing robust, sophisticated software solutions and hiring the operational staff to maintain the process. Depending on the size of a firm's client and asset base, the diversity of instruments in its portfolios, the skills of its staff, and the scale of its operations, the investment in a full installed portfolio accounting and reporting system may make perfect sense. For many in the advisory community, however, the tasks of managing data, the reporting processes, and performing reconciliation in house can be economically daunting.

Outsourcing offers a lower cost alternative, particularly upfront, while enabling you to leverage the technology, skilled resources, and data management capabilities of its provider.

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Defining Reporting Requirements

A major reason for outsourcing portfolio accounting is to be able to provide professional quality reporting that clients expect and regulators require—without having to do the bulk of the work necessary to generate them. Besides your internal management needs, you need to consider the requirements of your clients and the regulators in defining your reporting requirements.

Client Service and Reporting

As the investment environment has become more complex, and technology has evolved to keep pace, client expectations have become more sophisticated. Clients expect immediate answers on where their portfolios stand at any given time. They want to know how they are doing in absolute terms as well as relative to standard indices. Their reports need to paint a broader picture in light of their investment plans, so as to monitor their progress towards their financial goals. And they expect advisors to be able to explain and support their decisions and recommendations.

All of that requires a more advanced level of asset allocation and performance reports, and the ability to analyze the client's performance from multiple perspectives. Increasingly, too, investors want their investment managers to be comprehensive financial advisors. That means being able to provide reports with information that helps produce better tax-aware decisions—gains and losses with full cost basis details, income on dividends, interest payments, and capital gains distribution.

Besides offering a full suite of report types, a reporting solution also has to have sufficient flexibility to allow users to customize reporting formats. Can it create client summaries, or report packages? Can you choose different types of information to include in those summaries and packages, varying the level of detail according to customer type and preference?

Advisors can differentiate themselves on the basis of their ability to respond quickly and thoroughly to clients, provide clear and often customized reports, and explain what is happening in their clients' portfolios. These capabilities become even more important in times of uncertainty.

Performance Reporting

Made wary by the market volatility of recent years, investors are more acutely attuned to performance than ever. Performance reporting is an essential capability for any advisory firm.

Some outsourcing solutions rely on periodic "snapshots" to measure changes in portfolio values over time. But only with full transaction reporting—tracking every buy, sell, dividend, and cash deposit—will you be able to truly analyze and explain performance.

If you think of performance reporting as a roadmap—showing you where you've been and helping you figure out where to turn next—time-weighted and dollar-weighted rate of return reports are the longitude and latitude of navigation. Time-weighted rate of return helps analyze the performance of the investment selections, meaning the advisor's performance. Dollar-weighted rate of return, meanwhile, is a more effective tool to understand the investor's impact on performance. For example, if a client puts cash into their account at different times in a month, what effect does that have on overall performance? These two distinct performance calculations—both important, both useful—help analyze different issues but reveal your true position only when viewed together.

Regulatory Requirements

Regulation in the investment industry has been getting progressively more stricter in recent years. And with the signing of the Dodd-Frank Act, there is no doubt that investment advisors are going to be under more intense scrutiny than ever in the years ahead.

Fair and transparent practices are in everyone's interest. However, it means investment advisors are faced with more rings to jump through to prove they are upholding the integrity of the industry, and those rings are constantly shifting. Yet whatever the volume or complexity of regulation, or the rate at which it is changing, accurate and timely data and reports for compliance are non-negotiable.

When considering an outsourcing option, ask if the solutions available will enable you to meet increasingly demanding client expectations and regulatory requirements. Again, with anything less than full transaction tracking, you may have trouble getting through an SEC audit.

The Top 10 Indicators for Outsourcing

As the ranks of independent advisors have grown in recent years, many start-ups choose the outsourcing option to get their businesses off the ground. It gives them the technology to compete with established firms without incurring a major upfront IT investment or the immediate need for operations staff.

More established firms, however, are reexamining their systems and processes in light of a changing investment and regulatory environment. They need to improve efficiency, increase transparency, and deliver outstanding service. Answer yes to most of the following questions and your business may well be a candidate for outsourcing.

1. Is a disproportionate amount of your time spent on operational or administrative tasks, rather than on managing money or attracting clients?
2. Do you and your staff often have to work weekend or evenings to catch up with administrative tasks?
3. Have you had to add staff to handle your operations, reporting requirements, reconciliation, or IT troubleshooting—or are you contemplating doing so?
4. Have you experienced difficulty retaining or attracting qualified, essential staff?
5. Are your reports susceptible to inaccuracies, unclear, or less than professional in appearance?
6. Have you had negative feedback about your reports?
7. Are your quarterly reports frequently sent out late?
8. Is your account reconciliation often delayed or too infrequent?
9. Is it difficult to carve out the budget to upgrade your current portfolio accounting and reporting solution?
10. Can your current solution keep pace with your current—and desired—asset growth?

Outsourcing Pros and Cons

Outsourced services and technology have evolved rapidly, and today they offer far more robust features and flexibility than just a few years ago. Still, outsourcing is not necessarily the answer for all firms all of the time. And among outsourcing providers, capabilities vary widely. There are pluses and minuses to consider—and to be on the lookout for—in light of each firm's particular circumstance.

Advantages

- Containment of day-to-day operational costs
- A predictable monthly expense
- Freedom to focus on core competencies
- Data accuracy
- Quality and variety of reports
- Rapid solution implementation
- Predictability against future investment requirements
- Scalability to match business growth

Outsourcing offers a way to achieve data accuracy and reporting quality—to get the same level of sophistication that the largest, most technologically advanced organizations enjoy, and thus build credibility with existing and prospective clients—while keeping a lid on operational costs. It also circumvents the time-to-market issues that come from having to deploy a solution in house and train staff to use it. Meanwhile, it frees up the firm's advisors to focus on what they do best: manage portfolios and advise clients.

As your business grows, and your reporting and data requirements become more complex, you will need a tool that can cater to your changing circumstances. With an outsourcing solution, you don't need to rip out an old system you'd been running in house and install something new. Instead, with the right provider you will have a platform that can scale with your business, while sparing the extra expense of adding staff as you increase assets. Furthermore, as technological innovations come along, the onus will be on the service provider to make the requisite investments that keep their platform on the cutting edge, not you.

Disadvantages

With many outsourcing providers, you are likely to encounter:

- A "one-size-fits-all" proposition
- Limited customization capability
- Lack of implementation flexibility
- Limited investment product coverage
- Accountability concerns

For outsourcing to add value, there must be a correlation between the investment advisor's business scope and needs and provider's service model. That is not always the case. Different advisors have different requirements, with each looking for a reporting capability that fits its business profile. In contrast, the basic economic rationale from the provider's perspective is to maximize economies of scale, which means commoditizing the service wherever possible. Is there enough flexibility in the service to meet your individual requirements, or is what you see what you get?

Inevitably, your needs will change over time. As your business grows, will the outsourcing service be able to grow with you, or will it have to stretch to cope? And what happens if you reach sufficient scale that it makes more sense to bring control of the portfolio accounting and reporting function in house? Does that transition threaten any near-term gain that could be achieved from outsourcing?

Instrument usage is also changing, as diversification becomes more important and the investment landscape becomes increasingly multi-asset class. Does your investment style involve the use of complex or exotic products? If so, can your outsource provider deal with them? And can it keep pace as products continue to evolve?

Then there is the question of what happens when something goes wrong, or you need to ramp up the quality or quantity of your reports on short notice. With an in-house system, you have direct control over the process. In an outsourced environment, however, you are at the mercy of the service provider. Are they prepared to respond to your needs?

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Finding the Right Provider: Your Outsourcing Checklist

Outsourcing is more than a service. To be successful it should be a mutually beneficial relationship between you and your provider. As noted earlier, not all outsourced portfolio accounting and performance measurement services are created equal, so it is vital to give careful consideration to the propositions on offer.

Does the outsourcing provider:

- Offer the full spectrum of service level options?
- Offer a comprehensive range of reports?
- Have the flexibility for you to customize the report formats?
- Enable you to personalize the reports with your own branding?
- Cover sophisticated investment products?
- Guarantee the accuracy of data management?
- Integrate with your systems and those of your custodians to provide high levels of process automation?
- Have a track record of success?
- Have the sound financials for continual investment and improvement in its systems and services?
- Offer a clear technology upgrade and enhancement plan?
- Employ dedicated relationship managers to provide you with personalized and consistent support?
- Have a detailed security and business continuity contingency plan?
- Offer a migration path from a hosted to a locally installed solution should you require it as your business changes?

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Outsourcing for Today's Challenges and Beyond

The market volatility of recent years and the resulting pressure on advisors have stoked interest in outsourcing, with its promises of lower operational overheads and the freedom for firms to concentrate on their core competencies. In any kind of market, however, accurate and timely portfolio accounting and reporting are critical components of an advisor's business, both in meeting client expectations and ensuring regulatory compliance. To fail in this area is unthinkable, but to excel requires a high level of commitment often beyond the resources of many advisors. And with service demands and technology requirements on an ever-upward trajectory, that quandary is not about to disappear.

Fortunately, outsourcing has advanced significantly in a short time, with the reality of the proposition now matching up to the vision. Today's technology platforms are functionally richer and more reliable. The business model has matured, the service options have expanded, and the roadmap to the future has become much clearer than it was just a few short years ago.

Of course, there will always be advisors whose unique requirements drive them to take control of their accounting, reporting, data management, and reconciliation needs in house, and whose business is of such size and scale to rationalize the investment. However, for growing numbers of others who want to control costs without compromising quality, outsourcing is a viable alternative regardless of the economic climate.

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