

VIEWPOINTS

VIEWPOINTS provides timely commentary from Basis Point Group's Partners on topics of interest to investment management COOs, senior technology, operations and finance managers. We select topics that help managers enhance profitability, increase operating efficiency and improve investment returns. In this commentary we spotlight Operations Outsourcing, revisit on an old subject, "Cash Management: You Again?" and provide insights to managing investment management profitability.

Basis Point Group understands the challenges and has completed due diligence reviews and audits, application upgrade and development projects, and functional reorganizations to improve management controls and reporting.

Our Partners are results-oriented, senior industry professionals with a record of successes and substantial hands-on experience.

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Outsourcing — “A Solution Looking For A Problem”?

Although investment advisors use many outside services such as fund accounting, investment research, performance measurement and analytics, there is still some reluctance to outsource middle office investment functions. Service providers, primarily custodians are developing capabilities that could make this decision easier in the future. One advisor we have spoken with has taken the plunge (it can't get any worse); others are waiting for standards and practices to emerge that will make comparisons to their own shop easier. "Should it stay or should it go?" The jury is still out and wary decision-makers are looking for a few success stories before signing on.

Outsourcing has some merits:

- It allows firms to focus on investment business decisions and transfers the headache of operational issues to a dedicated outsourcing organization.
- It should stabilize or provide longer term savings in technology support and operations infrastructure costs.
- It eliminates issues of compensation, turnover, career path aspirations and training for non-investment staff.
- Leading vendors invest heavily in securities processing technology and bring significant technical resources and capabilities that are typically not resident in most advisory firms.

And some disadvantages:

- Name two advisors that have a similar investment process? Vendors like standardization; managers differentiate based upon their unique and proprietary practices. Are you willing to compromise?
- You can give up control but you can't abdicate the responsibility or liability.
- If it doesn't save money or significantly improve the service, why bother?
- What happens if the service deteriorates or the vendor doesn't invest in the business?

Our viewpoint:

- Although hedge funds do it, investment advisors will eventually outsource investment operations, media relations, finance, HR, compliance and even legal services. "Why didn't we do this before?"
- If Banks are to be successful as outsource providers they need to stop thinking like custodians.
- Passing off an inefficient operation in a lift-out doesn't improve with time.
- Don't underestimate the agony of repatriation. This is like buying a product without a return policy.
- Outsourcing everything doesn't make sense, but outsourcing nothing is a poor management of resources. Start with areas that are small enough to create an easy win, but large enough to make a difference.

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Cash Management: You Again?

You have 'good' security positions, so why can't you agree with your custodian on 'good' cash positions? Why do portfolio managers continue to complain about cash discrepancies when the process should be completely automatic? The point of the cash exercise is to ensure that client funds are fully invested. Cash takes on three characteristics: trades, income, and client flows. A source of the problem lies in trying to verify hundreds of daily transactions by client and portfolio, which are maintained across numerous custodians in various locations and time zones. Operations managers look to their custodian for enabling technology, but the challenge for your cash desk is how to consolidate this data across multiple custodians and accounts. It's unlikely this situation will improve as we move to shorter transaction cycles of T+1.

Questions to ask your cash manager:

- Do you consistently encounter differences between your own cash balances and those of your custodian? How large are the differences? Who is right?
- What percent of your positions that are held in cash sits uninvested every night or is swept or repo'd each day?
- Is there an effective process in place to accurately project cash flows and ensure that funds are quickly invested?

Our Viewpoint:

- Reconcile cash balances everyday. Banks do it, it's not impossible.
- Don't outsource control of your cash balances—focus on it.
- There is technology available to consolidate and manage cash positions from multiple sources
- Establish a dedicated cash operations group to serve as the focal point between your custodian and your cash desk. No Fails, No Float, No Errors.

Profitability

An article in *Global Investor* (1/3/03) "Asset Management CEOs on the Ropes" presents a compelling look at the financial and competitive difficulties facing money management firms. How can the market support the same the number of investment managers when total market caps have decreased 30% from \$17 trillion to \$12 trillion over the past two years? Firms that once enjoyed 40-50% margins are to coming to terms with earnings in the low 20's. Distribution and operating costs as a percentage of

AUM and revenue are too high to sustain multiple business lines. Hunkering down and reducing discretionary spending still doesn't address product proliferation, asset flight or shifts to lower margin bond and cash funds.

Richard Morris of Putnam Lovell was 'on the money' when he said, "It is very rare to come across managers in the investment management industry who understand managing for cost." What happens when "shooting the consultants and firing a few of the

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provides business, technology and operations advisory services to investment managers, service providers and plan sponsors. BPG specializes in operational improvements in front, middle and back offices using a proprietary operational performance measurement approach trading, technology, operations, compliance, acquisition due diligence and integration.

Basis Point Group partners offer a unique combination of operational and intellectual expertise that is unmatched in the industry.

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systems guys" doesn't stop the bleeding? Perhaps there is still too much margin in this business to compel managers to employ the same criteria to their own firms that they utilize as bottom up investors. If they did, they might be more inclined to critically assess those attributes that advance profitability, productivity and market positioning. The themes are self-evident: do more with less, do it cheaper, do it faster and do it better. After all, past performance is no guarantee of future results.