# Delivering Value from Outsourcing by European Asset Managers

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*In This Issue*



# Foreword

Over the last five years, there has been a trend among European Asset Managers to outsource varying amounts of their middle and back office activities. A central question for these managers and any others considering such a move is whether outsourcing adds value. It seems reasonable for firms embarking on new or additional outsourcing projects to demonstrate that there are net benefits which enhance the value of their business. Benefits often cited include lower operational costs, increased productivity, better technology and reduced risk.

At Oxford Metrica, we take an evidence-based approach to such questions. In this briefing, we report the impact on shareholder value of the major European Asset Management outsourcing deals during the last five years. We have examined in detail the share value impact of 21 deals by Asset Managers with more than US$2 trillion combined assets under management. The results indicate that the announcement of these deals is value enhancing. On average, value was increased by 10%. Of course, the usual omitted variable caveat applies; nevertheless, outsourcing seems to be a good thing. Furthermore, it appears that, although costs may be contained, direct cost reduction is not the major driver of the value. It is the release of management time to concentrate on performance. In addition, it is the ability to disentangle the elements of the business and to understand the true cost of each part of the process that determines the success of the deal. Done properly, outsourcing sends all the right signals about management.

In order to support the evidence, we conducted an extensive survey/interview with the decision makers of the major Asset Management firms, the results of which are documented.

We would like to thank The Bank of New York for commissioning this study.

Dr Rory F Knight
Chairman
Oxford Metrica

# Executive Summary

The aim of this report is to provide an independent shareholder value analysis of outsourcing across the European asset management industry. The key conclusions from the research are outlined below.

### Key Conclusions

1 Outsourcing offers many potential benefits to the asset manager including operational cost reduction, technology enhancement, reduced risk and improved productivity.

2 Outsourcing adds over 10% of shareholder value, on average, to European asset managers over the year following announcement of the deal; Figure 1.

3 The increase in value is not reflective simply of increased trading in the asset manager's shares; Figure 2.

4 The key driver of a successful deal appears to be the ability of asset managers to demonstrate understanding of costs and their drivers, and to discern between core and non-core activities.

5 The positive value impact does not appear to be affected by the type of outsourcing model adopted (lift-out or business service provider model, for example), or by the size of deal.

6 There is some evidence to suggest that outsourcing deals that are broader in scope - and include, for example, trade processing - outperform the more restrictive deals.

7 Outsourcing is viewed as a potential managerial solution for non-core investment operations; Figure 3.
The main resource benefit of successful outsourcing appears to be that of managerial time rather than, for example, direct cost efficiencies.

8 Ranked as the most important attributes of an outsourcing service provider are the long-term commitment and stability of the provider; Figure 4.

The empirical evidence on outsourcing deals reveals that such a move can add significant value to the asset manager. The ability to outsource successfully demands a clear understanding by management of the firm's costs and their drivers. This cost awareness and discipline sends a strong signal of managerial skill to the markets.

# A Changing Industry

The rapid flow of assets to hedge funds witnessed in recent years is not only evidence of change in the asset management industry, it also provides an exemplar of how mainstream asset managers are likely to organise themselves in the future. It is estimated that almost US$1 trillion of assets are under management in hedge fund style vehicles. These funds are characterised as being the ultimate in pure asset management, their only activity is investment decision making. They represent the core strategy of any asset management firm with all other activities outsourced. Back and middle offices are non-existent and demonstrably unnecessary. Although it will not be easy for traditional houses to emulate literally, they ignore the phenomenon of the hedge fund structure at their peril.

In fact, given the movement of hedge funds to long-only styles, and the drift of traditional firms to absolute return strategies, the definition is blurring. It is likely that the key definition of the sector for the future will revolve around structure rather than investment style. The service industry will see to it that all non-strategic activities are commoditised and asset management firms will compete on performance alone. Scale will be diluted as a competitive factor.

The boundaries of the asset management firm are being redrawn. The key challenge facing the larger institutional managers is not the definition of their core business; that has been decided by the market already but, rather, how to reorganise to refocus management time on the core activity. After all, the raison d'être of asset management always will be performance.

The evidence we present in this paper supports the proposition that the decision to outsource activities by asset managers is quintessentially about strategy and value, not primarily about cost.

Approaching the outsourcing activity primarily as a means to expand management's capacity to focus on the core is value adding. Chasing cost reduction as a primary purpose is misguided. Although cost reduction should be sought in any outsourcing, it should not be the only goal.

It appears that the process of outsourcing allows management to develop a much better understanding of their processes, how these relate to the core activity and, secondarily, how they relate to the attendant costs. The improved transparency is of course valuable. However, the real driver of value is the signal that management understand their purpose and the need to change.

This briefing aims to provide some evidence on how the process of outsourcing can add value if handled strategically. It appears that to date the outsourcing by European asset managers has sent all the right signals to the market. Evidently, the scale of the value enhancement is well beyond the expected present value of the direct cost saving. The extra value reflects an improved expectation of the manager's performance as a business as a result of the process.

## Evidence on the Value Added

Presented in this section is empirical evidence on the shareholder value impact on European asset managers of outsourcing some of their investment functions. Outsourcing offers a number of well-known potential benefits:

- Cost reduction as the asset manager's cost structure is converted from fixed cost to variable cost, and as the outsourcing service provider reaps economies of scale
- Technology advantages relating both to capital investment in new technology and reliability of service delivered
- Access to specialist investment skills, knowledge and expertise
- Entry to new markets and facilitation of faster deployment of new products

These benefits promise to reduce risk and cost, and to improve productivity for the asset manager. It is not clear, however, the extent to which an outsourcing solution actually adds value. The primary purpose of this research is to measure the shareholder value impact of outsourcing. Listed in Table 1 are the twenty-six outsourcing deals analysed, ranked by deal-related assets under management (AUM) on the date the deal was announced. Since then, some managers have increased the AUM outsourced. The deals represent the outsourcing of over US$2.3 trillion combined AUM. The date refers to the date on which the deal was announced in the press.

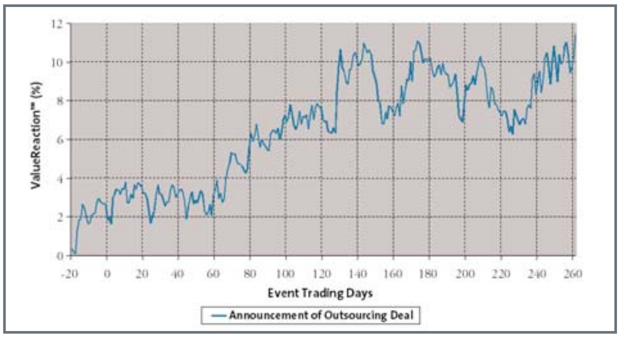
Twenty-one of the deals were made by publicly quoted asset managers[1], three by mutuals (Standard Life, Gartmore and Royal London) and two by privately-owned companies (Cazenove and Liontrust). Fourteen of the deals were announced since 1 January 2004, the remaining twelve being over the previous four years, illustrating the trend towards outsourcing across the industry. As this research was being undertaken, another deal was announced. On 24 February 2005, Old Mutual Asset Managers appointed Royal Bank of Canada as its UK fund administrator, global administrator, fund accountant and global custodian for US$6.7 billion AUM.

**Table 1: Outsourcing Deals in European Asset Management**

| Asset Manager | AUM (US$bn) | Date |
|---|---|---|
| AXA Investment Managers | 366.70 | 12-Aug-04 |
| Barclays Global Investors | 263.00 | 13-Jun-04 |
| F&C Asset Management | 218.76 | 16-Nov-04 |
| Morley Fund Managers (Aviva) | 193.09 | 15-Oct-04 |
| Insight Investment (HBOS) | 140.50 | 2-Feb-05 |
| Merrill Lynch Investment Managers | 135.00 | 23-Mar-99 |
| Scottish Widows Inv. Partnership | 131.56 | 12-Oct-00 |
| ING Investment Management | 123.00 | 22-Nov-04 |
| Schroders Investment Management | 112.39 | 1-Aug-00 |
| ABN AMRO Asset Management | 89.03 | 14-May-04 |
| ING Investment Management | 87.38 | 18-Jan-05 |
| JP Morgan Investment Management | 72.25 | 1-Apr-99 |
| F&C Asset Management | 68.06 | 11-Jul-03 |
| Aberdeen Asset Management | 38.02 | 1-May-02 |
| Investec Asset Management | 34.00 | 6-Oct-03 |
| Insight Investment | 14.24 | 15-Apr-04 |
| St James's Place | 14.03 | 29-Mar-04 |
| RCM UK Ltd (Allianz Dresdner) | 8.75 | 8-Sep-04 |
| Société Générale Investment Managment | 8.18 | 23-Mar-99 |
| Swiss Life Asset Management | 1.80 | 14-Jan-03 |
| Julius Baer International | 0.09 | 7-Sep-00 |
| **Public firms** | **2,119.83** | |
| Standard Life | 140.16 | 27-Jun-03 |
| Gartmore Group (Nationwide) | 41.50 | 29-Jan-04 |
| Cazenove Investment Fund Management | 13.55 | 16-Dec-04 |
| Royal London Asset Management | 8.23 | 2-Apr-04 |
| Liontrust Asset Management | 2.10 | 16-Dec-03 |
| **Mutuals & Private** | **205.54** | |
| **TOTAL** | **2,325.38** | |

Figure 1 shows the market reaction to the announcement of outsourcing deals by the public firms[2]. The graph shows a modelled share price reaction, where market-wide factors have been stripped out and the daily returns have been risk-adjusted. The dates on which the outsourcing deals were announced have been aligned on event day 0; 261 trading days reflect one calendar year. The portfolio effect ensures that idiosyncratic share price effects have been diversified away.

**Figure 1: Clear Value Added from Outsourcing**




Some information leakage to the market is evident in the twenty trading days preceding the public outsourcing announcement; between trading days -20 and 0. As shown in Figure 1, approximately 10% of value is added on average to European asset managers that choose to outsource some of their investment activities.

The magnitude and direction of the value impact did not appear to be affected by whether the initiative was one of the first or more recent outsourcing deals announced, by the type of outsourcing model adopted (lift-out or business service provider model, for example) or by the size of deal (in terms of assets under management to be outsourced). There is some indication, however, that those outsourcing deals that are more encompassing - and include, for example, trade processing - tend to outperform (by approximately 5% in value terms) those deals that are more restrictive.

In order to determine whether this value effect is being driven by increased liquidity, the trading volume activity in the asset managers' shares is analysed for the month following each deal. The Trading Volume Multiple is defined as the multiple of the previous year's average daily trading volume in ordinary shares. Thus a Trading Volume Multiplier of one indicates normal trading volumes and no significant impact on liquidity. Figure 2 reveals that, on average, there is no significant impact on liquidity from outsourcing.

**Figure 2: Liquidity Remains Stable**


This result indicates that the positive value impact from outsourcing is reflective of investors revising upwards their expectations of cash flow from the asset managers, and is not reflective simply of increased share trading.

Deeper analysis of the companies choosing to outsource reveals some interesting insights as to the source of value creation. It seems that the more successful outsourcing arrangements are those where the asset manager has had a clear idea of its business model and a sound control of its cost-base. The asset manager has demonstrated a good understanding of its cost-drivers and been able to discern accurately between those investment activities that are value-adding and "core" and those that are not and, therefore, can be outsourced.

Thus it is not cost-efficiency that is driving the value creation from outsourcing although it is expected that some cost savings would ensue. Rather, it is the signal to investors that the asset manager has control and discipline over the firm's cost-base and its drivers. The ability to outsource successfully becomes a signal to investors of managerial discipline.

Such managerial discipline enables the release of resources (not least scarce managerial time) away from administrative duties and towards optimising investment performance, the main goal of the asset manager.

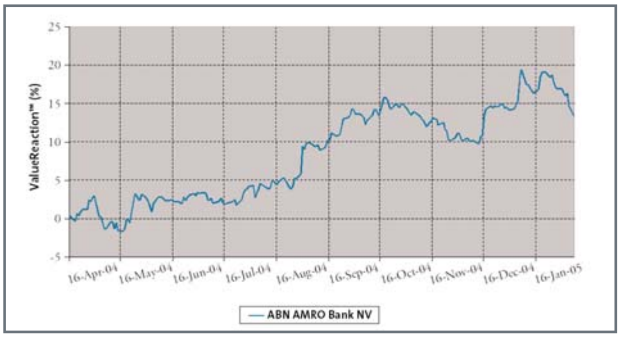
1 F&C Asset Management and ING Investment each appear twice, reflecting multiple outsourcing deals.

2 Aberdeen Asset Management is excluded from the analysis due to the extensive managerial issues affecting the company at the time.

### Selected Profiles

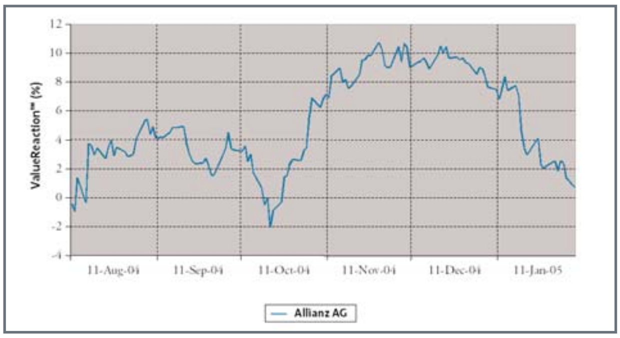
Presented below are three brief profiles of outsourcing deals by ABN AMRO Asset Management, RCM (UK) and Investec Asset Management, respectively. These profiles serve simply as exemplars that illustrate the aggregate result. It is appreciated that the asset management operation may be a small part of the parent company's full business. Furthermore, the idiosyncratic share price reactions from individual firms are diversified away in the portfolio context of the aggregate results reported earlier in this section.

### ABN AMRO Asset Management - 14 May 2004



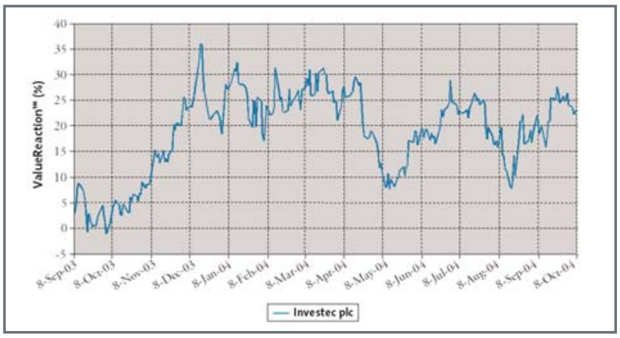

ABN AMRO Asset Management outsourced its fund administration and investment operation for US$89 billion assets in the UK, The Netherlands, Luxembourg and Sweden to State Street. Approximately 100 staff would be transferred to a new fund servicing centre in Amsterdam. ABN AMRO Chief Operating Officer Bert Schouws said of the deal, *"Outsourcing our fund administration and investment operations will enable us to support our business more effectively and to focus on the investment process. We have put in place a structure for future growth".*

### RCM (UK) Ltd - 8 September 2004




RCM UK, part of the Allianz Dresdner Asset Management Group, outsourced its back and middle offices of its US$8.75 billion assets in the UK to The Bank of New York. RCM Chief Financial and Operating Officer Michael Hooper said of the deal, *"We hope to realise significant operational efficiencies across the board through this outsourcing partnership. Following a thorough review of the services available, we were confident that The Bank of New York would provide us with the strongest platform available in the market and thorough support for our business processes. The partnership provides us with a basis for future growth".*

### Investec Asset Management - 6 October 2003




Investec Asset Management outsourced its global custody and fund accounting for US$34 billion of assets managed in the UK, South Africa, Ireland and Guernsey to State Street. Approximately 66 Investec back office staff based in Cape Town and London moved to State Street. Due diligence for the deal took approximately seven months to complete. Investec Asset Management Chief Executive Officer Hendrik du Toit said, *"The outsourcing agreement with State Street allows Investec Asset Management to focus on its core business of managing clients' assets and follows a growing trend in the fund management industry to outsource non-core functions".*

## Focus on Core Competencies

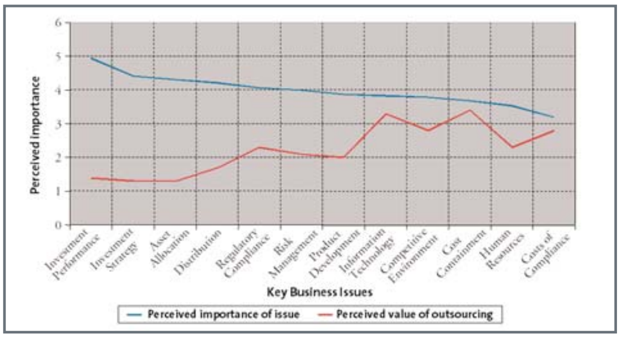
This section of the report captures some general views from the European asset management industry on the value and appropriate scope of outsourcing. The senior management of twenty asset managers, with combined assets of US$2.24 trillion under management, were surveyed or interviewed. Despite the range in size of asset manager - AUM ranged from US$3 billion to almost US$400 billion - the views expressed were remarkably similar.

All twenty asset managers had outsourced custody already. Approximately half of the sample additionally had outsourced fund accounting and fund administration, transfer agency, back office and securities lending. Only one or two of the asset managers had outsourced middle or front office, foreign exchange execution or equity execution. Some of the views reported in this section, therefore, reflect actual experience of outsourcing whilst others reflect their expectations. There was no clear difference in views between those which had or had not outsourced already.

The clear majority of those with only custody outsourced, expressed an intention to consider outsourcing more investment operations within the next two years. From this modest window into the industry, it seems likely that the trend to outsource will continue rather than abate.

Illustrated in Figure 3 is the ranking awarded by asset managers to the business issues foremost on their agenda; shown in blue. Shown in red, is the ability of outsourcing to help resolve these issues, as perceived by the asset managers.

**Figure 3: Outsourcing a Potential Solution for Non-Core Issues**




It is clear immediately that asset managers view outsourcing not as a tool to help address their key business issues directly but more as potentially helpful in addressing issues of lower priority. This makes sense and supports the value of outsourcing as a potential solution for managing efficiently non-core investment operations.

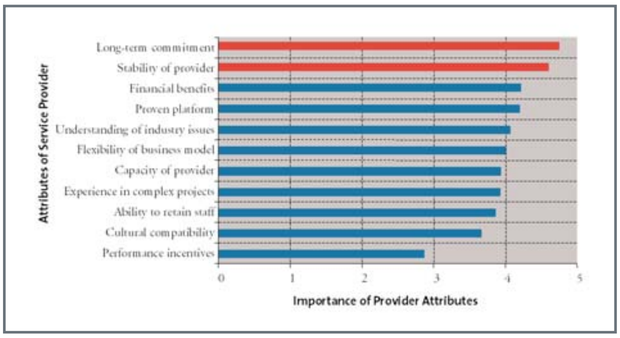
This prompts the question as to how managers can identify which of the firm's activities are "core" to the achievement of its goals and which are "non-core" and, therefore, can be outsourced. It is this keen awareness and understanding of the business model, its value drivers and cost-base that facilitates the success of an outsourcing initiative. And it is precisely this signal of managerial discipline that is rewarded in the markets by impressed investors.

Asset managers would also expect some cost-efficiencies as they move from their fixed cost-base to the variable costs charged by the custodian but the evidence suggests that this is seldom the primary driver behind the more successful deals. The majority of asset managers in the sample believe that their operational risk would reduce ultimately from outsourcing, following an initial increase during implementation. Indeed, that risk characteristics should be considered explicitly when selecting a provider. However, it was anticipated that this risk reduction would not lead to any reduction in either capital put aside to comply with capital adequacy standards (for example, Basle II) or in insurance premium expenditure. It is also noted that as the operational cost reduces, the cost of monitoring increases.

It would seem that the main "winner" from outsourcing in the battle for scarce corporate resource allocation is that of managerial time. By outsourcing genuinely non-core investment activities (those operations that have been analysed carefully and deemed not to be value-adding), managers have more time to focus on the business issues foremost on their agenda: investment performance, investment strategy and asset allocation.

Ranked in Figure 4 are the characteristics of outsourcing service providers that asset managers perceive as most important.

**Figure 4: Commitment and Stability of Custodian Essential**




To facilitate the benefits of outsourcing, asset managers clearly consider long-term commitment and stability as the most important factors in their selection of outsourcing business partner. This underlines the reality of outsourcing as a critical and long-term investment.

# Summary and Outlook

The research results suggest that successful outsourcing is a signal to the markets of managerial discipline. Asset managers are rewarded for this discipline by increased shareholder value of 10% on average. It seems that cost efficiency is not the primary driver behind the more successful deals but, rather, the desire to understand and manage more effectively one's business model and value drivers. A good outsourcing service provider will help its client to understand more precisely its business model and to discern carefully between those investment operations which are value-adding and those which are not. The professional custodian will help to bring discipline to the client's management of costs.

Once a thorough due diligence process has been completed, there is already great value to the asset manager from challenging its business model and increasing understanding of its value drivers. Should the firm choose to proceed with an outsourcing solution, the main benefit from its success is the release of managerial time from administration to maximising investment performance.

The outsourcing business partners need to demonstrate a long-term commitment and stable service provision. Credibility in outsourcing partner will come from the capability of its technology platform to be sufficiently standardised as to have stringent pre-set controls in place and to have the capacity for growth in assets under management.

There is much scope within the industry - across asset managers and custodians - to continue to generate significant value from outsourcing, provided that the due diligence process is undertaken with the clear aim of challenging and improving understanding of the asset manager's value drivers.

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