

Creating Advantage in a Time of Challenge

Until early 2008 consultants and other service providers could intelligently 'guesstimate' the pace of client growth, follow the size and shape of industry trends, and project the impact of regulatory and market-driven factors affecting the investment management industry. Since then and like most of you, we have experienced moments where we could only sit back in wonder and look at the stunning collapse of financial markets.

All of us working in the investment management industry have to some degree questioned our faith in a system that has destroyed trillions of dollars of client's wealth in such stunning fashion. For an industry rooted on the premise of safeguarding client assets, it has at times been difficult to follow the events taking place around us. Few of us have not questioned the long term viability of our own enterprises in the current environment.

Primary drivers affecting the Forward looking Firms decision to uncover opportunities in this market

Despite this current environment, we do see a good deal of firms taking advantage of these times to focus on self-improvement efforts. These efforts are aimed at achieving greater efficiency, scalability, and reducing redundancies in their processes. This effort will in turn improve client servicing and competitiveness in the near term and position them for greater profitability when global financial markets recover longer term.

Our work with investment managers, service providers and vendors points to four primary drivers which are today guiding the strategic thinking among investment firm leaders:

- Operating Margins
- Client and Partner Transparency
- Dynamics of Competition
- Regulatory Environment

Having recognized that fundamental change is well underway in the industry, forward looking firms are working hard to gain competitive advantage during the current environment. Firms are taking an opportunity to refocus on their core competencies - - essentially looking to insure they are achieving scalability, productivity and profitability as optimally as possible.

Operating Margins

In late summer 2008 we saw a dramatic increase in the number of investment firms placing enterprise level and other major projects on hold. In the face of dramatic losses of fee income tied to performance many firms put an immediate halt to non-revenue producing efforts. This knee jerk reaction – while understandable in its immediacy – will prove over time to be a costly and shortsighted reaction.

Investment managers face pressure on margins for both revenue and expenses. Balancing the loss of fee based revenue against the cost effectiveness of the internal operating model is what will determine whether a firm survives the current economic downturn.

On the revenue side margins are driven by clients and competitors. Even the most fiscally disciplined firms are at the mercy of their clients and their competition when negotiating fees. The state of performance in the current environment adds no value to a relationship today. The value of a long term relationship and stellar client service is of utmost importance at this time. We see forward looking firms using relative levels of compliance and client service as a means of competitive advantage in the face of poor market performance.

On the expense side, firms must control the drain on revenue from internal and external sources. Staff, infrastructure, and productivity are the internal forces of margin pressure. Applications, data and business vendors/partners are the external pressure points.

Firms are seeking to control internal costs by limiting compensation spending. This is happening by freezing salary and bonus

structures to prior year levels or by tying them to operating and/or performance levels. Infrastructure is being reviewed intensely in most firms we speak with as a means of finding cost efficiencies previously not sought out during 'cash flush' times. Not only is productivity being sought both through process revisions derived from infrastructure changes but also through the systematic review of individual value add from staff. As labor remains the most expensive component in the business model, firms are taking a long and hard look at the productivity of staff on hand.

Client and Partner Transparency

Ours is without question an industry that must work very hard to regain the trust of investors. The preponderance of illegality coming to light in the past several months has quickly shattered what for many remained a steadfast belief in the overall integrity of industry. A universally accepted premise of the Bernard Madoff fiasco is that it will spur ground-shifting changes in the realms of compliance, reporting and client service. The concept of due-diligence, proven a failure all too often, will change to become a process both of improved client service and competitive advantage.

Auditors, broker/dealers, consultants, custodians, fund managers, lawyers and other fiduciaries that are paid to evaluate and validate the capabilities and operational performance of investment managers will be held to a much greater level of scrutiny. In many ways they will be proving their own capabilities in order to reaffirm a level of credibility they earned over the years that has been discounted by industry events in just a very short time period.

Clients will expect investment managers to provide more timely and detailed reporting on transactions, holdings, and basic account servicing details. In an industry now 'guilty-by-association,' the level of client transparency will evolve over time to new standards previously deemed cost-inefficient but now mandatory to retain clients.

Transparency will evolve far beyond trade compliance and reporting. We expect that

industry participants will begin to seek more and more basic operating information about their counterparties. In the face of poor performing markets, clients will delve deeper into the value of their relationship with investment managers. In turn, firms will find it necessary to share information about their capabilities which they had previously not considered terribly important to others. For example, the absence of a fully documented and demonstrable business continuity plan will be not just embarrassing but a competitive disadvantage.

The concept of relationship management will morph far beyond the client realm and take greater precedence as firms look at the value they derive from the business partners (i.e. consultants, service providers, vendors). The value of partners – their current and planned capabilities to service your business model - will be reviewed with much greater frequency. Turnover in relationships will increase as firms seek more efficient and cost effective strategic relationships.

Dynamics of Competition

Industry consolidation and spin-offs will continue for the foreseeable future. Firms in survival mode seek an opportunity to partner with complementary organizations to build a competitive model in the face of dramatically changing market dynamics. Firms may see competitors for their niche of the market (be it strategy or targeted clientele) reduced in number as mergers result from a drive to survive. Alternatively as mega-firms (banks, insurers) strategically refocus on core competencies we anticipate that further spin-offs and lift-outs will occur. This will possibly increase the number of competitors in certain spheres of the market. While the number of competing firms may fluctuate the competition itself will remain.

Regulatory Environment

As the new administration fills its ranks and begins its efforts at change we can expect the regulatory environment to change in very fundamental and deep reaching ways. Risk management, leverage and liquidity are the

drivers beyond all of the various regulatory reform proposals being circulated today. As with most government intervention into the marketplace, we expect some regulatory over reach will eventually be tempered back to a practical level. How far and how long the reform process extends is unclear at this point. What is clear are some basic expectations:

- Regulatory agencies in the banking industry and financial markets will be fundamentally redefined. The elimination of some regulators will likely arise from a merger of monitoring and oversight responsibilities.
- A regulatory body will be given the role of 'systemic risk' or 'market stability' regulator to conduct oversight on the non-bank, non-broker participants participating in or supporting financial markets.
- Financial markets participants – all of us – will be required to provide a significantly greater level of detail and transparency about basic business process and practices.
- US regulators will coordinate their activities to a much greater degree with international regulatory authorities. The opportunities for lower operating costs in many non-US markets will decline as regulators world wide increase their basic demands for disclosure and transparency.

We believe investment firms should take the opportunity now to get ahead of the curve on this issue. The surprisingly high number of firms that do not have automated compliance systems in place must begin planning to deploy some level of automation in order demonstrate their willingness to service the compliance requirements of their clients/prospects.

Leveraging the Value of Your Technology Platform

Most mature firms (we'll define these as firms in operation at least 3 years) servicing an institutional level client base, have deployed a technology platform to automate the majority of front, middle and back office functionality. Firms understand the need to introduce automation to achieve internal efficiency and to meet the expectation of a demanding client base.

Firms of every size can now find a number of options to select from when seeking automation solutions for compliance monitoring, portfolio management, performance measurement, trading, relationship management and reporting functions. The difficulty in today's solution marketplace is finding the optimum choice that will best serve the needs of the enterprise to insure cost effectiveness is a by product of automation and process efficiency.

The lack of acceptable automation – generally a checkpoint in a due diligence process – is considered a competitive disadvantage. Firms will admit to being both under-served and over-served by their platforms but we've yet to find a firm that would admit it can live without a high degree of automation.

Technology can increase productivity by reducing the man hours that staff allocates to time-intense, repeatable process outputs. Similarly, scalability is achieved through technology when a firm can grow its AUM and account servicing operations without having to add additional staff. Finally, profitability is an outcome of technology expenditures when the platform is consolidated in a manner that produces both accuracy and efficiency within prescribed timeframes.

Firms we speak with understand that by leveraging their technology platform they create a greater opportunity to grow their business while achieving productivity, profitability, and scalability in the business model. While these points may or may not be accepted business logic in the current environment, they are vital to a firm's continued sustainability.

Creating Advantage

Without exception the firms we talk to are actively seeking opportunities to achieve or enhance scalability, productivity and profitability in the current down market. Strengthening the internal process model – especially those tasks which are client facing - is seen as the primary means to creating advantage relative to competitors and establishing a 'best-in-class' reputation in the eyes of clients and prospects.

We note the following efforts being targeted by investment managers:

- Enhancements to the integration of data between compliance, portfolio accounting, performance measurement, reporting, trading and other applications.
- Improved availability and quality of data for consuming applications.
- Ensuring proactive pre- and post-trade compliance monitoring
- More timely and accurate holdings and cash analysis for comparison to account models and benchmarks
- GIPS compliant performance measurement and reporting
- More flexibility in routine report construction and delivery.
- Enhanced ad-hoc reporting capabilities.
- Increased use of standard communications protocols and less reliance on proprietary equipment and protocols.

The following sections highlight some of the process improvements we see as mandatory for firms hoping to remain competitive in the future.

Compliance:

Whereas the concept of a 'culture of compliance' has been about for years in the industry, the fiduciary responsibilities of investment managers will increasingly share the primary focus with investment performance in the eyes of most clients. Compliance will become a demonstrable

competitive advantage for those firms who seize the opportunity to deploy it correctly. Automated compliance is essential to attract and retain institutional level clients. Gone are the days when the trader can 'take a peek' at the list of restricted securities taped to the wall adjacent to the PC screen before submitting orders. Investment firms of every size will find it necessary to demonstrate the full range of pre- and post-trade compliance processes. Failure to adequately comply with client specific compliance requirements will lead to a loss of AUM more quickly than had been the case in the past. In a prolonged down market you can be certain clients will no longer tolerate ineffective operational controls.

Existing compliance systems should be re-examined carefully to identify process and rules improvements that can be quickly implemented to improve compliance efforts and to accommodate changes that will grow from regulatory reform.

For firms seeking a compliance system for the first time - and there are many of you - we recommend a focus on integration with your existing order management or trading platforms. Cost advantages may exist in dealing with your current OMS or trading system vendor, an appropriate examination of all market options - including a proprietary application – is warranted for this effort. It is important that your compliance system – be it proprietary or vendor designed - contain a rules engine which provides the necessary flexibility to accommodate new client requirements and modify existing requirements 'on the fly' with an infallible audit trail mechanism.

Portfolio Management:

We hear more often than you might expect about the lack of adequate connectivity between the systems supporting the portfolio management discipline. Enabling order management, execution management, compliance, and portfolio accounting systems to 'talk to' each other and feeding them the fundamental financial, reference and security master data they consume daily can be a very complex undertaking. The lack

of connectivity or untimely delivery of data can adversely impact the quality of portfolio management services a firm provides.

Firms are seeking to improve their system integration and data integration processes. The focus is on optimizing system connectivity so that data flows will better support portfolio management. Client account data, financial instrument data, holdings and transaction data are all being scrubbed and mapped to ensure consistency and integrity. Where basic data is missing or was previously unavailable efforts are made to fill in the blanks and develop validation processes to guard against gaps in the future.

The depth of data is being expanded to allow for better drill down to support modeling and decision making by portfolio managers. Reports and screen views are being designed to more accurately reflect real time market values, account allocations, profit/loss, tax lots, cash contributions and/or withdrawals and account fees. **There is a** greater emphasis being made to having adequate real time data for comparison against multiple benchmarks and identifying variances from allocation targets.

Some firms are finding that their existing OMS and/or portfolio accounting system may not sufficiently support their goals for enhanced portfolio management tasks. The cost to design and implement enhanced reporting and integration may outweigh the benefits in the foreseeable future. For this reason we are seeing interest in serious exploration of alternative systems. Changing from one OMS or accounting system to another is an enterprise wide endeavor; we urge that significant business analysis be conducted as part of any serious exploration of alternative systems. At the very least, firms should understand all of the risks inherent in shutting down their existing systems before going live with a replacement.

We see a renewed emphasis on data availability and quality. Firms are intensifying efforts to clean up their security master and other reference data which feeds basic automation processes. Errors attributable to out-dated or incorrect basic data points are

embarrassing and reflective of a poor internal process model. Investment managers are increasingly aware of the competitive disadvantage of a failed trade resulting from an invalid CUSIP or SEDOL number or a client account statement that references an invalid security name. A growing number of firms are subscribing to data services to automate the initial population and subsequent refresh of security master and reference data to support their accounting, compliance and trading applications. Lower cost data and increasingly easier technical interfaces are making the previously accepted concept of manual security set-up a dying art.

Performance Measurement:

For a good number of years investment managers have debated the value of moving to performance measurement based upon the Global Investment Performance Standards (GIPS). We can appreciate both sides of the debate while we believe the benefits of being GIPS compliant far exceed the costs involved. In fact, as the cost of gaining GIPS certification continues to fall and the demand from clients/prospects increases, many of the firms we talk to are viewing non-GIPS compliance as a competitive disadvantage.

GIPS is predicated on the concepts of fair representation and full disclosure. These concepts support the coming changes in disclosure and transparency which will follow from regulatory reform. GIPS compliance therefore demonstrates a willingness to meet client needs in that regard.

The ability to accurately roll-up returns into equity sectors and styles, asset classes and sub classes, industry sector and subsectors, etc. is consistent with the type of customized and flexible reporting that clients will come to expect. Firms are finding that daily aggregation of account, instrument, position and transaction details to support GIPS calculation is in fact a further cost benefit of the data and system integration efforts that are implementing across the enterprise.

Reporting:

Reports are often the most tangible collateral some client see from an investment manager. The accuracy, timeliness and quality are paramount to the value add of reports. The old adage of 'you never have a second chance to make a good first impression' repeats itself with every iteration of client reports. Forward looking firms are preparing now to meet these expectations and use them to competitive advantage.

Firms should prepare for a reporting structure that provides flexibility to prepare ad-hoc and scheduled reports, addresses clients specific uniqueness and produces output that appears 'high-end' to create a 'best-in-class' impression of the firm's most tangible collateral. Firms are reporting substantial increases in the number of ad-hoc or 'special request' reports sought by clients. We suspect this trend will continue for some time as clients seek the appropriate level of detail and transparency they need to support their own risk management efforts. Proprietary reporting systems have a cost effectiveness edge over vendor reporting systems. Firms contemplating a new reporting approach should keep this in mind.

It would be wise for firms to study the reporting process from point to point to find the full range of opportunities for improvement. For instance, consider the value of a fairly inexpensive mechanism in which client are able to sign-in to a secure web portal or FTP sight to retrieve reports as opposed to receiving them via email. Most firms will admit to not considering the delivery of client reports and other confidential documents via email. All too often confidential material is simply emailed in an unencrypted, unsecure and untracked manner. Both managers and clients are guilty of not stopping this behavior. But simple process changes can make a big impression. By requiring clients to log-in to a web portal or a FTP site you are implementing a more secure delivery mechanism which demonstrates your commitment to fiduciary responsibility. This simple but very thoughtful type of process improvement which may set your firm apart from others the client deals with and create a

very low cost competitive advantage to the relationship.

Trading:

A number of firms that have invested in order management, execution management and portfolio management applications have yet to fully integrate these applications. While automation of basic processes and tasks has been deployed, much room for improvement remains in tying the investment decision making process to compliance and order generation and releasing trades to counterparties for execution and settlement.

Firms are looking at basic trading communication protocols for the first time in a long time with an eye on real cost benefit analysis. In many cases, they are finding that overlap now exists between protocols that did not at the time of implementation. They now are looking to consolidate trade communication to few standard protocols as a cost efficiency measure.

We are aware of many firms trading fixed income and OTC derivatives products that continue to use broker-proprietary communications links and equipment in lieu of migrating from installed older versions of FIX to FIX v4.3 which supports both of these asset categories. While FIX v4.3 has been deployed for a number of years and has been subsequently replaced by FIX v5.0, many investment managers have not felt a need to modify their trading operations to take advantage of the support for the additional asset categories. They simply continue to rely on previously installed proprietary communications links which remain effective. However as overall support costs come into focus, we expect many will invest the time and effort to make the move to v5.0 and do away with the expensive non-scalable use of proprietary trading communications protocols.

One wonders if we will ever see the extinction of the paper trade confirmation. Domestic equities have long been efficiently, confirmed, affirmed and settled. Same day affirmation rates have risen steadily over the years as a result of the deployment of

centralized matching utilities and local matching services in the US and abroad. Now however, the cost benefits of trade matching for fixed income and non-domestic equities trades are being sought as firms look for quick fix efforts to cut costs while improving efficiencies and quality levels in their trade processing operations. Trade matching and exception based processing are increasingly viewed as the best solution for providing the scalability firms are seeking.

Post-Trade/Custody:

Application vendors and service providers are working to offer more streamlined reconciliation processes and solution offerings to allow investment managers to achieve economies in the post settlement sphere. Significant expansion in the number of custodians participating in messaging delivery mechanisms has occurred. Networks of service providers have grown substantially in the last few years. Rare is the global custodian without an adequate presence in the various commercial interface offerings.

Many investment firms for the first time are examining their proxy processes and policies to determine if greater efficiencies can be gained while maintaining service levels. In addition, tax reclamations and other niche services are being examined for process improvement.

Staffing Issues:

Human nature being what it is, the biggest obstacle to achieving cost and process efficiency remains an internal resistance to change.

There is no hiding the fact that our industry tolerates under performing employees in a bull market.

We're not operating in a bull market any more. We've haven't been for quite some time.

We are seeing an increasing number of firms make the often painful decision to let go of staff that no longer have the capability or

motivation to support the firm's long term goals.

Firms positioning themselves for survival will consider any number of methods for attracting new clients. This can include expanding the number and type of products and strategies offered. Often firms may find themselves in need of expertise to support asset categories where existing staff has no previous experience or expertise. To control the risk in such scenarios, firms find themselves with the decision to add more qualified staff and the resulting decision of what to do with existing – now 'surplus' staff. Unless the firm can afford the increase in head count – a seeming rarity in this environment - many experienced but loyal employees are finding themselves phased out of jobs. For smaller firms, this can be a particularly painful scenario; for larger firms as well the loss of experience and dedicated personnel is an unfortunate reality.

Let's talk about outsourcing ...

Any debate about the most effective method for refining the process model will invariably include the question of whether to outsource a portion of the business. Investment management firms look to outsourcing as a means of streamlining their business model to focus solely on core competencies - the management of client assets - with non-core tasks (those that support the investment management functions) performed by external parties.

Over the past decade investment managers have developed a growing variety of 'non-core' tasks including fails management, maintenance of standing settlement instructions, performance measurement & attribution, reconciliations, trade confirmation processing, and transition management services. Examining this breadth of service, it is not difficult to understand there remains a healthy debate among managers as to what is in fact a core part of the business model - what is not.

The primary factors in making the outsourcing decision usually come down to controlling the cost of on-going technology support (including labor costs) for the

business model. This consideration is followed by the belief that an external party can more efficiently provide the transparency sought by clients and regulators. The growing number of specialty services required to process increasingly more diverse trades and more complicated market environments. Investment managers have come to believe that shifting the non-core focus out of the office to an external provider will allow them to more effectively improve their own investment performance.

When outsourcing first came of age most investment managers found the cost structure for basic services to be too prohibitive for serious consideration. As custodians have expanded their breadth of services and achieved economies of scale a growing number of non-custodian service providers have entered the marketplace. This growth in competition has made pricing more attractive for investment managers. In the current environment, firms that had been previously lukewarm to the idea of outsourcing are giving it more consideration.

Seek an independent opinion

We are hearing more and more from clients and others who are seeking assistance in conducting a 'self-assessment' of their business model. Many admit to knowing they need to make changes but are unsure of how to effectively examine the inter-dependencies of applications and processes. Some have indicated a desire to seek assistance in finding the most appropriate solutions including negotiating optimum contractual agreements. Some firms tell us they are reluctant to face some difficult decisions regarding the capability of their existing staff.

Many firms consider a self assessment to identify and remedy process deficiencies in their existing business model. Others consider the use of a consulting firm to provide independent opinions where change is appropriate. An external party can conduct an objective examination, provide an unvarnished opinion of your current environment, and how you compare with other firms.

At Finnovative, we conduct Enterprise Effective Assessments on a routine basis. We visit firms and interview staff from C-level to entry level. We study the history of the firm and the near and long term goals that management has in place. We study the effectiveness of business partners and the demands of the client base. We review the platform the business model is built upon and the dynamics that are in place to accommodate applications and systems. Our findings are presented to management in a report which details our recommendation for achieving process improvements, mitigation of risks, and increased profitability.

If you'd like to learn more about our assessment service, please contact us at 650-393-5666 ext 107 or ext 101. www.finnovative.net