

Buy-side focus: Sharing the burden

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Gill Wadsworth looks at how outsourcing has become a permanent fixture on the post pandemic landscape.

The unwelcome arrival of Omicron, the latest Covid variant, has brought with it not only a widespread fear of a return to the bad old days of rising death tolls and mass lockdowns, but also severe market volatility.

Asset managers already grappling with the challenges since the pandemic first struck two years ago, face renewed pressures to prevent asset outflows and keep their ships steady until some sense can be made of the latest virus mutation.

Outsourcing, which played a significant role in helping asset managers cope during the chaos since 2020, with some organisations willing to offload trading to third parties, looks set to remain core to surviving the latest outbreak.

This year UBS and Axa Investment Managers took the decision to outsource trading, while a survey of 84 buy-side equity traders in North America – published by Greenwich Associates in February – found that 30% of institutional investors in the US and Canada consider outsourced trading desks as ‘a good solution to help buy-side firms manage their trading flow and achieve best execution’.

Meanwhile a 2020 Northern Trust survey of 300 global asset managers published this November, found that 85% of respondents either already outsource their trading desk or are interested in doing so, and the firm says this is 'borne out in experience', with more than 70 asset managers moving to its outsourced trading platform in the last four years.

Brian Jepsen, head of outsourced trading at TORA, says that while traders were already able to work remotely using cloud-based technology, the market volatility resulting from the pandemic increased demand for outsourced trading to help in-house desks manage the sudden increase in trading activity.

Jepsen adds: "Covid disruptions underscored the need for business continuity plans including outsourced trading instead of just in-house traders working remotely."

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Jack Seibald, Global Co-Head of Prime Brokerage and Outsourced Trading at Cowen, agrees that the remote working demands forced on asset managers during the pandemic accelerated the nascent trend to outsourced trading desks.

Seibald says: "The uptick in the level of inquiry was followed by the adoption of outsourced trading solutions by more managers, and notably, more established ones with larger funds under management. Among new launches, the uptake of outsourced trading, which in our experience has been overwhelming in recent years, proved even more so since the onset of the pandemic."

The types of services asset managers are outsourcing varies by firm, according to Matt Nelson, vice president, buy-side strategy & business development at Broadridge.



“Each manager had their own unique pre-pandemic gaps that were exposed,” Nelson says. “In truth, all that’s really core to an asset manager is its ability to raise capital, manage assets and support clients. For everything else, the cost and operational risk can be mutualised by outsourcing to a trusted service provider. This spans across the trade lifecycle today, from back office to middle and front.”

He adds that Broadridge is seeing interest in outsourcing to support product and asset class expansion. “For example, private equity managers are looking to outsource administration of their funds and private debt managers are looking for support with complex securities like collateralised loan obligations,” he says.

Nelson says Broadridge has experienced an increase in demand for outsourcing across order management, data warehousing, reporting, reference data management and risk management, suggesting needs that span the front, middle and back office.

The value proposition

While asset managers face considerable pressures on fees, which is a large driver in the move to outsourcing, research from Fitch Ratings reveals full-year profitability was not significantly damaged in 2020. The ratings agency found that most investment managers reported fee-earning EBITDA margins ‘in excess of 30%, helped by a degree of flexibility in their cost bases, which enabled them to offset the temporary decline in fee revenue’.

This suggests that outsourcing providers need to demonstrate they can do more than simply reduce costs and deal with a number of pressures.

A 2021 research report from Quinlan Associates shows that despite benefiting from numerous technological developments over the years, especially the growing use of electronic trading, ‘the buy side trading desk has had to contend with several challenges. These include a dearth of competitive pressure as well as unresolved inefficiencies’ alongside cost burdens.

The research finds that sub-optimal trading operations, which includes a lack of technological proficiency, poor choice of execution method, and the widespread absence of internal/external partnerships can impact fund performance by 1.2-2.7% a year, costing the very largest asset managers in excess US\$18 billion a year in opportunity cost.

In response, Seibald argues that there are 'many benefits to outsourcing beyond cost reductions'.

"Outsourced trading can be scaled up or down, depending on client requirements and this provides a huge amount of flexibility," he says. "Some firms choose to have a best-of-both worlds proposition, keeping in-house traders for specific needs while opting for outsourced trading to extend the firm's capabilities in a particular geographic or asset class coverage."

He also says 'another huge benefit of the outsourced trading model' is access to the additional skills and experience of the outsourced service provider's team as well as access to their infrastructure and state-of-the-art technology.

In addition, TORA's Jepsen claims outsourcing trading delivers 'greater scale, global coverage, access to a larger network of brokers, fully redundant infrastructure and risk management'.

However, the Quinlan research says there is a 'limited, genuinely accretive usage argument for a significant proportion of the asset management industry'.

The report states: "While staffing a full-time desk is no doubt a meaningful economic commitment, outsourcing, despite its marketing, follows the basic tenet of best execution in somewhat of a haphazard manner. In farming out trading, it is likely that an asset manager could be falling short of both its performance and regulatory obligations."

Given this assessment it is no surprise that Quinlan suggest asset managers retain control of their trading desks and consider 'the need for structural changes and a more fundamental reinvention of the buy side trading desk'.

Should asset managers share this view, providers will have their work cut out maintaining the momentum in business they have enjoyed so far.

Nelson says that since asset managers have 'struggled with the shift from performing functions directly, to supervising their outsourcing service provider' it will be incumbent on providers to identify that challenge and support the asset manager with change management and rearchitecting and re-training the operations team.

"This will allow the manager to start operating in a way that will maximise the managers' benefits from outsourcing," Nelson says.

Meanwhile, Neil Sheppard, Global Head of Business Development Asset Servicing at SmartStream Technologies, suggests outsourcing providers appreciate the reputational issues asset managers face when shifting competencies to third parties.

"Asset management firms will pride themselves on their reputation, so the relationship between the buy-side firm and the provider is key. It may not all be about pure operational and economic processes; it's equally important to understand how a firm will thrive in the face of competitive and commercial pressures," he says.

While outsourcing trading may have appeared to be a panacea to various pressures on the asset management industry – especially during the pandemic – the buy-side might also benefit from rethinking their internal operations before offloading to a third party.

As the Quinlan research concludes: "Given the sheer size of the economic upside at stake for their end clients, we see this as a critical time for the asset management industry to start trading up."