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## MAKING IT A REALITY

### Permanent Cost and Risk Reduction



*Market and economic volatility continues to wreak havoc with planning and cost reduction initiatives in investment management firms. While many have made valiant attempts to cut costs using short-term approaches, the ultimate prize for asset managers is permanent cost reduction. Laudably, a handful of firms have managed to seize the opportunity to substantially lower fixed costs and mitigate risk by investing in programs to rationalize systems, reengineer processes and rethink their business. These firms will have a significant competitive advantage going forward - lower costs and more flexible operating models will allow them to take advantage of new opportunities much more quickly and efficiently.*

### The Returns Drought and its Ramifications

Major equity indices have trended upwards in the past year: the FTSE 100 is up 9.8%, the CAC 40 is up 12%, CSI 300 is up 10%, and the S&P 500 has advanced 19%. However, despite these encouraging developments, the performance of equity markets has been dismal since 2002. In the past 10 years, the S&P 500's annualized return, after inflation and with dividends reinvested, was a paltry 0.8%. Feeble economic growth looks set to be the norm in the years ahead, with analysts citing predictions in the 4% - 5% range as optimistic. For investment managers this has a direct impact on their bottom line, as

most of them try to cope with flat, or worse, shrinking revenues. Customers across the spectrum are now balking at fees that were normally tolerated in a high return environment. Naturally, firms have made every effort to reduce costs but the cuts so far have fallen disproportionately on operations and systems areas. Meanwhile, the effectiveness of these cost reductions is increasingly blunted by the need to satisfy many new demands, such as regulatory reporting, more customised requirements, additional support for complex investment strategies and products, and mobile computing platforms.

## Ongoing Budget Uncertainty and Its Impact

These competing pressures can lead to budget cuts and cancellation of important strategic projects. Attempts have been made to stabilize budgets, but see-sawing markets often lead to demands for further cost reductions and even the cancellation of essential maintenance and system upgrades. In this environment, planning becomes extremely difficult. The problem is that hesitant budgeting can result in a fraying of the support model, limiting the ability to benefit from any technical or service advances. Perversely, this approach inevitably leads to higher fixed costs as a firm becomes locked into an inefficient processing model, hampered by workarounds in the face of new business demands.



Most firms have had cost reduction measures in place since at least 2001, as a result of the post 9/11 market plunge, and again after the global financial meltdown in 2008. The benefit of these early, obvious cuts has already been harvested, however, and additional tactical cost cutting is likely to reap only modest gains. Furthermore, core investment processes do not typically lend themselves to traditional cost cutting initiatives. Investment processes (analytics, trading, risk, performance attribution, research) are not commodity functions and require specialized capabilities and processes that need the support of highly experienced experts. Instead of managing their investment systems and operations in the shadow of unpredictable markets and continuous budget changes, firms must take control of their own destiny.

## The Practicality of Doing More with Less

Standing still is not an option - firms must find a way to do more with less. Investment managers are now obliged to comply with new regulatory regimes which are costly and complex. At the same time, to remain competitive, they must deliver ever more sophisticated services including risk, performance attribution, trading, derivatives, client reporting and client facing capabilities.

When it comes to cost reduction, outsourcing technology infrastructure and non-investment activities becomes an attractive alternative. Many firms have established joint ventures or strategic partnerships for product distribution to minimize capital outlays and risk. Others have ceased costly development for core investment applications and are buying software packages or services. The adoption of cloud computing, with its associated set of sophisticated service providers, allows firms to move beyond a single in-source or outsource decision while instead choosing from

a variety of solutions across an array of implementation options.

While various programs have cut peripheral costs, many firms are still stuck with complicated operating models that are not really meeting business needs and are expensive to support. A strategic approach that looks beyond individual tactical solutions is vital in any rigorous and comprehensive effort to create a simplified operating platform. This requires a thorough review to eliminate

redundant applications, potentially reduce the number of geographic locations, customers, and products, and streamline business processes. If executed effectively, this will create a more agile operating platform with lower fixed costs that will respond to inevitable demands for additional services without introducing expensive new support models.



## Current Architecture Complexity

A major obstacle to moving to a more simplified operating platform is the current maze of applications and services currently supporting core business processes. Most firms have an unwieldy web of systems, processes and workarounds that have evolved from acquisitions, new product demands, client requirements, geographic expansion, and special requests from investment professionals. One firm that CutterConsulting recently assisted had 783 applications, including 6 performance attribution systems, 5 trading systems, 9 portfolio accounting systems, numerous portfolio management systems, 7 data warehouses, countless data marts, and multiple risk management systems. These multiple systems, duplicated across a variety of functions, loosely integrated through complicated interfaces and integration methods, can transform a simple application upgrade into a monumental undertaking. Fortunately, there is an approach employed by leading firms that addresses this problem without wholesale replacement of core applications.

## The Strategic Approach

A number of leading investment managers have successfully started simplifying their operating platform using a strategic approach, which is detailed below. Similar methodology, for example, enabled the firm referenced above to consolidate systems and processes and reduce their fixed costs by 18% within three years. This simplification process is a firm-wide effort that requires a clear understanding of all business drivers. The following steps are suggested:

- Analyze your firm's five year strategic plan to understand if additional systems or operational support is required
  - Evaluate the value chain to determine revenues and costs to support each product and client
  - Assess the current and potential profitability of each product and client by geographic location
  - Conduct a detailed evaluation of each supporting system and service
  - Review the structure and capabilities of the support staff for systems and operations
- Next, determine what is required to achieve a simplified operating platform.
- Define which products, clients and geographic regions will continue to be supported
  - Review the systems and operational requirements needed
  - Identify systems, process and operations personnel required by the current business and to support the five year plan

Then, propose systems and processes to be consolidated.

- Identify redundant systems and processes to be eliminated
- Quantify personnel needs to support the new investment processing platform
- Reengineer the core business processes

Achievement of this revamped model, supported by a streamlined organization, requires a commitment that extends over a number of years and for which a comprehensive multi-year roadmap must be created. The order and timing of the individual projects must be prioritized by business needs, necessary precedence of activities, benefits to be gained, and organizational capabilities. The project team also needs to remain flexible yet determined in addressing new needs as they arise, while continuing to move forward in reaching their goal. Smaller projects, 3 – 6 months in duration, wherever possible, are usually preferred. This allows the

team to deliver immediate benefits and build momentum for the program. It also allows the project team to gain a feedback loop that enables them to continue to refine and revise the program as they move forward.

### Executive Sponsorship

A project of this magnitude is a firm-wide effort that will result in short-term increases in cost as well as organizational disruption. To be successful, active and involved executive sponsorship is essential. Organizational restructuring necessitated by these changes is often fiercely resisted - users are frequently wedded to a system or process and will work to maintain the status quo. Strong executive leadership and clear direction is needed to arbitrate conflicts, while supporting and enforcing decision making around systems, processes, product and geographic consolidation. Executive guidance will ensure that the project team is able to achieve the desired outcomes despite these roadblocks.

### Reaping the Rewards

It all sounds straight forward and, of course, it is not. But it's worth it. Those firms that have made the effort to rigorously determine the best client, product and geographic locations from the perspective of profitability and then retool their investment processing platform can permanently lower their operating, organizational and systems costs. A simplified operating model, in addition to saving money, reduces complexity and risk. It also enables the organization to satisfy new business needs more quickly and easily, respond to market changes, take advantage of new technology and services and have the budget and flexibility to execute on business opportunities.

