CONVERGENCE

resulting in disruption and yielding better outcomes

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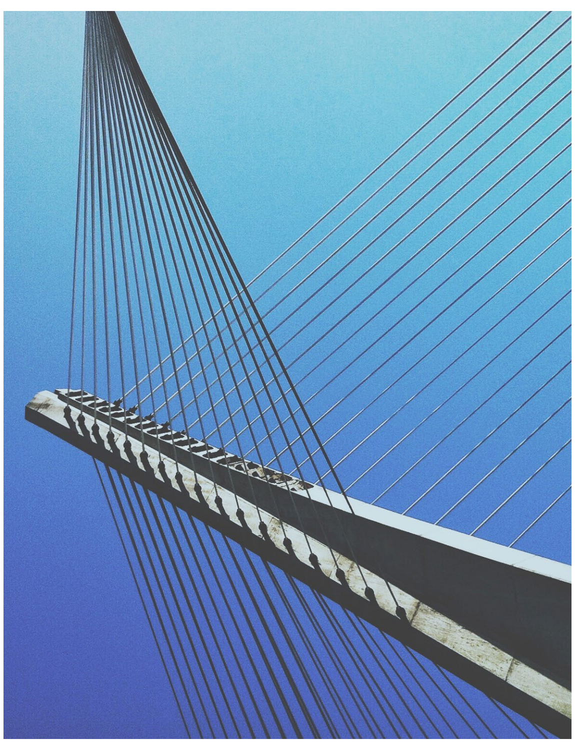
Convergence is underway in the institutional investor space on three distinct, but interrelated fronts. The first is the convergence of the investment manager's front, middle and back offices. The second is the convergence of investment management, investment consulting and the growing practice of the Outsourced CIO (OCIO) in the US and Delegated Solutions[1] in the UK. The third is the convergence of asset management, asset servicing and technology. These three convergences are themselves converging, signaling an inevitable disruption of the status quo.

Convergence of the front, middle and back offices

Convergence of the investment manager's middle and back offices has been underway for a decade in the form of middle office outsourcing offered by asset servicers (custodians/trust companies) as a value added service to augment their back office capabilities. That service model promised to reduce the investment manager's operating cost and enable them to focus on their core competencies while the asset servicer leveraged their own infrastructure and capacity. This proposition has delivered on its promise, but there is yet more value to be realized by extending the levers of an enhanced middle office into the front office, thereby empowering dynamic real time interaction. This convergence will enable product developers to bring sophisticated new investment products to market with agility, and portfolio managers to nimbly make tactical and strategic adjustments to the complex portfolios they are designing and managing.

These capabilities will provide competitive differentiation and yield top-line value for innovative firms, enabling them to acquire new clients, grow revenue and secure market share while achieving yet greater operational efficiency and cost savings.



Convergence of investment management, investment consulting and OCIO

Convergence across the roles of investment management, investment consulting and OCIO is obvious, but nevertheless warrants discussion. This convergence is occurring as (i) investment management firms leverage their expertise to design asset allocation strategies, (ii) consulting firms manage portfolios for which they previously only provided consulting, and (iii) asset owners consider alternative ways to fulfill their fiduciary responsibilities and investment objectives.

Over-simplified for the purposes of this piece, the traditional objective of the investment manager has been to work within a prescribed mandate, typically a particular asset class or sub-class and to deliver a targeted investment return within an agreed upon risk profile. Success or failure was, and still is, measured in terms of over/under performance.

On the other hand, the core objective for investment consultants has been to design and monitor a total asset allocation strategy, considering the institutional investor's objectives and resources. This requires the ability to evaluate and understand the client's situation and objective with a superior level of professional expertise, and design a multi-asset investment strategy that will perform over time and through various market regimes to deliver successful outcomes. Therefore, in addition to understanding the client's profile and objective, the investment consultant's core competency is asset allocation, rather than generating alpha.

The OCIO is a convergence of these, performing many or all of the functions of the investment consultant, but with the additional practical responsibility for implementation and execution, and the increased fiduciary responsibility of the investment manager, not just for a narrowly specified mandate, but for the performance of the overall portfolio, i.e. for delivering a successful outcome, the role otherwise assigned to the plan sponsor. Thus, the OCIO provides an alternative means for plan sponsors to fulfill a significant aspect of their fiduciary duty, and for other types of institutional investors to increase the degree to which they rely on external firms for overall investment strategy and execution.

Lastly, while the convergence of these business roles is self-evident, what is less obvious is the convergence and enhancement of the underlying technology platforms and operating models that are necessary for the success of the OCIO.

Convergence of asset management, asset servicing and technology

Institutional investors are moving aggressively toward complex, pooled, multi-asset, open architecture, managed allocation structures in which the principal value proposition is a highly engineered asset allocation solution that adjusts dynamically over time through changing market regimes. This has been the fundamental approach for defined benefit pension trusts for decades, and is now increasingly the case for defined contribution investments and other multi-asset investment strategies. These investment structures require highly advanced technology platforms to successfully implement and operate without losing any of the value that is engineered into their sophisticated design.

Asset managers have attempted to stretch front office platforms, and asset servicers have added component solutions to augment their legacy platforms in hopes of keeping pace with this rapid product development. However, even with those bolted-on components, the technology is not able to effectively support the innovative solutions now being designed. Desktop tools are being used to bridge the gap, but those bridges are frail and creaking as they strain to support investment structures that are growing more and more complex. Asset managers need the ability to quickly design new strategies and nimbly implement and execute them with unconstrained flexibility, precision, reliability, and at scale. Therefore, they are motivated to implement solutions that substantially improve, combine and/or replace their current technology and operating models.

This motive is driving the convergence of asset management, asset servicing and technology, and the agility that will result from that convergence will be a critical factor in each firm's competitive profile.

Convergence as a global phenomenon

The notion of convergence among Investment Management, Investment Consulting and Outsourced CIO/Delegated Consulting seems to be borne out in ai-CIO's 2016 Outsourced Chief Investment Officer Survey[2]. This research surveys 53 Outsourced CIO providers, including the global footprint of their Discretionary Management Practice. The top 12 of those 53 OCIOs manage 74% of the aggregate assets.

Of those 12 OCIOs, representing 23% of survey participants, 6 come most essentially from a legacy as a consultant, while the remaining 6 from a legacy as an asset manager with recognized expertise in asset allocation and sophisticated, often bespoke, product and solution design.

Lastly, and perhaps most interestingly, the survey indicates this to be a global phenomenon. Of the top 12 OCIO providers, 8 providers while tilted toward North America[note] reported the distribution of their OCIO clients spans all 4 regions, with 60% in the US, 4% in Canada, 23% in UK/Europe, and 13% in Other (including Asia Pacific). This signals that convergence is a global phenomenon.

Note: Of the top 12 OCIOs one provider did not indicate any geographic distribution data, and 3 others reported that all of their discretionary assets are only US based.

Conclusion: It is all about outcomes

The ability to bring highly innovative products to market with speed liberates a firm's most valuable asset, its Intellectual Property. Leveraging that ability across the firm's lines of business and global locations multiplies that value. When you add to that equation the ability to concurrently drive down incremental unit production costs, you expand the addressable market, thereby delivering better products to more clients at lower cost, resulting in yet another convergence: that of the interests of the providers and their clients, and better outcomes for both.

Institutional investors are redefining success in terms of successful outcomes in place of absolute or even relative returns. This outcome orientation is a more nuanced, challenging and valuable approach. In 2012, McKinsey declared that "Outcomes are the New Alpha,"[3] as the title of a Financial Services Practice Report, and just a year later, The Boston Consulting Group observed that "the continuing fast growth of solutions and specialties confirms a structural shift in the market,"[4] and, "a smaller group of managers…are capitalizing on the market's recent evolution, successfully building capabilities in solutions – the asset allocation offerings, that along with passives and specialties, now capture a disproportionately large share of the market's growth."[5]

So, the observations of this paper are not new, but the industry continues to search for technology that will enable firms to implement and operate the complex and high value investment structures that are required to bring these advanced investment designs and business models into practice.

That technology must provide:

1. The precise, flexible and zero-latency performance that is promised by the convergence of the front, middle and back offices
2. The control, reliability and geographic reach required by diversified global investment firms that seek to capitalize on the convergence of investment management, investment consulting and OCIO
3. The accuracy, control and cost efficiency required in the convergence of investment management, asset servicing and technology

And that technology must be scalable: it must achieve all of the objectives and requirements listed above and a diminishing cost per incremental unit of production.

The value that the convergences described in this paper promise is too great to leave un-realized, but the rate at which they are progressing is highly constrained. The means to accelerate that rate of progress already exist, but will not be discovered in traditional legacy technologies. Those means are available in technology that is purpose built for these complex pooled investment structures and converging business models.

Firms that find and implement such technology will be able to rapidly pursue this disruptive strategic path, seize share in a vast and growing market, and capture substantial reward for leading the industry in the delivery of outcome based solutions.

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[1] Also referred to as 'Delegated Consulting,' 'Implemented Consulting,' 'Delegated Services,' 'Delegated Investments,' 'Fiduciary Services,' and other similar descriptions.

[2] Outsourced Chief Investment Officer Survey, ai-CIO Chief Investment Officer, February 2016, page 56.

[3] "The Asset Management Industry: Outcomes are the new Alpha", McKinsey & Co., 2012, cover page.

[4] "Capitalizing on the Recovery," The Boston Consulting Group, 2013, page 3.

[5] "Capitalizing on the Recovery," The Boston Consulting Group, 2013, page 21.