



## Uncovering Hidden Costs in Middle & Back Office Operations

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During this period of falling and uncertain revenues in the asset management industry, it has become common to focus on cost reduction while still maintaining the processes viewed as driving growth: portfolio management, sales, and client service. However, as the number of accounts has grown in recent years, middle and back office operations are no longer viewed as disposable. Now rightfully, they are considered integral to the success of an asset management firm of any type, be it wrap, private wealth, institutional, or sponsoring firm. Even so, there are painfully few within the investment management industry that have a full understanding of the actual costs of these essential functions, all of which are now competing for scarcer resources. Before seeking reductions in costs, it is imperative to understand their sources, which include hard costs as well as hidden.

For purposes of this paper, middle and back office operations are being defined as all steps required to manage portfolios, while still ensuring regulatory compliance and accurate reporting. At a high level, this requires the following functions: order management, portfolio accounting, performance measurement, and data warehousing. Assuming that these functions are automated by the electronic transmission of data between various counter parties, connectivity and hosting should also be considered basic requirements.

Upon examination, one could argue that there are many reasons as to how the industry has evolved to its current state of affairs—that of having disparate, unintegrated operations solutions supporting one or more business channels. One reason may be that heretofore high profit margins made it easy to overlook inefficiencies. Another is that different business channels require different kinds of support—the wrap channel needs scale, the institutional channel involves product complexity, while the private wealth channel requires customization. But one common and overriding cause is a lack of understanding of both the hard and soft costs of supporting a middle and back office. With this lack of understanding, internal costs are often allocated to inappropriate areas within the firm, creating an inaccurate cost accounting.

Consider new accounts processing. If you take a very basic operations research approach and actually observe the process, it can often be seen that there are many more hands involved than just those of a dedicated new accounts administrator. Here is a specific case study from a member of our executive team:

I ran a Sales Due Diligence session about 5 or 6 years ago where I specifically focused on the new accounts process. Instead of sitting in a conference room with the COO, I asked to walk the floor and speak with those designated to set up new accounts. I was told, “Well, that will be easy, Louise L. sets up new accounts for us.”

After sitting with Louise for 15 minutes, watching her input an account on the system, I noticed she put all the paperwork into a folder and placed it in a bin on her desk. Curious, I asked, what next? It turned out that the folder was then physically walked around the office to five additional people within the firm who completed various steps; suitability, restriction review, entering sales tracking data, creating fulfillment materials, etc. The folder was then finally dropped off at a trader’s desk to be invested. The time for the entire process was not the 15 minutes it took to input data, but rather often more than an entire business day from when the account was accepted to when it was invested.

Upon creating a diagram to illustrate the process and showing it to the COO and CEO, they were shocked at the amount of work and the number of people that touched a new account. Only then did they realize what their true cost was for new account servicing. After discussing the process and what activities could be eliminated, they were very willing to entertain an end-to-end solution.

Unlike hard costs, such as operations staff, software, hardware and service contracts, soft costs are more difficult to observe. They are “hidden,” but nonetheless real. These hidden costs include things like:

- Missed investment opportunities caused by an inability to quickly assimilate portfolio data.
- Missed business opportunities because a platform lacked functionality to support a specific product type.
- Missed marketing opportunities caused by an inability to easily access client information.
- Trading errors caused by poor data flow or slow operational procedures.
- Lower marks on an SEC audit because a sufficient command of the business could not be demonstrated.

Here is another example of how soft costs can be hidden:

Mary M. has the title of marketing assistant; her primary goal is to produce and distribute client reports. To ensure that the reports are accurate, she spends the bulk of her time working to reconcile problems between her firm’s accounting and custody systems. She also spends a great deal of time extracting data from a performance measurement system which is not fully integrated with the firm’s portfolio accounting system. While Mary is considered part of the marketing team, her primary functions are those of the back office. This can skew a cost analysis so that marketing appears to be less efficient than expected, whereas it is the back office process that is not being adequately fulfilled.

In both case studies, a closer examination of the actual work uncovered costly, inefficient processes and misallocations of resources. Processes should be simplified, and in so doing, ensure they receive the correct allocation of resources. For both examples, a self contained end-to-end solution would provide for increased productivity through more efficient processes. An integrated approach necessarily simplifies processing because all relevant data is stored in one place and is readily transparent. In the first case study, an end-to-end solution would have provided an automated means of entering new account data plus the receipt and storage of documentation. Such a workflow would dramatically reduce the processing time for a new account cycle: document receipt, data input, review, approval, and initial investment. In the second case study, an end-to-end solution would have improved data flow from portfolio accounting to performance measurement on to the data warehouse—quickly generating the necessary reports.

As previously mentioned, and demonstrated by the examples presented, the asset management industry is rife with unintegrated operations solutions supporting one or more business channels. It is worth briefly examining the evolution of middle and back office operations to explore why this may be and how an end-to-end platform can be the most efficient solution.

There are essentially three general approaches to support a middle and back office. The first is to build all systems and operational infrastructure internally. Early in the evolution of the industry, this was the only way to automate the process because so few applications were available. This void was gradually filled by an abundance of isolated tools needed to support all major functions. Inevitably, a firm’s internal build was gradually supplemented with various external software applications.

This evolved into the second approach where little is built inside a firm, and the operational flows are determined by the options provided by available software. While this approach may be less costly than an internal build, it does not come without some significant challenges. The primary hurdle is to find the intellectual capital necessary to choose and integrate the various components. But this assemblage must also be coupled with sufficient internal political power to ensure both the adoption of the solution and its ongoing support. If the intellectual capital is not immediately at hand, then outside consulting help can be sought. However, consulting mandates can be very expensive in the near-term, and this approach does not come with a guarantee

of the desired outcome. Additionally, launching a consulting project can be extremely distracting, especially at a smaller firm where resources and capital can be more dear.

The final approach is to utilize a single, consolidated end-to-end platform that supports all the necessary functions. This platform could be hosted behind a firm's firewall, as would be the case for purchased software with contracted support. But depending on a firm's size, the more cost effective approach is likely to be a platform provider that hosts the end-to-end solution from behind its own firewall, with the client firm accessing it remotely. While there are hundreds, possibly thousands, of financial technology firms with products for middle and back office functions, there are very few that support the entire end-to-end process. Even if there is an end-to-end solution for one business channel, it may not be sufficiently robust to support others. For example, there are very few multi-channel asset management firms that support their entire business on one end-to-end platform. The most common deployment is to use an end-to-end process for one of its channels, such as wrap, while the institutional and private wealth channels use different technologies.

In many cases, the main impediment for business executives not choosing an end-to-end solution for their middle and back office is a lack of time or focus, but it is just as often the failure to fully recognize the *true* cost of processing their business. When all the costs are totaled, including hidden costs such as lost sales opportunities or incomplete or untimely trade information, an executive can make more accurate technology and servicing decisions. Consolidating back office systems and operations into a single end-to-end solution will not only shed light on a troublesome and complex area, but also help reduce total costs, both hard and hidden.