

Investment Managers and the Middle Office: Where Outsourcing Can Add the Most Value

Whereas historically investment managers completed the middle-office functions within their own organizations, today we are seeing more and more managers outsource their middle-office functions to independent administrators. Middle-office outsourcing first gained momentum immediately following the recent financial crisis as firms felt both pressures to cut costs and pressures from investors and regulators for more process transparency and independent oversight. However, fund managers are now realizing other benefits from outsourcing, as they receive value-added services enabling them to focus more on critical core functions such as portfolio management, investment strategy and risk mitigation.

An Increased Focus on the Middle Office

Core middle-office functions include collateral management, valuation validation, reconciliation, compliance monitoring, risk management, and trade support. An effective middle-office structure should bring the owners of processes and data that are interdependent under one umbrella. In response to client needs and industry trends post-financial crisis, fund administrators increased their capabilities and service offerings in the middle-office area, and consolidated roles and responsibilities to provide dedicated support to their clients.

Administrators are continuing to invest in middle-office functionalities as more investment managers are looking to focus on their core business of investing and avoid the costly technology and resources to build and support the infrastructure needed for today's complex trading. The increasing demand for

independence and transparency from investors and regulators continues as well and also factors into the equation. By outsourcing their middle-office functions, investment managers can reduce costs, respond to the increased pressures in the market, leverage the expertise and technology platforms already in place at administrators, and manage counterparty, operational and other risks in the process. Outsourcing middle-office functions can be a win for both the investment manager and administrator.

Collateral management and valuation validation are the two middle-office functions that have seen the greatest interest in outsourcing, which is not surprising given that the financial crisis made the risks associated with these areas clearly evident.

Collateral Management

For collateral management, the primary risks are in counterparty exposure and the operational process. Before the credit crisis, some investment managers relied on the counterparty for calculating margin calls, and managers performed weekly reconciliations. Now, managers want to know their counterparty exposure daily, and perform reconciliations on a daily basis with each counterparty, particularly for OTC derivatives. However, executing a robust, consistent, and transparent daily collateral management process that actively manages exposure levels, asset utilization and counterparty risk can require a sizeable operational investment if a manager decides to build or buy systems for in-house use.

Instead, administrators have invested in the necessary technology and processes and are actively managing the collateral for investment managers daily. With several clearing platforms available and the use of multiple counterparties and complex securities, administrators have the resources to invest in and offer advanced collateral systems. This provides managers with a more automated, controlled, and independent method for managing counterparty exposure; calculating and communicating calls, recalls, and releases; issue resolution;

and calculating and notifying interest on collateral, among other things. In some cases, administrators have hired industry experts to support this new business and have invested in technology that provides added value by automating the daily valuation and position reconciliation between the counterparty and the fund. Given these developments, investment managers are realizing that managing collateral on spreadsheets is not only onerous and risky, but also puts them at a competitive disadvantage to peers that are gaining better systems by outsourcing.

The part of collateral management that appears to be the most time-consuming and causes the most controversy is margin calls. Margin-call disputes can arise, for example, over portfolio mismatches or the value of individual positions. Valuation discrepancies remains one of the main causes of ongoing collateral disputes, with unresolved questions regarding which party has the more accurate valuation, and a comparison of the models, inputs, assumptions, market data, etc. being used. Risks regarding the accuracy of the valuation not only impact collateral management, but also have an impact on the investment decisions and risk mitigation for the portfolio.

Pricing Valuation Validation

The basic definition of valuation validation is the comparison of the valuations of each holding in a portfolio to two or more independently-sourced valuations and determining if the valuations are within an established tolerance range. This definition can also be expanded to include a comparison, as applicable, of model inputs such as yield curves and volatilities; assumptions such as default rates; the model methodology and any adjustments that are made; Monte Carlo simulations generated; the Greeks; correlations; etc. The investment manager can therefore be provided with additional information in regards to what the market is seeing and considering as industry standard for the particular holding.

However, as many industry experts have realized that markets may not follow a traditional normal distribution, models are being developed to more accurately reflect actual market conditions and incorporate better fat-tail measurements. Given that valuation models are constantly being revised and enhanced to account for market realities, it's imperative to have a team that understands the strengths and weaknesses of pricing models and inputs, recent developments in industry and academia, and general shifts in model methodology. Administrators with a dedicated middle-office team typically have experts that keep up with the latest thinking and methodologies.

As with any valuation process, a sound governance process is critical. This includes having a valuation committee, documented policies and procedures, quality controls, and a stringent due diligence process for the pricing vendors and specialist firms that are providing independent valuations, market data, and model analytics. In addition, a robust process for ongoing monitoring, backtesting, and enhancements should also be established.

When successfully developed, managers can expect a valuation validation process that provides them with full transparency to information that is consistent, actionable, appropriate, and timely. Additionally, they should gain a process that continually incorporates new methodologies, new products and enhanced reporting in a customized and flexible format. However, while an administrator can provide a world-class process, the manager still must be fully involved and maintain oversight.

When it comes to reporting, investment managers can gain a more comprehensive understanding of the valuation and drivers, including how prices were derived for valuations that fall outside the tolerance range, if their reports display two or more independently-sourced prices per holding with associated inputs, assumptions and sensitivities. Investment managers should also investigate whether their reporting gives them an increased understanding of market risk and other factors that may have an impact on the portfolio or specific holdings; pricing trends and performance attribution including yield curves, correlations, volatility, liquidity, and macroeconomic variables; and shifts in portfolio composition.

The risks associated with valuations do not only concern the investment manager. Investors and regulators have been requesting more transparency in the valuation process, and want to better understand the underlying risks. Increasingly, they are also demanding managers seek out valuation validation by independent third parties for each holding in the portfolio.

Given the increasing demands from investors and regulators, not to mention the pressures to keep their cost structures lean, managers are increasingly turning to administrators to help manage the middle office. Not only does this allow the manager to concentrate on retaining and gaining assets, it also enables managers to gain operational efficiencies, controls and transparency, thereby creating a competitive advantage to further their success.

To learn how SEI can help improve your middle office, please contact us:

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