MONOCLE

THE ASSET MANAGEMENT **TARGET OPERATING MODEL**

Building Platforms for Growth

Monocle Research Team

2021

The global investment industry is undergoing immense transformation. Downward pressure on fees combined with increasing operating and compliance costs have compressed margins and challenged existing business models. Firms that don't have the necessary scale or resource efficiencies risk failure.

At this critical juncture, Monocle believes operating model transformation offers the opportunity for asset managers to not only defend their existing business models, but to compete for assets under management (AuM) and achieve margin expansion. Critical to this process of model transformation is the development of a target operating model (TOM), which defines the people, processes and technology required to deliver a particular business strategy, describing how these components should be organised and interact with one another.

This paper will examine the forces shaping the investment industry and highlight the opportunity for margin and efficiency gains by suitably transforming the business through a TOM strategy.

INDUSTRY FORCES IN ASSET MANAGEMENT

The global asset management industry has been shaped over the past two decades by two related secular forces: **fee compression and the rise of passive investment products**.

FEE COMPRESSION

Downward pressure on fees combined with increasing operating and compliance costs has compressed profit margins in the investment industry and driven smaller asset managers to merge or close altogether. Asset managers earn a margin by charging investors a higher fee, as a percentage of AuM, than the operating cost of administering a product. These costs as a percentage of AuM are called total expense ratios or TERs. The average expense ratio of all US open-ended funds and ETFs have steadily declined, with passive index-tracking products experiencing the sharpest decrease.

Fig.1 Compression of fund expense ratios [1]

Product	2008 Average Expense Ratio	2018 Average Expense Ratio	Change (Percentage Points)	Percentage Decrease
Active Equity Funds	0.94%	0.76%	-0.18%	-19.15%
Active Bond Funds	0.65%	0.55%	-0.10%	-15.38%
Index Equity ETFs	0.29%	0.20%	-0.09%	-31.03%
Index Bond ETFS	0.19%	0.16%	-0.03%	-15.79%
Passive Equity Funds	0.18%	0.08%	-0.10%	-55.56%
Passive Bond Funds	0.16%	0.07%	-0.09%	-56.25%

1. James Duvall, 'Trends in the Expenses and Fees of Funds, 2018', *ICI Research Perspective*, 25/1(2019), 4-16, https://www.ici.org/pdf/per25-01.pdf

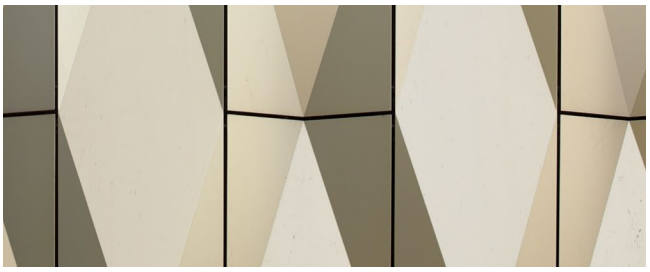
Asset managers seeking to increase revenue must either increase the margin earned per product or grow the assets under management. The former is challenged by extremely cost-sensitive retail and institutional investors, thus, operating costs and increased management fees cannot be passed on to investors as higher TERs. The latter is driven by market performance and sentiment and is largely out of the asset manager's control. **The only remaining lever to increase margins is therefore to reduce the operating costs of each product**.

THE RISE OF PASSIVE PRODUCTS

The rise of passive investment products, which offer investors the return of the market or an index at a low cost, have contributed to the downward pressure in expense ratios across the asset management industry. **The two most common products used to implement index-tracking passive strategies are unit trusts and exchange traded funds (ETFs)**. A unit trust is a basket of securities held in a fund where the fund is unitised or divided into units. An ETF is a basket of securities held in a fund where shares in that fund are listed on an exchange.

Fig. 2 Exchange traded fund structure

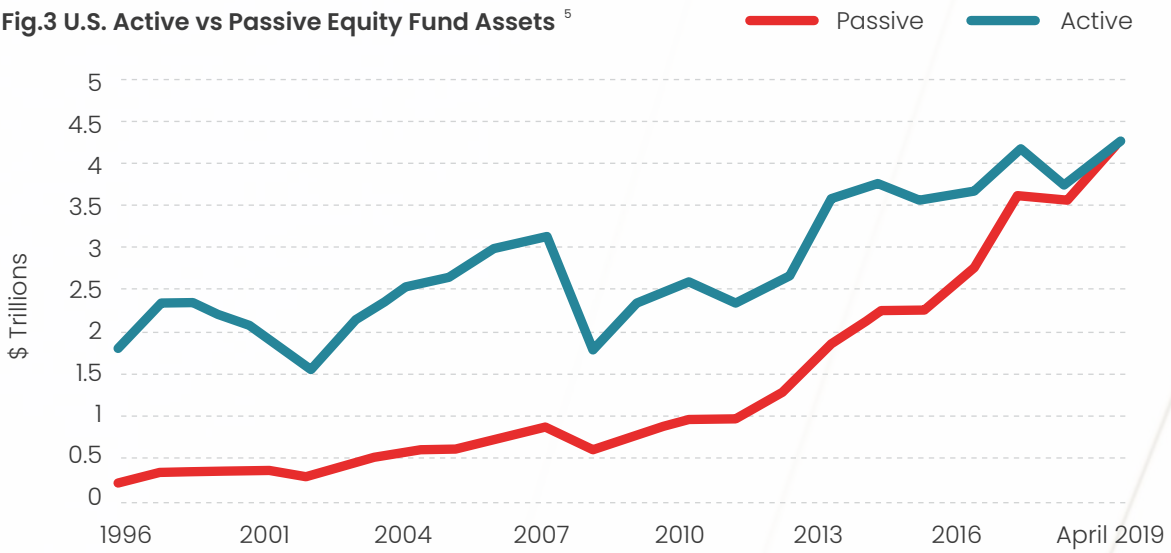
Research on US fund flow trends shows passive investment products have consistently gained market share from actively managed funds.[2] In the US Equity category specifically, passive funds reached the milestone of parity with active AuM in April 2019, as indicated in **Figure 3** below. In contrast, ASISA [3] and ETFSA[4] data shows exchange traded products only garner 4.36% market share of the approximately R2.58 trillion AuM held in South African Collective Investment Schemes (unit trusts) as of the quarter ended September 2020. **This suggests South Africa is massively underpenetrated by passive and exchange traded products**.



Despite the relatively slow adoption of passive investment products, global trends indicate that local passive product issuers are set to thrive as fund flows will continue shifting to passive products. Asset managers could therefore seize this opportunity to position their businesses and investment operations to benefit from this growth.

2. McDevitt, K. & Watson, N., 'The Decade in Fund Flows: A Recap in 5 Charts', *Morningstar (29 Jan. 2020)*, https://www.morningstar.com/insights/2020/01/29/fund-flows-recap
3. ASISA, '30 September Holdings Information', *ASISA (September 2020)*, Collective Investment Schemes Statistics, https://www.asisa.org.za/media/2jwdsxug/30-september-2020-holdings-information.xlsx
4. etfSA, Market Capitalisation – September 2020, *etfSA (Johannesburg, September 2020), 7*, https://www.etfsa.co.za/docs/perfsurvey/market%20capitalisation%20-%20sept2020.pdf

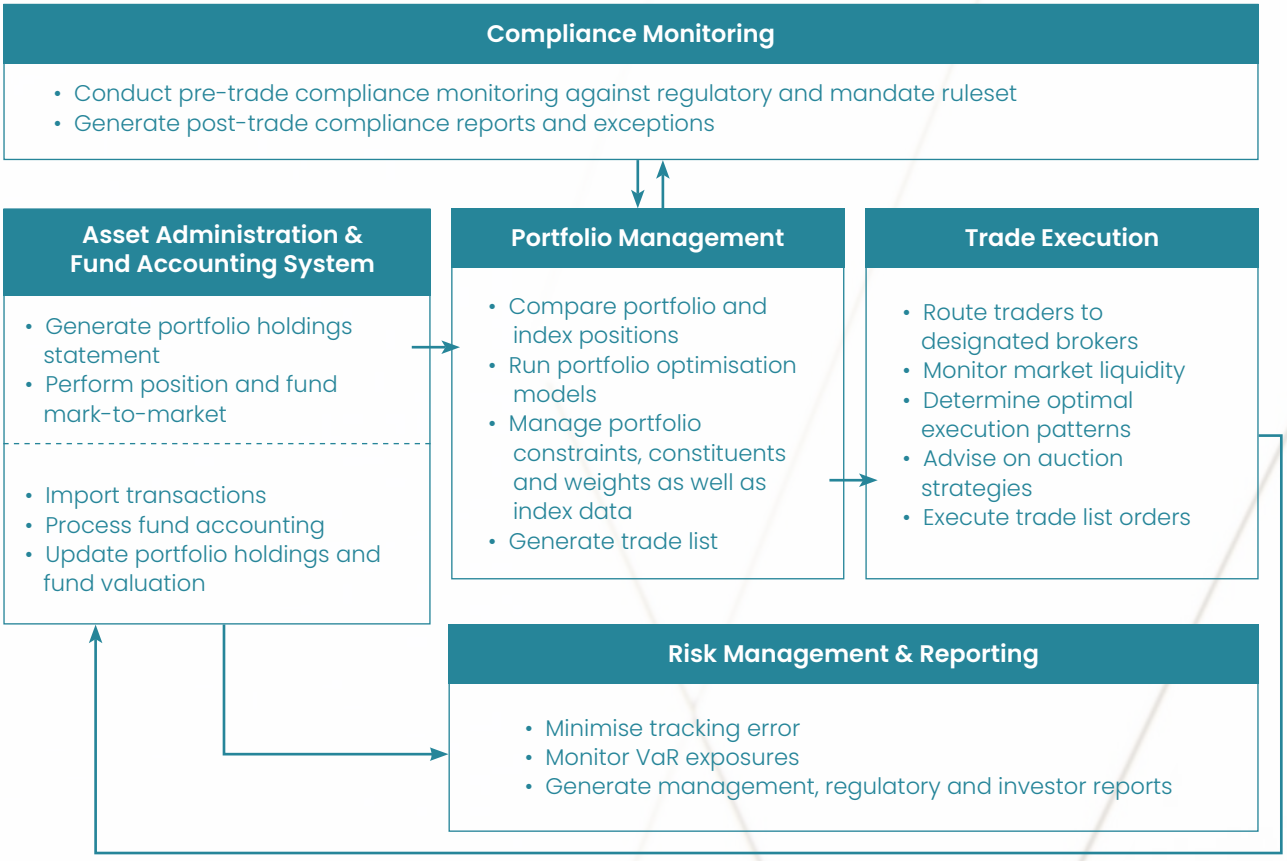
Fig.3 U.S. Active vs Passive Equity Fund Assets [5]



THE CHALLENGE OF OPERATIONAL INTENSITY

Issuing and managing passive investment products or exchange traded funds (ETFs) is an operationally intensive business with data, systems, people and processes required to support integrated capabilities across the investment administration and trade lifecycle.

Fig.4 The trade lifecycle of passive investment products



5. Lauricella, T. & DiBenedetto, G. 'A Look at the Road to Asset Parity Between Passive and Active U.S. Funds', Morningstar (12 June 2019), Big Picture, https://www.morningstar.com/insights/2019/06/12/asset-parity.

Figure 4 illustrates the multiple integrated capabilities, processes and subprocesses required to manage the trade lifecycle of a passive product. In reality, there are multiple systems and data requirements underlying this seemingly simple diagram. Index providers or calculation agents construct and maintain indices. Product providers pay a licence for these indices and receive the constituents and weightings of an index daily, as well as proforma constituents leading up to index rebalance dates. Investment managers then ensure the fund portfolio holds the specified securities in the weightings prescribed to the fullest extent possible, to maximise replication and minimise tracking error**. Fortunately, the features of passive asset management businesses lend themselves to modern technological solutions and process automation**.

THE TARGET OPERATING MODEL OPPORTUNITY

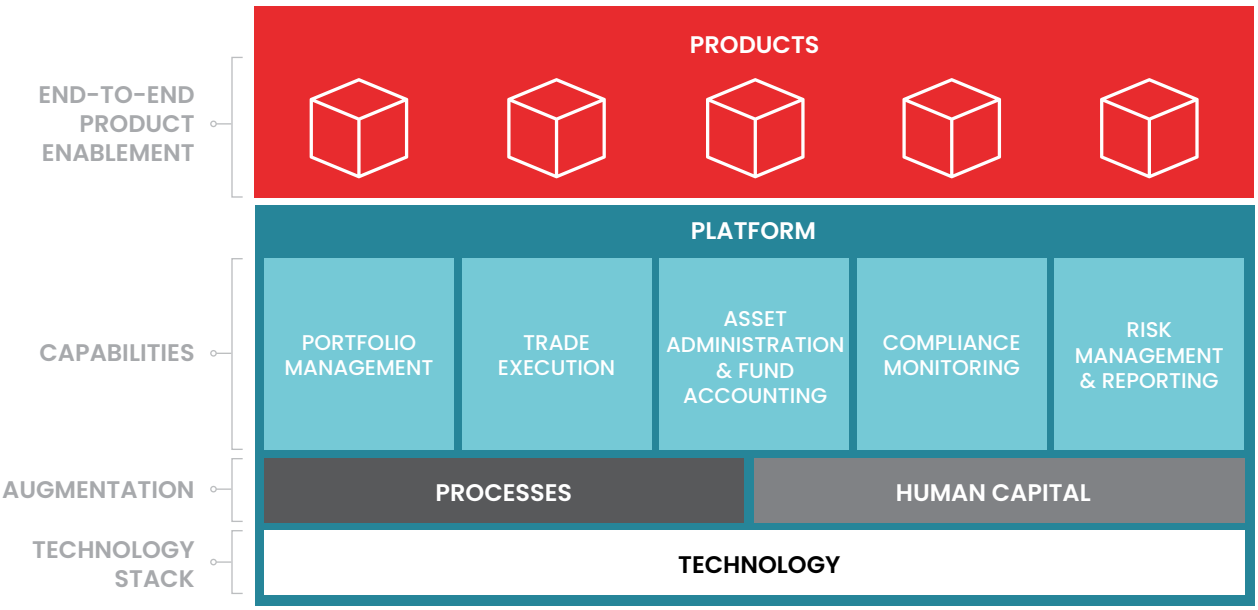
BUILDING A PLATFORM FOR GROWTH

We believe the key to competing in a low-cost asset management industry and positioning an asset management business for growth is through designing and implementing a platform for growth. This platform includes a target operating model that facilitates end-to-end product enablement and intricate management of the trade lifecycle with an optimised cost structure.

Platform for growth

A scalable combination of core capabilities underpinned by technology and supported by human capital and processes to facilitate end-to-end product enablement.

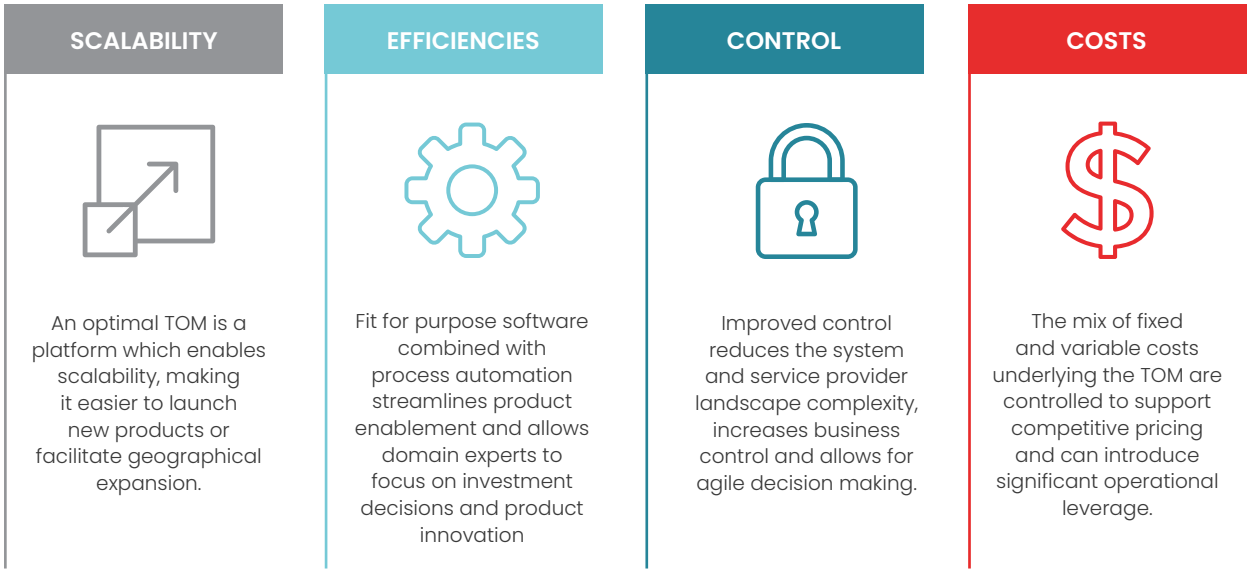
Fig.5 A platform for growth



A platform for growth comprises a technology stack augmented with processes and human capital to fulfil the core capabilities required for product enablement. Products sit on top of this technology-led platform underpinning investment operations.

An automated product enablement platform with a strong emphasis on digitisation and scalability provides multiple benefits beyond lower operating costs and driving efficiency. A future-state TOM can enable seamless expansion into new geographies, simplify the product development and testing process and respond through agile decision-making to enable managers to future-proof their business models.

Fig.6 Platform benefits



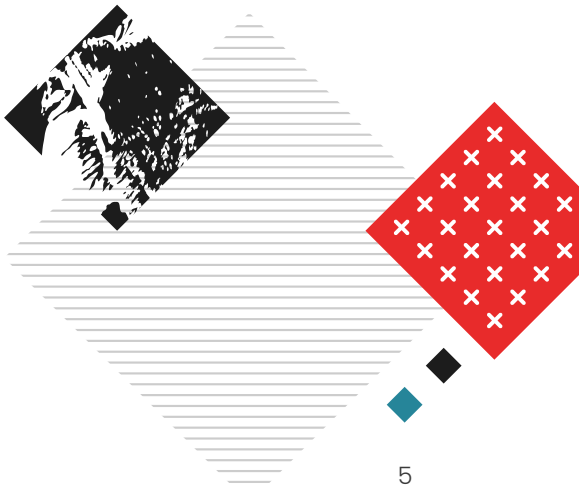
MARGIN EXPANSION

Building a fit-for-purpose platform can optimise the cost structure for the current product scale as well as support and enhance the benefits accruing from future scaling. Existing business models that rely on outsourced capabilities have operating costs skewed to variable costs. As a result, increases in AuM provide only limited margin expansion as variable costs rise proportionately. **However, a TOM that strikes the optimal balance between fixed and variable costs can result in instant margin expansion and introduce enhanced operational leverage in future**.

Figure 7 below details the most common variable product operating costs between index-tracking unit trusts and ETFs. The average product carries variable operating costs of between 11.5bps and 19bps. If we layer on fixed costs for exchange traded products such as JSE annual listing fees, Strate fees, corporate sponsor fees and the annual audit costs, an ETF with R100m AuM can cost an issuer as much as 30bps per year. If we consider that the cheapest ETF available on the JSE charges investors a TER of only 10bps, it becomes evident that some products are loss-making.

Fig.7 Variable product operating costs

Operating Cost	Amount (% of AuM)
Asset manager	0.05% - 0,10%
Index provider	0.025% - 0.05%
Asset administrator	0.03%
Custody fees	0.005%
Trustee fees	0.005%
Total variable operating costs	**0.115% - 0.19%**



So how does a product issuer capture margin? **If operating costs cannot be passed on to investors in higher TERs, the only remaining option is to reduce the operating costs of each product**. A transformational target operating model can convert the largest variable cost drivers, asset management and asset administration to a lower fixed cost base and capture cost efficiencies.

Fig.8 Operating model cost transformation

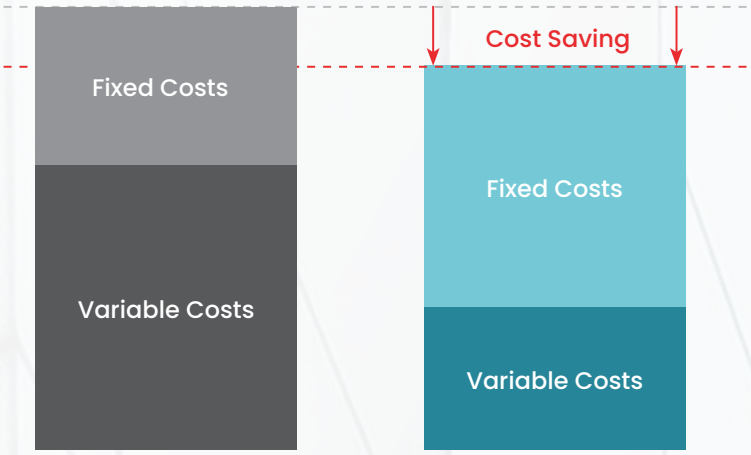
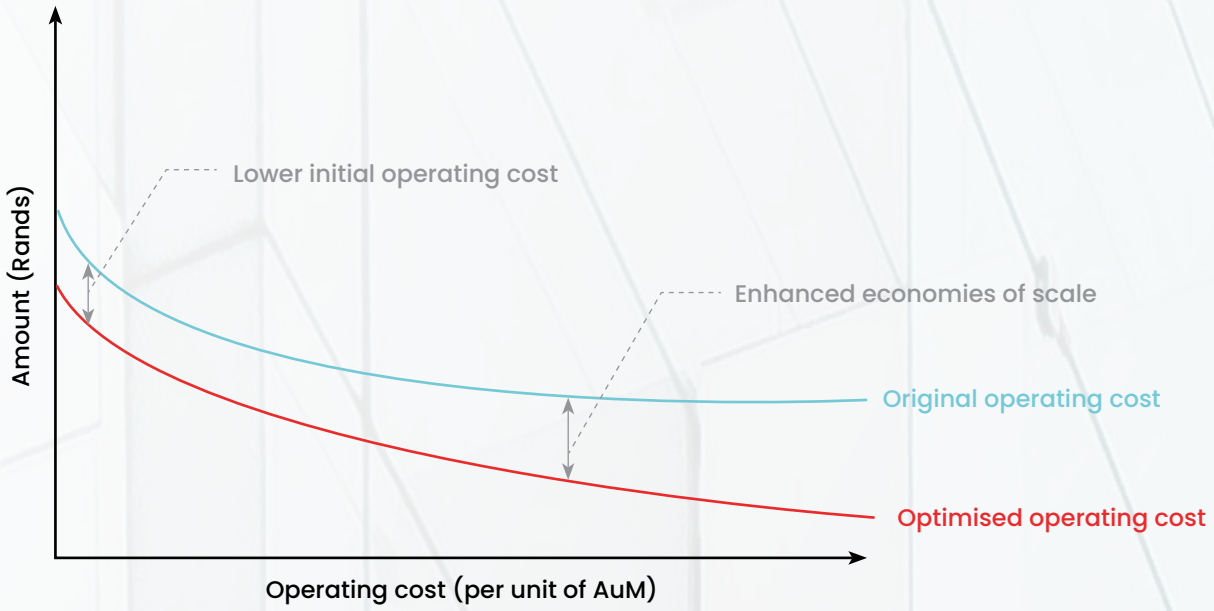


Figure 8 above indicates the effect of substituting variable costs with lower fixed cost technology solutions on reducing overall operating costs. **Figure 9** below further illustrates how converting a portion of variable costs into fixed costs lowers initial operating costs. A higher proportion of fixed costs enhances the effect of operational leverage where profits increase disproportionately to increases in revenue as product AuMs scale up.

Fig.9 Enhanced operational leverage



DEFINING A TARGET OPERATING MODEL STRATEGY

A target operating model will only be successful if it is designed to enable the defined strategy and support the way in which a business aims to create value. A small firm may have a defined strategy of focusing on maintaining a niche set of products whilst focusing on the firm's core competencies. In this case, a TOM that can be sustained with limited product scale and leverage global best practices through outsourced investment operations may be more suitable. Conversely, a large firm with scaled products and internal investment operations expertise may seek to enhance process efficiency, increase operating model control and shift focus to research and product development. **Investment managers should therefore look beyond the goal of cost reduction and develop a holistic strategy that takes into account the unique complexities faced by their particular business**.

This strategy translates into a principles-based approach to target operating model design that aims to streamline the trade lifecycle, capture cost efficiencies and align operational purpose throughout the business. Design principles are represented by clear statements that if achieved, will result in successful execution of the organisation's strategy.

Design principles for target operating model efficiency

- Improve existing expertise and address weaknesses
- Optimise costs to support both the current and future business scale
- Enhance flexibility of processes and business model
- Minimise handoffs between systems and service providers
- Eliminate avoidable duplication and increase automation of tasks
- Target a robust control environment
- Partner with strategic software providers for customisation

IDENTIFY CRITICAL CAPABILITIES

Traditional unit trust asset managers as well as exchange traded product issuers require core operating model components to ensure end-to-end product enablement. **Asset managers should Identify the critical capabilities required of the TOM, evaluate the benefits of each and assess their current TOM before continuing with a business transformation engagement**. It is on this foundation that companies can build an overall strategic vision and determine the goals the target operating model should fulfil.

Fig.10 Core operating model components

Portfolio Management

- Constructing the optimal portfolio to achieve the fund objective, managing constraints and rebalancing

Trade Execution

- Routing trades to brokers or internal dealing desks, working trades into the market and auctiions, processing, matching and reconciling executed trades

Asset Administration & Fund Accounting

- Performing fund accounting, instrument and fund valuation, cash and currency management, unitisation and processing creations and redemptions

Compliance Monitoring

- Pre-trade compliance screening, ongoing post-trade compliance monitoring and regulatory reporting

Risk Management & Reporting

- Portfolio risk and performance analytics, managing exposure and liquidity thresholds, compiling client and management reports

IMPLEMENTING CRITICAL CAPABILITIES

Once the organisation has defined its strategy and design principles and identified the critical capabilities to focus on, the implementation can begin. Implementing a sustainable TOM requires:

- Integrated systems
- Critical skills to support capabilities
- A data management and governance framework
- Defined roles and responsibilities
- Embedded processes and controls
- Management of outsource/insource capabilities

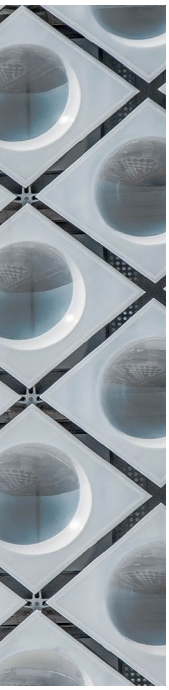
A systematic analysis of the data, systems, processes and controls required to fulfil each capability must be undertaken. This analysis informs the suitable implementation approach for the organisation's maturity and competencies. **A critical implementation consideration will be the decision to outsource or insource components of the TOM. We propose the following considerations when evaluating whether to outsource or insource each capability in the context of the complete target operating model design**:

FOCUS ON SCALE

The important consideration here is "what is the minimum AuM required to support the TOM?" New management companies initially use a full outsource model for core investment operations to reduce time to market, access best-in-class services and match cost structure to business scale. As AuM and the product suite expands, opportunities for hybrid and insource models expand.

The optimal TOM will support the inclusion of additional products, have capacity for transaction volume and AuM growth, extend use cases to adjacent business lines and enable seamless geographical expansion.

NOTE:	Cloud-based solutions in the market offer scalability from an infrastructure perspective and allow seamless real-time information sharing internally and with clients.



CONSIDER EXISTING INFRASTRUCTURE AND DOMAIN EXPERTISE

All good strategies require a clear understanding of the current position. Identify the existing skills, processes and technology infrastructure within your organisation and assess the maturity. The available resources determine the feasibility of building and supporting a solution inhouse, assist in selecting a software provider that will provide the most seamless transition and provide clarity on the current operating model weaknesses that need to be addressed.

OPTIMISE THE FIXED VS VARIABLE COST MIX

Clients and their advisors alike have reflexively pursued an outsourcing agenda with the aim to convert fixed costs into variable costs and focus internal resources on core activities. However, the ideal cost structure is more nuanced for asset managers. The optimal mix of fixed and variable costs is entirely dependent on the business strategy and we caution clients to avoid converting fixed costs to variable costs in blanket fashion.

Variable cost solutions often appear to be clear choices when evaluated against higher initial investments and the total cost of ownership of a comparative fixed cost-leaning model. However, organisations should consider the effect of operating leverage on profit margins afforded by fixed cost-skewed models, as well as factor in the risk of cost-creep from variable cost service providers.

Fig.11 Typical Fixed and Variable Costs

Fixed costs	Variable costs
• Software licences	• Asset administration
• Services (eg. audit & tax)	• Index licence fees
• Exchange listing fees	• Order execution costs
• Corporate sponsor	• Discretionary portfolio manager fees
• Extra headcount to support TOM	• Trustee & custody fees
• Market data	• Compliance monitoring
• Database infrastructure	

Ultimately, controlling the cost structure on a per product basis directly drives gross margins and allows for competitive pricing.

REDUCE SOLUTION COMPLEXITY

Business continuity and service levels are a key consideration when outsourcing. Too many moving components and management of multiple service providers and workday schedules limits control of the process. Reducing the system and service provider landscape complexity through insource and hybrid models increases business control, reduces the scope for data discrepancies, allows for agile decision-making and increases adaptability to evolving business needs.

Integration of solutions should be supported by a robust data management and governance framework. By minimising hand-off points, instilling clear data ownership and avoiding data duplication in multiple systems, the scope for data discrepancies is reduced. This in turn reduces inefficient time spent on reconciliation and data quality remediation issues.

NOTE:	This is a particular pain point for the majority of mature asset management firms who, each month, dedicate valuable resources to unproductive data maintenance and reconciliations. Straight-through processing (STP) allows the team to focus on core value-adding activities.

INDUSTRY PRACTICES

Fig.12 Typical Fixed and Variable Costs

Most outsourced	Least outsourced	Most shared
• Tax services • Securities trade execution & settlement	• Investment advisory • Portfolio management • Compliance monitoring • Analytics	• Data centres & networks • Investment research • Reference & market data management

MOST OUTSOURCED CAPABILITIES

Asset managers are most likely to outsource auxiliary services for a marginal cost. Trade execution is a particularly valuable component to outsource as there is a symbiotic relationship between portfolio managers and traders. Traders who are constantly screening the market are well-positioned to support the portfolio manager by providing insight into timing, current liquidity, significant market movements, alternative instruments and guidance ahead of fixed income auctions. The portfolio manager can therefore focus on the positioning of the portfolio.

In recent years, asset managers that have continued to focus on scale have found value in building out internal trading desks to provide dedicated execution, as well as oversee scrip lending and collateral management as a revenue enhancer.

LEAST OUTSOURCED CAPABILITIES

Portfolio management and compliance monitoring are the least outsourced functions. For active asset managers who live and die by performance, the portfolio management function is viewed as both the key value driver and a competitive advantage. There is therefore an incentive to retain control. Similarly, there is significant business and reputational risk associated with compliance monitoring. Asset managers and product issuers bear the regulatory responsibility for this and are ultimately accountable for any compliance failures. To the benefit of investors, compliance has taken root as a culture within firms where portfolio managers form the first line of defence, fortified by internal legal and compliance teams, supported by software.

Portfolio and risk analytics further enhance compliance and risk management. By its nature, the capability requires accurate, robust and timely data. As such, this lends itself to insourcing and is best integrated into front-office and asset administration systems supported by a strong data management framework.

Whilst fully outsourced and fully insourced operating have their respective benefits, a hybrid solution may prove the most feasible for the operating model transition journey. Hybrid solutions insource and optimise core competencies whilst leveraging best-in-class third party services.

The asset management industry is facing the reckoning of intensifying fee pressures coupled with the increasing cost and complexity of regulatory compliance. The resulting squeeze on profit margins has caused smaller firms to close, whilst larger asset managers have consolidated the industry. We believe the key to competing in the current environment and positioning oneself as an asset management business for growth is designing a technology-driven target operating model. The scalability, efficiency, control and cost benefits provided by an optimised target operating model allows asset managers to withstand further fee pressure whilst capturing profit margins. Passive investment product providers in particular stand to benefit the most from TOM transformation. Therefore, we believe asset managers should seize the TOM opportunity to build a **platform for growth**.

HOW CAN MONOCLE ASSIST?

With Monocle's extensive experience delivering operating model and cost transformations in the financial services sector, we understand the challenges and complexity involved in projects of this nature. We partner with our clients to build bespoke solutions that solve their unique challenges.

Monocle can assist your organisation's transformation journey by conducting the various capability and cost assessments required, designing a target operating model, implementing the systems and processes that support a sustainable TOM design, as well as assist with developing the data management capabilities that underpin the solution. This will enable your business to achieve its strategic objectives and realise operational and cost benefits post-implementation, and into the future.

JOHANNESBURG

13th Floor, Greenpark Corner,
3 Lower Road, Morningside,
Sandton, South Africa

Phone: +27 (0) 11 263 5800
Fax: +27 (0) 11 263 5811
Website: www.monocle.co.za

CAPE TOWN

301 New Cumberland,
163 Beach Road, Mouille Point,
Cape Town, South Africa

Phone: +27 (0) 82 952 1415
Website: www.monocle.co.za

UNITED KINGDOM

4 Lombard Street,
London,
EC3V 9HD, England

Phone: +44 (0) 2071 902 990
Website: www.monocle.co.uk

AMSTERDAM

Weteringschans 165 C,
1017XD Amsterdam,
Netherlands

Asset Management