RIGHTSOURCING

FINDING THE BEST BUSINESS MODEL FOR YOUR ASSET MANAGEMENT AND RELATED OPERATIONS

P&I CONTENT SOLUTIONS GROUP

BNY MELLON

This report examines the key decisions that U.S. and international asset owners must consider when structuring their asset management model. The research, which canvassed corporate and public pension funds, and endowments and foundations, was sponsored by BNY Mellon and conducted by P&I Content Solutions, a division of *Pensions & Investments*, during July/August of 2015. The respondents were drawn from P&I's Research Advisory Panel, a group of tax-exempt investors who serve as an important source of market intelligence for P&I and its partners. The respondents represent 245 U.S. and international institutions. Statistical analysis was conducted by Signet Research Inc. For more information on this study, including the methodology, final survey data and additional published material on global investing, please visit **www.bnymellon.com**

01/2016

BNY MELLON

Executive Summary

BNY Mellon and *Pensions & Investments* conducted a survey to examine the decisions that asset owners face when structuring an asset management model. One fundamental decision involves whether asset management and related operations are handled internally or externally.

Of those asset owners that have brought asset management in-house, many believe that they can achieve the dual benefit of cost savings and better investment returns. Importantly, the decision to insource is not always combined with a desire to bring middle-office functions in-house. In fact, many asset owners view the operations of asset management as complex and technologically challenging.

The majority of the firms surveyed continue to outsource their asset management strategies and cite satisfaction with the performance of their external managers and the ability to scale their businesses as chief reasons.

THE SURVEY, WHICH INVOLVED 245 U.S. AND INTERNATIONAL ASSET OWNERS, SHOWS THAT THE INSOURCING TREND HAS GROWN RECENTLY:

- 46% of asset owners that manage assets internally increased their proportion of in-house-managed assets in the last two years
- 28% of these asset owners say they will increase this proportion further in the next two years; 24% remain undecided
- 25% of asset owners that insource manage over 50% of their portfolio in-house
- 40% of public pension funds surveyed manage assets internally, compared with 32% of endowments and foundations and 19% of corporate pension funds
- 41% of asset owners that insource say they expect to outsource some or all of their middle-office functions at some point

LARGER ASSET OWNERS ARE MORE LIKELY TO MANAGE ASSETS IN-HOUSE:

- 58% of asset owners with assets in excess of $25 billion manage some assets in-house
- 26% of asset owners with assets of less than $25 billion manage some assets internally

BUT THE MAJORITY OF FIRMS WILL CONTINUE TO OUTSOURCE:

- 67% of those responding choose not to insource, across all sizes and types of asset owner
- 63% cite satisfaction with the performance of external asset managers as a reason not to bring asset management in-house
- 45% felt they did not have sufficient scale to commit to in-house management
- Of those who outsource, only 2.4% will insource in the next 24 months; 8.5% are unsure

Introduction

Highlights

Insourcing investors are looking for a more transparent and holistic view of their portfolio, whether part or all of the assets are managed in-house.

Investors who insource cite better risk-adjusted returns and risk management as a result.

Large institutions start by insourcing the easier-to-manage asset classes such as cash and fixed income, before considering other asset classes.

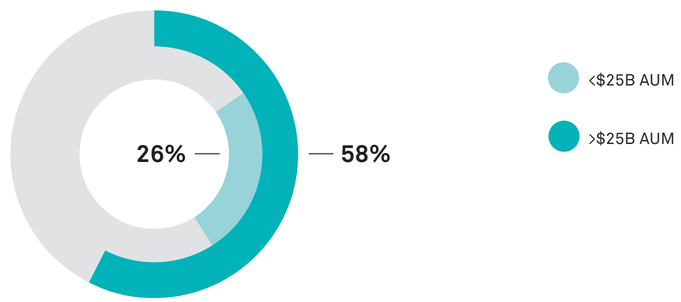
A majority of asset owners do and will continue to outsource their asset management in the future, citing satisfaction with external managers as the primary reason.

Smaller asset owners – those with under $1 billion assets – are more likely to outsource asset management as they do not believe they have the scale to support in-house management.

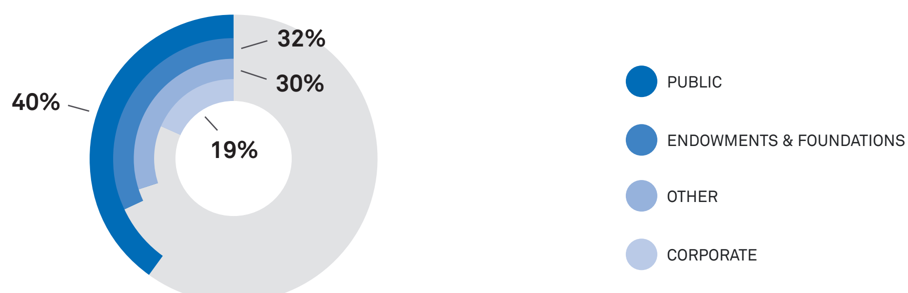
Certain back- and middle-office functions have become so complex and subject to rapidly changing regulatory and reporting demands that many asset owners that choose to insource investment management now are choosing to outsource such components in the future.

It’s a trend that may seem counterintuitive: Many large asset owners are reviewing their external asset management and considering expansion of their in-house investing capability. The reasons for this move are largely philosophical and a reaction to the lack of control many asset owners experienced during the financial crisis. For some, a tradition of in-house investment management has been expanded to include additional asset classes; for others, the lower cost of in-house management has contributed to better risk-adjusted returns over time.

Larger Asset Owners are More Likely to Manage Assets In-house



Public Pension Funds are the Most Common Type of Asset Owner to Embrace Insourcing



But the Majority of Firms Will Continue to Outsource Asset Management

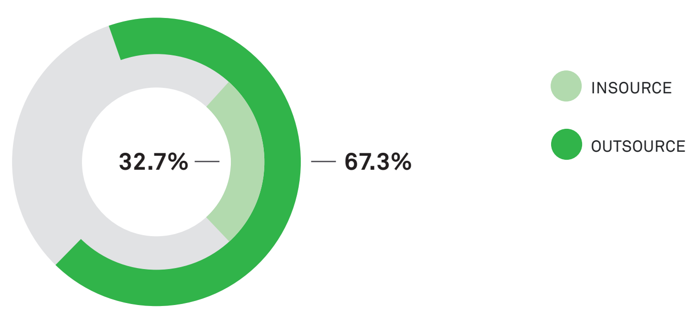


Exhibit 1

Internal Management by Asset Class

Cash and fixed income are the most common asset classes managed in-house across the size spectrum, though over two-thirds of large asset owners manage equities and alternatives in-house

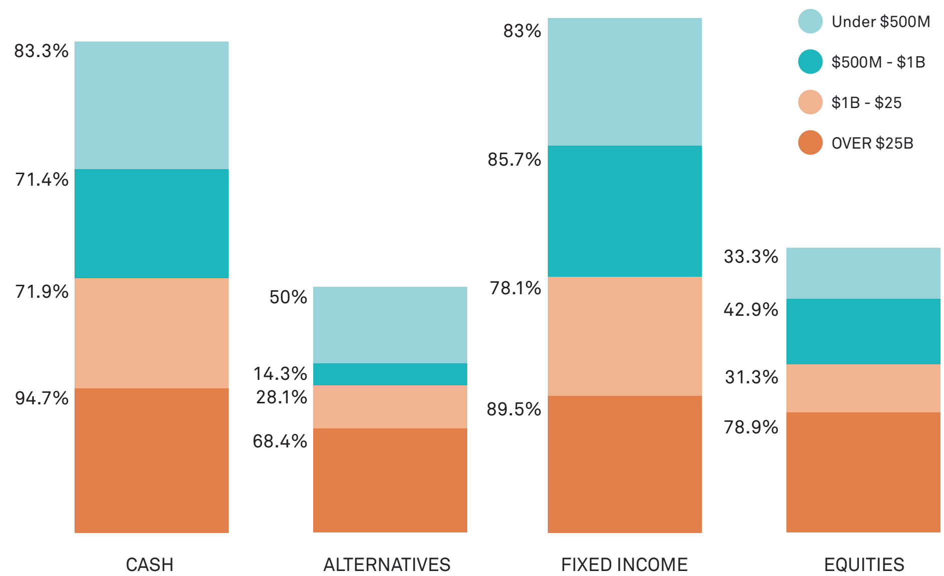


Exhibit 2

The nature of "rightsourcing" has and is continuing to evolve, as asset owners look to develop new kinds of collaborative arrangements with outside asset managers that blur the lines between internal and external management, while at the same time seek to outsource additional middle office and technical support functions. Asset owners are identifying areas where insourcing can add value and where it can't.

The largest asset owners are the most likely to insource investment management, with 58% of those with portfolios over $25 billion among the 245 U.S. and international asset owners surveyed managing assets in-house. The survey results indicate that of these larger asset owners, public pension funds are more likely to insource than corporate pension funds, or endowments and foundations.

Overall, a quarter of asset owners that insource manage over 50% of their portfolio in-house. Cash and fixed income are the asset classes most likely to be managed internally: 79% of asset owners that insource manage cash and 80% manage fixed income. For the largest institutions, equities and alternatives are also common areas for insourcing, with 79% of asset owners with $25 billion or more managing some equities and 68% managing some alternatives internally.

Are You Rightsourced?

> Some 62% of respondents thought that the ability to align investment strategy and practice to long-term objectives was important.

Reasons Cited for Managing Assets Internally

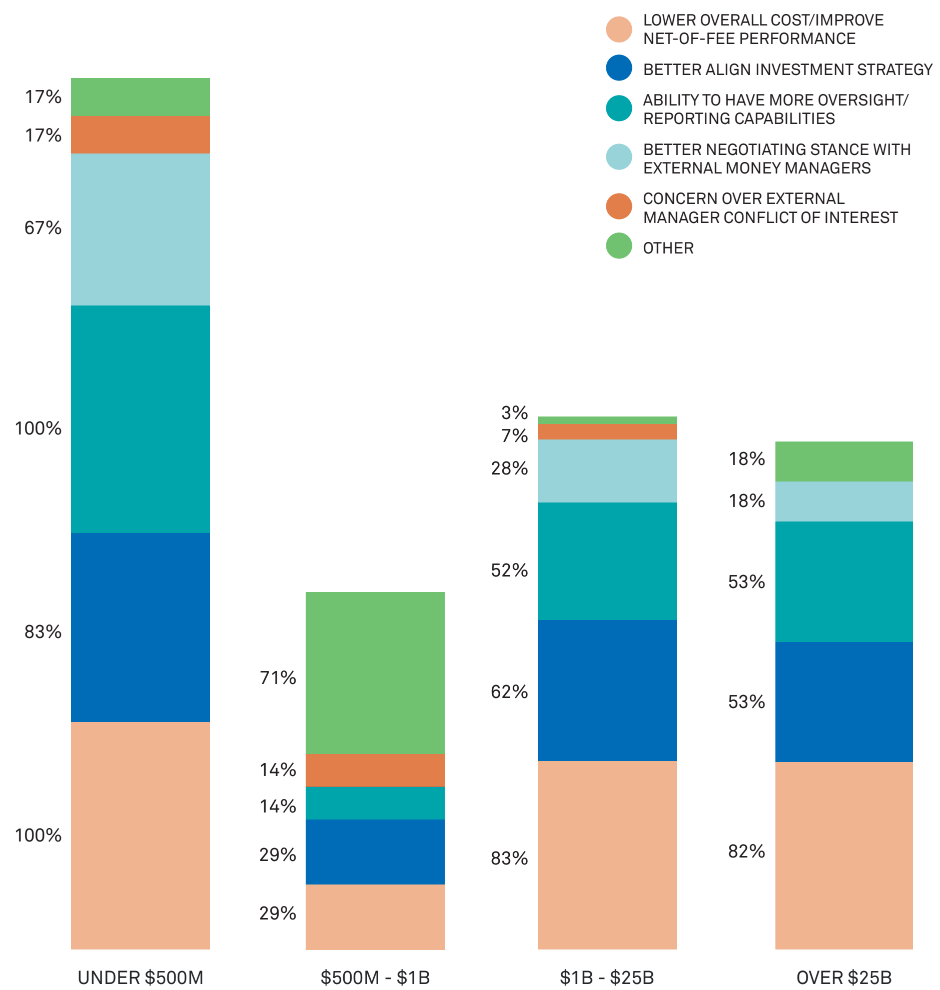


Exhibit 3

In exploring the reasons to consider insourcing, asset owners most often cited lower overall cost and improved net-of-fee performance as the drivers (80%). Interestingly, while cost is an important factor, it's performance that motivates more asset owners to insource or to expand their in-house capabilities. That's because the cost savings available do not seem to be considerable. Over half of respondents suggested that cost savings would be under 10% for equities, alternatives and cash, and even lower for managing fixed income investments. Not surprisingly, those asset owners expecting and experiencing the most cost savings are the largest – those with portfolios over $25 billion.

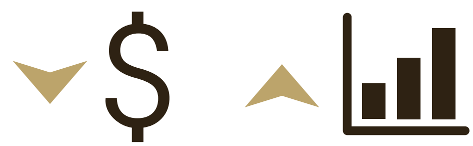
The issue of control is a big factor when determining the right insourcing or outsourcing model. Some 62% of respondents thought that the ability to align investment strategy and practice to long-term objectives was important. This thought is shared across the size spectrum. These asset owners also want to have a better handle on reporting and oversight of their portfolio. Very few asset owners are concerned about perceived conflicts of interest with external asset managers. And only the smaller investors think that managing assets in-house gives them leverage in negotiating with external managers.

In many senses, scale is an important issue when considering cost. From an infrastructure and technology perspective, it can cost as much to support a $200 million portfolio as a $1 billion portfolio. For those considering launching an insourcing project, start-up as well as ongoing costs can be considerable. In that way, those that are already insourcing seem to have a leg up when thinking about expanding their insourcing activities.

The minimum asset level needed to insource prompted a wide range of views in this survey. These differed depending on the size and type of organization answering the question. For example, 45% of institutions with assets over $1 billion identified either less than $100 million or between $100 million and $250 million as the amounts where it began to be less expensive to manage listed equities in-house. Public pension funds were more likely to cite smaller asset sizes – under $100 million – as needed to manage fixed income and cash in-house, with larger portfolios required before considering alternatives and equities.

While 46% of survey respondents that do manage assets internally increased their proportion of assets in the last two years, only 28% say that they will make similar moves in the next two years; 24% are undecided about future moves. In part this likely reflects a need to bed down recent changes. However, it also shows that once an asset owner has committed to insourcing, it is easier to increase the proportion as well as the kind of assets that are managed in-house. In a world where some asset pools are declining in size while others are growing, the questions of asset growth and purpose must be considered.

Survey respondents claim lower overall cost and improved net-of-fee performance are key drivers for insourcing



“

In order to insource, ‘we would need to have the funding and confidence that we could manage assets better than third-party managers.’

Percent Savings by Asset Class

Internal vs. External Management Comparison

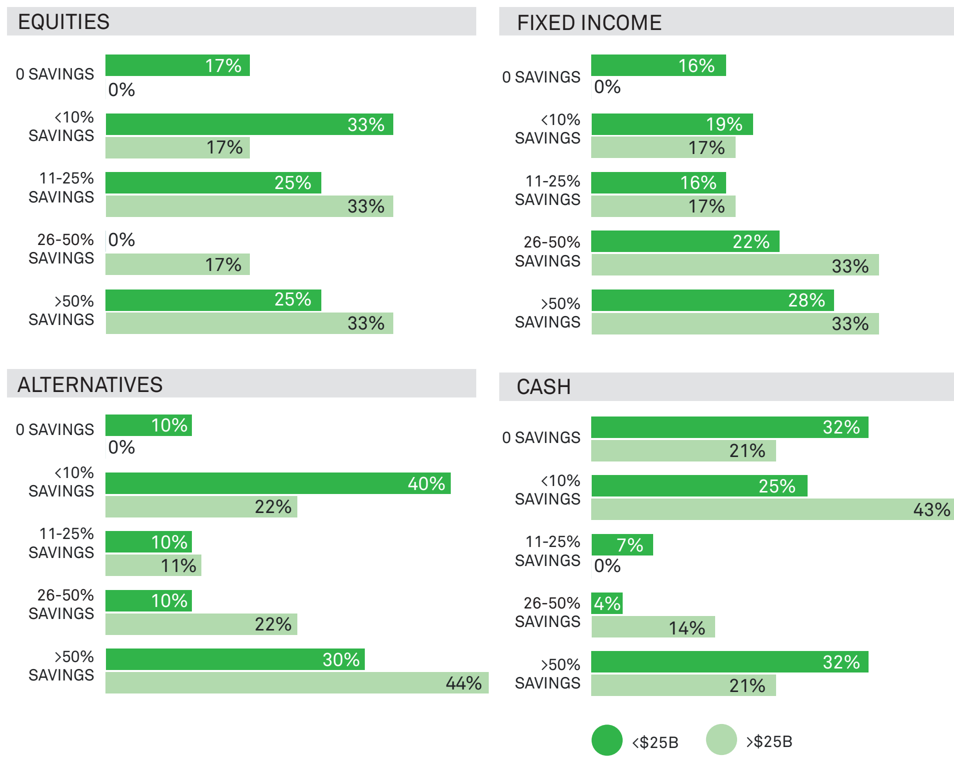


Exhibit 4

> Risk can be effectively managed with an outside manager as long as there is sufficient communication and sharing of data and information.

CASE STUDY
A Culture of Insourcing

"We are always entertaining the idea of doing more internally," says a public fund executive with listed equity and fixed income managed in-house. The rationale is clear. "It would cost us four times as much to have these assets managed by external managers." The insourcing process began years ago, before many involved joined the institution, but the culture is now entrenched. After the financial crisis, the insourcing project gathered speed, as qualified personnel were available at a more reasonable cost. Now hiring is more challenging, but the board, convinced by the quality of risk-adjusted returns, is willing to consider bringing more asset classes in-house if the opportunity arises. In large part, that does depend on the availability of staff. The technology and systems needed to manage this range of assets in-house have built up over time. Again, staff have been able to make the case to the board to keep up with advances because of the information flow and transparency that allow for better oversight and risk management.

Who Has Brought and Who Will Bring More Assets In-house

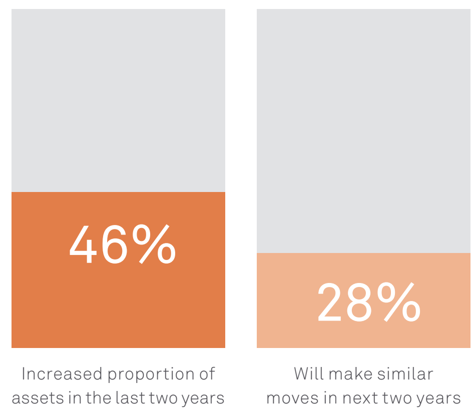


Exhibit 5

CASE STUDY
Starting from Scratch

Even though many institutions that insource have done so for many years, there are new converts. After determining that external active management was costing too much for lackluster results, one public fund is in the process of converting to primarily in-house passive management. It can be a somewhat Herculean effort: "The first step is developing systems and a direct management capability – and we're going slowly. The second step is developing the technology capability. Then we'll look to add staff, but that won't be as complex as it might be if we were looking for market-leading, alpha-generating active managers." The focus of the exercise, though, is on asset management. This institution is clear that it will continue to outsource middle-office functions and execution, because they don't think bringing these in-house will add value.

CASE STUDY
Being Nimble and in Control

Somewhat against the grain, some institutions are actively looking to increase the percentage of assets they manage in-house. That's because "we're able to generate fee savings that far exceed any salaries we pay the people who are making those decisions." This institution starts small, usually hiring one or two people to oversee an external allocation. The hope is that over time those staffers will transition to become managers themselves. In alternatives, for instance, experience in co-investing led to direct investing. "It's been a natural progression but allows us the time to create a story that we can take to the board to justify new positions for in-house management. If you sell them on the people, they know they will need tools to do their job, so getting technology is a lesser issue for us."

Challenges to Managing Assets In-house

Insourcing is not without its challenges, with most occurring in the initial stages of implementation. Perhaps the largest obstacle that an asset owner encounters involves reorienting all the governance processes of the organization. Once this has occurred, governance becomes a strength, with 85% of institutions reporting that their governance structures can accommodate in-house management. Some 70% report that bringing new or additional assets in-house would not require any new disclosures to regulators or stakeholders. This situation contributes to the trend that those asset owners with in-house management are most likely to increase their capabilities in this area.

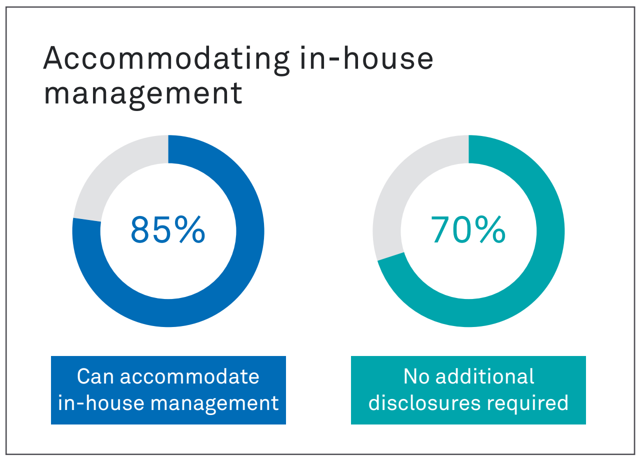


Exhibit 6

> Cyber-security is an area where even large asset managers are finding it hard to keep up.

Beyond governance, insourcers face some specific and often ongoing challenges. Prime among these is the issue of compensation when staffing an internal investment team. In this survey, some 74% of asset owners felt unable to pay market-clearing compensation, though for those with over $25 billion in assets, this drops to 56%. Public pension funds are more likely to accommodate the pay scale, with 36% saying that it was possible to pay the going rate, compared with only 17% of corporate pension funds and 19% of endowments and foundations able to do so. Nonetheless, 57% of respondents reported that the inability to pay market rates does not hamper their ability to insource.

Of course, pay isn't the only consideration when hiring internal investment staff. Some of the asset owners surveyed report that being located outside of traditional financial centers in places that offer a better quality of life can override some of the compensation considerations. Certain asset owners have successfully ring-fenced their investment professionals so as to be able to pay them salaries more in line with the asset management industry.

Most organizations suggest that they would need more employees if they were to increase in-house asset management, with the majority identifying between one and five as the number required at a professional level and a similar number at an administrative level in all asset classes.

CASE STUDY

Staying in the Game

One institution that has long managed assets internally sees one of the key benefits as not simply cost or even net-of-fee performance, but rather the advantage it provides the staff with managing the external managers it hires. It seems a bit contradictory, but the institution deliberately manages a portion of its equity, fixed income and alternatives allocations internally. “Understanding a bit about the process of trading in general helps us evaluate the skills of third-party managers.” This institution believes that the practice of internal management furthers staff development and helps to keep staff stable.

Today Those With Internal Capabilities Handle Many Middle-Office Functions In-house

Many asset owners handle substantial middle-office functions in-house, but this may change as the investment landscape becomes more complex

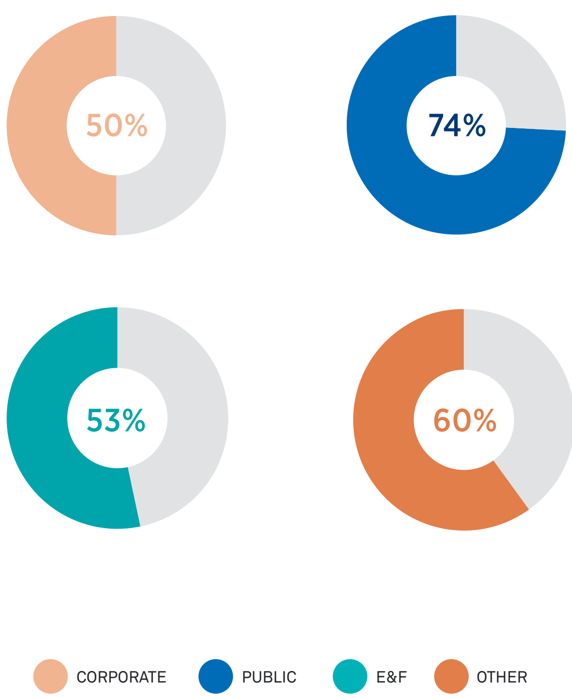


Exhibit 7

“

Some **74%** of asset owners felt unable to pay market-clearing compensation, though for those with over **$25 billion** in assets, this drops to **56%**.

Outsourcing Middle-Office Functions

When it comes to those important middle-office functions that make investment management possible, a majority of all asset owner types with internal management capability currently handle these activities in-house. However, asset owners report that for some of the more complex and demanding middle-office activities, this is likely to change. Some 41% of asset owners that are currently managing assets in-house expect to outsource some or all of their middle-office functions down the line.

The survey shows that the number of middle-office functions that asset owners expect to outsource outstrips those they expect to maintain in-house. Top of the outsourcing list overall are performance attribution, trade processing and reconciliation. Smaller asset owners – those with less than $25 billion in assets – are more likely to outsource portfolio accounting, collateral management and corporate actions.

One particular area where asset owners are most likely to seek support from outside vendors is data management and oversight. While asset owners report that a key reason to insource is to have the ability to have greater oversight over their portfolios, they are increasingly finding it hard to keep up with the demands to manage huge amounts of data to create the reporting they need. Hence the indication in Exhibit 8 that many asset owners will be looking to outsource investment risk reporting and performance attribution, just to name two.

However, it isn't just data that is causing concern. Asset owners of all sizes are facing a raft of pressures when it comes to providing for the complex and ever-changing infrastructure and operational needs to support in-house investment management. Primary among these is the specter of cyber-security. It's an area where even large asset managers are finding it hard to keep up. For asset owners with in-house portfolios, it's an aspect where they are unlikely to have the necessary expertise.

> Some **41%** of asset owners that are currently managing assets in-house expect to outsource some or all of their middle-office functions down the line.

Insource/Outsource Middle-Office Functions

Applies to those that answered that they are thinking about insourcing and outsourcing middle-office functions in the future

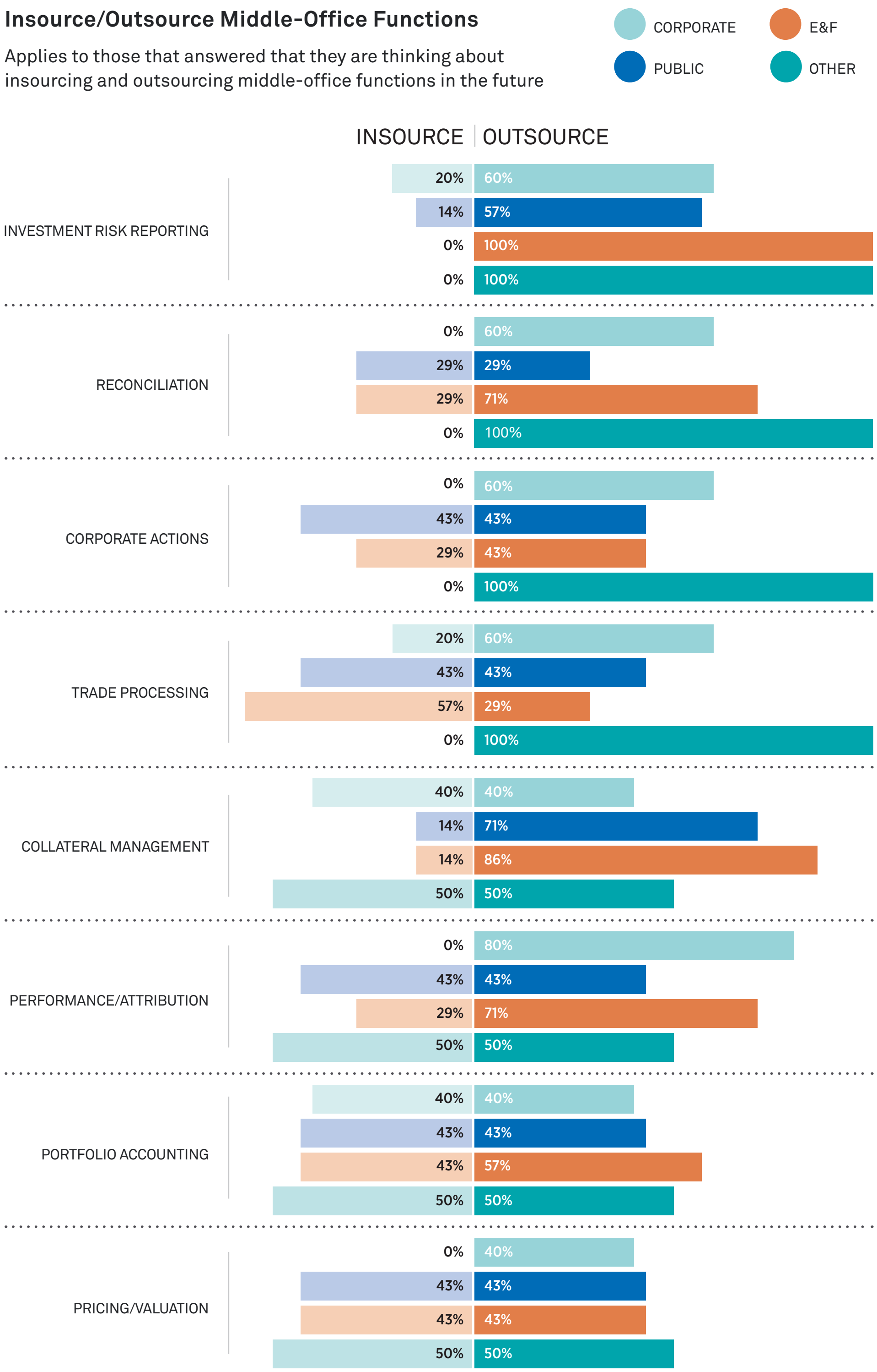


Exhibit 8

Why Outsource Asset Management

One asset owner that has chosen not to manage any assets internally had this comment: “The overall strategy would have to change. This would require cultural, governance and policy change.” This comment confirms survey results that 67% of all respondents across all sizes of asset owner choose not to insource any assets. As many as 63% cited satisfaction with the results they receive from external managers. Additionally, 45% felt they did not have a sufficient scale of assets to commit to in-house management. Some commented that they might consider in-house management if the assets were invested in traditional and relatively simple asset classes - for instance, if a pension plan were fully closed and inactive, and the portfolio consisted of 100% matched fixed income.

This focus on using external active managers is borne out by the relatively low level of internal active management, particularly in equities. Only 17% of those surveyed reported that they engage in active equity management.

“

45% of those who out-source felt they didn’t have a sufficient scale of assets to commit to in-house management.

CASE STUDY

Keeping Up With the Times

As very few institutions manage 100% of their assets in-house, they often use a patchwork of insourced and outsourced middle- and back-office services. With a constant eye on the cost of technology, institutions that manage funds internally typically have their own portfolio accounting system while those that outsource use external portfolio accounting services. Sometimes institutions run a duplicate set of accounting books, as a double check against the custodian for daily reconciliations and performance attribution, for instance. However some of these functions can become too complicated to manage in-house. “Collateral management is new to us,” says one institution, “because the trading agreements we’ve had didn’t require collateralization. But now we do need collateral management, and we’re doing it in-house. That process is always under evaluation, so if gets to be too significant an endeavor, we may seek a third party to help us.”

CASE STUDY

Politics Are a Deterrent

Some institutions simply don’t consider in-house management an option. It can be a simple matter of cost. “We pay one basis point for our index products and make about one and a half basis points on our securities lending. We couldn’t do that internally.” It’s also a question of competing for staff. Salaries can be prohibitive, particularly when it’s a public institution answerable to politicians. There may be no extenuating circumstances, such as an attractive location in which to live. This institution is convinced that “managing managers makes the most sense to us, particularly when it comes to active management, where we couldn’t afford the staff.”

Conclusion

This survey demonstrates that asset owners are constantly evaluating the options available to them as they consider the right asset management model for their institution. The survey data points to a variety of approaches and most of all a desire to *rightsource* their business operations and achieve successful outcomes – through a combination of developing talent in-house and outsourcing.

For some asset owners this means expanding their in-house asset management strategy. For others, it means considering a deeper outsourcing strategy of middle- and back-office functions.

There is more consistency in the attitudes of the largest asset owners, many of which have been long-term proponents of in-house asset management. Having started by managing cash and fixed income internally, they have often branched out over time and are now managing a variety of alternative asset classes internally.

Complex active equity management does not appear to be a popular insourcing choice, though many asset owners with experience in managing domestic portfolios are looking to branch out into global or international equities.

Other key features of the rightsourcing trend:

– While looking to develop a broader and deeper expertise in asset management, asset owners are not necessarily seeking to develop extensive in-house middle- and back-office infrastructure. It is likely that many of these functions will be further outsourced in the future.

– Complications such as pay rates and governance issues are not holding back those asset owners with a philosophical commitment to insourcing.

– Asset owners with a history of in-house investment management report high levels of satisfaction with the risk-adjusted returns and the greater control over the portfolio achieved.

The survey suggests that rightsourcing is a permanent feature of the investment landscape. Larger asset owners are focusing on ways to leverage their size to create more efficient approaches to asset management, which may include combining forces when it comes to defined benefit and defined contribution plans. Already, many DC plans have benefited from the expertise that the investment office has in managing the DB plan. For those plan sponsors expanding their in-house asset management efforts, using the platform to manage DC assets could continue to feed that process.

As financial technology continues to develop, it becomes more possible for all sizes and types of asset owners to consider internal investment management as an alternative. Yet all asset owners will continue to feel the pressure to reduce costs and expenses in this low-yielding investment environment. Finally, the memory of the financial crisis remains powerful, and asset owners are mindful of the need to manage risk and performance analytics closely. This in turn suggests that asset owners will be looking for external back- and middle-office support for their insourcing activities. ❖

> "The focus on our own business requires us to outsource the asset management.

BNY Mellon is a global investments company dedicated to helping its clients manage and service their financial assets throughout the investment lifecycle. Whether providing financial services for institutions, corporations or individual investors, BNY Mellon delivers informed investment management and investment services in 35 countries and more than 100 markets. As of Dec. 31, 2015, BNY Mellon had $28.9 trillion in assets under custody and/or administration, and $1.6 trillion in assets under management. BNY Mellon can act as a single point of contact for clients looking to create, trade, hold, manage, service, distribute or restructure investments. BNY Mellon is the corporate brand of The Bank of New York Mellon Corporation
(NYSE: BK). Additional information is available on **www.bnymellon.com**. Follow us on **Twitter @BNYMellon** or visit our newsroom at **www.bnymellon.com/newsroom** for the latest company news.

FOR MORE INFORMATION, PLEASE CONTACT:

Philip J. Falivene
212 635 7321
philip.falivene@bnymellon.com

S. Karolyn Ferris
212 298 1758
karolyn.ferris@bnymellon.com

BNY MELLON

P&I CONTENT SOLUTIONS GROUP