Four Mistakes to Avoid When Choosing an Outsourcing Provider

Outsourcing middle and back-office functions can have a substantial impact on a financial services firm’s operational cost and ability to execute investment strategies. As a result, outsourcing adoption has been steadily growing since the market crash in 2008 with no signs of slowing down. As investment managers focus on transparency and performance, they are turning to outsourcing providers to provide key services and technologies that will cost effectively achieve these goals. According to a recent study from Aite Group, “Overall, 56% of asset managers outsource back-office functions, including accounting, reporting and custody, and 30% outsource middle-office functions such as reconciliation, investment performance and collateral management.”
Decision-makers typically understand how they can benefit from outsourcing arrangements in theory. However in many cases, they are not aware of common pitfalls which can derail these benefits and end up increasing costs or risks. Below are four common mistakes that asset managers should avoid when choosing an outsourcing provider and plan.

**Mistake #1 – Outsourcing Your Core Competencies**

The decision of whether to outsource should not be taken lightly. Operations, technology and management teams may spend years determining whether outsourcing is the right fit for their business. However, decision-makers often see outsourcing as an “either/or” proposition – without consideration to the full spectrum of services and technology options available.

As an example, if a business has spent over a decade investing in development of a proprietary performance measurement system that is deeply entrenched in the firm’s hardware and software infrastructure, there may be significant pushback to outsourcing. Trying to convince internal stakeholders that giving up this specialized technology in order to boost reconciliation capabilities through a fully-hosted arrangement could be an uphill battle. In this case, it may be most prudent to leave performance measurement in house while outsourcing other middle and back office systems. Too often, firms do not realize that this type of component outsourcing is not only a viable solution, but often the most sensible one.

While outsourcing service providers typically offer secure access to applications while managing the hardware and software infrastructure, most vendors lack subject matter expertise related to the actual applications being hosted. In many cases, application management will fall back on the IT team and negate the benefits of outsourcing. For these reasons, decision makers should not only assess which areas of the business stand to benefit from outsourcing, but also where the business’s core competencies lie. An outsourcing arrangement should strike a balance between the two, freeing up resources where current operations are falling short, but retaining ownership in the areas of the business that are clearly competitive differentiators.

**Mistake #2 – Choosing a De-Centralized Outsourcing Solution**

Often investment managers do not have full transparency into their outsourcing vendor’s third party relationships. This can lead to a de-centralization of the investment manager’s software, data, and services. Many outsourcing vendors themselves outsource, relying on outsourced software, hardware, and services to deliver some portion of an outsourcing agreement. This fragmentation can cause problems with operational risk, control, and flexibility.

If the investment manager has no visibility into the service-level agreement between its outsourcing service provider and the service provider’s vendors, it unknowingly loses significant control over its business and increases exposure to operational risk. If the investment management firm’s outsourcing services provider has outsourced some form of its services or data to a third party vendor, the investment management firm is most likely not educated on that third party’s risk controls and cannot influence how they manage critical information to align with their own risk strategy.
An outsourcing vendor that owns the technology on which it outsources is capable of customizing its hardware or software to meet the specific and immediate requirements of its customer. For example, if a firm must develop a specialized reporting process to respond to a new regulatory requirement, it is paramount that the outsourcing service provider can deliver a customized solution quickly. Vendors who rely on third-party technology can rarely deliver this level of flexibility, particularly within a tight timeline.

**Mistake #3 – Focusing Solely on Cost Savings**

Cost-savings is a clear benefit to outsourcing, and most firms weigh cost as a key factor in making a decision on whether and how to outsource. This is no doubt an important criterion, but many asset managers don’t understand the cost/benefit breakdown – particularly over the long term. When deciding whether to outsource, decision makers will often assess the cost in their service-level agreement but ignore how translating fixed costs to variable will help them grow their business.

As an asset management firm grows, it can be incredibly difficult to keep pace with increased data flow, reporting needs, client service, reconciliation, and a number of other processes. By hosting data with a third party or outsourcing some portion of its business operations, investment managers can opt to pay based on their AUM which allows them to easily align costs to their business results. This can also be useful for a component outsourcing arrangement. For example, if a firm requires only performance and attribution technology without staffing, they can implement the software now and add business support later, if necessary. With the ability to scale up the business over time, investment managers can undertake new strategies and clients, compounding the net effect on their bottom lines.

Many investment managers focus only on the reduction of fixed costs when considering vendors. An outsourced service provider should have a wide breadth of offerings and the ability to service almost all levels of the front-to-back office. As a business grows, the flexibility to expand an outsourcing agreement without switching vendors can be invaluable in terms of time and cost savings.

**Mistake #4 – Selecting an Inexperienced Vendor**

While some vendors have an extensive history providing cloud-based solutions, others are late or partial adopters. A proven track record is particularly important when selecting an outsourcing service provider. Vendors who have not purpose-built their technologies and infrastructures to support client demands are more vulnerable to operational risk, and vendors that don’t have in-house expertise in their clients’ businesses may not be capable of providing a high level of service.

A vendor that has experience in managing high volumes of data can anticipate breaks and outages, and is prepared for validation, exceptions management, and reconciliation at a high level. Those vendors with advanced operations can provide sound business continuity and disaster recovery capabilities, including mirroring to an alternate site for failover, redundant systems, and generators to keep the infrastructure up and running in the event of a power failure. Newer outsourcing providers often do not have the wisdom of experience to know if their contingency plans are failsafe.
Beyond better risk controls, experienced providers are able to offer expertise that helps shape their technology solutions and offer more outsourcing options to their clients. Providers with a deep understanding of the regulatory landscape and industry challenges can serve their clients as a resource for guidance in an increasingly complex business environment. Experienced outsourcing service providers should have a verifiable track record of success. If decision makers can’t confirm this track record, they are taking a serious gamble.

**The Bottom Line**

The choice of how to outsource can be complex, but every investment manager can benefit from industry expertise and best-of-breed technology provided by the right vendor. When undertaking a new outsourcing strategy, don’t fall into the trap of over-committing to an outsourcing arrangement. Beware of choosing a vendor who lacks a full range of in-house data or technology solutions. Don’t base your selection solely on sticker price, and be sure to select a vendor with a proven track record of success.

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For additional information on how outsourcing can improve the performance and efficiency of your middle and back-office operations, contact Kristen Schwecke at kschwecke@sscinc.com.