

THE SIMPLIFICATION OF COMPLEXITY: ECONOMIES OF SCOPE NOT SCALE

The American fund management industry is facing twin challenges. To continue to grow at home, it must innovate. To escape saturation at home, it must expand abroad. Both options entail an escalation of operational risks and complexities. Mitigating and managing those risks and complexities is the *raison d'être* of the securities services industry, whose leadership is now exclusively American. Yet the leading global custodian banks seem more intent on building scale than adapting their business models to the rapidly changing needs of their clients. Chandresh Iyer, North America Head of Securities and Fund Services in Citi's Markets and Banking in New York, offers an alternative: economies of scope not scale.



Chandresh Iyer

For American fund managers, the domestic marketplace presents an unusual combination of challenges. The savings markets are saturated in terms of traditional investment management products. This is forcing American fund managers to explore opportunities to distribute their traditional products outside the United States. Yet the American domestic savings markets are also undergoing an immense structural change that is equally rich in opportunity, if they are bold enough to innovate. That innovation entails a drastic adaptation of existing savings products to an environment based on income generation rather than the demand for capital appreciation that has fueled the growth of the fund management industry since the Second World War. As it happens, that self-same process of adaptation also entails finding ways to increase the exposure of domestic portfolios to new investment strategies and asset classes at home, as well as to faster-growing economies outside North America.

One fact explains the seismic character of the structural change now taking place in American financial markets: Over the next seven years, 77 million Americans will retire. The transition of the Baby Boom generation out of the American workforce presages a fundamental shift in the pattern of saving, from the accumulation of wealth to the generation of income. Some \$4 trillion of savings will move from capital growth to income strategies over the next ten years. But the working population of America is not just planning to retire: Its members expect to live longer, too. Actuarially, there is now a one in four chance that an American husband or his wife will reach the age of at least 90. So it is scarcely surprising that Americans are concerned they will outlive the assets they have accumulated for their old age. Nor is it surprising that they are ready buyers of savings vehicles that do not merely generate a retirement income, but incorporate long-term health and invalidity insurance and care services as well.

Some American fund managers have responded to the challenge by forming alliances with health insurers to create bundled retirement

income and medical expenses products. The health savings accounts (HSAs) created by the legislation of December 2003, which allow Americans to set aside pre-tax dollars in mutual funds or other savings vehicles to pay for post-retirement medical costs, present fund managers with a massive opportunity to create a new type of savings vehicle in a familiar guise. While the Department of Labor figures show that only 6% of private sector employees in the United States had an HSA at the end of last year the parallel with the rapid growth of the 401(k) defined contribution pension plan industry in the United States over the last decade is striking.

The parallels go beyond tax-exempt dollars. Both HSAs and 401(k) plans have one extremely important feature in common: they are distributed largely through the workplace. Since the passage of the Pension Protection Act (PPA) last year, American plan sponsors have had to comply not only with new rules on the funding and valuation of pension plans, but also meet new obligations to inform and advise employees on their savings strategies. This can be expected to increase the flow of savings into 401(k) plans, increasing their share of a retirement market that managed \$14.5 trillion at the end of 2005. This makes American employers a vital distribution network for American fund managers. And the opportunity is not confined to 401(k) plans either. Employers are the chief sponsors of HSAs, individual retirement accounts (IRAs), traditional annuities, and the new breed of target income in retirement products. Fund managers geared to soliciting asset management mandates from defined benefit pension plans advised by consultants, or distributing mutual funds to retail investors, are already re-focusing their efforts on ensuring their funds are offered through the workplace.

In short, the American retirement market offers massive opportunities to fund managers willing to seize them. To do so, fund managers need operational support, and usually of a complicated kind. HSA and 401(k) plan sponsors, for example, require connectivity to the fund managers, which invest the sums remitted by the beneficiaries, and to the distributors of the combined products. They also require cash management capabilities to collect subscriptions and make disbursements when claims are made, or pensions are paid. Those fund managers are likely in turn to be invested in a much wider range of assets, and across a broader spectrum of markets, all of which need to be settled, serviced, reconciled, valued, allocated, measured for transaction costs and against an appropriate benchmark, and reported. By supplying these services to fund managers active in the 401(k) and HSA markets, Citi is helping them access the single most important new distribution channel for the products they develop: the workplace.

The products fund managers distribute through the workplace will include a much broader array of asset classes and investment strategies than the stocks and bonds and equity-based funds of the recent past. After all, American employers, as pension plan sponsors, are the first group to be forced to grapple with the scale of the demographic challenge. Despite the stronger stock markets of the last four years, actuarial science dictates that more and longer-lived pension plan beneficiaries still imply funding shortfalls in traditional defined benefit pension funds. This is the largest single factor behind the switch by plan sponsors from defined benefit to defined contribu-

tion schemes such as 401(k) plans instead. Employers that continue to support defined benefit plans have a different solution. They have an increased appetite for reliable sources of fixed and annuity income such as government bonds and real estate—to offset the actuarial risk—but also for higher-yielding emerging market equity, private equity, and especially hedge fund strategies.

The growing popularity of absolute return funds, which promise a return in all market conditions, is a clear symptom of the growing demand for defensive products among institutional investors in the United States. Long-only fund managers are now developing absolute return strategies for their traditional institutional clients, of which the fast-growing 130/30 funds are the most conspicuous example. The same institutional investment in hedge funds is behind the concomitant demands for greater transparency over the investment strategies and trading positions of hedge fund managers and for closer monitoring of all the types of risk they take, including operational risk. The diverse tastes of hedge fund managers are simultaneously increasing the range of assets held to include OTC derivatives, commodities, structured products, and private equity. It was chiefly in order to enlarge its capacity to process transactions in these asset classes, and value them accurately and in a timely fashion, that Citi recently agreed to acquire the hedge, mutual and private equity fund administration businesses of BISYS.

But the novel risks being run by institutional investors in the United States are not confined to unusual or illiquid asset classes. They include exotic markets too. Client demand is encouraging American fund managers to invest in markets far beyond the United States, and in frontier as well as emerging markets. American investors are now active in Central and Eastern Europe, the Middle East, East Asia, Latin America and sub-Saharan Africa. This is exposing American institutional investors, most of them used to investing in the domestic market only, to new risks. Yet, the local or regional trust banks they rely upon for custody, clearing, settlement, valuation and reporting services find they are unable to supply these services in a lengthening list of markets around the world. Most choose to outsource the task to one of the major global custodian banks. Citi currently looks after over \$3 trillion of assets on behalf of local and regional American trust banks and their clients.

For certain segments of U.S. Fund managers, American Depositary Receipts (ADRs), have long been a popular instrument for investing in non-U.S. companies, particularly where eliminating custody and cross border safekeeping challenges is a key concern. The ADR instrument is often favored by mid-tier institutional investors that may be prohibited or limited by their charters or by regulation from investing in non-U.S. securities purchased in the issuer's home market. However, less than one-fifth of non-U.S. issuers are available in the form of ADRs, which puts fund managers able to invest in foreign securities directly at a distinct competitive advantage.

But the ability to invest directly in foreign securities also involves operational and regulatory hurdles, exposing the fund managers and their clients to brokers, banks, stock exchanges and alternative trading platforms, clearing houses, central securities depositories, payments systems, proxy voting agencies and order-routing and messaging utilities all over the world. To allow investment in the broadest possible spectrum of global securities, the Citi global custody and clearing network can make the complex simple, enabling fund managers to execute trades in capital markets worldwide cost effectively, with full multi-currency operational support. Where fund managers wish to distribute funds in the same fast-growing markets, Citi can also supply them with custody, fund accounting, reporting, transfer agency and distribution support services.

Among the chief beneficiaries of these international capabilities are the members of the growing army of investors through Separately Managed Accounts (SMAs). International equities now make up a quarter of the assets invested through SMAs, against a fifth only five years ago. SMAs as a whole have grown rapidly in the United States in the last few years, not least because they are an attractive option for so-called “mass affluent” Americans, three out of four of whom do not yet have a financial plan of any kind. SMAs are proving popular because they address the appetite of asset-rich Baby Boomers approaching retirement for holistic wealth management services that can consolidate assets scattered across 401(k) plans, IRAs, HSAs, cash-in-the-bank, taxable savings vehicles, securities held in employee stock ownership plans, real estate investments and residential housing as if they were parts of a single portfolio. The “unified managed account” (UMA), which is the latest buzz phrase in American fund management, is a logical evolutionary step for the SMA.

It is unlikely to be taken, however, until the infrastructure that supports the SMA industry improves significantly. The SMA market needs automated account opening, subscription, redemption and reporting services to link the wirehouses as distributors, the fund managers that invest SMA assets, and the investors as account-holders. SMAs have also created demand from fund managers with SMA offerings for institutional-quality execution, trading and operational services. Fortunately, like the stock and bond markets in the 1970s, and the mutual fund market in the 1980s, the SMA market is now attracting service support and infrastructural investment on both the operational and the execution sides of the business. The Depository Trust and Clearing Corporation (DTCC) will introduce next year an SMA account opening hub. Based on standards drawn up by the SMA industry body, the Money Management Institute (MMI), Citi is supporting the new platform by offering fund managers a service that automates their communication with both Smith Barney as a distributor and the DTCC. Established SMA service providers such as Checkfree and Vestmark are developing similar services to support the DTCC platform.

In a separate development, DTCC sister company Omgeo has adapted its Oasys stock and bond trade confirmation and allocation tool to the SMA market, allowing managers to send aggregated blocks of allocations to distributors. This has facilitated automation of the allocation of assets to SMA sub-accounts at the level of the distributor. The same logic, of bundling orders into large blocks, is now being applied to increase efficiency on the execution side. Fund managers have traditionally executed trades with SMA distributors sequentially, denying them the efficiency, speed and pricing advantages of aggregating trades into larger blocks. In conjunction with Citi Global Markets, Citi Securities and Fund Services (SFS) now offers distributors direct market access (DMA), a crossing network, best execution measurement and (soon) algorithmic trading tools that enable them to execute blocks of trades with particular fund managers on more advantageous terms.

It is measures of this kind that lie behind predictions that the SMA market in the United States will grow from around \$800 billion in 1 million accounts today to \$2 trillion in 12 million accounts by 2010. Whether it will do so at the expense of the mutual fund industry—as many observers have predicted—will depend on a variety of factors. One reason SMAs have grown so fast already is that they enjoy a more advantageous tax treatment than mutual funds. But SMAs also represent an opportunity for the mutual fund industry, provided it becomes easier for SMA distributors to adopt mutual funds as an important asset class, alongside ETFs, hedge funds and common stock and bonds. At present, differences between the managed account and mutual fund processing systems used by SMA distributors has necessitated a high degree of manual intervention. This has discouraged distributors from expanding the use of mutual funds within SMAs. However, Citi is now developing a service designed to bridge the systems gap, and so make it easier for mutual funds to expand their share of the SMA market.

Which is a reminder of the range of skills that the modern securities services provider has to master. They include execution, clearing and settlement in multiple instruments and markets; foreign exchange and cash management; securities lending and financing; credit; hedge and

mutual fund accounting and administration; asset-servicing capabilities such as corporate action entitlement collection; transfer agency; and connectivity and processing technology in fields as various as OTC derivatives and SMAs. To match the multi-dimensional nature of the modern fund management client, all of these skills also have to be delivered off an integrated global platform that insulates clients from the complexities of the task. If it can be accomplished, the benefits are alluring. It is estimated that one dollar in every three fund managers spend on overhead is already absorbed in operational costs. If that proportion can be decreased, even as the complexity of investment strategies increases, the value created will be enormous.

As the market continues to evolve and transform, fund managers will increasingly demand flexible infrastructure solutions so that they may focus on their core competency of generating performance. In the face of a challenge of this magnitude, it would be easy for fund managers to seek refuge by retreating into a niche, or adding bulk by acquisition. Neither represents an effective response to the realities of the American fund management marketplace of today. The benefits of scale alone are illusory because the costs of coordination outweigh the benefits of consolidation. Similarly, a niche adds a further layer of complexity to the coordination problem. What is actually required is economies of scope, in which a service provider offers a full set of services that address all client needs, and which can be accessed on an integrated or a modular basis.

Citi has created a global investment administration services platform that addresses the needs of asset managers as they seek a strategic operating model that speaks to their needs. An example of this prototype is the recently formed hedge fund services group within Citi. It offers hedge funds securities lending, financing, risk management, capital introductions, accounting and administration, traditional back office services such as clearing and settlement and asset servicing, plus middle office services such as reconciliation, risk analytics and performance measurement, and on a global basis. What it offers hedge fund managers is the simplification of complexity. It is the ambition of Citi to deliver the same promise at every point along the American fund management spectrum.

FOR MORE INFORMATION

Chandresh Iyer
North America Head of Securities and Fund Services
212-816-6940

