

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Not a Crisis but a Crossroad, Part III: Defining the Challenge in Processing Separate Accounts

Bevin Crodian

This is Part III of a three part series on the state of operations in the middle and back office in the separate account industry. In [Part I](http://www.srconsultant.com/Articles/2004-03-Crodian-Not-Crisis-But-Crossroad1.pdf) (<http://www.srconsultant.com/Articles/2004-03-Crodian-Not-Crisis-But-Crossroad1.pdf>), we suggested that although not necessarily in crisis, this part of the industry is at a crossroad, and the direction from here will impact future industry growth, product and distribution. To help describe the current situation, we introduced the requirements of complexity, customization and scale. The priority that the asset management firm places on these requirements often tells a lot about its business. The institutional manager has a greater interest in supporting complex transactions, the private wealth manager is more interested in customization, and the wrap manager focuses on scale. In Part I, we also tried to sort out the confusing terminology that hampers accurate communication in the industry. In [Part II](http://www.srconsultant.com/Articles/2004-04-Crodian-Not-Crisis-But-Crossroads2.pdf) (<http://www.srconsultant.com/Articles/2004-04-Crodian-Not-Crisis-But-Crossroads2.pdf>), we moved on to addressing the components necessary to creating a platform to deliver process efficiency to the middle and back office. Finally in Part III, we discuss some common fallacies that frustrate the debate about how best to improve conditions.

The “Let’s Go To A Meeting” Fallacy

Industry meetings and conferences are certainly a good thing. Within the past few years, there has been a proliferation of them, and that too is a good thing. If nothing else, they provide a change of scenery, an opportunity to network and potentially the opportunity to gain different perspectives about ways to approach your work and career. However, if you analyze the way in which current conferences are organized, especially ones dealing with the wrap industry, here is what you often find. Regardless of how the topics are titled, they usually touch in some way on the technological components required to support the investment process. In

Part I, we defined the process as the “end-to-end investment service that successfully delivers asset management to a client.” The attempt to describe, define and analyze these components with the hope of improving their process efficiency is a good thing and should be welcomed by all concerned. However, the process, especially the wrap component, does not operate in a vacuum. So now, let’s turn to some constraints on the process that inhibit a frank discussion in a conference environment.

We shall see that many parts of the process are beyond our control. First, there are regulatory issues handed down by the SEC. Not a lot to be changed here. Second, the sponsors offer a major constraint on the process by setting operating protocols that are virtually inviolable. This is not necessarily bad; someone has to set the rules. The problem starts when these protocols are not uniform between sponsoring firms. Furthermore, the sponsors are usually reluctant to openly discuss what they consider to be their internal business issues in front of

their competition. Third and finally, the sometimes overweighted participation of technology vendors in the various sessions further frustrates objective dialogue.

However, the fallacy that we are discussing here is the idea that a conference necessarily provides serious, public dialogue about process efficiency in the middle and back office. Since we have virtually no practical control over the regulatory constraints, let’s examine the sponsor and vendor constraints on meaningful dialogue. First, let’s consider the sponsors. Also, let’s remember that in the wirehouse version of a sponsoring platform, the sponsor is also the broker and the custodian. Although this fact may still dumbfound the institutional side of an asset management company, in the wrap world, the wirehouse sponsors are the clients – not the vendors. We would speculate that there are some very smart people at various investment organizations, who are still trying to assimilate this simple fact. *When their traders call the institutional desk, they*

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are a client; but when possibly the very same traders call the wrap desk, they are a vendor. Regardless of how difficult this conundrum may be to assimilate, let us simply pose the question: "What are the percentages in arguing with your client?" A public discussion about the part of the sponsor's role in the process is probably a non-starter.

We are left with only one constraint on the process that might be open for dialogue and that would concern the current workflow created by the vendors who support the middle and back office. We will discuss workflow in more detail later. For the time being, let's define it as the "operational tasks required to support the process." However, one of the larger problems in the industry is that workflow is constrained by the products and services currently available. Call it the tail wagging the dog or whatever, but if you doubt this fact, consider the technological evolution of the wrap process. Neither the sponsor nor the asset manager platforms were built from the ground up with process efficiency in mind. The business was started on the back of some fairly rudimentary technology that was sufficient to get things started. This was not a trivial exercise; the engineering of this product was no small feat. But in the early days, few envisioned the industry growing to its current levels, and even fewer envisioned the technological issues raised by today's current volume. Over time, the technological infrastructure advanced in a very ad hoc fashion by assimilating whatever isolated tool showed the promise of efficiency. Consequently, a meaningful discussion of workflow is really a discussion about the constraints provided by the current suite of technology solutions that have been connected with varying degrees of success and considerable functional overlap. With the vendors who provide these products and services often organizing the discussions, it is clearly difficult to have an open and critical dialogue. If next Tuesday, you are planning on petitioning the vendor for a discount, today is not a good time to publicly criticize some workflow failure that results from their product. Once again, this is not to say that there is no value in conferences, but it is to say that public, constructive dialogue about problems

concerning the process is a worthy conference goal but rather, a very problematic one.

The "Let's Think Outside-the-Box" Fallacy

This is less a fallacy and more of a common nostrum, but the concept, while laudable, is often misused. One of the more memorable instances of thinking outside-the-box is Einstein's Theory of Relativity. Attempting to emulate Einstein surely can't be viewed as a bad thing. However, thinking outside the constraints of your current business model is usually the province of the CEO, not the COO. COOs are expected to execute within the conditions presented to them. However, for the

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sake of example, let's assume an enlightened CEO approaches a COO and asks her to "think outside-the-box." What would this exercise look like?

The Problem. The CEO of an asset management company confronts the COO with this dilemma. In the wrap component of their business, margins are being reduced because the fee allowed by the sponsor has been cut. The COO's mandate is to restore the firm's margins in the wrap business.

Obviously, profit margins are determined by two components: revenues and expenses. Regarding revenues, it doesn't seem on the surface that much can be done. One instance of thinking outside-the-box could be this. Take the same wrap business process to a different distribution channel that allows the market to set the price that the money manager can charge. Regardless of how practical this may or may not be, let's assume that finding another

channel is not an option right now. Consequently, there may be no opportunity to "think outside-the-box" on the revenue side.

Next, let's consider the expense side of the equation. Here, there may be an opportunity to find some relief. The operational costs for the wrap business are very high. Costs are high especially because of the head count required to run the firm's current technology. In theory, if we can simplify the technology, then we should be able to reduce head count, lower costs and thus increase margins. In this case, thinking outside-the-box requires either replacing or modifying your platform. However, if there is no alternative platform available, then your only other option is to build your own. This is clearly an instance of thinking outside-the-box, but it may not improve your margins.

The real issue is related to the constraints on the process discussed in the "meeting" fallacy. There are really few aspects of the process that can be realistically changed. To consider those parts that can be affected will require some focus and fortitude. To use the language drawn from the history of scientific theory, it often takes a theoretical paradigm shift – the Theory of Relativity being one of the most famous – before persons can readily "think outside-the-box". Here is an easy example of what we mean. There was a time, possibly still is, when a major activity to the wrap part of the process was managing telecommunications costs. There were meetings about T-1 lines, what they are, how to get them, who was going to pay for them, etc. However, how necessary is this conversation if the web comes to replace the need for T-1 lines? This is an example of a minor, but real, paradigm shift. This is an instance of thinking outside the box.

The "Workflow" Fallacy

Surely this must rank close to the "outside-the-box" fallacy in misuse. Workflow is great. Who could be against it? Unfortunately, like many terms in our industry such as "growth," "value" and "risk," it is not highly meaningful unless accompanied by a specific definition. It is unlikely that someone would apply the term "workflow" to describe a rock, but they might



conceivably use it to describe a space ship. So what does the term mean? We were heartened to hear a panelist at a recent conference admit that the term “workflow means different things to different people.” This public admittance represented a significant step forward and frankly, was worth the price of attendance to hear it.

After some analysis, it seems that the term “workflow,” as it is currently used, refers to specific software applications that monitor the status of documents required by the process. This is not a bad thing, and no doubt adds value over the status quo. However, it would seem that the focus should be elsewhere. Specifically, as opposed to monitoring the process, why not focus on making the controllable parts of the process more efficient and thereby less in need of monitoring? If there is a mantra out there, it seems that it should be something like process efficiency, not “work flow.” But before we become guilty of entering another vague term into the dialogue, let’s define what we mean. At a high level, the quest for process efficiency should be preceded by monitoring, benchmarking and simplifying the steps (workflow, if you will) necessary to complete a process. This should be self-evident. And who could oppose this? This approach is one of the essential theses of Edward Deming’s work. At this level, process efficiency is a form of operations research – or maybe workflow analysis. Let’s assume for the sake of our discussion that someone can be found to empirically and accurately perform this analysis on the entire process. However, it is still the next step that is currently missing in the discussions about workflow. And, it is this: the step that uses comprehensive operations research to develop the simplification and automation of operational tasks to increase processing speed and lower cost. This is what we mean by process efficiency.

If nothing else, here is a rough and ready empirical test of process efficiency. If a proposed change to the process reduces steps while maintaining functionality, it’s likely to be process efficient; if it is additive, it’s probably not. For example, although current workflow

monitoring solutions may inform us about document status, may warehouse the documents and may even modify the process to some degree, these technologies are additive and, most importantly, do not attack the essential problem – the need for process efficiency.

The “Tax-Lot Engine” Fallacy

Like the “connectivity” fallacy to be discussed below, the “tax-lot engine” fallacy is usually a strong indication of someone’s orientation to the process. For example, decision makers with an accounting background see accounting as all-important. Similarly, decision makers with a telecommunications background

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favor connectivity. However, for some in the industry, there is a continuing belief that a middle and back office processing platform is composed primarily of tax-lot accounting software and little else. Some will admit that there may be other functionality required – like trade and order management, performance measurement, automatic reconciliation, connectivity, etc., but these functions are trivial and can be easily assimilated into the platform once the “best of breed” (also more on this later) tax-lot accounting system has been installed. Let’s illustrate this fallacy with an example.

Think for a moment about how an internal combustion engine drives the wheel of a car. To accomplish this, you need a variety of things. In its simplest form, you need at least a combustion chamber, compressed gas, a piston and

a rod connecting the piston to a crankshaft. Also, you need a spark that will ignite a gas explosion in the combustion chamber. This will, in turn, drive the piston through the connecting rod toward the crankshaft, thus forcing the crankshaft to turn. The crankshaft turns the drive shaft that drives the wheels, etc. Now, it is fair to ask this question: If your goal is to make the wheels turn, which of the above components is more important than the other? In this process, is the spark more important than the crankshaft? Is the compressed gas more important than the piston rod? In logic, each of these items would be considered necessary but not sufficient conditions of the desired result.

Consequently, when we hear the tax-lot engine fallacy enter into the dialogue, we freely admit that it is a necessary condition of middle and back office processing, but we are very reluctant to agree that it is the most important component, nor is it functionally or logically sufficient to create process efficiency.

The “Connectivity” Fallacy

Like workflow and the accounting engine, connectivity is another topic that holds out false hope for the solution of problems in the middle and back office. Obviously, connectivity cannot be ignored. However, the fallacy is in the belief that connectivity will solve all problems in the middle and back office. Connectivity

is but one of the components required to form an integrated platform to service the middle and back office. Improved connectivity may solve some, but not all, problems in the industry. For example, connectivity does not provide accounting for asset-backed securities. Connectivity does not provide performance attribution at the security level. Connectivity will neither scale your architecture nor block your trades. Like the tax-lot accounting fallacy, connectivity is a necessary but not a sufficient condition for the execution of an efficient platform.

The “Best of Breed” Fallacy

This fallacy could also be termed “when a committee tries to build a horse.” Best of breed

is another concept like workflow and connectivity that should be hard to oppose. Certainly, it would be absurd to seek the “worst of breed.” But this should be a warning sign. When you cannot logically put a minus sign in front of a statement, the statement probably doesn’t carry much meaning. Let’s assume that a COO has been given the mandate to assemble a “best of breed” solution. At a very high level, here are some questions that might be helpful to ask before you proceed.

1. Who will be delegated to list the different technologies needed?
2. Who will be responsible for identifying the best technologies in the class?
3. Assuming two technologies serving two different departments represent an either/or situation, who can be relied upon to fairly decide between them?
4. Even if we can legitimately discover the best technologies, how can we determine the compatibility of one system with the other?
5. What are the qualifications of the persons to whom these tasks are delegated?
6. Once integrated, what will be the process required to operate the “best of bread” solution? Will it eliminate processes (see process efficiency above), duplicate them or will it add more steps?
7. Finally, assuming that questions 1-6 above have been answered, who is going to assemble all these components into one integrated platform and at what additional cost?

The notion of assembling “best of breed” technologies is not necessarily a complete fiction, but in reality, it is at best an ideal. Given that the best component systems may not necessarily be easily integrated with the other best components, then part of the organization may have to sacrifice desired functionality to another. Who on your staff is going to have sufficient business, and operational and systems experience to adjudicate fairly these issues for the best functional solution for the organization? This is especially true when the focus is on finding solutions that were built with the sole purpose of addressing one isolated component of the process. Focusing on the

functionality of one component of the platform to the exclusion of others may not make the entire platform any more efficient, and it may add a lot of cost.

Here is another example. It might be conceivable to take one connecting rod designed for a Mack truck engine and install it in a Honda engine. No one would doubt that this connecting rod is more durable than the Honda version. After a remarkable amount of modification, one could have the benefit of an industrial strength connecting rod to help propel your Honda to the grocery, but the car is no faster than before, not necessarily more reliable, and is most definitely now a lot more expensive. Possibly worse, your mechanic may never look at you the same way again.

Conclusion

In Part II of our series, we identified some high level components that were necessary for a platform that creates process efficiency in the middle and back office. Some examples of these components are tax-lot accounting, trade and order management, operations and connectivity. Moreover, the platform must be constructed on scalable hardware that supports an open relational database. This, in turn, will allow easy modification and, most importantly, easy integration of the various components. Lastly, the platform cannot be simply a monument to technical virtuosity, but it must also solve the problems created by the need to handle complexity, customization and scale in the middle and back office. In short, it must deliver process efficiency across all businesses simultaneously – private wealth and wrap. The fallacies discussed above enumerate some of the rhetorical and logical blind alleys that confuse the dialogue about the essential issue – defining process efficiency and describing how it can be delivered to the separate account industry. ■

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