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NEWS RELEASE

SMA OUTSOURCERS LOOK FOR END TO DRY SPELL

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New deals to outsource separately managed account operations for money managers have slowed to a trickle, with 2008 bringing only a handful of announcements. But several outsourcers in the SMA operations niche say they are quietly shaping a wave of new contracts.

While the slowdown has prompted speculation that SMA industry trends are harming prospects for the outsourcing business, the providers contend that market fundamentals remain strong. SEI[1], Citi Global Transaction Services[2], JPMorganChase[3], and Market Street Advisors[4] in particular all promise that new announcements with money managers are just around the corner. Prospects for three other firms that have plied the sector – Bank of New York Mellon[5], State Street[6], and PFPC[7]– are unclear.

The spotty results of the past year don't suggest the outsourcing market is failing, says Alois Pirker, senior analyst at Aite Group[8], a Boston-based research firm.

"There is definitely capacity for the outsourcers to recruit [new] business, but there might not be room for growth for all of the current players," he adds. "There probably should be consolidation, and we could see a shakeout."

Despite the dearth of publicly announced outsourcing deals, there are efforts in the background that will bear fruit by year's end, says Scot Knight, v.p. and product manager for JPMorgan's Managed Account Solutions Group. "I'm seeing more interest in outsourcing in the SMA space than I've ever seen," he adds. "There are more RFIs and we're being requested to make more demonstrations than ever. I'm very bullish and very busy right now."

SEI and Market Street appear to be the most active so far in 2008, though Citi and JPMorgan both say they have active pipelines. [See bottom of article for a roundup of recent deals.]

The business has its roots in deals from about a decade ago that tried to address the operations snafu of the SMA, which entails each investor holding the individual securities within a manager's strategy. Each manager needs a framework to handle many administrative and investment transactions and then spread those across large rosters of clients – tasks that some managers gladly hand off to outsourcers, typically under five-year contracts.

The outsourcers take on a variety of middle- and back-office functions, such as trade routing and execution; account set-ups and maintenance; reconciliation; performance and compliance reporting; modeling; or tax management. In most cases, the outsourcers automate the functions, typically charging on a per-account basis, though some larger managers pay a percentage-of-assets fee instead.

The sector especially ramped up in 2005, when more than a dozen deals were announced, but the pace flattened out in 2006 and 2007. Since November 2007, the leading firms have made only two deal announcements. The drop-off has been unexpected, says **Dan Seivert**, CEO and managing partner of Echelon Partners9, a strategic consultant in Manhattan Beach, Calif.

"They thought it was really going to take off, but in the last year in particular it's been flat to down," he adds.
Most observers say the market is down, but there is little agreement over whether the cause is a normal business cycle, the flagging economy, or deeper issues affecting the outsourcing business. Those factors include the rise of model portfolios, which shift many SMA functions from money managers to sponsor firms; the introduction of new account transaction standards that aim to streamline SMA operations; the fast rise of other fee-based platforms, particularly mutual fund wrap programs; and even the overall profitability of the SMA outsourcing model.

Model portfolios may be the "the question in the room" right now for managers, says Aite's Pirker. It is unclear whether sponsor firms are going to eventually shift most business from the traditional SMA world, where managers handle account administrative functions, to a full model portfolio format where sponsors take over those transactions – leaving managers to simply hand over trading instructions for their strategies. The sponsors could also keep both systems up and running, or adopt a hybrid system in which managers keep some duties but hand over others.

"It's putting a pause on things," Pirker adds.

Seivert says the shift in attention to model portfolios is clear, and that managers need to assess the trend. "The managers have to decide how they need to play in those products, and whether there is enough scale there to justify [using an outsourcer]," he says.

But others say it's unlikely that traditional SMA management will fade away.

"There is no proof that the whole industry will switch to a model-based approach," says **Bevin Crodian**, CEO of Market Street. "Just because [model portfolios are] new doesn't mean the traditional form of business is going away. It's easy to have huge growth rates when it's new, but the industry won't be transformed overnight. It doesn't work that way."

Very few money managers are focused only on models business today, says JPMorgan's Knight. "Most asset managers have a mix of models and traditional SMA business," he says. "There's a spectrum there, and we're seeing asset managers are utilizing all aspects. It's not black and white."

Even in a full model portfolio world, there are reasons for managers to use an outsourcer, Pirker says. Some managers like to have a "shadow accounting" function on transactions handled by the sponsor so they can track their own performance. Others might need it for reconciliation or other specific tasks the sponsor might not monitor for them.

The profitability of the SMA outsourcing model presents a deeper question. Crodian says that most of the large companies in the space don't view SMA outsourcing as a core business but rather are using it as a wedge to win institutional outsourcing or custody assignments. "These [SMA outsourcing] units are lower-margin businesses if not loss leaders, and these firms maintain them just to have that box checked on the RFIs. It's a place mark, an arrow in the quiver, an accoutrement to the custody business."

Still, Seivert says most of the companies "can weather just about anything" financially within the outsourcing sector.

Pirker says it may end up that a few players withdraw from the market if they fail to land deals this year. "I suspect that a few of them are not profitable," he adds. "The question is that if you don't get the critical mass on your system, how long can you stay?"

Recent deals in the sector include:

• **SEI**– The Oaks, Pa., company had four clients sign on this year, a spokesman says, but it only officially announced adding Turner Investment Partners10 of Berwyn, Pa., in January. It also signed on Riverfront Investment Group11 of Richmond, Va., for an SMA deal, according to executives of the new firm, which several former Wachovia Securities12 executives formed last month. SEI now has 13 SMA money manager clients with $21 billion in assets and 80,000 accounts.

• **Market Street**– The firm in Edison, N.J., announced one deal this year, but has had 11 others over the past year, Crodian says. It only entered the space – which is part of a fuller menu of outsourcing services it offers – last year. Market Street announced signing on Munder Capital Management13 earlier this month.

• Citi - The securities and fund services unit at New York-based Citi had five SMA outsourcing mandates last year and has "a strong pipeline ahead," says a spokeswoman. Its last announced deal was with Harding, Loevner Management14 last October.

• **JPMorgan**– The New York-based company's last announced deal was landing Boston-based John Hancock Private Client Group15 last October, giving it eight clients overall. Knight says his unit expects to announce several new deals soon.

• **PFPC**– A spokesman says the Wilmington, Del., company's tally consists of six SMA outsourcing clients with 50,000 accounts containing $17.5 billion in assets. Its last announced deal was in January 2007 with SeaCap Investment Advisors16 of Seattle.

• **Bank of New York Mellon**– The company did not provide updated information. Its last announced mandate was signing on O'Shaughnessy Asset Management17 of Stamford, Conn., last October to outsource both its institutional and SMA businesses.

• **State Street**– The company did not provide updated information. It does not appear to have announced any SMA outsourcing deals since 2005.

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ECHELON Partners (ECHELON) was formed in 2001 to offer investment banking and consulting to a subset of the financial services industry known as "investment product developers and distributors" (IPDADs). Since that time, ECHELON's professionals have helped hundreds of senior executives envision, initiate, and execute a multitude of complex business strategies and transactions. ECHELON's business is making companies more valuable through delivering advice and orchestrating transactions. Accordingly, ECHELON measures its success in the enterprise value it creates for its clients. Companies that strive to outperform their peers choose to work with ECHELON because we are as passionate about their results as they are.

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