May 2013

STRATEGIC CAPITAL MANAGEMENT

INVESTMENT INFRASTRUCTURE

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Background

Adam Smith famously wrote in his 1776 book *An Inquiry into the Nature and Causes of the Wealth of Nations* about the division of labour. Smith uses the example of pin manufacturing to highlight the productivity increases that result from specialisation.

”One man draws out the wire, another straights it, a third cuts it, a fourth points it, a fifth grinds it at the top for receiving the head: to make the head requires two or three distinct operations: to put it on is a particular business, to whiten the pins is another ... and the important business of making a pin is, in this manner, divided into about eighteen distinct operations, which in some manufactories are all performed by distinct hands, though in others the same man will sometime perform two or three of them.”

For a long time these tasks were performed by a single worker who would perform the tasks in a linear manner. Smith highlighted that if the work was divided into a set of simple tasks performed by specialized workers, there would be a productivity increase by 240 times, i.e. that the same number of workers made 240 times as many pins as they had been producing before the introduction of labor division.

These observations have been applied across the industrial world for over 200 years and now specialisation is one of the strengths of a modern business. By focussing upon the skills and experience that provide a point of difference allows for greater productivity and a better end result for clients.

For a small wealth business or family office our advances in technology and the democratisation of investment information present them with a conundrum. Where do they specialise?

Where should they focus their attention for managing their clients’ wealth when the spectrum of services required is quite large? Should they look to focus upon the investments only? And if so which asset type? Or should they look to provide back office services such as consolidation and reporting? Or can these be provided by better and cheaper by scaled service providers?

This paper seeks to outline the various parts of the investing value chain, or what we call the Investment Infrastructure, and then present a case for keeping this skill in house and a case for outsourcing these services. This paper does not intend to say which is the better option, rather to provide family offices and wealth businesses with a framework with which to calculate the value that their firm brings to their clients and then use that to make informed decisions around which services to keep in house and which to outsource.

Investment Infrastructure

There are eight key categories across the Investment Infrastructure (which we will subsequently group into three supersets), that can be used to describe the end to end chain of investments and their management. Obviously this categorisation is subjective but we feel these categories describe the process well and provide logical breaks in the decision making process for in-house or outsourced service provision.

Client engagement – this is core to any business and remains crucial, independent of whether services are provided in house or out sourced.

Transitions – while this is a one-off service, it is vital for ensuring that the correct information is recorded initially which has flow on effects both from a reporting and a regulatory perspective.

Transactions – with a diversity of investments (and bearing in mind the size and scale of some investments) a combination of on market and off market investments may need to be made. Some consolidation and creation of investment vehicles may be required.

Transaction reporting – Crucially most transactions need to be monitored and actions taken when required. These may be corporate actions from listed equities, redemptions from funds or contributions to private equity. Many clients may also have real estate assets with rental income needing to be monitored and accounted for.

Performance reporting – Consolidation of assets from multiple sources and comparison reporting is a key concern for many family offices and wealth managers. Performance reporting needs to be able to show returns, risks, diversification and then align with the clients' objectives and investment mandate.

Investment Advice – there are lots of advisors lining up to provide advice around investments with multiple differing opinions as to how to create value for clients. These need to be married against the clients return expectations, their risk appetite and their personal areas of expertise.

Investment Management - We tend to look at this as a passive vs. active investments, are clients looking to set and forget their investments and use a longer term asset allocation methodology to build their wealth or to try to create outperformance through active management.

Regulatory and Compliance administration – with an ever-changing regulatory environment it is crucial that wealth advisory firms (and family offices) are across these changes to ensure their clients remain compliant

Back Office

The first of the three supersets is the back office; this covers the administration and daily management of the investments and covers any regulatory and compliance requirements.

There are equally valid cases for providing the back office in house vs. outsourcing this service. The main driver of benefits for providing back office services internally are shaped around the control of the administration, and the assurance that regulatory and compliance issues are dealt with in accordance with the family or firms internal controls. By maintaining control of the information, the ability to consolidate the information from multiple investment sources and to verify this information on a regular basis can provide the family or firm with greater surety around investment management. This is complemented with the knowledge that all filings and regulatory reporting are completed and that the scope for mismanagement resulting in fines may be reduced.

This positivity for establishing a back office to control the administration and management of either the family's investment or the firm's clients' investments needs to compared with the amount of work required to establish this service and the ongoing management and oversight needed to ensure the service remains up to date with changes in regulations and collation of investment information from multiple sources. The need for systems to process the information and to consolidate and report across multiple asset types and potentially currencies, plus the ongoing management of these systems must be costed and included in any adjudication.

These negatives for in-sourcing coincide with the positives for outsourcing the service to an external provider. Specialist outsourcing firms have resources and systems that are trained and built to focus specifically upon consolidated administration and regulatory tasks. They are up to date with the latest changes and can bring specialist knowledge to deal with unusual or challenging situations. Benefits can be realised by knowledge gained for one client being used for multiple clients.

Negatives around outsourcing can include response times to your requests, flexibility in reporting and operational outputs and reliance on key relationships within the outsourcing service. The key to overcoming these negativities is to undertake good due diligence on the service provider and to ensure a liaison is appointed from within the family or firm and from the service provider.

When the two options (internal vs. external) are placed side by side, the arguments for each can be compared along three main criteria; Cost, Control and Value

For the cost criteria, the main driver is scale, while this might seem obvious - the larger the investment the lower the cost per unit, or the larger the number of clients the lower the cost per client – where careful analysis is needed is around the tipping point between using simplified systems such as excel and single resources for compliance and the need for larger more complex systems and compliance resources with greater skill sets. There are points where it is not economical to service the families' or clients needs with the tools in place either because too much manual intervention is required or because the tools and resources are too expensive for the volume required.

Control over the administration is a subjective decision required by the family or the firm, in which the level of control (and by association the trust placed in service providers) can be graded from full control where all administration is conducted by the family or firm, through to a review of the quarterly and end of year reports. Where a family views itself on this spectrum will be an indicator as to the level of outsourcing they are comfortable with. Strong auditing and a good relationship with the service provider can often provide a level of comfort for those families or firms looking to outsource.

The value of a service is crucial across all supersets and should really drive any analysis as to where efforts should be expended in managing either family or clients' investments. When we refer to value it refers to the unique value added to the investment infrastructure by an internal or external service provider. We will go into further detail of value analysis in the calculating value section; however there are specifics for back office that should be analysed. Key questions for a family or firms to ask are;

- Are my (or my clients) investment needs unique,
- Do we have complex structures or arrangements that would be hard to explain or manage,
- Are we good at or enjoy the administration aspect of investments,
- Am I prepared to take on the regulatory risk for my family or clients?

Middle Office

The second superset in the process is the middle office; this includes transaction and execution plus any performance reporting. We will compare the pros and cons of in-sourcing and outsourcing across the middle office using a similar format as we did in the back office. That is to outline the positives and negatives for hosting and for outsourcing and then defining three criteria on which to evaluate the services.

The rationale for managing the middle office internally is getting stronger as technology liberates these services from traditional broker houses. Until recently there has been a need to engage with a broker for all equity and fixed income transactions. However advances with self direction on equity platforms, (plus the recent bond market openings) have created an opportunity to make transactions independent of the broker relationship. The advantage self direction creates, is around cost management (not paying brokerage) and transparency.

These advantages need to be tempered with the time and resource requirements around active trading and management, plus the price spread difference that can be catch the infrequent trader unawares. These disadvantages can easily wipe away any cost advantage that occurs with self direction.

The positives of outsourcing this service is based upon the skills and experience (plus transparency) of the service provider. If the provider is able to successfully develop and implement an equity acquisition and disposal strategy that maximises the returns to the firm or family then the expense in paying for this service is negated. This is especially prevalent where large single stock positions are held by a family; institutional placement specialists are required for these transactions and may be used on a one off basis.

The disadvantages of outsourcing is allocated around the need to adjust internal processes and reporting to adapt towards the existing processes to the outsource provider. The provider will often have multiple clients with similar needs and to enable cost reductions will need to ensure a level of similarity across the client offering.

The criteria for evaluating the middle office has a slight variation to the criteria for the back office, here the key areas are; Service Provider Skill, Transparency and Value.

As briefly touch upon in the positives of outsourcing, the skill and experience of the middle office service provider is instrumental in whether the service becomes an advantage to the family office or wealth firm or a drain on the investment income. If the provider is actively providing advice to the family or firm on when or how (e.g. purchasing options can provide alternatives to purchasing equity outright) to purchase equity or bonds and that advice is valued then the case for outsourcing becomes stronger. If however the provider is charging excessively for a vanilla transaction, question marks need to be raised as to the necessity of the service.

Transparency is a criteria in two parts, firstly the transparency of trades and the knowledge that your family's or clients best prices are being achieved and secondly the transparency around the charges for services. The first part essentially asks you to evaluate the difference between your family or firms' ability to receive the best prices in the market and a provider's ability to generate a better price. This may well be a 'horses for courses' approach whereby for some asset types and sizes intermediaries are used to facilitate the trade and for others the family or firm takes control of it.

The second area is around the transparency of charges and a service provider's reluctance or enthusiasm in providing you with a breakdown of how charges are defined and where they can show they are adding value to the transaction. The market for transactional services is very competitive and your family or firm should use that competitiveness to your advantage to generate extra investment value.

As discussed in the back office section, when we refer to value it refers to the unique value added to the investment infrastructure by an internal or external service provider. We will go into further detail of value analysis in the calculating value section; however there are specifics for the middle office that should be analysed. Key questions for a family or firms to ask are;

- Can I execute my transactions for a reasonable price,
- Is my service provider assisting with implementation and management advice,
- How bespoke does my performance reporting need to be,
- What are the risks in managing the transactions internally?

Front Office

The final stage is the front office; this covers the client engagement, investments monitoring and investment advice.

While it might appear at first glance counter intuitive to outsource the client engagement for either a family office or a wealth firm, there are aspects of the client engagement service that may benefit from the utilisation of an external service provider. These areas would be different for a family office as compared to a wealth management firm.

Within the family office context it might be advantageous to use an external party to provide the independent voice and knowledge when dealing with family members as clients, thereby facilitating the removal of family tensions from the discussions. Additionally the skills and experience that a third party can bring in areas such as family governance, goal setting and opportunity evaluation should not be underestimated.

For a wealth firm, the advantages of outsourcing the client engagement again are focussed around specific services not the whole client relationship, these areas would include client documentation (such as Statement of Advice), needs analysis and wealth planning. The ability to leverage off a larger service provider to provide either compulsory (regulatory) documentation or one off client services is advantageous.

These benefits around client engagement need to be tempered with where your firm or family feels the client engagement process begins and where you value additional help. For a wealth firm it is very important to convey to your clients that your firm is leading the engagement in which case it is vital to select a provider who is happy to white label their services, allowing your firm to brand the client facing documents.

For investment advice (including ongoing monitoring), the advantages of performing this service in house either by the family office or by the wealth management firm are centred around skills and knowledge. The family may have built up wealth and experience in a particular type of asset class (e.g. retail, property or mining) and it is imperative that the family utilises that knowledge within their investments without building up too much concentration risk. For a wealth firm the advantage comes from their investing genesis, if they have a strong team with robust processes for investing in particular asset types then they should lead their clients through that type.

The negatives of in house investment advice can come from a bias for a particular asset type with blindness to either the concentration risk within the investments or from an inability to spot alternate opportunities. These disadvantages often go together with investments decisions that are not process driven and instead are reliant upon a single adviser's belief (intuitive) or alternatively are diluted across multiple managed funds to the extent of a neutral asset allocation with significant fees.

Outsourcing the investment advice has its own disadvantages; these are primarily around the alignment of an external advisory firm's goals with the family or firms goals. Too often investment advice centres upon ensuring the advisor makes a fee for the transaction rather than whether the transaction is beneficial for the clients. Obviously some due diligence is required, on both investment advisors as well as the investments themselves; however a rule of thumb can be applied, the greater the transparency the greater alignment of interests.

The advantages of outsourcing investment advice are around leveraging the knowledge and skill of a specialist firm to meet the families or firms client's needs. The ability to translate client's investment expectations (in terms of returns and more importantly risk) into financial instruments and manage that across economic cycles is a skill that should provide the family or firm with the surety that their investments are aligned. Our belief is the greatest advantages come from robust process and intellectual rigour being applied to investments, and that a service provider who can supply that to you in a transparent fashion is advantageous.

The criteria for evaluating the front office include; Scope of expertise, Investment Process and Value.

When evaluating whether to in-source or outsource the front office (and in particular the investment advice) it pays to be very honest around the skills and scope of expertise of the in-house team and the external service providers. For this evaluation it would be beneficial to separate the investment universe (i.e. scope of asset types) into active and passive investments – active investments are where your skill and knowledge will create the most value, passive investments where your feel another party would provide the better outcome- and then assess where the gaps in the in-house team are, before beginning to look for a suitable service provider to plug those gaps.

As mentioned above a robust process for analysis and recommendation is paramount in investments. If you have decided that certain asset types require external service provision, then it is a matter of evaluating the providers on their investment philosophy and process. Areas to be aware of are single advisor relationships, (where too often hunches or feelings are used in investment recommendations), firms that are not independent and have large holdings of their own products or funds within their investment recommendations and providers who don't make their fees and process available for scrutiny.

As discussed in the previous sections, when we refer to value it refers to the unique value added to the investment infrastructure by an internal or external service provider. We will go into further detail of value analysis in the calculating value section; however there are specifics for the front office that should be analysed. Key questions for a family or firms to ask are;

- Do I have the skills and knowledge to assess multiple asset classes,
- Does my service provider have a robust and transparent investment process,
- Am I comfortable in the independence of the investment advice I receive,
- Can I evaluate all the risks in my investment portfolio objectively?

Calculating Value

Calculating the value of a service (either in-house or outsourced) can be a fairly subjective affair, but it is important to develop a process for evaluation, that way internal service provision can be compared with outsourcing the service (and for that matter comparison of various service providers).

The first stage in the process is to define the criteria upon which the evaluation will be performed. As discussed in the sections above there are some examples of criteria for evaluation. It is important to also define for your business or family office key criteria. Some examples of the criteria are cost, strategic alignment, risk (delivery and ongoing) and experience.

Next it is important to weight each of the criteria according to your family or firms preferences. By this we mean to apply a relative percentage to each criterion. This allows from a high level perspective to value what is important to the firm or family.

Subsequently define tasks or services are available for provision. For example within the compliance service from the back office superset, you could include monitoring applicable regulatory developments, maintaining the compliance manual and code of ethics, on-site client consulting engagements, ASIC compliance audits, policy and procedure reviews, internal control reviews, and compliance program design.

By giving each of these tasks a weighting within their specific criteria, it allows each task across the complete service provision to have a relative weight assigned to it.

Finally grade each individual task, with the internal team being actively compared to a service provider. You should be able to get a final score to objectively compare internal service provision with external, and establish where you feel value would be added.

As an aside, we have a spreadsheet to help with this evaluation, please send an email to info@scmlgroup.com for a copy.

Conclusion

At the start of the paper we set out to highlight the relevant categories that make up the investment infrastructure and then highlight the positives and negatives for both internal service provision and for external service provision. We then endeavoured to establish some criteria for evaluating each of the categories before finally producing a framework for undertaking the evaluation.

We hope that the reader feels those goals have been achieved and that they are able to utilise these insights when making decisions around their own firm or family office. We are happy to discuss any aspect of the investment infrastructure with those who wish to explore these themes in more depth.

To help with the decision making process we have produced a summary table that highlights some key themes discussed in the paper.

Category	Super Set	Internal		External		Key Criteria
		Positive	Negative	Positive	Negative	
Compliance Transitions Administration	Back Office	• Control • Regulatory compliance	• Administration Burden • System purchases	• Scale • Resource capability • Specialisation	• Response Times • Limited flexibility	• Cost • Control • Value
Transactions Transaction reporting Performance Reporting	Middle Office	• Cost Management • Transparency	• Price Spread • Resource requirements	• Placement Skills • Experience • Strategy development	• Adjustment of process	• Provider Skill • Transparency • Value
Client Engagement Investment Advice Investment Management	Front Office	• Client knowledge • Asset knowledge	• Concentration Risk • Instinctive Investing	• Process driven • Broad asset knowledge • Scale	• Goal alignment • Fee structure	• Expertise • Investment Process • Value

About SCM

Strategic Capital Management

Strategic Capital Management (SCM) was formed in 1999 to create an independent investment firm with a focus upon providing strategic investment advice. SCM specialises in providing tailored advice to a select group of clients which include corporate, investment management firms, superannuation funds, sovereign wealth funds, charities, high net worth individuals and family offices.

SCM has extensive experience across the development of specific investment mandates and vehicles, such as the Commonwealth Government Superannuation Funds and National Charities. These mandates are complemented with advisory transactions for global institutions.

The founders maintain management of SCM and are employing the rigour and process to investing that SCM has applied at a funds management and institutional level to retail clients and their advisers through SCM Advisory

At SCM Advisory (SCMA) we believe the best way to deliver sustainable wealth creation is through systematic investing in a risk budgeting framework. Taking quantitative and qualitative measures of the global investment universe and then managing the investments through direct model portfolios.

The cornerstone of wealth creation is capital preservation, by managing clients' portfolios from an absolute return perspective we are able better align risk tolerance to client expectations and focus on risk-adjusted returns.

We offer the full spectrum of investment infrastructure services to our clients and work with them to undertake an evaluation of their areas of skill and expertise. We then marry that skill with our in house team and external service providers to deliver an end to end solution for our clients.

This service is available for established firms or family offices that are looking to further develop their business or to fine tune and reduce costs, and for establishing businesses that are looking to provide services to their clients without having to develop their own investment infrastructure.

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