

InsideOps | Insights for Asset Management Operations Leaders

Exchange Traded Fund Operating Model: The Insource-Outsource Spectrum

A large blue chevron graphic pointing to the right, positioned behind the text "High performance. Delivered."

High performance. Delivered.

While mutual fund managers may choose either an insourced or outsourced model for their middle and back office operations, the choice is more difficult for Exchange Traded Fund (ETF) sponsors due to their inherently different operations. The processes across the ETF operating model are unique and more complex in comparison to mutual funds, which leads many new ETF sponsors to initially utilize an outsourced model for core investment operations. As the book of business expands and matures, the opportunities to leverage hybrid and insourced models increase. The rapid proliferation of ETF products and styles presents an opportunity for sponsors to insource key processes in order to differentiate their products and enable smooth trading and operations. This makes it an interesting time to look across the ETF operating model spectrum and consider the timing and circumstances when insourcing, outsourcing or hybrid operating models are appropriate.

Core Components of Every ETF Operating Model

While operating models that asset managers have in place today to support their ETFs may vary from one another, there are four key components common to each:

Core Components of the ETF Operating Model



Source: Beacon Consulting Group

Basket Creation

Basket Creation is the daily generation of a basket of securities performed by portfolio managers on the day prior to Trade Date (T-1). This process may vary depending on the type of ETF, whether traditional index, "smart beta" (complex index), transparent active or nontransparent active. Basket construction for funds tracking a quantitative index aims to reduce any deviation between the fund and the index, while an active ETF's basket construction objective is to execute the portfolio manager's strategy to deliver alpha. The optimization of basket components includes index replication strategy, tax lot management, trade execution impact, and derivatives exposure.

Basket Processing

Basket Processing consists of all accounting adjustments made to the basket on T-1 in order to determine the cash component and prepare the basket to trade close to NAV on Trade Date (T). This includes the projection of corporate actions, income and expense accruals, and determination of the cash component of the basket for publishing to the NSCC. This portfolio and the cash files must be delivered to the NSCC by 8:00pm each day. The preparation of the iNAV basket (typically the full portfolio) also needs to be published to the exchange throughout the day.

Trading and Order Taking

Trading and Order Taking are the daily processes of accepting and approving orders throughout the trading day and pushing the orders through a transfer agent (TA) and back into accounting systems. It is essential that an online trading/order taking system is provided and complemented with a call center to ensure all orders from authorized participants (APs) are captured and processed through the TA. A compliance staff is also required to approve each order. After the trading day's close, the day's in-kind transactions must be transmitted back into the accounting system, more commonly referred to as the "bursting" of underlying in-kind securities. The trading support role is also needed to help APs and market makers execute trades in the primary and secondary capital markets.

Collateral Management and Settlement

The Collateral Management and Settlement component, at a basic level, is most similar to typical trade settlement and collateral functions which manage the settlement cycle and marking of collateral to market on a daily basis. Tracking all trades settling and following up on any failing deliveries of securities, including securities on loan that have been recalled, must be complemented by a tightly coordinated effort with the custody team to release ETF fund shares as securities are received and cleared. The manager will need to take collateral from APs and mark-to-market until settlement for all ETFs containing fixed income or non-U.S. securities that don't clear through the NSCC.

Each of the four pillars of any ETF operating model outlined above must be tightly coordinated in order to reduce risk and avoid costly operational errors.

Standard Practices for Supporting Each ETF Operational Component

The four key components to supporting ETFs must be tightly coordinated, but each of the functions can be either retained in-house or outsourced to a service provider. Historically, standard industry practice has dictated the following approach to insourcing versus outsourcing each function:

Basket Creation

Typically completed in-house by portfolio managers who want control over the flow of securities into the fund (create basket) and out of the fund (redeem basket). Smaller, start-up ETFs tend to have the service provider create the basket using predefined rules.

Basket Processing

Commonly outsourced due to the operational complexity of the required T-1 accounting projections and the processing required to estimate the cash amount.

Trading and Order Taking

Historically this function was outsourced, but that has been changing. Over time, more firms have been building out trading desk capabilities to support their ETFs, however many are still continuing to use a third party's order taking platform.

Collateral Management and Settlement

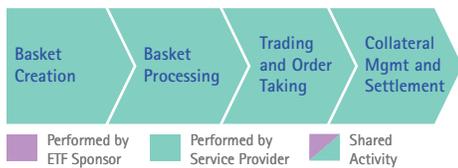
Most often outsourced to keep the process close to the custodian.

What had been standard industry practice once is quickly transforming due to multiple factors including the increased complexity of ETF product offerings, expansion in the number of funds, and entrance of new ETF sponsors. In this environment, ETF operating models have been taking shape over time and developing from a foundation that often leverages existing technology and service relationships.

What is the Right Model for You?

The most efficient service models are able to minimize handoffs, eliminate manual processing, and utilize a strong control environment while being supported by associates with expertise and experience in ETF operations. The shape and design of this optimal service model might need to evolve over time. The evolution of the operating model is predicated on a number of factors including domain expertise, technology capabilities, and business requirements. As an ETF business matures from its initial launch to one of increasing size and scale, the service model should also grow and evolve.

Model 1: Full Outsource Model



Source: Beacon Consulting Group

For start-up managers or sponsors that are new to the ETF space or those seeking a simplified model, a fully outsourced operating model provides a near turn-key platform. This model takes advantage of, and leans on, the service provider's expertise and industry proven solution. Under these circumstances, many managers find this level of support necessary to fill gaps in domain expertise and internal capabilities. Given the risk, time, and cost required to build out capabilities and develop the necessary expertise to support these functions, a strong business case can be made to initially outsource all main functions.

Model 2: Capital Markets Model



Source: Beacon Consulting Group

Variations to the full outsourcing model often include ETF sponsors taking responsibility for the trading of their products themselves. ETF sponsors tend to seek to deploy capital markets teams themselves to initially manage key relationships with market makers and APs. ETFs mature not only through increased sales and assets under management, but also by maintaining tight trading spreads and increasing liquidity. The institutional trading community must understand how the ETF will trade under different market conditions, and managing that task is now often considered core to the efficient functioning of an ETF.

Model 3: Product Ownership Model



Source: Beacon Consulting Group

Once an ETF business begins to reach scale, the opportunity to differentiate the product by internalizing certain operations begins to emerge. The business itself can support the development or the acquisition of the capabilities, expertise, technology and infrastructure necessary to complete key functions that are best controlled by the sponsor. Naturally this refers to basket creation, the function closest to the investment decision making process. This is particularly true for ETFs that pursue an active investment strategy. While sponsors can provide clear rules and guidelines to their service provider to "cut the basket" in line with the portfolio, the sponsor may want to take control of this front office function to reduce risk as they gain increased comfort, experience, and capabilities.

Model 4: Product and Trading Model



Source: Beacon Consulting Group

As the funds' assets grow and the complexity of the business increases, the operating model may need to support an order taking platform to capture systematically custom order requests from APs. Larger, more liquid ETFs will generate demand from more market makers who will also have specific requirements incorporated into their orders. A customized order taking platform that can support these requests becomes more of a requirement for larger sponsors with more funds. In most cases the approach is to develop an internal solution.

Model 5: Full Insource Model



Source: Beacon Consulting Group

Finally, experienced ETF sponsors with size, scale, and resources may look to insource all functions they can perform themselves. If a sponsor already performs its own fund accounting internally, it may decide to add a basket processing module to its accounting platform. Today, there are not yet any fund accounting platforms available that can offer an integrated ETF module, so a custom development effort would be required. Collateral management can also be insourced as the internal ETF operations team can manage collateral movement and notify the custodian as share or cash collateral is delivered or transferred. Under most scenarios, settlement should stay with the fund's custodian.

Conclusion

The appropriate operating model to support ETF products is dependent on a number of factors ranging from product complexity to domain expertise to resource availability. As a result, many combinations of outsourcing and insourcing exist to get the asset manager to the same result. Full outsourcing provides new market entrants with a launch platform and sponsors with a scalable, cost effective operating model. As complexity and the number of funds expands, the business case may support a hybrid model where certain key functions are insourced. The ETF sponsor's appetite to insource components will increase as experience, process, and technology provide differentiation and mitigate operational risk.

Contacts

Adam Lerner
Management Consulting Senior Manager
adam.lerner@accenture.com

Zach Pettengill
Management Consulting Manager
zachariah.pettengill@accenture.com

About Accenture

Accenture is a leading global professional services company, providing a broad range of services and solutions in strategy, consulting, digital, technology and operations. Combining unmatched experience and specialized skills across more than 40 industries and all business functions—underpinned by the world's largest delivery network—Accenture works at the intersection of business and technology to help clients improve their performance and create sustainable value for their stakeholders. With more than 375,000 people serving clients in more than 120 countries, Accenture drives innovation to improve the way the world works and lives. Visit us at www.accenture.com.

This content was previously published by Beacon Consulting Group. Beacon is now part of Accenture.

This document is produced by Accenture as general guidance. It is not intended to provide specific advice on your circumstances. If you require advice or further details on any matters referred to, please contact your Accenture representative.

Copyright © 2016 Accenture
All rights reserved.

Accenture, its logo, and
High Performance Delivered
are trademarks of Accenture.