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Legg Selects Citi to Run SMA Operations

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The multilayered relationship between [Citigroup](#)¹ and [Legg Mason](#)² in the separately managed account business got thicker this week. Baltimore-based Legg, one of the largest SMA managers, has hired the SMA operations outsourcing division of New York-based Citigroup.

The deal is hardly a straightforward example of SMA outsourcing, a specialty corner of the industry consisting of three dozen arrangements where managers hand off the complex operational tasks required to execute their investment strategies across hundreds or thousands of client accounts. In this particular case, Legg is hiring the outsourcer unit but is keeping its accounts on legacy systems built for it years ago that now reside elsewhere within Citigroup.

That deep entanglement exists because Legg added the bulk of its SMA business in a high-profile 2005 swap where it acquired [Citigroup Asset Management](#) in exchange for Legg's brokerage, which in turn became part of Citigroup's [Smith Barney](#)³ brokerage.

“This is a very complicated arrangement,” says [Joel Sauber](#), head of U.S. product at Legg Mason, who himself came over in the swap. “But we've had a long relationship with Citi, and much of our SMA business came from Citi, so we are familiar with many of the folks over there and many of the systems. This allows us to leverage that continuity.”

The deal is the SMA outsourcing market's first to be publicly announced since last fall. The outsourcing business had expanded rapidly from 2002 to 2005, but since then has flattened.

The market leaders are Citigroup's [Global Transaction Services](#)⁴ (GTS) unit, which now counts 13 clients, and [SEI Investments](#)⁵, which reports 16 clients, including four it signed on when [State Street](#)⁶ and its [Boston Financial Data Services](#)⁷ affiliate bowed out of SMA outsourcing last summer.

Sauber says the deal's timing is unrelated to market conditions, which have hit Legg hard. Its SMA assets fell from \$66.5 billion in the third quarter of 2007, the market's peak, to \$32.7 billion in the fourth quarter of 2008, according to [Money Management Institute](#)⁸ data. Legg only dropped from the top spot to second in that timeframe, trading places with [Nuveen Investments](#)⁹, which now is on top with \$33.9 billion.

Sauber says the decision also doesn't stem from Citigroup's pending plan to sell 51% of Smith Barney into a joint venture with [Morgan Stanley](#)¹⁰.

Instead, Legg's move results from longer-term strategic planning. “It was a decision we needed to make,” Sauber adds. “It was a logical time to do it.”

Nevertheless, SMA outsourcing providers are expecting the tough times to generate clients. Managers that have built back-office account management and trading functions face sizeable fixed costs to maintain those systems. And for a business where revenue comes as a percentage of the value of client assets, the near-halving of the SMA market in the past year is squeezing firms where revenues are down but fixed costs remain.

“We think that the case for outsourcing is more compelling now, especially for larger managers,” says [Andy Clipper](#), director in the Investment Administration Services

unit that directly runs Citigroup's outsourcing business within GTS. "We've seen a number of larger managers show more interest than a few years ago."

The down market has forced managers to reassess their options, says **John Alshofski**, head of business development for SEI's Investment Manager Services division. "The market has strengthened the rationale for outsourcing," he says.

And the difficulties show outsourcing not only makes operations costs scalable on a per-account basis as assets grow but also when they plummet, says **John Shields**, a principal in Portsmouth, N.H., for **MainStay Consulting Group**¹¹.

But even before the market crash last fall, SMA outsourcers were predicting an active 2008. Relatively few deals emerged.

Shields says he is surprised there have been few deals since the crash. "I would have thought a lot more of the major players would consider and implement outsourced solutions," he says. "I know that behind the scenes, there certainly have been a lot of discussions and meetings between asset managers and third party providers. This [Legg-Citigroup deal] could be that tipping point."

Still, the Legg arrangement will have few peers. When Legg acquired the SMA business that became its **ClearBridge Advisors**¹² affiliate, it took along some of the staff and systems that ran its SMA accounts, but left other parts in Citigroup's global wealth management business, which Smith Barney dominates. Legg maintained an operations relationship through service agreements with Citigroup.

For several years, Legg ran its SMA accounts from ClearBridge and its **Western Asset Management**¹³ fixed income shop through this arrangement, which essentially kept intact the operations framework originally built for Citigroup Asset Management. At the time, Legg was not using the GTS outsourcing group, which is in a Citigroup separate division.

But last year, the set-up got more complicated when Legg sold back to Citigroup a trading platform and overlay management team led by **Roger Paradiso**, whose group joined Smith Barney to run a new unified managed account program. That meant Legg's SMA business now ran back through Citigroup staff for certain other functions on the trading side, though Legg kept its own version of the trading platform.

Now, the Smith Barney sale would add yet another twist, because Paradiso's trading and overlay group is set to go into the joint venture. It's unclear whether other operations teams and systems are also going with the sale. A Citigroup spokesman declined comment on the details.

And because the new deal will have Citigroup GTS run Legg's operations but still use the old platforms for many accounts, the manager will essentially be working with staff or systems from three different divisions of Citigroup – GTS, the global wealth management arm, and the Smith Barney joint venture.

The upshot is that Legg has signed on with GTS as an outsourcer to help it manage tasks such as account servicing, reconciliation, and performance reporting. Both sides say the deal could pave the way for Legg to eventually bring some or all of its SMA operations over to the "OpenSMA" platform on which GTS serves its other clients.

"We obviously have a strong understanding of their business, and that's going to be an advantage," says **Jonathan Flitt**, a director who works alongside Citigroup's Clipper.

As for the rest of the industry, MainStay's Shields says SEI and Citigroup are well-positioned, but he adds that the next tier of players – **Market Street Advisors**¹⁴, **PNC Global Investment Servicing**¹⁵, **Bank of New York Mellon**¹⁶, and **J. P. Morgan**¹⁷ – might also grow. Market Street is the only firm to have announced new deals since last summer; it has disclosed two. "Each of these outsourcing firms has their own personality, and there is room for choice there," Shields says.

SEI confirms its roster grew last year with **J. & W. Seligman**¹⁸; Legg's **Brandywine Global Investment Management**¹⁹ affiliate; **State Street Global Advisors**²⁰; and **Advanced Investment Partners**²¹, a State Street affiliate. All four had been State Street outsourcing customers.

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