# The Evolution of Buy-Side Firms

## Internalizing Treasury Functions and Leveraging Securities Finance for Strategic Growth

**October 2024**

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J.P.Morgan

*Buy-side clients are increasingly building in-house central treasury functions, impacting the suite of securities services they require.*

# The buy-side extends its reach

*Historically, buy-side firms have focused on investment alpha. Pension and insurance funds, for example, have reinvested their premiums across assets, including equities, fixed income, private credit, and infrastructure, to match their liabilities. Optimizing collateral and maximizing revenue have remained priorities, albeit ones often dependent on external partners.*

*Recent events, including Uncleared Margin Rules (UMR) and 2022's UK Gilt crisis, in conjunction with increasing vendor dependence realized during the Covid-19 pandemic, have provoked buy-side firms to adopt approaches traditionally undertaken by banks and broker-dealers. Simply put, buy-side outsourcing of operations such as fund management and central treasury functions is out. Insourcing of those capabilities is in.*

*Yet even as buy-side firms grow in sophistication from within and continue to insource these particular functions, others are not as easily brought in-house on the quest for alpha. This paper investigates the growing trend of internalized functions at buy-side firms and why they are increasingly seeking external help to assess their collateral's value to maximize revenue in securities finance.*

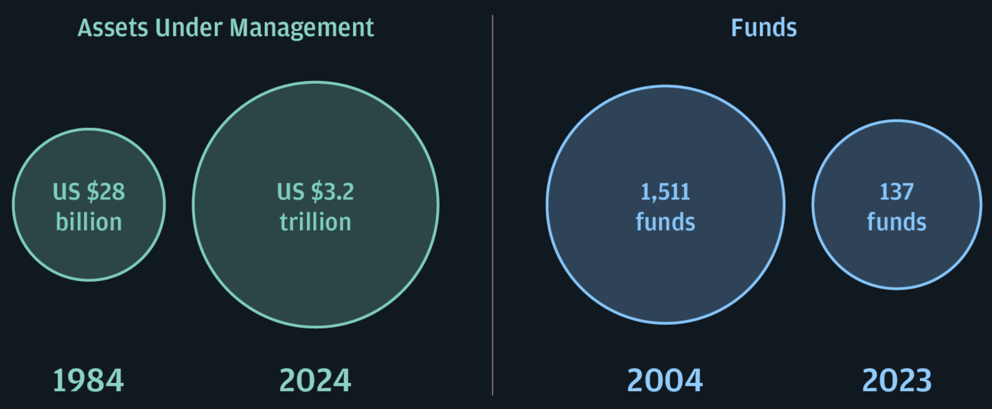
# What's up Down Under:
# Australia leads a global trend

The collapse of Archegos Capital Management and the UK Gilt crisis have highlighted the limitations of buy-side liquidity facilities, while Fed rate hikes have more widely emphasized the focus on internal treasury and active cash management at buy-side firms. But this all began in Australia, where superannuation funds have stood at the vanguard of the trend – one that is spreading the world over.

In the last 40 years, the Australian pension system has increased by more than 100x, from USD $28 billion[1] to USD $3.2 trillion.[2] The last two decades have witnessed a concurrent consolidation of superannuation funds, whose numbers dropped more than tenfold, from 1,511 in 2004[3] to just 137 at the end of Q1 2023, including five mergers finalized last year and another four pending.[4] The consolidation of these funds and simultaneous expansion of the pension system have pushed these buy-side institutions to grow in sophistication.

With that swelling capital distributed across far fewer asset owners and stricter pension fund performance regulations in Australia, the individual superannuation funds have been hesitant to outsource fund management. To avoid basis-points fees that are skyrocketing when applied to ballooning AUM, Australian superannuation funds have boosted their internal treasury units and portfolio management teams. To do so, they have hired sell-side investment professionals and brought them in-house to reduce their fee base, efficiently manage their balance sheets, and drive returns. Despite rising headcount costs, buy-side firms facing stricter regulations and performance pressures want to take a hands-on approach to deploying their deep asset pools, increasing control and agility to seek alpha.

## The Australian Pension System Over Time




*Sources:*

*Deloitte Actuaries & Consultants, March 2024*

*Australian Prudential Regulation Authority (APRA)*

*1 Australia's Privatized Retirement System: Lessons for the United States, The Heritage Foundation*
*2 Dynamics of the Australian Superannuation System: The next 20 years to 2043, Deloitte Actuaries & Consultants, March 2024*
*3 Superannuation in Australia: a timeline, Australian Prudential Regulation Authority (APRA)*
*4 The Future of Superannuation: Optimising Outcomes Through Global Investments and Unlisted Assets, J.P. Morgan, 2023*

**Maple Eight:**

**52%**

**of assets managed in-house**

**Global peers:**

**23%**

**of assets managed in-house**

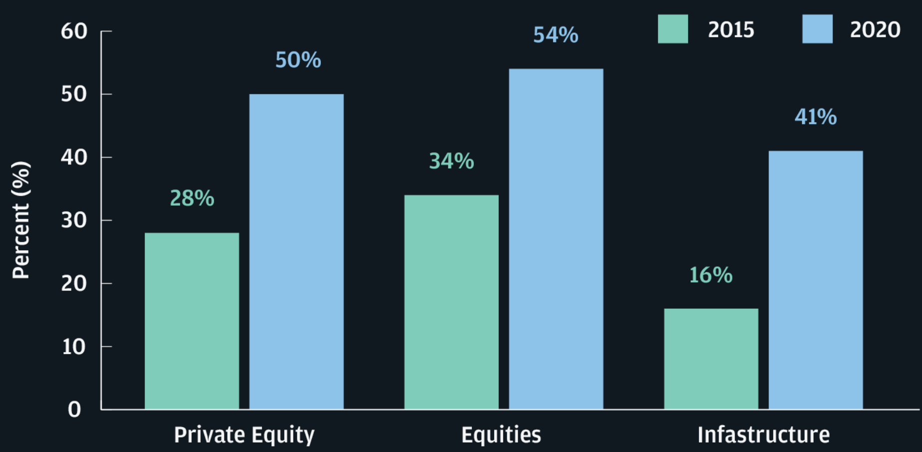
*Source: Journal of Portfolio Management*

The results are demonstrably positive: in a survey of public pension funds and sovereign wealth funds (SWFs) that examined the relationship between the percentage of asset owners whose portfolios were managed externally and those funds' financial performance, Global SWF found a -13% correlation in performance compared to asset owners who managed their funds in-house.[5]

Increasing sophistication among the buy-side, indeed, is not confined to Australia. SWFs globally, notably across the Middle East and Asia, saw an uptick in the proportion of particular asset classes managed internally from 2015 to 2020 – most dramatically from 28% to 50% for private equity, 34% to 54% for equities, and 16% to 41% for infrastructure.[6]

In addition, Canada's eight largest public pension funds, known as the Maple Eight, have increasingly welcomed internal fund management for their USD $2 trillion in AUM,[7] helping them to outmatch peer funds in investment performance and liability hedging between 2004 and 2018, per a McGill University study.[8] The Maple Eight manage more than half (52%) of their assets in-house compared to fewer than a quarter (23%) in the case of global peers, according to the McGill study, which analyzed performance, asset allocation, strategies, and cost structures of 250 public pension funds, endowments, and SWFs from 11 nations.[9] By managing such a high proportion of their assets internally, Canadian funds have slashed their costs by a third and boosted performance through re-deploying resources to special investment teams for each asset class.[10]

## Proportion of Asset Classes Managed Internally by Sovereign Wealth Funds




*Source: Invesco Global Sovereign Asset Management Study, 2020*

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5 *Global SWF, 2021*

6 *Invesco Global Sovereign Asset Management Study, 2020*

7 *Creating a Reliable Future for Canadian Retirees Through Maple 8 Pensions: Case Study, McKinsey & Company*

8 *The Canadian Pension Fund Model: A Quantitative Portrait, Journal of Portfolio Management, 2021*

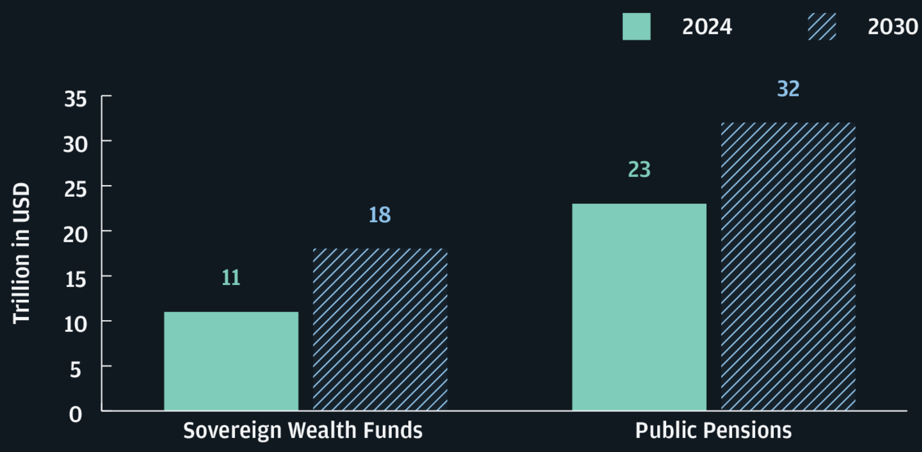
9 *Ibid*

10 *Ibid*

*continued from last page*

To boot, the more money managed, the more Canadian pension funds skew towards internal fund management: 80% of Canadian funds with more than USD $50 billion are managed internally compared to just 34% for non-Canadian funds above that threshold.[11] That trend tracks for SWFs globally that have increasingly taken the reins of internal fund management, especially as they have grown in size. In fact, for SWFs investing in private credit opportunities, 35% of funds managing north of US $100 billion solely use internal managers, compared to just 15% of funds with less than US $100 billion in AUM.[12]

## Projected AUM Growth




*Source: Global SWF Annual Report (2024)*

The buy-side propensity to internalize treasury functions and fund management amid AUM growth – to save on external management fees and boost performance – will be all the more popular ahead as asset owners across the globe continue their upward trajectory of asset accumulation. SWFs are expected to grow from US $11 trillion to US $18 trillion by 2030, and public pension funds from US $23 trillion to US $32 trillion over the same time period, according to the 2024 Annual Report from Global SWF.[13]

In the European Union, the internalizing of certain functions is not just a cost-saving mechanism and means to generate alpha. The Sustainable Finance Disclosure Regulation (SFDR) has pushed EU asset owners to move fund management in-house for another reason – to set sustainable investment performance indicators for their own portfolio reporting, with KPIs that outline a portfolio's impact on the environment. As such, funds have reviewed their managers against such objectives and reconsidered their suitability, with Sweden's AP2 recently terminating three external portfolio managers whose methods failed to align with the public pension fund's approach to sustainability and climate change.[14]

With more pressure on these buy-side firms to lower costs, generate alpha, and manage environment, social, and governance (ESG) commitments – transferring the operational burdens of fund management in-house – it would suit these buy-side firms to partner with a firm that can holistically optimize their lending opportunities while solving their collateral challenges.

*11 Ibid*

*12 Invesco Global Sovereign Asset Management Study, 2024*

*13 2024 Annual Report, Global SWF*

*14 Insourcing Gathers Pace Among Retirement Funds, Pensions & Investments, May 25, 2023*

# Sophisticated buy-side relies on understanding the value of assets for securities finance

**More than**

***80%***

**of the top 100 Defined Benefit pension plans in the U.S. engage in securities lending, a practice widely adopted by asset owners.**

*Source: Finadium*

Now more than ever, the search for additional revenue in securities financing necessitates strategic consideration around a firm's solutions toolkit to enable inventory and collateral optimization. While the aforementioned insourcing of functions centralizes control internally, collateral optimization has remained a challenging regulatory hurdle, along with added pricing constraints.

Securities lending is widely adopted by asset owners; for instance, more than 80% of the top 100 Defined Benefit pension plans in the U.S. engage in the practice.[15] Yet collateral management in securities lending is not the only obstacle buy-side firms are facing. While the traditional apprehension around securities lending, particularly regarding dividend withholding tax arbitrage and ESG guidelines, has subsided with the introduction of mitigating measures (recalling on-loan assets and ESG collateral criteria, respectively), the conversation has shifted away from the existential conundrum of whether assets should be lent, and instead toward considerations of a lending program's existence within the broader ecosystem of a firm's asset use. Alongside UMR, buy-side firms are increasingly scrutinizing the value of their eligible collateral versus its sourcing and mobilization costs. Here, asset owners are eager to curtail the impact of new margin requirements through minimizing pre- and post-trade margin requirements, as well as meeting Variation Margin (VM) cash obligations and high-quality liquid assets (HQLA) requirements more efficiently.

There is one significant blind spot, though: the cost of mobilizing eligible collateral. Given the number of counterparties and clearing houses the buy-side faces, comparing quotes between trading venues can help to achieve the best pricing.

In spite of this, the cost of mobilizing eligible collateral may not be ascertainable at the point of execution, and difficulties can arise over which assets to utilize for collateral or cash raising obligations. From understanding the fair value of collateral, and as such an asset's liquidity, to appreciating an asset's demand and value in a volatile lending market, these nuanced comprehensions can prove complicated, even to the most sophisticated of owners.

For buy-side firms, truly understanding the value of assets used as collateral is a challenge for a particular set of reasons. Most assets possess an intrinsic value based on how much a borrower is willing to pay to borrow that security. Yet ascribing exactly what rate is accurate and fair can prove more complicated. Sure, for equities and in-demand higher-yielding fixed income assets that typically trade actively in the securities lending markets, estimating revenue from assets loaned is relatively easy. That is not always the case for the likes of government bonds and other more standard collateral assets that are often traded on the repo market, itself lacking in transparency.

In addition, the more sophisticated buy-side firms are also implementing innovative strategies to maximize the return-to-lendable of their assets; wide borrower acceptance, flexible collateral eligibility, term trades, and cash collateral reinvestment, alongside centralized teams focused on efficient allocation, aid the capture of available revenue. Risk management processes, including sufficient collateral haircuts and regular appraisal of collateral pools, are also essential in reducing potential loss. Fundamentally, these buy-side firms are set on getting the right assets to the right place at the right time.

15 *US Pension Plans in Securities Lending: A Statistical Analysis, Finadium*

# A one-stop-shop for inventory optimization

As the buy-side's proclivity towards internal central treasury and fund management functions evolves, so too do firms' conversations with securities services providers. No longer are automation and fees the priority; instead, asset owners are seeking data-driven algorithms for collateral optimization and maximized alpha generation.

J.P. Morgan helps clients navigate these complexities within the securities finance ecosystem. By bringing together J.P. Morgan's Agency Securities Finance, Collateral Management, and Tri-Party services under our Trading Services business, along with Custody, we offer a flexible, modular suite of services to buy-side clients to help them take on developing challenges in asset mobilization and optimization.

Leveraging scalable solutions globally to boost operational alpha and optimize collateral management, J.P. Morgan smoothly and expediently steers the right assets to where they belong.

For instance, we developed a new solution bridging our Tri-Party and lending programs by working in close partnership with a large sophisticated pension fund:

## Helping our clients optimize collateral

### The scenario:

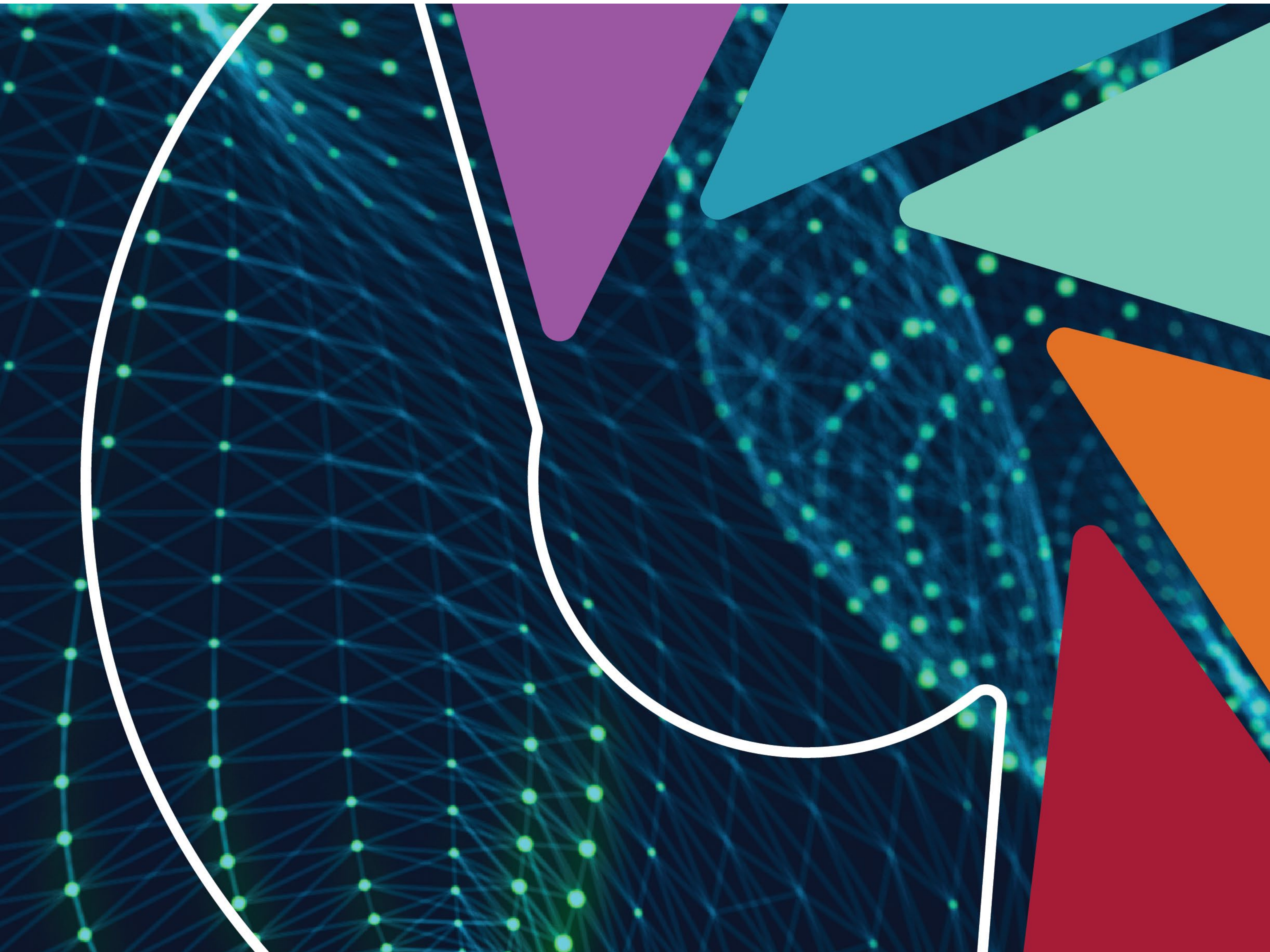
A broad Securities Services client that used J.P. Morgan as its sole custodian, collateral manager, and agent lender needed additional assistance. Ahead of Phase 5 of the UMR rules as we were pitching our Segregation of Initial Margin (Seg IM) services - expanding collateral management and the use of Tri-Party to post IM to counterparties - the client approached us to solve for three challenges.

| The challenges | The solution |
|---|---|
| 1. Without SWIFT capability, the client could not instruct Tri-Party agents on how to receive the securities from custody.<br>2. Once assets were used as collateral within Tri-Party, the client had no way of tracking these assets or knowing when they needed to be recalled from Tri-Party to allow the sale to settle after a fund manager sold them.<br>3. The client was concerned about the impact on its agency lending program and did not want assets with intrinsic value in the lending market unnecessarily used as collateral. | This led to J.P. Morgan's development of Collateral Transport: using the securities lending infrastructure, we could treat a Tri-Party longbox like a lending counterparty (borrower) and instruct the delivery of assets (solving 1), track when a fund manager sale left the custody account insufficient to settle a sale as done with securities lending (solving 2), and provide our securities lending trading team with visibility into the lendable assets that had been used as collateral, thus allowing the desk to recall if there was a better use of the asset (solving 3). |

Though we are able to solve for this complex set of obstacles through Collateral Transport today, for tomorrow, J.P. Morgan is expanding the functionality to help clients that post collateral bilaterally as well as those that use Tri-Party, in addition to developing the capability to auto-select assets from custody based on client preferences, eligibility per their bilateral agreements, and delivery price.

Clients understand that any solution needs to be future-proofed – especially as the focus on distributed ledger technology in financial markets continues. With that in mind, we have also developed our Tokenized Collateral Network (TCN), which tokenizes assets using J.P. Morgan's private, permissioned blockchain, allowing clients to post tokenized assets as collateral, without transferring the underlying assets to the collateral receiver.

Within J.P. Morgan's Trading Services ecosystem, there is a holistic approach across the asset pool to optimize collateral and lending, an approach our buy-side clients are increasingly adopting. From pension funds in Australia and Canada to sovereign wealth funds in the Middle East and Asia, as buy-side firms increasingly internalize central treasury and fund management capabilities, they need a strong partner to grasp additionally complicated securities finance needs. In our offerings, J.P. Morgan empowers these sophisticated buy-side clients to optimize their liquidity and treasury needs by delivering innovative securities finance and collateral solutions.



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