Honey, I Shrunk the Software Market

The shrinking software market presents challenges and unique opportunities for investment managers considering system replacement

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Over the past decade and even more so since the financial crisis of 2008, the software industry has witnessed substantial consolidation. Nowhere is this more apparent than within the sector that serves investment management. With strong profits, the industry is shopping within, seeking deals using low-cost capital, yet at the same time shrinking choice for the end user.

In our 2013 Industry Perspectives, "*Managing Vendor Risk: What Should You Be Doing?*" we noted several factors that have transformed the investment management marketplace including globalization, product diversification, and mergers & acquisitions. It's also important to note that vendor firms have been transformed. Beginning in the 1990's, several rounds of mergers have consolidated the market and served to limit choice, presenting a challenge to managers in selecting a vendor. A quick sampling of companies acquiring other providers in this space over the past several years includes acquisitions of Equipos by Simcorp, Wall Street Office, Thinkfolio and Cadis by Markit, PORTIA by SS&C, PolarLake by Bloomberg, and Omnium by Northern Trust to name a few.

Buyers and end-users, already challenged to keep up with this consolidation, are now in a more challenging position; replace aging systems and address enterprise inefficiencies while sorting through a shrinking vendor pool that offers fewer choices.

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Innovation from unexpected sources

With the stakes higher than ever, software selection must be considered as a long term strategic mandate that enables growth and competitiveness, versus one that is relegated to line of business decision makers.

With the underlying dynamics of consolidation and restructuring in the software market, it is more critical than ever for investment managers to have a clear picture of how the vendor landscape is settling out and what forces will shape it in the coming years, so that they can make the right decisions when replacing inadequate and aging systems. Making this choice presents investment managers with a daunting task; balancing the needs of the enterprise with limited vendor choices, selecting an unproven but innovative vendor, or adopting a managed service model.

Second, as long as Wall Street continues to develop innovative investment products, investment managers are going to require new systems to manage those products. We are reminded by looking at the historical record of equities and bonds, and the subsequent creation of many more investment products and classes including derivatives of other asset classes, real estate, venture capital, all driving innovation and the need for new investment systems and new capabilities. The nature of innovation is such that as soon as the industry catches up with systems and technologies that can manage new products, another wave comes along, and system vendors (and service providers) need to figure out how to manage that change.

Looking forward and recommendations

Today, the idea of working with a so-called "too big to fail" vendor is still held as a viable option in an industry offering far fewer choices to managers. However, this presents managers with single-source company risk. Smaller innovative vendors often pursue a path of focused excellence where they perform one element of the investment management process well, yet are frequently acquired by a larger vendor, resulting in a net loss of innovation from the industry. This lack of innovation and ensuing competition through the vendor landscape is unhealthy for the industry, stifles competition, and constrains internal development of new products because of more conservative R&D practices.

The software industry today has an ever-shortening window of opportunity for vendors; they must act quickly, decisively, contend with the software product obsolescence lifecycle, innovate or die, or be acquired.
We encourage smaller and innovative vendors to stick to their original vision, and resist the temptation to become an in-house solution for a single client. Build functionality to accomplish something new, versus having an eye on acquisition and dovetailing product into a larger solution suite.

Investment managers should require that vendors deliver on a proof-of-concept to validate their capabilities.

Weighing the options

To establish credibility, work with investment managers to demonstrate ROI by showing how you will sustain your business, support testing, and understand their users and the issues they are trying to solve. Investment managers can also foster the innovation dynamic by working with vendors as early adopters, keeping in mind that cost and efficiency gains can be realized with this model, as shown with other early-stage technologies.

Investment managers should require that vendors deliver on a proof-of-concept to validate their capabilities. Depending on the functionality or solution that you're looking to replace or introduce, we also suggest that investment managers forgo a full RFP because its value is significantly diminished if there are only two or three viable vendors. In this case, a fairly high-level RFI and a comprehensive POC is the way to go, as we discussed in our recent Corporate Intelligence "*14 for '14.*"

Forward looking investment managers will embrace vendor evolution and innovation as a way to concentrate core competence within their organizations. A managed service model is not a mechanism to lower cost, but instead allows managers to focus on investment management and leaves the technology to the tech firms, effectively "thinning" the organization and mitigating IT risk while providing benefits of scale, reliability, resiliency, and security.

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