INTRODUCTION

A NEW CHAPTER IN SUB-ADVISORY

Is the award of a sub-advisory investment mandate to a hedge fund by Fideuram Investmenti the shape of things to come, or is the demand from investors simply not there? Elisa Trovato reports

The recent investment mandate awarded to a hedge fund company by Italian asset management firm Fideuram Investimenti has given the term "sub-advisory" a new broader meaning.

From October this year, GLG Partners, the London-based hedge fund firm will run, using full powers granted by Ucits III, three different equity mandates, US, Europe and emerging markets equity on behalf of the Italian company for a total of $3bn (€2.1bn).

But Tommaso Corcos, chief executive officer at Fideuram Investimenti, which serves the largest financial advisers or promotori networks in Italy with over 4500 agents, is keen to emphasise that this is much more than a traditional sub-advisory contract.

"This is a technical partnership which gives us the possibility to gain access to a highly valued team," he says. Through this agreement the Italian firm has ensured that the fund manager, or a senior partner from GLG, will always sit in its own investment committee, bringing experience, professionalism and potentially different views on markets. "It is as if metaphorically we had hired a new very high level manager," he says.

These sub-advised products will be employed as underlying funds in Fideuram Investimenti's revamped range of GPFs (gestioni patrimoniali in fondi), which are the Italian discretional and personalised investment portfolios for high net worth investors.

The recent mandates are part of a broader series of investments that Fideuram Investimenti is making in these products, bucking the recent trend in the domestic industry which has seen many Italian banks dismantle the GPFs in favour of funds of funds type of products, in an attempt to bypass the transparency constraints imposed by the European directive MiFid, which also affect the retrocessions obtained from third-party managers employed in GPFs.

Multi-brand products have also increased in the GPFs, which amount to €11bn of the total €30bn managed by Fideuram Investimenti. Including the three new mandates to GLG, over 50 per cent of a typical GPF balanced portfolio will now be managed by third-party managers, explains Mr Corcos.

GLG will contribute to the right asset allocation strategy within the GPF product itself, although the final decision lies with the Italian firm. GLG have all interest in getting the asset allocation right as if the GPF product goes well, that means that sub-advised assets will also grow, says Mr Corcos.

Mr Corcos sees the strong approach to trading in which GLG has a strong ability to generate added value, in addition to stock picking, as an important strength for the GPFs products.

Thanks to the use of financial derivative instruments that Ucits III has allowed in retail investment products, the distance between a traditional long only firm and a hedge fund has significantly shortened and products originally created as hedge funds are being transformed in Ucits III products targeting retail clients.

This is an opportunity for hedge funds but also a challenge. This is why the GLG Fideuram Investimenti technical partnership is necessarily a two way flow of information, says Mr Corcos. Fideuram Investimenti is an asset manager which traditionally has a close contact with the private bankers and the end clients, he says. Hedge funds such GLG, on the other hand are pure managers, whose ability to service the end clients and provide services and information is a bit "more subdued". But symbiosis between the two firms will produce very good results, he says.

GLG Partners has also been managing for the Italian firm a €140m investment mandate for a high volatility flexible growth product since last October.

Fideuram Investimenti also employs Goldman Sachs Asset Management (GSAM) to sub-advise a flexible dynamic product for a total of €700m. The two firms are currently reviewing the structure of this product that has

been managed by GSAM for the past 3 years. Mr Corcos reveals that the GSAM's Core Flex 135/35 range will be employed in the fund, which will further improve the quality of stock picking and market timing.

TOWARDS MORE NICHE ASSET CLASSES

The increased client demand and the significant amount of assets gathered in some more niche asset classes is driving SEB Wealth Management to consider the opportunity to sub-advise specialist mandates. These can be single country equity funds or sub-sectors of fixed income, such as emerging market debt local currency, predicts Magnus Björkman, head of partnership management at SEB Wealth Management (WM).

"Let's take India and China, for example, where we are currently offering third-party funds. Clearly, investing in these regions is no longer just a market timing bet. These will be long term assets in any client portfolio and SEB wants to offer and sponsor funds for which the demand is likely to be secular or long term," he says.

Offering more specialised funds enables to put together more compelling investment solutions for clients and give better advice, he says. "If for example we include a Bric fund in a global equity portfolio we are not in the position to help the clients determine what their asset allocation should be fully, because some of those asset allocation decisions are outsourced to the external manager. Country funds make this easier," he says.

More in general, the delegation of fund management is driven by the need to generate alpha. SEB Wealth Management has awarded mandates in several broader asset classes where the firm did not have the critical mass and investment competence/competitive advantage. This argument will continue to be valid in the future but will affect some of the narrower asset classes as well, says Mr Björkman.

Indeed, whether to manage an asset class in house, to delegate it on a sub-advisory basis or to offer a third-party product depends on both the ability to hire investment management talent in-house and the ability to generate assets in that asset class. "The bottom line is that we want to make our clients happy. A lot of the analysis has to do with answering to the questions 'do we think that we are the best managers for this product and are we likely to meet our clients expectations?'" Mr Björkman explains. "If not, we shouldn't be managing it in-house, somebody else should.

"If the demand for that product is likely to be significant and long lasting we will procure sub-advisory mandates. If we are not sure about it, but we see a significant interest and a demand we need to respond to, we will do so initially through the offering of a third-party fund. Giving a sub-advisory mandate is a lower commitment than establishing a brand new team and set up a fund within your organisation. But it is significantly larger than offering advice on a range of third-party funds," he says.

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The sub-advisory relationship tends to be longer term in nature than a third-party fund distribution, as it is a significant investment for both the distribution and the investment managers, he adds,

But sub-advisers, as well as third-party funds, are strictly under scrutiny by the research and selection team at SEB WM and in the past 18 months a couple of sub-advisory replacements were made, says Mr Bjorkman. The Japanese mandate, which was previously managed by Schroders Investment Management, has also been split in two different funds, giving to Goldman Sachs Asset Management the management of the core Japanese fund, and to DIAM that of the Japanese alpha fund.

Of the total €145bn that the Swedish group manages, around 25 per cent, across all distribution channels and geographies are managed externally, either in the form of sub-advisory or through the use of third-party funds. "I think that overtime the percentage of assets that we will sub-advise is going to increase," says Mr Bjorkman.

GROWTH DRIVERS

Major regulatory developments such as Ucits III should be driving banks and insurance companies to delegate their investment management to an external group, explains Richard Haxe, head of institutional and retail distribution and client service in continental Europe, Middle East and Africa at Alliance Bernstein. But there is no evidence of this yet, he says.

However, examples of sub-advisory business at firms such as Fideuram Investimenti are clearly in conflict with his views.

"It is difficult in this fast changing investment world to be at the forefront of product development," he says. "A lot of these new products, whether it is 130/30, hedge funds, absolute or total return types of structures, require you to be experts in techniques or in instruments, like complicated derivatives or shorting mechanisms. A lot of people just don't have the risk management capabilities for them and it would make sense for them to outsource them," says Mr Haxe.

"But we haven't really seen it happening. I think the reason for that is simply that allocation to hedge funds and to total return types of products is a small part of investors' allocation in Europe. Therefore the demand is simply not there," he says.

PWM's latest sub-advisory research found that out that of the 90 banks and asset managers interviewed only a few considered Ucits III an important driver to sub-advising. Magnus Björkman, head of partnership management at SEB Wealth Management perhaps can help shed some light on this.

"I don't think that Ucits III in itself has affected SEB's demand for sub-advisory services," says Mr Björkman. "I can't say that the opening up of new investment opportunities has led us to look for an external manager to manage an in-house product in a more compelling manner by using derivatives." In fact, explains Mr Björkman, derivatives expertise goes hand in hand with investment management expertise in those asset classes managed in-house. In those areas where SEB's investment expertise is not as strong, they would have contemplated to delegate the investment management anyway, and so the expertise in the derivatives area becomes a secondary issue. "I think it is fair to say that Ucits III has had an impact on all our investment funds equally, regardless of whether they are managed in-house or externally. The broader investment mandates have enabled us to create more compelling investment vehicles for our clients," he says.

The drivers to sub-advise remain mainly four, according to Mr Haxe at Alliance Bernstein. Firms typically tend to sub-advise to gain access to the external manager's alpha generating capabilities, or because they want to offer a wider range of products to their clients in an open architecture approach. In some few cases large organisations may decide they may want to set up their own fund to avoid the risk of becoming too big in the external manager's fund.

On the institutional side, mainly in the Netherlands and also in global organisations, sub-advisory is just part of the firm's business model. Fiduciary managers, for example, outsource all their asset management capabilities and focus on their clients only, he says.

The majority of the $9bn that Alliance Bernstein sources from European clients, both institutional and retail, are in value equities, explains Mr Haxe, although some mandates are in growth equities and fixed income.

Value equity is an area of core expertise at Alliance

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Bernstein, which manages around $717bn globally, of which $92bn run on a sub-advisory basis for 248 accounts.

"Firms delegating fund management are looking for a consistent investment process around a robust investment philosophy and a predictable pattern of returns; our Bernstein value business has done that over many years," he says. "Firms typically put together a number of managers that are lowly correlated with each other and that means that you seek managers that are distinct in their philosophy."

The widespread use of sub-advised funds in multi-manager types of structures explains why a higher percentage of funds managed on a sub-advisory basis at Alliance Bernstein tend to be equity and more risky products, compared to the funds distributed, says Mr Haxe. "It makes sense for multi-manager firms to put together high risk seeking managers in one product, as the risk goes downs overall because of low correlation between the different portfolios performance streams."

BENEFITING FROM THE CREDIT CRISIS

Although the majority of mandates that European banks and insurance companies give to external managers tend to be in the equity space, as highlighted in the recent PWM sub-advisory study, Pimco, the fixed income specialist, has no shortage of work in the sub-advisory space, assures Michael Thompson, Pimco's co-head of European institutional remarketing.

In Europe, the US subsidiary of Allianz Global Investors manages on a sub-advisory basis $20bn of assets on behalf of financial institutions, which represent around 10

per cent of its total assets sourced from Europe ($200bn).

The drivers in the fixed income space are exactly the same as in the equity space, he says. "Clients tend to be professional investors that build products for their clients on a best of breed basis and that kind of methodology and level of expectations from the client is exactly the same whether it is fixed income, equities or hedge funds," he says.

Five main fixed income strategies are most popular areas of investment with financial institutions, including total return, global bond, high yield, investment grade credit and emerging markets. "These strategies represent about 80 per cent of the sub-advisory work we do," says Mr Thompson. "But clients are increasingly becoming more selective and are allocating to more specialist areas of the fixed income space, such as local currency emerging market debt, mortgage backed securities, high yield, investment grade credit and inflation protected products, or real return strategies," he says endorsing SEB's Mr Björkman's views.

In fact, in the specialist areas of the market, or in less developed sectors or more inefficient markets there tends to be higher opportunity to capture alpha or high yield. "[These niche fixed income sectors] may be attractive either on a strategic or tactical basis, provided that they are outsourced to managers which have the skills to be able to extract that risk adjusted return and not just leveraged beta, which can be very volatile," says Mr Thompson.

Mr Thompson's has positive expectations on the continuation of the growth of the retail sub-advisory business in Europe. And the credit crunch seems to have stimulated the interest in this business model. "The whole point of sub-advisory is to outsource mandates on a best of breed basis. In a period like the one we are through, it becomes very obvious who has the resources to navigate this type of environment and who doesn't," he says.

A DIFFERENT BUSINESS MODEL

With around $41bn in assets managed on a sub-advisory basis globally, Goldman Sachs Asset Management (GSAM) is at the forefront of the sub-advisory world and has been promoting this concept to distributors actively over the past few years. But how does sub-advisory differentiate itself from fund distribution?

"Sub-advisory is often a different service model, especially if it is a single managed fund that is being outsourced," says Nick Phillips, head of GSAM's third-party distribution business in Europe and the Middle East. "Single manager outsourcing is often more of a strategic partnership, where in multi-manager you are one of the many managers that could meet the requirements of the manager selection process," he says.

"Sub-advisory is a very efficient model, we benefit from another organisation's business model and their distribution." And the relationship with partners is deeper and often includes the provision of marketing support or training. One interesting evolution in the sub-advisory space is that, in some cases, a financial entity decides to sub-advise, because it does not have the right expertise, but with the idea of acquiring it in the future, explains Mr Phillips.

"Our partners are learning from us and building up their expertise. So that over a period of time, five, six or seven years, or whenever they are comfortable they would say 'We can do this ourselves now, we have learned from you, let us move on to something else'. That happens not just in banks or insurance companies but also with the big pension schemes," he says.

Mr Phillips' business philosophy is to focus on few very big clients and service them well, rather than a high number of narrow relationships. "The way we structure our business is around cross border global entities or dominant local entities," he explains. "The requirements of each can be the same but just on a different scale, on a geographical level."

While the majority of the assets that GSAM sub-advises are in equities, followed by fixed income, the firm has seen an increasing sub-advisory demand in the hedge fund space, especially in the past year or so, explains Mr Phillips. To meet clients' demand, the firm has also set up a platform where hedge fund managers are mixed to create bespoke portfolios more quickly and efficiently. GSAM in this way would act as an adviser, giving access to a range of pre-selected hedge fund managers.

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