ROUNDTABLE DISCUSSION

UNLOCKING SECRETS OF SUB-ADVISORY

PWM aims to examine the role of banks, wealth managers and fund houses as asset allocators, to ascertain which asset classes are best suited to the sub-advisory model and which are best managed in-house, to estimate the optimum mix between internally managed and outsourced assets, and to evaluate changing distribution models in the light of depolarisation. To do this, we have invited a selection of wealth managers and investment providers to share their sub-advisory secrets with us

Roundtable participants

Round Table focusing on UK and Northern Europe sub-advisory market, London, November 2006

- **Peter Hugh-Smith**, *managing director, partnerships and distribution*, Russell Investment Group
- **John Cleary**, *managing director and chief investment officer*, Focus Capital
- **Thomas Fleck**, *co head of European financial institutions*, Janus Intech
- **Andrew Humphries**, *head of asset management*, St James's Place
- **Glyn Owen**, *chief executive officer*, RMB multi managers
- **Philip Saunders**, *head of global asset group*, Investec Asset Management
- **Chris Wyllie**, *chief investment officer*, wealth management, Arundel Iveagh
- **Alan Sippetts**, *head of investment*, Lloyds TSB Private Banking
- **Panel moderator; Yuri Bender**, *editor-in chief*, Professional Wealth Management

Yuri Bender: *Thomas Fleck, at Janus, whereas you use broker dealers to sell funds directly to the retail market in America, in Europe you have invested significantly in the sub-advisory model, which means private and retail clients can possibly best access your funds through insurance companies and other financial houses that you manage money for. Could you explain the thinking behind this approach?*

Thomas Fleck: The key is to provide a tailor-made solution. You refer to the US market, which you cannot compare with the European market; in other words you have to adapt to market needs and client needs. That is exactly what we are doing. Historically, even in Europe, we started our business at the end of the 1990s with an IFA driven, or broker dealer, approach. However, as it turned out with platforms as the ideal solution, we migrated and used our capacity for focusing on those clients that had high potential and high credibility; in other words those financial institutions where we felt we could get durable or sticky assets which, according to economic matrices, are much more worthwhile and predictable. As a publicly listed company, that is one of the most important things. That is why we focus on this area, and it turned out that it was exactly the correct approach because the whole market shifted significantly into a more institutional approach. Looking at how financial instiutions carry out their selection process and you see a very similar approach.

Yuri Bender: *You have also targeted Germany, but the foreign groups present in that market seem to be having a tough time in the sub-advisory space. Why has the UK been easier for you to penetrate?*

Thomas Fleck: We are maintaining our commitment to the continent as a whole, including Germany and other countries. Some managers enter markets for the short term and then leave, but we are in these markets for the long term. sub-advisory business is a long-term commitment and our commitment to these markets is high. Basically, history is the principal answer to your question; in Germany the idea of being a manufacturer, on one hand, and being a distributor, on the other hand – is very likely to be within one organisation. However, that approach does not make too much sense today.

Looking at the history of sub-advisory over recent years, the UK, Scandinavia and Switzerland are much faster in adapting to change, while others are running behind. We will see the same momentum, going forward, in Germany as well, which brings me back to my first point that if you stay in the market for the long term, you are committed.

Yuri Bender: *Peter Hugh-Smith, Russell hopes to win sub-advisory business from banks and insurance companies, yet the assets you gather are also contracted to third parties. What is to prevent banks setting up segregated mandates for external managers in the way Abbey did with €30bn outsourced? Why should they go to just one manager of managers house? Is there a danger this dilutes performance, and they end up buying the market?*

Hugh-Smith: the commitment to research and understanding is considerable

Peter Hugh-Smith: There is nothing stopping very large organisations such as Abbey going directly to the market. The large organisations potentially have resources to do that, and the assets to finance doing that themselves; whether or not they have the inclination to do it themselves is another question.

The commitment into research and understanding the market is considerable. Coutts and Barclays have followed a manager of managers model and applied it themselves rather than outsource it. Large organisations often see themselves as distributors, rather than manufacturers of products and try to focus on what they see as core competencies of distribution, working with their clients and their normal banking services. They look to other organisations to provide specialist skills.

Going forward, our view is that researching managers is going to become an increasingly specialist skill; understanding what a manager is doing and what they will potentially do in the future, is not something you can identify quickly or easily. Combining that together takes skill and resources. When you move away from larger organisations, smaller organisations are beginning to consider whether manager research is an area in which they can have credibility. Those organisations are looking to providers which can give them ‘controlled open architecture’; they do not want to hand over everything to a single manager, but rather they want to have a choice of managers for their clients. However, they do not necessarily want to make that choice themselves, or even give that choice to their end client. So there will be increasing demand for the sub-advisory model we provide, in which we are on both sides. It is about getting money from people giving out sub-advisory and handing it out in a controlled manner to underlying specialist managers.

With regard to the dangers of just delivering the market, that is a real risk with any multi manager type portfolio which is managed poorly. If you go out and hire lots of managers randomly, that is where you end up; in fact you will actually end up reasonably below the market, when costs are taken into account. However, if done sensibly and you combine together different highly skilled managers who select stocks in differing ways, with thought and a great deal of research, that can deliver above market returns.

Alan Sippetts: At Lloyds TSB Private Banking, we have a multi-manager relationship with Russell, where we put together straightforward, long-only, equity strategies. But we manage bonds, property and hedge funds across the market in a fund of funds approach. We have found Russell to provide excellent value in equities. This approach to manager selection gives us very good service for our clients.

We did also complement Russell with other external managers. In the majority of cases, Russell’s breadth, experience and ability to put together mandates for us meant that they could cover all the execution of the long-only investments that we need.

Russell also has a relationship with Scottish Widows; that relationship reflects within Lloyds’ UK retail banking arm, rather than the private bank, with private banking coming through IFAs and retail banking business being tied to the Lloyds TSB brands, including Lloyds, Cheltenham & Gloucester and Scottish Widows. That Scottish Widows element has a financial advisory business, which itself makes use of Russell’s products.

Yuri Bender: *What do you feel has been the level of preparedness for depolarisation among UK banks, and what kind of role will sub advised products have to play in the long term within the process?*

Alan Sippetts: The banks can look very seriously at what is the most appropriate model for them in their positions. We saw each group announce, pretty overtly, whether they were looking at the IFA model to make that offer, or whether they would do multi-tied approaches, or whether they would only offer in-house solutions. The position in which big banks finds themselves when they review will have influenced strongly their decision, and it would have influenced ours strongly as well. I think it would have been quite a surprise to see that we would look to deny the partner the opportunity to promote its product and brand through our retail banks in the UK. Barclays, HSBC and others have each reviewed and have come to slightly different conclusions, each reflecting their own preferences and positions.

Andrew Humphries: At St James’s Place, depolarisation was almost a non-event for us; we had a very well established wealth management business model in which the partners are through St. James’s Place regulated businesses. Polarisation did not make an enormous difference to that. The change for us is about what impact depolarisation will have on the IFA marketplace and what are the decisions taken by IFAs, whether that is through a network or multi-tied or whether it is directly authorised; and what opportunities there are for us to recruit from that marketplace. The impact of depolarisation has been slightly slower to come through than we had originally anticipated, although this year we are seeing considerably more IFAs reviewing their model. People are thinking about what is the right model for their businesses, with their strengths.

Yuri Bender: *Regarding the underlying managers who sub-advise your funds, you have certainly chosen boutique managers rather than some of the more well known names. What is the reasoning behind this?*

Andrew Humphries: I do not think it is a conscious decision; it is simply a reflection of where the industry as a whole is going. Many talented managers have become frustrated at working in large asset gathering environments and have chosen to go off and set up their own businesses. They might be seeing their colleagues in the hedge fund market have the flexibility and benefit of running their own businesses. When we are looking for fund management talent, frankly, we are quite ambivalent about whether they are large branded names or whether they are towards the boutique end.

Glyn Owen: What is happening is that in response to the challenge of the boutiques, the asset gatherers are re-establishing themselves as boutiques of a sort; one or two have quite deliberately gone down that direction. It is a question of where you find the talent; if it is in a big firm, fine, but the key is to make sure the manager understands the limits of his capacity. It is quite clear that performance is inversely correlated with the size of the assets. We are happy to hire managers from large firms as long as they have control over their own destiny in terms of assets under management.

Yuri Bender: *Many have jumped on the "village of boutiques" bandwagon, because they feel this is what consultants and clients want to hear. Is this just a marketing tool?*

Chris Wyllie: The industry has adopted that language and, to some degree, has walked the walk as well as talking the talk. However, there are not that many which have real control over their P&Ls, with separate businesses with firewalls around them. The acid test only really comes during periods of poor performance. Since this mantra has been adopted we have had a favourable period for active managers, so I would say it has not yet been put to the test. I would be slightly sceptical.

Glyn Owen: There is a long history of firms – which are now claiming to be 'villages of boutiques' – being major asset gatherers, irrespective of their investment performance. Scepticism is appropriate, although some are genuinely trying hard because they have to in order to compete with the real boutiques. If they do not empower the fund managers, they will lose them anyway; the test will come when we go through a more challenging period. The industry has changed to such an extent in recent years, that they are going to have to move in that direction on a structural basis. The jury is out, in our view.

Will these little villagers actually close their assets when they say they are going to do so? I do not see too much evidence of that yet because it is a fairly new concept, but that will be quite a serious test.

Yuri Bender: *John Cleary, your track record is that you were formerly CIO at Standard Asset Management, where you were managing white label money. With the new boutique you have launched, is it your belief that the emerging market arena is one particularly well suited to the sub advised approach?*

Cleary: it is a ridiculous time to enter emerging markets as the money will be the first to exit if market turns

John Cleary: I have become more convinced about that with experience. My experience in different shops in both developed and emerging markets is that no one manager outperforms in all market conditions. Organisations intend to make profit, so they have to market certain products, which are the most popular ones; unpopular managers therefore become disillusioned and there is a rotation of managers every three to five years. Emerging markets is at the extreme; every crisis blows out probably 50 per cent of managers, who re-emerge as product managers and marketers, retirees or working for a different shop. Emerging markets is at the extreme and the volatility offered by emerging markets tends to bring about the most dramatic reorganisation of the talent around there.

We look at emerging markets specifically because it is one of the most misunderstood asset classes, even by multi-managed groups, because it is very volatile; it will not hit the radar in terms of the efficient frontier basis until volatility normalises, by which time many of us have turned to stocks. If we look now, many consultants are recommending an allocation to emerging market bonds, where there has been zero allocation for the past decade, leading to a big flow of money. It is a ridiculous time to enter the market, being so late in the game; the money that is coming in right now will be the first to exit if the market turns.

Yuri Bender: *If emerging markets represents perhaps 15 per cent of market capitalisation and probably 50 per cent of industrial output, what kind of allocation do you suggest private clients have to emerging markets in their portfolio?*

John Cleary: I believe they should have at least 15 per cent. It astonishes me that UK institutions have a core strategy and they are quite happy having an allocation in the FTSE where one of their holdings could be 10 per cent of that index, which is one corporate, yet they do not even have 10 per cent allocated to emerging markets, let alone the corresponding equities which are spread across 30-50 countries and 900 companies. There is a huge misunderstanding of what is involved in emerging markets, and if you look at the composition of companies in the FTSE 100, their earnings are increasingly coming from emerging markets. They have some form of emerging market exposure, although it is not direct. Increasingly, there will be a higher allocation to get the higher returns that are available. You have a broad convergence of emerging markets, albeit not on a straight line, from an economic and from a capitalisation perspective, and there are factors, which are drawing the emerging market allocation higher.

Philip Saunders: The regional model that many institutions have deployed is completely out-of-date. If you had a global, bottom up approach to stock selection, then emerging market exposure would be what it is on the equity side. We still think in a very regional way, which is totally at odds with globalisation.

Top down is such a blunt instrument. Equate it to the traditional model where you have these regional building blocks on your platform, and it seems incredibly old fashioned. We should take a much more global view of equity as an asset class. The correlations within that asset class are enormous and are becoming more marked.

John Cleary: Old models are old fashioned, but there is a danger of managers becoming over eager in their allocation or anomalies that they fail to understand. Emerging market equity specialists understand the macro picture far better than developed market equity managers who try to pump in equities, or developed–market bond managers who try to pump in bonds. There is a naivety and that naivety is what introduces volatility when the market turns; those non specialists are very quick to get out of a market when it becomes more volatile. Emerging markets is a very specialist area and should be left to the specialists; generalist managers will not have a sufficient understanding.

Glyn Owen: There are some very specialist areas, which are more suitable to being externally managed, such as what are now loosely called ‘alternatives’, including private equity, funds of hedge funds and, arguably, property. Few institutions can build the resources necessary to do the research and build their own products in those areas. Picking the best of those firms and blending them in the right way is also increasingly specialist. In the obvious area, what used to be called alternatives, there is a very powerful case for outsourcing; but also in more conventional areas there is a growing argument for outsourcing.

Yuri Bender: *It used to be the case, that open architecture for private clients and the retail side was something for equities only; every European bank would be laughed at if it did not have a reputable bond team. You simply will not see the likes of UBS outsourcing bonds for domestic customers, and that is a huge percentage of what they hold. What is your feeling about what can and cannot be outsourced, acceptably?*

Owen: there is definitely now a more persuasive case for outsourcing all assets

Glyn Owen: I do not see why it is not acceptable to outsource a great deal. Bonds are an interesting area; there are so many products available in that area, which historically has been very difficult in which to generate alpha. The question is whether it is worth doing that internally when most bond managers fail to beat the benchmark, and you can buy the benchmark today for almost nothing. In bond areas, why do it internally when you can outsource the beta for next to nothing and you could add some alpha generating product around the periphery. The way the industry has changed, with the emergence of index like products such as exchange traded funds (ETFs), the separation of manufacture from distribution and the trend towards specialisation, I believe provides a more persuasive case for outsourcing all assets.

Thomas Fleck: From the distribution standpoint, that is exactly our experience as well. It really depends on the structure of the client; does a private bank or a small insurance company really need its own asset arm? They have to be cost efficient and to reduce fixed costs while the competition is growing, so the alternative is to outsource.

The key question is in what way you are doing it; you can either look for the best of breed, like the boutique approach, or you can enter into strategic partnerships. Approximately 45 per cent of sub-advisory firms end up in strategic partnerships. Again, there is a scary factor that you can rely too much on the strategic partner, so I would prefer to use the best of breed strategy and to select the best from the market, instead of entering into a strategic partnership; then maybe you get everything and nothing. It is crystal clear that insurance companies, private banks and

even universal banks see their core competency more in client relationships and selling products to the end customers, more than in the asset management arm.

Philip Saunders: This whole business of intelligent commissioning is very important. If you like, you can fire your fixed income department and outsource that, but it is not just about manager selection. It is about looking at real value added and whether you start to choose things with passive components, and whether you use hedge fund replication, for example, as opposed to investing in hedge funds of funds. The distributor still has to maintain beta selection competence in order to do product design well and to incorporate external components effectively.

Too often, the investment management team gets fired or farmed off into a boutique and you get a hollowing out at the centre; you lose that knowledge and you populate the new manager selection team with people who come from actuarial and consulting backgrounds, almost exclusively, and then you find out several years later that you are building yesterday's products and you have failed to fully appreciate the beta component of manager selection and so forth. That is a very real issue.

Andrew Humphries: Owning distribution gives you a different slant; one of the key reasons why we outsource everything is that we want to ensure there are no conflicts and that our distribution has a very clear view as to what the St James Place Capital proposition is all about. In our view, the danger is that if you have this blend of in-house and external management, then you can lose clarity on what you are presenting to the end consumer.

When you are as close to the end consumer as we are, then you are very clear that you want a very linear relationship in which you are responsible for fund manager selection but solely from external fund management groups. That is very clear now and our partners and our clients understand that. In part, it goes back to that old Irish joke: 'How do you get to Dublin?' 'Well, you wouldn't start from here.' We were quite fortunate in that we did not have this in-house asset management team in the first place, so we did not have to debate whether we should get rid of them, or what their core competences were and what we should outsource; it was quite clear and neat. I am conscious that different groups have different issues when they are making those decisions.

Humphries: the danger is having a blend of in-house and external management as you lose clarity to end consumer

Yuri Bender: *Philip, you have been a fixed income chief in the past; bond management is very different now, as Glyn was saying, with the Ucits III legislation and the various derivatives that can be used. Is it a much more demanding discipline now, with greater performance expected? Does this provide a range of bond based opportunities for good external sub advisors?*

Philip Saunders: Clearly, it has become more difficult because you no longer have the beta carrier wave that was there; we are at the end of a bull cycle for bonds. That means the smarter bond teams have already moved on and are reinventing themselves as absolute return managers. Crédit Agricole were one of the first to wake and smell the coffee on that front, and they completely reinvented their business. The conventional fixed income departments which still reside within some of the major distributors have not, with some exceptions, skilled up to meet the new challenges. The problem is that you have fee pressure on one side because, as Glyn rightly points out, if you cannot intrinsically generate that much alpha then there are limits to what you can charge.

I ran a whole suite of fixed income currency products with a team of four people at one point, and GT was the same, but there is absolutely no way that one could do that these days because it is a multi-alpha proposition; you have to have a credit side and you have to disaggregate everything. Returns will be lower and you have to work harder to generate those returns. Much of the time you can use passive instruments in core parts of the portfolios, whereas on the equity side we have been moving away from passive, although that might swing back.

Yuri Bender: *Chris, you have managed both retail and institutional money in the past, and you have more recently moved to overseeing private client money. Is there a limit to the expansion of sub-advisory business?*

Chris Wyllie: I do worry about the amount of people who are now following the sub-advisory mantra, however, it is very hard to challenge. As you mentioned, I do have a great deal of experience managing retail money on an international basis, as well as balanced mandates on the institutional side, where the house did asset allocation and all the stock selection on a global basis. I cannot tell you the number of meetings I have been to where I had to explain mixed performance because nobody can be best in class in all areas all of the time. This is why the sub-advisory model makes sense and coming to the wealth management world it is refreshing that this has been accepted. The real challenge comes down to implementation and investment judgement; you cannot escape that.

Our view is that it is important to have an investment philosophy for approaching that problem. The philosophy we adhere to is value-based, because most research on stock-market performance over time suggests this is by far the most successful strategy. It is also a philosophy, which addresses successfully the requirements of private clients to capture upside in good markets and protect downside in bad markets. It also helps to avoid the pitfalls of investment 'faddism'; if you have contrarian instincts you are unlikely to be sucked into asset classes and managers at the top of their performance cycle. We are always much happier roaming the valleys, as I put it, rather than scaling the peaks, when we look for investment opportunities.

The logic of the sub-advisory model is unimpeachable, but in many cases, the people implementing decisions are not from investment backgrounds, which creates problems. As a start up, we had the luxury of beginning with a blank piece of paper; we can adhere to the sub-advisory model and our partners are all people who come from investment backgrounds.

We spend all our time talking about investment; we decide how to tilt our portfolios, taking into account current trends but with a contrarian mindset, and then allocate to managers who can execute for us. I am intrigued by wealth managers who embrace open architecture, yet still retain 70 per cent of assets in-house. This is difficult to justify to clients, and strikes me as a bit like saying: 'I have turned vegetarian but I am still going to have my Sunday roast'.

Yuri Bender: *We hear CIOs from global distributors have identified key investment themes, emerging markets currently being one of them; but there has been a lack of managed strategies in which to invest private client money. How does it work as a CIO? You might calculate that commodities are a good area for investment, but would you ever think: 'There is no point in making a big call about that because we have not got the products'? Alternatively, would you say: 'I will make the call and then we will find the products somewhere, even though some asset classes in the market might not be adequately serviced'?*

Alan Sippetts: There are some areas in which we believe opportunities might develop, but before we sit down and appraise that, we need to identify whether or not there are managers available for us to make that appraisal. You have mentioned emerging markets and whether there are opportunities in any particular territory; if we do not know that there are enough competent managers for us to appraise and get a good understanding of what one manager is doing in comparison with another manager, in a specific area – we will simply walk away from what might seem at a high level to be a good potential area.

Sometimes, in practice, there are either not the managers or the products out there that will allow us to make use of it in sterling or appropriate for an onshore UK client base. You may believe there is an opportunity, but in practice you have to find a way of executing that. If the capability does not exist; if your knowledge is not great of the manager community in an area which would be able to capitalise on what you have identified; or if your confidence in those individuals is not high, then you would leave it alone at that juncture.

Sippetts: if we cannot get an accurate appraisal we may simply walk away from an area of potential opportunity

Chris Wyllie: The revolution which helps to break this log-jam is around ETFs and structured products. This also has a bearing on the discussion about the degree to which you need in house management expertise. Sometimes the role of in house management is simply to produce index-type core products; I can go out and get that at very little cost by buying an ETF. As the global count of ETFs expands monthly, there are more and more strategies available. If they are not available, then structured products also offer solutions in a way which is crafted to meet the broad requirements of private clients.

Peter Hugh-Smith: The ability to find product remains a real issue, particularly if you are looking to implement through funds. There are an astronomical number of funds in Europe now, something like 80,000. When you look at funds with a decent amount of scale, in which larger organisations could deploy reasonably significant amounts. In fact, there are relatively few out there, and many of the managers you want to be with in the future, are in boutiques. For large organisations, getting access to those managers in a sensible and a fair way, is an important issue. This is quite a challenge for people looking at the sub-advisory model; how do you structure that if you are a large organisation? If you are a small organisation it can be a lot easier, but if you have billions of capital to deploy relatively quickly it can be a real issue.