New City Initiative

# Delivering Value for Money

The Case for Boutique Active Management

## About the New City Initiative

NCI is a think tank that offers an independent, expert voice in the debate over the future of asset management.

Founded in 2010, NCI counts amongst its members some of the leading independent asset management firms in the City and the continent. The NCI gives a voice to independent, owner-managed firms that are entirely focused on and aligned with the interests of their clients and investors.

Over the last decade, a traditional “client-centric” approach has enabled entrepreneurial, owner-managed firms to emerge as an important force in a financial industry dominated by global financial giants. Now, more so than ever, these firms play a key role in preserving the stability and long-term focus of the financial sector, which is of benefit to society at large.

## About the Author

### Charles Gubert

Charles Gubert is a consultant to the NCI. He is founder of GTL Associates, a research, copy-writing and marketing consultancy to financial services institutions, and a contributing editor at Global Custodian Magazine. Prior to this, he was a research manager at Thomas Murray IDS, a consultancy and editor at COOConnect, an online title aimed at chief operating officers at alternative and long-only fund managers. He started his career as a reporter at Risk Magazine and Hedge Funds Review.

## Office

New City Initiative
16 Babmaes Street
London
SW1Y 6AH

+44 (0)20 7484 1198
www.newcityinitiative.org
toby.illingworth@newcityinitiative.org
@NCityInitiative

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# Foreword

The active asset management industry has been under attack for a number of years from passive products, smart beta strategies, and latterly the press and the industry regulator. Although there has been a huge amount of coverage of the active versus passive debate, the tendency has been to group all active managers together, rather than to dig deeper and differentiate between types of active manager. In this paper we explore some of the risks of passive products and highlight some of the benefits of active management.

NCI members are specialist boutiques, with an owner-management ethos and strong alignment of interest with their clients. NCI believes these key traits provide structural advantages, particularly when compared to closet index trackers which charge high fees for index-like performance.

NCI recognises the attraction of passive products, which are another tool in the toolkit for investors. For some investors a purely passive approach, or a mixture of passive and active makes sense, but the majority of investors have the information and capacity to do better by selecting active managers.

This availability of information is key. Transparency is a core value of NCI. We believe value for money is in the eye of the beholder. By providing an investor with clarity about objectives and transparency of information, they are able to make an educated decision about whether a manager can add value to their portfolio. Large institutional investors have been able to obtain detailed information on the costs of running portfolios for years. Our message to all investors is to ask managers for detailed information on costs and charges. If the manager is unwilling to provide them, that probably tells you something.

The paper ends with what we hope are helpful conclusions to guide investors, and a call to the industry to consider working together to adopt technology to ease the investment process and reduce costs.

**Jamie Carter**
Chairman, New City Initiative
Chief Executive, Oldfield Partners

# Executive Summary

Active asset management in the last decade has witnessed significant change, but it could be unrecognisable in the next two to five years if present trends and attitudes continue. The growth of low-cost passive fund products has occurred in response to a number of factors bedevilling active managers, the most obvious of which are fees and the variable returns across the industry. NCI believes that investors should only pay fees on the basis that the returns delivered justify them. As an industry group, we have also taken a firm line against the growth of closet index products, which do not warrant the fees charged.

NCI represents the interests of boutique, owner-managed asset managers, and we believe there is a strong case for the inclusion of their investment strategies in the portfolios of investors. Members were quick to highlight the advantages of boutique active management, namely their nimbleness, asset class specialisms, and comprehensive understanding and engagement of Environment, Social and Governance (ESG) issues.

We also understand that passive funds may have a place in a balanced portfolio providing a multi-asset class solution. “Active boutique managers and passives can both be used by investors as a sensible way to balance their portfolios,” said one NCI member. However, the paper alerts investors and regulators that these new fund structures pose potential risks. Common concerns flagged by our membership about passive products included a lack of downside protection and concentration risk.

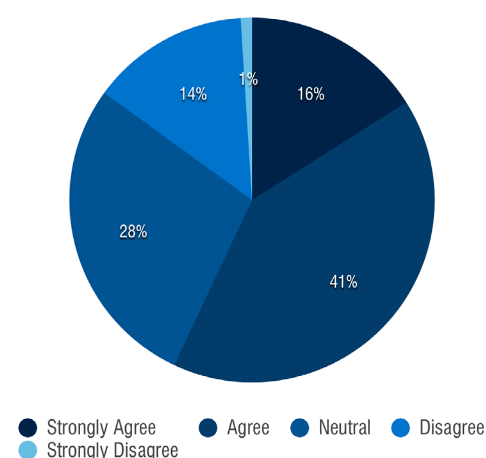
The paper also identifies a series of recommendations for active managers, around how they can maintain an edge over cheaper alternatives. Suggestions included adoption of innovative technology by managers themselves and service providers, as well as material improvements to the alignment of fee structures. If such changes can be executed, the active management industry will have a bright future ahead.

# Passive Fund Growth Since 2008

Passive funds, which include exchange traded funds (ETFs) and index trackers, are poised to achieve a leading share of the US market by 2024 or sooner, according to a report published by Moody's Investor Services.[1] At present, passive investments account for around $6trn in assets globally, and 28.5% of assets under management (AuM) in the US, and this is forecast to exceed 50% within four to seven years, it added.[2]

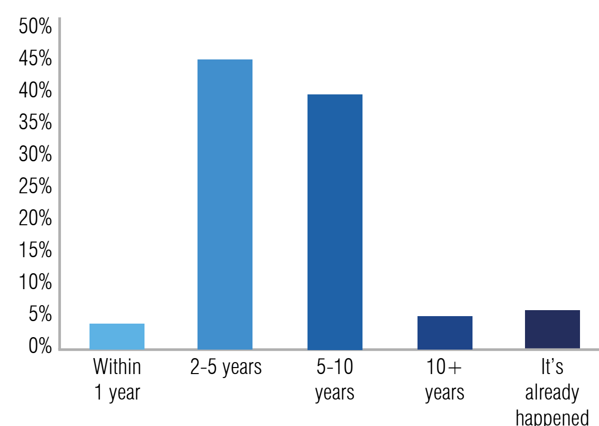
Morningstar found AuM in passive products grew by 230% since 2007 (to $6trn), whereas active funds saw an increase of 54%, bringing AuM to $24trn.[3] A study by Calastone, a financial technology company, found 57% of market participants agreed that passive funds would take over from actively managed funds to become the dominant product for mass retail.[4] The same study said most people felt this transition would happen in two to five years.[5]

**Figure 1: Passive funds will take over from actively managed funds as the core investment product for mass retail customers - do you agree?**




Source: Calastone

**Figure 2: How soon do you think passive funds will take over from actively managed funds as the core investment product for mass retail customers?**




Source: Calastone

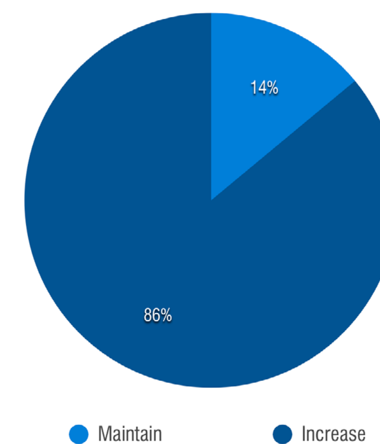
It is not just pure passive products that are attracting investor capital. Smart beta, a strategy that utilises factor-based investing (i.e. a focus on fundamental drivers such as growth, momentum, value, small size, low volatility to construct portfolios/funds, rather than purely market capitalisation), have also been winning mandates.

A report in the Financial Times said AuM in smart beta products had expanded by 30% each year since 2012, and was on course to exceed $1trn in the next six months.[6] Meanwhile, a study by Citi released in 2016 said AuM in smart beta and risk premia funds were projected to rise from $265bn in 2014 to $1.2trn by 2019 making it one of the fastest growing fund subsets in the asset management universe.[7]

1 Moody's Investor Service (February 2, 2017) – Passive Investing to Overtake active in just four to seven years in US
2 Moody's Investor Service (February 2, 2017) – Passive Investing to Overtake active in just four to seven years in US
3 Financial Times (May 29, 2016) – Passive funds grow 230% to $6trn
4 Calastone – Distribution: State of the Nation Research Report
5 Calastone – Distribution: State of the Nation Research Report
6 Financial Times (July 9, 2017) – Smart beta funds on course to pass $1trn milestone
7 Citi Prime Finance



**Figure 3: Expected Risk Premia/Smart Beta investment in the next 3 years**



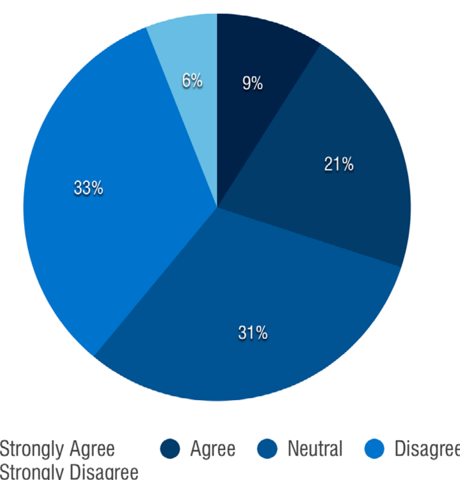

Source: Citi

In 2016, passive funds were given a huge boost when the UK's Financial Conduct Authority (FCA) released its interim Asset Management Market Study (AMMS) highlighting the fee divergence between active and passive products. The FCA AMMS study said a managed equity fund typically charged 0.90% to a UK investor whereas a passive product levied a fee of 0.15%.[8]

The FCA highlighted that active managers did not in aggregate outperform their benchmarks, although the regulator clarified in its final report in June 2017 that its report was not meant to be construed as being an endorsement of passive funds over active. Many in the industry recognise that the popularity of passive products is here to stay.

Equally, there is a clear differentiation between institutional versus retail approaches to investment management. There was a marked contrast in the Calastone study with fewer respondents believing passive products would be the dominant asset class for institutional investors.

**Figure 4: Passive funds will take over from actively managed funds as the core investment product for sophisticated invetors - do you agree?**



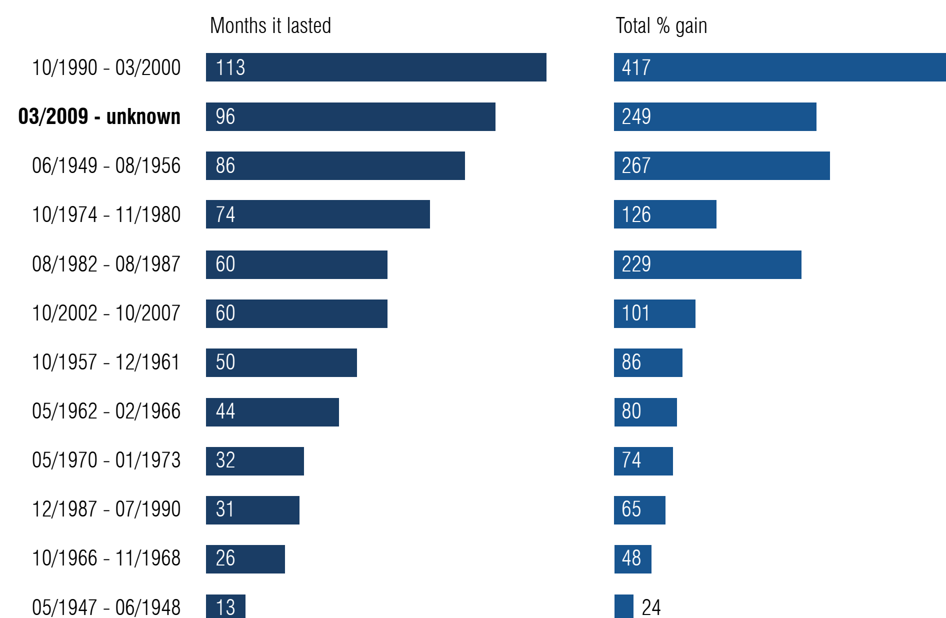

Source: Calastone

8 Financial Conduct Authority (November 2016) – Asset Management Market Study Interim Report

# Passive Risks: Suffering The Downside

Since 2008, equity markets have seen an unparalleled bull-run, which has obviously served passive products well. To put this equity bull run into perspective, it is the second longest rally in the S&P 500's history (the longest was between 1990-2000); and the 250% gain on the index is the fourth best.[9] In such a steady, positive macro environment, a passive fund delivering index returns minus fees looks attractive.

**Figure 5: S&P 500 Bull Markets Since WWII**




Source: Forbes

However, a major risk for passive investors is any adverse turn in market conditions. "In the event of an equity market correction, it is inevitable some passive investors will get burnt. If we look back over the last seven to eight years, huge amounts of money have gone into passive, and this is resulting in significant crowding. At some point, markets are going to go down and passive investors are going to be hit by all of the downside," said an NCI member. It is here that active managers play an invaluable role, protecting investors from the worst of the downside and short-term volatility.

Another NCI member agreed. "The volume of capital that has gone into passive products is mindboggling. If we see a repeat of 2008, there could be huge problems. Take ETFs, for example. Many ETFs do not own the instruments they are exposed to outright, but via synthetics. This could unsettle markets if panic selling followed," he said.

Furthermore, several members pointed out passive flows often impeded true price discovery and efficient capital allocation, whereas active managers will conduct thorough analysis on companies to assess their viability and real value, a point made by an equity fund manager.

9 Reuters (March 8, 2017) – Factbox: Bull market turns 8 – historical facts and figures

One of the most powerful arguments against passive is that its investments mimic mainstream market cap weighted indexes. In other words, passive products typically overweight expensive securities that have done well and underweight cheaper ones, a point made in an RWC report.[10]

"Passive investors in 2000 were allocating large chunks of their money to bubble stocks like Cisco, Sun and Yahoo, and also to accounting frauds like Enron and Worldcom which were on their way to zero. This negative aspect of passive investing is demonstrated by the fact that index returns can be improved just by equal weighting, or weighting by a variable such as sales," it added.[11]

Furthermore, passive investing often exposes investors to concentration risk. A paper by Schroders summarises this nicely. "While the MSCI World Index is currently composed of over 1,600 stocks, we calculate that the universe of global stocks with sufficient investable liquidity comes to more than 15,000. Moreover, as we have suggested, index investors further narrow their choices by their bias towards big companies. There is a huge range of mid, small and micro-cap stocks beyond the reach of the index which have all been shown to outperform large cap over the long term," it read.[12]

"Many investors associate active returns with "risk" (higher tracking error for instance). As a result, investors have moved into passive funds in their droves in the hope that they will be reducing their "risk exposure". This is leading to continued inflation in asset prices of securities held in passive portfolios which in fact increases investors' valuation risk. To manage risk appropriately, it seems far more appropriate to be exposed to better-priced, off-benchmark assets which everyone else is not already invested in. The increasing concentration of global pension fund assets in a limited number of on-benchmark securities is quite frightening," said an emerging markets manager.

While active management performance is under scrutiny, the RWC study articulates the reasons for this. Active managers tend to do well when cross-sectional volatility - the dispersion of stock returns - is high, and when pairwise correlation is low, allowing for unique insights to be deployed in stock movements. "Unfortunately for active managers, since 2007, macro factor risk has driven correlation to historically high levels and return dispersion to low levels," it continued.[13]

In short, underlying fundamentals have not been dictating price movements at companies, but as an article in the WSJ points out, "entire sectors of the market trade in lockstep."[14] Nonetheless, the RWC paper acknowledges that this trend may be coming to an end, making it a very bad time to switch from active to passive.

10 RWC (February 2017) – The Reports of the Myth of Active Investing have been Greatly exaggerated
11 RWC (February 2017) – The Reports of the Myth of Active Investing have been Greatly exaggerated
12 Schroders (June 2014) – The Hidden Risks of Passive Investing
13 RWC (February 2017) – The Reports of the Myth of Active Investing have been Greatly exaggerated
14 Wall Street Journal (February 7, 2017) – Tiger Hedge Funds become Wall Street Prey

"Active managers give investors the ability to outperform the market whereas passives do not. It is axiomatic, that in a market more or less consisting of investment professionals, the average active manager will underperform. The question is whether it is possible for investors to choose a number of managers, the majority of whom will, over the long term but not in every period, outperform. I believe sensible investors with enough information can do this." said an NCI member.

A regular criticism of products such as ETFs is that some of them participate in securities lending, and a few experts are concerned that providers are either engaging in quite liberal lending activities or accepting lower quality collateral. While securities lending does provide returns to ETFs, it can introduce unnecessary risks, a point made by several NCI members, many of whom avoid the practice. "The true risks of ETF securities lending activities will become apparent during the next crisis," said one. Liquidity risk could be exacerbated in the event of mass investor outflows from ETFs at a time when markets could be highly illiquid.



## Not All Active Managers Are Made The Same

The NCI has always advocated transparency of fee structures so that customers have the information they need to make an informed decision about whether the strategy offers value for money. It is here where we believe boutique providers, which are highly client-centric and have a greater alignment of interest with their clients, have an advantage. "Well managed boutiques have strong differentiators, namely around their distinctive product offering, ownership structure, but also outperformance," said one manager.

"Boutique asset managers have a unique opportunity to showcase their differentiators over large asset managers and passive products. Our smaller size gives us flexibility. For example, a $50bn AuM emerging markets equity manager is not going to be able to access the best opportunities given its size, whereas a boutique provider can. As boutiques are owner-managed, have high levels of co-investment with their clients, and maintain strict capacity limits, we feel this gives them an edge," said an NCI member.

Boutiques tend to specialise in one, or a small number of strategies, asset classes or investment styles. They do not offer a complete set of broad-based products to cover the waterfront and suit every type of investor from all over the globe. Specialisation brings greater focus, creates less internal friction and - according to research from Northill Capital[15] - helps produce better results.

Another benefit cited by an NCI member was the ability of active managers to be more flexible in areas such as ESG (environment, social, governance) investing than their passive peers. The NCI firm acknowledged passives could not engage with corporates to the same degree as active managers. "Many of our investors take corporate governance engagement and ESG seriously, and active firms will speak regularly with companies about these issues. I do not think passives can compete on this," said a discretionary investment manager.

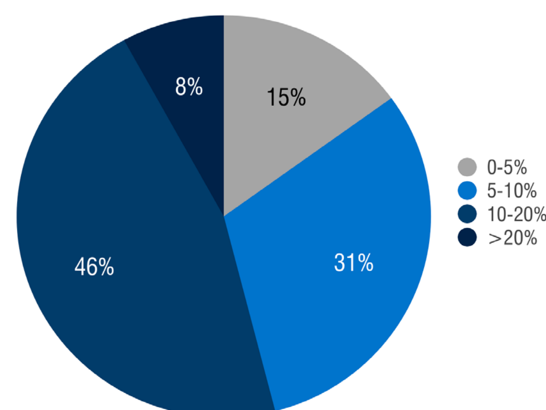
A passive fund, exposed to thousands of individual stocks, cannot possibly be as effective in engaging with management teams as an active manager with far fewer positions. One NCI member said: "As longer term, active investors, companies should welcome our interest and they are more likely to listen to constructive engagement as we could walk away and sell the holding, potentially damaging the share price. Passive funds do not have that choice or threat." As such, boutique active firms should highlight this advantage.

15 Northill Capital (August 2016) – Nowhere to Hide: Focused Active Asset Managers Outperform

# Rising Costs And Pricing Pressure

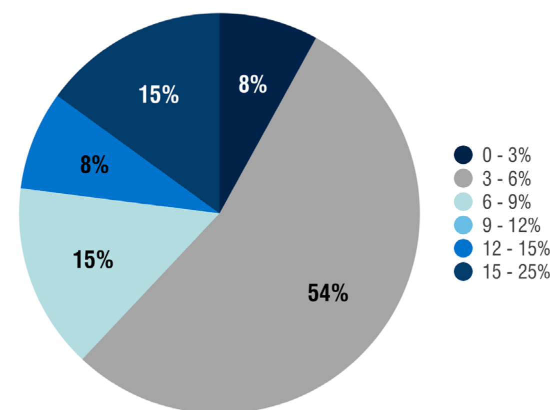
But how can active managers compete on price in this heavily regulated environment against cheap passive funds? The active management space has had to absorb huge costs over the last few years. Polling of our membership in 2015 found 54% of respondents spent around 9%-12% of their operating budgets on regulatory compliance.[16]

**Figure 6: Time spent on regulation by management (% of total)**




Source: NCI Member Survey 2015

**Figure 7: Cost of regulation as a proportion of operating costs (% of total)**




Source: NCI Member Survey 2015

"Rules including the research payment provisions under the Markets in Financial Instruments Directive II (MiFID II) have had high absorption costs," commented a discretionary manager. The reality is that these costs are relatively fixed in nature so the smaller the firm, the larger the negative impact to profitability.

In addition, the FCA's push for a single fund charge, which encompasses most or all costs, including separate ancillary charges such as custody, administration, legal and audit charges, favours larger managers with greater bargaining power. Equally, boutiques have to invest heavily in operational infrastructure to ensure they meet clients' risk and stability assessments and due diligence requirements. In such an environment, costs have to be managed carefully.

There may be opportunities for the industry through increasing the use of shared technology or collaborative purchasing of outsourced services, but this requires concerted effort and organisation at a number of levels. "The industry does need to become leaner given the fee pressure it is facing. It needs to reduce costs and apply more pressure on service providers such as index providers and IT services companies," said an emerging markets equity manager.

One NCI member suggested Blockchain – once it is better understood – could be synchronised with the workings of asset managers to deliver cost benefits. "Distributed Ledger Technologies (DLTs) such as Blockchain permit scalable, auditable and secure solutions that can facilitate workflow, particularly in areas such as the middle and back office or in regulatory transaction tracking."

16 New City Initiative (October 2015) – The Next Five Years: Regulatory Challenges That Will Impact Asset Managers



Others agreed innovation needed to be promoted at asset managers as a means to obtain better economies of scale. "A lot has been said about innovation, and one area we are seeing a lot of change is around data management. Enhancing data management through technology will bring efficiencies to the industry," said one investment management firm CEO.

Better use of technology by managers, custodians, fund administrators and transfer agents could facilitate an easier, accelerated process of investing in pooled funds. Direct investment into a pooled fund (not through a platform or other intermediary) often involves completing a detailed application form and providing anti-money laundering (AML) paperwork in hard copy, a process which requires multiple manual interventions in processing. Automation in this area is being progressed, however, and this may generate savings.

Others believe change needs to be internally-led through realigned fee structures. "In its interim market study report, the FCA correctly pointed out that the prevailing model of fees – namely a fixed ad valorem structure – incentivises firms to chase asset growth, which is not necessarily in the best of interests of clients. This conflict arises because it is well known that larger pools of capital are harder to manage than smaller ones. One solution would be to align the incentives of clients and the manager by linking fees more closely to the investment performance delivered to clients. For example, having managers offer a lower fixed management fee, but a higher performance fee, that is refundable in the event of subsequent underperformance. This would mean that managers are incentivised to generate long-term sustained performance rather than chase assets," commented one equity fund manager.

The active management industry has a lot to confront, but boutiques, with their owner-manager culture, specialist approach and greater alignment of interest, are in a strong position. "Index huggers and passives have a low potential to outperform. Boutiques – with their concentrated portfolios and committed strategies have strong potential to outperform, and that is exactly what investors want," said one member.

NCI members welcome competition, and some argued the growth of passive funds would help motivate active managers. "Passives have introduced more competition into the market, which we fully applaud, and their entry increases the bar for active managers, and makes outperformance even more necessary as clients have a lot of alternative products to choose from now," said one equities-focused investment manager.

It has been a long time coming, but the transparency and wide availability of information means that managers need to be at either end of the spectrum – either passive or truly active, with fees that reflect the difference. Customers can then make a decision as to what they believe represents value for money. Those in the middle that charge active fees but hug the index are in a very difficult position and must adapt or suffer.

# Conclusion

- NCI believes a balance of active and passive products can provide good solutions to investors in certain environments. However, there has been excessive bias, driven by huge marketing and sales dollars, to push investors towards passive and a narrow range of smart beta products. This introduces risks to the efficient functioning of the market and for the end clients.

- Passive products deliver in bull markets, but will suffer all of the downside if the market falls. The effect of crowding means the most pain may be felt in the passive and smart beta products which have been highly popular, as a vicious cycle of market falls and redemptions develops.

- Active managers can offer downside protection to investors and take advantage of the opportunities a sell-off in passives, or the overcrowding within passives, may create. An increase in the dispersion of stock returns has in the past been favourable for active managers.

- Active managers can access stocks not included in passive or smart beta products, and boutiques can do this more easily due to their smaller size.

- Investors looking for active managers will only get value for money from managers that are truly active. Index-hugging products with very low active share by definition deliver index-like returns minus fees.

- Boutiques have structural and cultural differentiators which give them an advantage. They have a greater alignment of interest through being owner-managed with a long term horizon, having strict capacity limits, high levels of co-investment and specialisation in a focused number of strategies or asset classes.

- NCI recognises that in order to cope with the pressure on fees, particularly in an environment of rising costs, the industry needs to make better use of technology and innovation. This may include industry-wide initiatives to expand the applicability of distributed ledger technology or Blockchain.

## New City Initiative Members

### UK Members

- Artorius Wealth
- Bentley Reid & Co.
- Brown Advisory
- C.Hoare & Co.
- Cape Ann Asset Management
- Cologny Advisors LLP
- Crux Asset Management
- Dalton Strategic Partnership LLP
- Edgbaston Investment Partners
- Findlay Park Partners LLP
- Floreat Group
- Independent Franchise Partners LLP
- Kairos Partners
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- Kestrel Investment Partners
- Kiltearn Partners
- Majedie Asset Management Ltd
- Mayfair Capital Investment Management Ltd
- Montanaro Asset Management
- Morant Wright Management
- Northill Capital LLP
- NS Partners Ltd.
- Ocean Dial Asset Management Limited
- Oldfield Partners LLP
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- Polar Capital
- RWC Partners Ltd.
- Sanlam Four Investments Ltd
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- Stanhope Capital LLP
- Stonehage Fleming Family & Partners
- S. W. Mitchell Capital LLP
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### Continental Members

- ACER Finance
- Carmignac Gestion
- Comgest S.A.
- ERES Gestion
- Diamant Bleu Gestion
- La Financière Responsable
- Mandarine Gestion
- Metropole Gestion
- Moneta Asset Management
- Montpensier Finance
- Quero Capital
- Skagen Funds
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- Sycomore Asset Management

**www.newcityinitiative.org**
**@NCityInitiative**

New City Initiative, 16 Babmaes Street, London SW1Y 6AH