'The fund industry needs a cultural revolution'

Interview

Somerset Capital's Dominic Johnson tells **Steve Johnson** that the way firms are structured is more important than regulation

Dominic Johnson is a worried man for an unexpected reason. The chief executive and founding partner of Somerset Capital Management, a London and Singapore-based emerging markets house, bemoans the lack of competition he is facing.

"I don't think a global asset management firm has been set up in the UK since us in 2007," says Mr Johnson. "A lot of people come to me asking for direction, but the environment to set up a new business is very different now. The regulatory environment is a lot harder. You need more money, so it's harder to start small."

As a result, "the direction of travel is towards asset-gathering behemoths. Less competition means those left have greater pricing power, which I don't think is healthy," he argues.

Mr Johnson, who doubles as a director of the New City Initiative, a think-tank comprised of 42 independent asset managers from the UK, France and Belgium running approximately £300bn, believes overzealous regulators have harmed the interests of investors. Instead, he wants to change the culture of the fund industry.

"It is important not to confuse regulation with culture. Culture is 100 times more important," he says.

To some, "culture" is a nebulous concept wheeled out by business people who instinctively oppose all outside regulation and who propose their industry can regulate itself just fine, thank you, if they can weed out a few "bad eggs".

However, the structures Mr Johnson and his colleagues have created at Somerset give his campaign greater credence.

Like many in the industry, he talks fervently about "aligning the interests" of fund managers and their clients. The fact that, according to Mr Johnson, Somerset has only ever lost a handful of institutional investors (of which it has about 150) in its six-year history, suggests it may be having more success in this regard than most.

He believes this alignment is best achieved by creating employee-owned businesses. He argues they provide staff with a strong incentive to generate good performance, while discouraging actions that could lead to the business' demise.

"The big problem with the banks was that you didn't care if the guy next to you was losing £6m on inappropriate proprietary trades. If you have a business that is properly structured, you look over your shoulder if what [your colleague] is doing directly influences your income.

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"If the guy next to me blows the business up, I lose my business too. That changes how people assess risks. I passionately believe that the concept truly reduces risk in those firms and in the system at large," says Mr Johnson, who also claims this structure reduces employee turnover.

In pursuit of this nirvana, Somerset was created as a limited liability partnership, with a reasonably diverse ownership base. There are 11 active partners, alongside 15-16 sleeping partners, who receive a share of profits. Several larger clients are also partners.

Separately, Somerset operates a working-partners' pool, which is also used to reward some non-partners, and a stockpickers' pool, which allocates 2.5 per cent of profits to its analysts.

According to Mr Johnson, fixed pay for Somerset's fund managers has averaged around £110,000 over the past three years, a figure he believes is "significantly lower" than industry norms.

Their variable remuneration (much of which must be invested in their own funds) is largely based on how well Somerset as a whole has performed and the individual's role within that, hence the interest in how colleagues perform.

"If you have a team of fund managers, you want to get them to work together and it's very hard to get them to do that. We want to incentivise them to reduce risk in each others' portfolios. They are a tight family, working with each other, criticising each other."

If a fund has a performance fee, the fund manager also receives a share. The European Parliament has debated restricting the use of performance fees, but Mr Johnson argues they are a valuable way of generating revenue for boutiques that wish to stay small, rather than raising as much money as possible for their funds. This tactic can lead to poor performance and make it harder to maintain a close relationship with investors, he believes. Somerset has pre-announced cap levels for many of its funds.

But Mr Johnson believes performance fees are "inappropriate" if a fund's assets are not capped. "The whole point is to incentivise fund managers to keep their funds small," he says.

Despite his antipathy to red tape, Mr Johnson would like to see regulators introduce an official standard for performance fees, ensuring they meet certain standards, such as meaningful hurdle rates and ensuring performance fees are measured over a reasonable time period of, say, three years.

Somerset has established an innovative advisory board, comprised of many of its main clients. It assesses whether the business is jeopardising its future success by raising too many assets or launching too many products, as well as ensuring teams are incentivised appropriately and ownership is spread widely.

"I'm a big believer in an egalitarian ownership structure," Mr Johnson says.

In many regards, Mr Johnson is a natural campaigner, having enjoyed a bewildering array of political connections during his career. Before founding Somerset, he was director of marketing at Lloyd George Management, headed by Robert Lloyd George, great-grandson of Britain's last Liberal prime minister.

His fellow defectors to Somerset included fund manager Mark Asquith, a descendant of the penultimate Liberal prime minister, and co-founder Jacob Rees-Mogg, now a Conservative member of parliament. His father-in-law, Archie Hamilton, was a junior government minister.

Mr Johnson himself was a councillor for London's upmarket Kensington and Chelsea district, where "as a good capitalist" he helped found a credit union to attempt to bring a savings culture to "areas of the community that can be forgotten by the banking system".

And he is not above paraphrasing Chairman Mao.

"There was no law firm or accounting firm that collapsed in the crash. They adopt LLP structures and some of them, [such as] PwC and Clifford Chance, are some of the largest organisations in the world. None of the private banks, such as Hoare, went bust. Their culture was different," he says.

"We need a cultural revolution, not a regulatory one, to let a thousand small firms bloom."

Somerset Capital Management

Founded 2007

Assets under management $2.6bn

Number of employees 24

Offices London and Singapore

Ownership Limited liability partnership

Curriculum vitae

Dominic Johnson

Born 1974

Education
1995 Durham University, BA in politics

Career
1995 Far East sales (broking), Robert Fleming, London

1998 Far East sales (broking) Jardine Fleming, Hong Kong

1999 CEO and founder, Assetline.com (online construction equipment auction website)

2001 Director of marketing, Lloyd George Management

2007 Founding partner, Somerset Capital Management