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Many mouths to Feed

Special Report by Andrew Whiteley

Increased scrutiny of client charges in fund portfolios means advisers are under more pressure to both justify costs and also pick the top performers at the same time

Perhaps the major beneficiaries of the recent FSA focus on risk analysis and suitability have been the providers of multi-asset solutions to the IFA market. This enhanced scrutiny coupled with the increase in volatility that we have witnessed in traditional asset classes – who would have picked index linked gilts and Japanese equities as the top performing asset classes in 2011 – has highlighted the need to cover all the bases within your chosen investment proposition.

The multi-asset approach is not new, it has been with us in some guise or other for a long while – the Investec Cautious Managed Fund was launched in 1993 – but what seems to be appealing to IFAs looking to build compliant investment propositions for their clients is the ability to offer a range of risk-graded solutions using ostensibly the same assets with varying allocations to each.

Traditionally this would have been achieved either through a single strategy unit trust such as the aforementioned Investec Fund or later through a fund of funds arrangement. These funds tended to sit in the IMA Balanced and Cautious Managed sectors and did not historically form part of a full range spanning the entire risk spectrum. Back in the days when your typical risk analysis consisted of asking your clients where they thought they sat on a risk scale of 0-10, these funds tended to satisfy the vast majority of answers and attracted significant inflows. Whilst they were marketed as multi-asset solutions, in reality the funds really only paid lip service to most asset classes outside global equities and bonds but they offered a handily packaged diversity with actively managed allocations.

As the market grew and as more asset classes were added to the mix, the fund of funds structure became the default for most offerings and several managers saw huge inflows, with Jupiter's Merlin range being perhaps one of the best supported with nearly £7bn held across the four portfolios at the time of writing.

All good so far but unfortunately the Retail Distribution Review has alerted everyone's attention to the rather large elephant in the room wearing a big T-Shirt with the word "CHARGES" printed on it.

Access to a wide range of asset classes doesn't come cheap. The TER of the Jupiter Merlin Income Portfolio Institutional Fund is 1.93% which is awkwardly close to 2.00%. I can hear IFAs all over the country shouting that the fund has been a top performer over 1, 3 and 5 years, but that was then and this (well 2013 at least) is now. In our brave new world of total transparency you will need to show your client exactly how much that performance has cost and in addition, exactly how much your advice to invest in that portfolio has cost and added to that how much the custodian has charged to let them see how they are doing on the world wide web!

My guess is that once that figure gets over 3% per annum you will be having some difficult conversations with your clients regardless of how well the fund has done.

One way of successfully tackling the issue of cost is to use passive investment vehicles rather than active funds in the construction of multi asset portfolios. Examples of this in the Fund of Fund space include 7IM's AAP range where TERs are far lower with the 7IM AAP Balanced Institutional Fund coming in at 0.61%. Unfortunately the cumulative performance of this fund compared to the IMA Mixed Investment 20%-60% Shares (the sector formerly known as Cautious!) has been somewhat average since launch in March 2008 and has led commentators to question whether the use of passive funds in multi asset solutions brings any advantage. This must be music to the ears of the active fund managers.

Solution?

Unfortunately this issue of client cost has not been resolved by the recent emergence of Wrap based Model Portfolios offered, it would seem, by just about every Discretionary Fund Manager known to man. Whilst they may offer a more complete solution across the full spectrum of risk, they do nothing to address the issue of cost. In fact I would argue that in the main they are more expensive Fund of Funds without the tax efficiency of the OEIC or Unit Trust wrapper. In the main the underlying strategies are built around actively managed funds and so the combined TERs are still relatively high with an additional "Management Charge" bolted on for good measure. The emperor is in town and he's wearing some rather natty new threads…..

Again my view is that once the fund charges, management fees, wrap fees and adviser costs get north of 3% then clients will question the value being offered. This will be particularly so for lower risk clients where, by the very nature of the asset allocation required to reduce risk, high annual returns are unlikely and therefore a 3% total annual charge could quite easily reduce the net annual return achieved by the client to 3% as well…awkward!!

The underlying problem in all of these off the peg multi asset solutions is that there are too many mouths to feed. Where there is an IFA, an investment manager and underlying fund manager all wanting their pound of flesh from the client there just isn't enough to go round particularly at the lower-risk end of the spectrum. Using lower cost Index Tracking Funds and Exchange Traded Funds might help a little but in reality something else has to give in order to make the charges/return balance more acceptable to clients. No IFA who has spent the past 18 months devising a profitable RDR proof adviser charging proposition of 1% per annum allied to a third party run multi-asset investment proposition wants to find themselves under pressure to reduce their advice fees after the first round of client annual reviews.

The obvious solution is to cut out the "middle man", the DFM or Fund of Funds provider. As well as the obvious cost reduction there are other significant benefits to this approach in that the client is under no illusion as to why they are paying the IFA a higher fee and there is no chance of them being seduced into the advice services offered by more and more Discretionary Fund Managers these days. The downside is that the due diligence and experience required to manage an in-house multi-asset investment proposition will probably require the full attention of an IMC qualified individual at some considerable annual cost.

Insourcing

There is an alternative multi-asset solution which I think goes a long way to solving all of the problems outlined above and which should prove equally attractive to both active and passive devotees as it involves the active management of asset classes using passive funds. Rather than outsourcing the investment management function to a third party the IFA "insources" the intellectual property required to construct and maintain their own range of wrap/platform based model portfolios.

The portfolios benefit from low-frequency/high-duration tactical asset allocation which makes them ideal for IFAs with advisory permissions as well as those with discretionary powers as changes are infrequent and long lasting. Every month the IFA receives an updated position for each of the portfolios and updates the model on the wrap/platform accordingly. Clients can be rebalanced back to the appropriate tactical position at the frequency of their choice and they are left in no doubt that the IFA is earning his (increased) fee by undertaking all of this work on their behalf.

Fixed Fees

So far so similar to many of the solutions outlined above so what I hear you cry makes this so different? Well, as opposed to every other outsourced solution where each individual client pays for the investment management advice, this service is paid for by the IFA firm through a fixed monthly fee calculated by reference to the number of Registered Individuals (RIs) at the firm and without reference to the value of assets allocated to the portfolios by that firm.

With subscription fees starting at £500pm + VAT this is an extremely cost effective solution and with underlying portfolio TERs of 40-50bps the actual charges the clients see are exceptionally low even allowing for a 1% adviser charge.

Whilst this approach is pretty unique at the moment I predict that there will be a rise in demand for this type of fixed fee pricing for investment management especially if IFAs begin to feel the squeeze on their own fees!