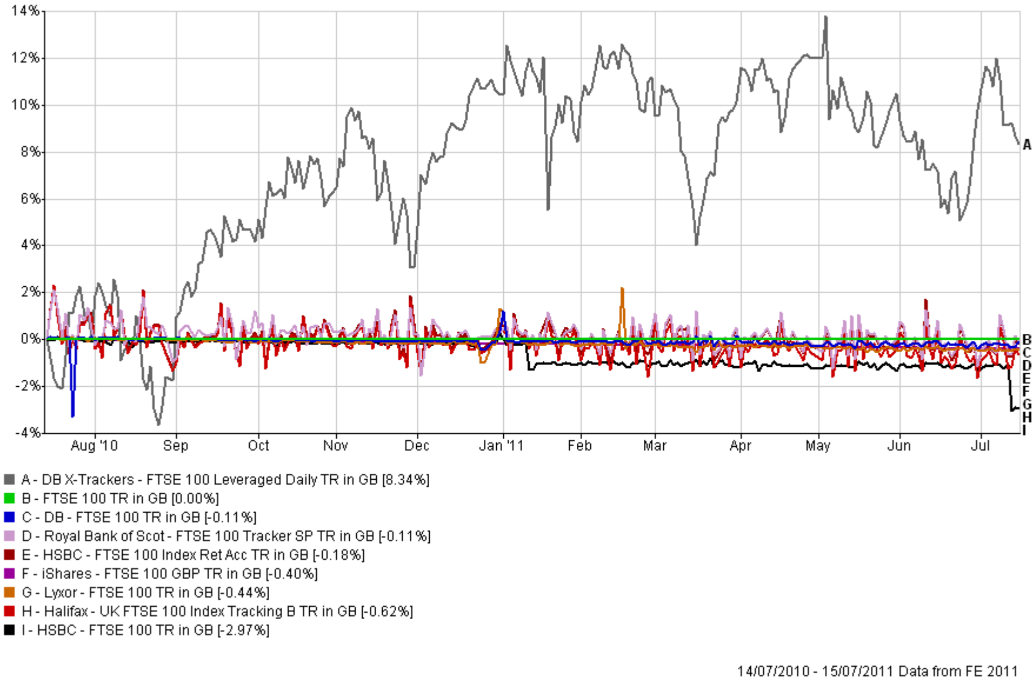
THE GROWING TREND IN PASSIVE INVESTING AND THE EFFECTS IT WILL HAVE ON IFAS

In its purest form an effective multi-asset, risk-graded, asset allocation strategy should in my view (where possible), utilise passive funds to fulfil each of its specific asset class investment requirements. How else can you be sure that your risk/reward integrity is not compromised by the best intentions of an active fund manager who pushes the envelope of his or her fund's mandate to try and eke out a bit of that elusive alpha.

But where there used to be a handful of passive funds to choose from to populate your opportunity set there are now hundreds! Not all of them are quite what they seem, some hold all the constituents of the index that they track, others hold assets that are nothing to do with the index or commodity that they track and are reliant on a derivative contract for their return but all share the same characteristic in that they offer low cost access to a specific asset or sub-asset class. In the early days when wraps were things your gran wore and before counterparty risk was a topic of conversation at dinner parties, the passive IFAs stock selection due diligence process would have been to find the lowest cost index tracking unit trust from a reputable firm and retire to the pub.

Not so now! Not only are there many more ways to track the rise of an index such as the FTSE100, you can actually profit from any fall....twice over if you fancy! The chart below tracks the relative performance over 12 months of a selection of funds and ETFs which have FTSE100 in their name and shows - as well as the obvious divergence from the index of the leveraged fund - just how different the end result can be from what ostensibly is an identical investment! Woe betide any adviser who does not keep an eye on their chosen tracker to make sure it is doing exactly what it says on the tin!



To add to the confusion, an IFA can these days choose to include components in their client's portfolios that they would never have dreamt of including before - Brazilian equities, Zinc, Timber, Lean Hogs, the list is seemingly endless. Add to this just about every type of fixed interest index you can think of and you could be forgiven for wanting a lie down.

So what is any self-respecting IFA to do?

One option is to delegate the responsibility to a third party either a DFM or a fund of funds manager. This might suit some IFAs - particularly those that buy into the theory that active management can lead to consistent outperformance - but for many who either don't, or just don't know, it is another daunting step. And, if you find the stock selection due diligence process too difficult, how do you undertake due diligence on the due diligence processes of the DFM or FOF Manager? What about assessing the true cost of the DFM/FOF proposition including dealing costs and underlying fund management costs?

Furthermore, whilst we may all like to think that all our clients value us for our cash flow-modelling and for remembering their favourite drink and biscuit brand at reviews, you can bet your bottom dollar that that will all go out the window if **you** cannot explain why their portfolio has fallen by 10% when “the chap at the club’s has gone up by 10%.”

Conversely, if the DFM is doing such a good job of managing your client’s portfolio, what is to stop them being tempted to look at their financial planning arm? (if they haven’t got one yet they will have one soon) Unlikely perhaps, impossible, certainly not!

There is another option which keeps the IFA right at the heart of the client relationship. Using effective asset allocation and investing in low cost passive products is a strategy that is consistently proven to deliver results and so is becoming increasingly popular but herein lies the problem, passive fund due diligence is becoming as complex and costly as that for active funds – AMCs, TERs, Tracking error, stock lending policies, counterparty strength, liquidity, collateral quality, base currency, tax treatment, etc.

By “insourcing” from a firm that specialises in this area, IFAs can construct and maintain their own range of risk-graded, multi-asset model portfolios on the platform of their choice. The proposition must be backed up by robust, independent research with a bespoke Investment Manual detailing the full methodology behind the top-down approach to the construction of the portfolios alongside thorough due diligence on the passive or active (yep sometimes this can be the best option) stock selection criteria used to fulfil each asset class requirement.

The benefit of this top-down approach (with fund selection the last rather than the first consideration) is that it allows for a formal process of risk management to be effectively incorporated in your investment management service. The lower costs associated with passive funds are a happy by-product of this approach and allow the adviser greater margin to charge fees which are appropriate for the work involved in providing a high calibre investment service without imposing prohibitive costs on the investor.

Ultimately there is no right or wrong answer, but with RDR bringing the focus squarely on client charges, an independent, well researched range of low-cost, risk-graded, multi-asset model portfolios seems a very compelling proposition indeed.