

## BOUTIQUE FUND MANAGERS



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# Choosing a manager in a crowded market

**EDWINA BEST** and **AMANDA RETHUS** compares the advantages and disadvantages associated with choosing a boutique fund manager over their larger counterparts.

Late last year a major Australian bank announced the establishment of a boutique incubator division to help expand the company's presence in the boutique space.

Why would a large investment bank with a great brand set up another differently branded funds management company?

For the past two decades, quality investment management teams have developed within primarily large financial institutions, but many of these fund managers have been leaving to establish their own boutique firms. They move to capitalise on their success in the institutional environment, often with initial funds under management provided by a former institutional client. The fund manager generally owns and runs the business.

With the trend continuing, what should financial planners make of this? Are small boutique

fund managers able to deliver or are there more issues to consider for a financial planner when allocating investment funds?

Has the four-year bull market in Australia given rise to the extensive number of boutique operations starting up or is there real merit in what boutiques can offer over economies of scale?

The term 'boutique' suggests up-market exclusivity on a small, personal scale.

Boutiques do tend to be small in size, especially at the inception stage, and each house is generally identified by one or two key individuals who own and run the company, specialising in single asset classes, often focused around equities. Boutiques typically have less than \$1 billion under management.

Another defining feature of boutiques is independence from the influence of parent or related

companies within the same financial group.

However, the recent success of boutique operations has also led to businesses being developed to house or incubate boutiques as a unique business proposition.

Perennial Investment Partners and Treasury Group are two of the better-known operators using this model in the Australian market.

Perennial uses a single brand and the Treasury Group uses individual branding such as Global Value Investors (GVI) and Investors Mutual.

The number of boutiques has increased dramatically in Australia in the past 10 years and the general perception is that boutique managers have had more success in achieving outperformance.

Hence boutique fund managers have recently attracted a significant slice of funds under



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management and large institutions are developing strategies to secure a piece of the action.

Barrie Dunstan reported in the *Australian Financial Review* in December 2007 of the arrival in the Australian market of Affiliated Managers Group (AMG), a listed US investment firm.

This is a significant vote of confidence in the boutique sector of the Australian market, as the firm focuses entirely on acquiring small or 'boutique' fund managers, formerly in the

US only, but now with a focus on Australia and Europe.

Sean Healey, the chief executive of AMG said in the article, "There is something special about the investment and operating culture of boutique managers which should be preserved after any transaction..."

In other words, boutique operations should never remove what makes them different from large scale organisations, and the single biggest factor here is equity ownership.

For example, in the National Australia Bank's (NAB) boutique incubator the arrangement is NAB owns 51 per cent and NorthWard Capital owns 49 per cent, with a view that the investment team will eventually own a majority holding.

To ensure survival and success, boutique fund managers have to differentiate and carve out a niche for themselves. This is done primarily by way of specialisation in specific asset classes or investing philosophy and styles.

The investment philosophy

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of boutiques can have an important influence on their investment focus.

Most large and more established companies tend to have multiple investment disciplines compared with boutique fund managers, which generally have only a single investment discipline.

This may work for the boutique fund manager when the market is performing in line with its investment style, however, if the market turns, a boutique manager may have limited flexibility.

Larger fund managers can offer the opportunity to invest in different investment styles and products.

The current sub-prime crisis, which is causing significant difficulties for managers in this sector, provides an example of when product and asset class diversification is of benefit.

#### What is the key to boutiques' success?

It is claimed that the decision-making process is a lot more efficient in a boutique operation given a generally flatter hierarchy structure, which should enable investments to be executed more quickly.

Small fund size also allows fund managers to be nimble; they have the ability to move in and out of markets quickly in response to market events.

The relatively smaller fund size also enables the fund manager to skew the investment focus away from large capitalised companies and to adopt a more bottom-up investment approach.

As such, stock picking and the ability to frequently take advantage of price anomalies may be

more important than macroeconomic and asset allocation calls, which are widely practised among the larger fund managers.

Large financial groups comprising stock broking, corporate advisory, investment banking and fund management operations may be limited by conflicts of interest that are not generally present in smaller boutiques.

All of these factors are cited as contributing to investment out-performance for clients.

#### The risks for investors

However, on the flip side, boutique fund managers usually have limited resources. In most cases boutique companies have no global affiliations.



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Information technology (IT) resources may not be available, nor the services of an in-house economist or the extensive research that is available at large institutions.

Many investment decisions may not be able to be researched as thoroughly as they might be in a larger house.

Boutiques often defend this accusation with the assertion that it is better to have a smaller number of stocks very well researched than a larger number of less well researched stocks.

Larger investment houses can

offer economies of scale not available to smaller boutiques. Custody costs, IT costs and research costs can all be spread across a much larger funds under management pool.

For boutiques, the focus is usually on managing money first, marketing second and administration third.

Boutique managers risk going out of business if they suffer consecutive years of losses.

No business can run on investment performance alone – running these businesses requires focus and discipline on the marketing and client services side in order to grow successfully. That is why credible research houses put as much effort into reviewing and rating the busi-

ness (administration, marketing and sales) of a funds manager as well as their investment expertise.

Larger companies have a brand to protect and a client base, and put a lot of effort into making sure the administration and marketing communication needs of clients are met as well as the investment performance needs.

Many boutique managers outsource most back-room operations involving the administration and investment operations to third parties.

While this can free fund managers from administrative work

will implement – all the while ensuring there is no impact on clients' funds under advice.

AMG also talked about the importance of "long-term employment agreements" being a key consideration for staff in boutique organisations.

#### Looking out for ...

Boutique fund managers do not generally have an extensive distribution network or a large workforce.

A smaller team and the absence of intermediaries between the fund manager and client have the potential to translate to a closer client-manager relationship.

However, while clients might be provided with a closer relationship with senior people, they may be being distracted from the task of managing money by dealing with them.

Is this the best result for your clients?

Boutiques rely solely on income from funds under management; this provides a real motivation to perform. Large organisations may be able to lean on their parent or related companies for survival.

Many boutiques have performance incorporated into their fee structure that additionally motivates the manager.

However, this also partly explains why boutiques tend to have an absolute performance target rather than benchmarking their performance against indices.

The alignment of customers' and fund managers' interests is an important feature of any manager, and gives comfort to investors that managers stay focused on what they're paid to do, which is generating alpha.

The success of a fund manager is critically dependent on their delivery in terms of performance. Therefore, commitment and focus is critical. The fund managers' track record is their best advertisement.

What does it all mean?

Boutiques and large-scale institutions offer investors different advantages.

Are exclusivity and high profile investment managers something you can offer your clients that others can't?

Or do brand name and a global presence give your clients greater comfort?

What is important for the financial planner is ensuring that each manager you choose for your client's portfolio can meet your needs and those of your client.

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and allow better focus on investing, it can add to the complexity of sorting through potential client issues and may mean that the manager has less control of the outcomes.

For boutique managers, there are also apparent weaknesses in terms of key-man risks.

While the owner-manager isn't likely to leave the company, if they do it is unlikely someone else will be available to step in and replace them.

One of Australia's most successful boutique operations, Platinum, has been recently downgraded by Lonsec Research for their flagship asset class, international equities, due to the departure of the fund's leading portfolio manager.

This, of course, is also a risk in large organisations.

The recent defection of almost the entire Suncorp Australian equity team to set up a boutique through the Pinnacle Partners structure means investors and planners are faced with the decision of whether to move clients' money to follow the talent or to see what replacements Suncorp