PRIVATE CLIENT INDICES

Do DFMs Offer Value For Money?

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"Fairness in life and in business is so important. It helps us keep level headed, and striving to change the world for the better. From human rights to industry competition, fairness makes the world go round, and ensures we never settle for anything other than what's right." Richard Branson, Entrepreneur

The FCA Asset Management Market Study Final Report was published in June and some of the main findings were:

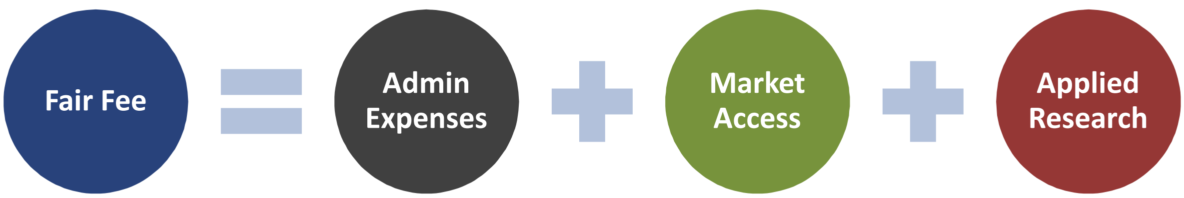
- There is some evidence of a negative relationship between net returns and charges
- Investors should understand the total cost of investing
- Value for money comes in the form of risk-adjusted net return

At ARC we entirely agree with the FCA that value for money for investors comes in the form of risk-adjusted returns after all fees and charges. Indeed for the last twenty years our ARC Diamond portfolio performance rating system has explicitly targeted risk-adjusted returns versus the manager defined benchmark. Similarly, the ARC Private Client Indices are compiled net of discretionary fund manager (DFM) charges so private clients can compare their portfolio performance versus peers on a net of fees and charges basis. But how can a private client assess whether the fees and charges being levied on their portfolio are fair and reasonable?

ARC Fair Fee Formula

The ARC Fair Fee Formula provides a framework for any private client investor to assess whether the cost of investment levied by a DFM is fair and reasonable.

The Fair Fee Formula is simple in construct and recognises that price and value are different. A fair fee is not the same as a low fee. A fair fee ensures that the provider of a service receives remuneration for the services rendered that the recipient of those services deems to be reasonable. To paraphrase Aristotle, the investor is best placed to judge the value of services rendered.



ARC breaks down the cost of investment into three core elements: administration expenses; market access; and applied research. This framework allows every investor to consider precisely what services are being provided by their DFM and to allocate a reasonable cost to each service element.

Administration Expenses

These expenses relate to the administrative and regulatory burden borne by a DFM in operating an investment portfolio. Some of these expenses are unavoidable. Some are optional. But all should be considered as "flat expenses" rather than "ad valorem fees". Examples include: suitability assessments; know your client procedures; provision of statements and valuations; tax computations; liquidity management; receipts and payments; and client correspondence and meetings.

The common factor here is that the cost of these activities can be thought of on the basis of time spent and can be calculated accordingly. Clearly each private client has a unique set of administrative needs and each DFM has its own break even charge out rate. As a rule of thumb, administration expenses are likely to be in the range of £2,000 to £10,000 per annum.

Market Access

The cost of market access can be thought of as the cost of replicating the neutral asset allocation of a portfolio through purchasing, holding and periodically re-weighting a basket of index tracking funds or exchange traded funds. With index tracking funds available for almost every conceivable asset class, it is possible to estimate the cost of market access for almost any investment strategy. It should be noted that the cost of market access is not merely the cost of the index tracking funds being purchased but also needs to include trading costs and custody costs.

The cost of market access is usually ad valorem based rather than an amalgam of fixed charges. It is most easily calculated when the cost of custody is separately quoted by the DFM and when a discretionary portfolio has been allocated an agreed benchmark or neutral asset allocation. However, based on the expected risk profile and/or target return of a portfolio, the cost of market access can be always be estimated and compared with industry norms.

Applied Research

If a discretionary portfolio follows a passive mandate (seeks to track a defined benchmark or composite benchmark) then the cost of applied research is assumed to be zero. All costs of operating that “passive” investment strategy should have been included in the first two factors. However, most DFMs aim to add value for their clients by seeking to out-perform the agreed benchmark, be it a composite of market indices or a target absolute return.

There are three main ways that DFMs attempt to achieve this objective for their clients: tactical asset allocation; judicious underlying fund selection; and superior stock selection. The combination of these three elements is sometimes called alpha (the returns from market access being referred to as market beta). To generate positive alpha (or in plain language, to outperform a passive portfolio) by design rather than by luck requires skill; and skill relies upon applied research.

But how much should an investor pay for accessing applied research? The principle adopted by ARC is that there should be an equitable division of the potential benefits from applied research between those providing the intellectual capital and those providing the investment capital. This outcome can theoretically be achieved through an agreed performance fee in the form of X% of the outperformance of a given (investible) benchmark. It can be thought of as the DFM agreeing with the investor the “Value Capture Ratio”. By way of example, if it is agreed that the rewards from applied research should be shared 60:40, the investor would retain 60% of the outperformance of the benchmark and the performance fee would be 40% of the outperformance of the benchmark.

In practice, such performance fee arrangements are rare for private client discretionary portfolios due to the income uncertainty inherent in such an arrangement for the DFM and the fact that private clients worry that the overall fee taken by the DFM may be well in excess of more conventionally constructed fee levels.

A practical alternative is to consider the potential for out-performance of a benchmark inherent in the investment style being employed by the DFM. Out-performance potential is a function of the size of the active bets made by the DFM. The greater the divergence between portfolio composition and benchmark construction, the greater potential that portfolio has to out-perform (or under-perform) its benchmark.

Thus, in the absence of an agreed Value Capture Ratio, the quantum of fee payable for applied research can be calculated as a function of the actual (or expected) size of active bets by the DFM, which is measured statistically by tracking error. The selection of the correct multiplication factor for any given portfolio requires an understanding of the nature of the investment philosophy and process of the DFM and the specific portfolio mandate. However, as a rule of thumb, a factor of 0.25 can be used.

A Worked Example

So how does the ARC Fair Fee Formula work in practice? Assume a discretionary portfolio of, say, £2 million, following a composite benchmark of 60% world equities and 40% UK bonds with an expected tracking error of 4% per annum and a total cost of investment of 1.75% per annum.

After discussion with the DFM the cost of administration is estimated to be, say, £4,000. This cost covers, inter alia, quarterly valuations, semi-annual manager meetings, preparation of a tax report each year and organising sporadic payments.

The cost of market access is calculated as being 40 basis points per annum representing a blended ETF cost of 20 basis points, custody fees of 10 basis points and re-balancing costs of 10 basis points.

Using a tracking error multiplication factor of 0.25 suggests an acceptable applied research fee of 100 basis points (4% x 0.25).

Fair Fee	=	Admin Expenses	+	Market Access	+	Applied Research
1.60%	=	0.20%	+	0.40%	+	1.00%
£32,000	=	£4,000	+	£8,000	+	£20,000

Thus, in this example, the total cost of investment for the portfolio is £3,000 or 15 basis points higher than the ARC Fair Fee Formula indicates. Note that the ARC Fair Fee Formula as calculated above does not take account of actual outcomes but rather assumes that future out-performance is a function of the quantum of applied research.

Conclusion

As Richard Branson observed, fairness in business is critical and the FCA's recent Asset Management Market Study highlights that many investors do not know how to assess whether their investment manager is delivering value for money. But, cheap is not the same as fair. The ARC Fair Fee Formula allows each investor to assess whether they are receiving value for money from their DFM by unbundling the service elements being provided.

Research costs money but brings opportunity. A fair fee is one that delivers value for money, where each DFM is paid a fair price for providing investment administration services, financial market access and for applying their investment knowledge and skills to enhancing an investor's wealth.

For further information:

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