Outsourcing to DFMs: Where next for the industry?

The Panel

GILLIAN HEPBURN

DIRECTOR, DISCUS

Gillian has over 25 years' experience within financial services and is a Director of DISCUS which she launched this year with business partner Abbie Knight (née Tanner). DISCUS was developed in response to the increase in the use of outsourced investment propositions by financial advisers.

Following many years at Standard Life, latterly as a BDM for the platform, Gillian set up her own consultancy business (Quality Platform Solutions). The business offers consultancy services, including due diligence on platforms and investment propositions, and has an extensive range of clients including financial advisers, life companies and platforms.

STEPHEN GAZARD

MANAGING DIRECTOR, SESAME BANKHALL GROUP

A financial planner by background, with subsequent experience in the full business cycle from launch through growth, merger, acquisition and PLC listing, Stephen joined Sesame Bankhall Group in 2013. With a broad background from adviser through to operations, change management, business transformation, risk and commercial, he is ideally placed to lead the Executive team and ensure that SBG remains at the forefront of financial services. Outside of SBG Stephen is Vice Chairman of the leading Meningitis Charity 'MeningitisNow'.

BARRY NEILSON

BUSINESS DEVELOPMENT DIRECTOR, NUCLEUS

Barry is Business Development Director at Nucleus, the financial adviser-owned wrap platform, where he looks after the sales, account management and communications teams.

Before joining Nucleus in January 2010, he spent 14 years working with financial advisers in a range of senior investment sales and proposition roles at F&C Investments, where he was the architect behind their pioneering range of risk graded investment funds. While at F&C, he also created their innovative Trust Review Service proposition.

LAWRENCE COOK

DIRECTOR OF MARKETING AND BUSINESS DEVELOPMENT, THESIS ASSET MANAGEMENT

Lawrence brings a wealth of experience in distribution and business development. Working for Standard Life for over 25 years, he has wide experience of developing business primarily with professional intermediaries. Prior to joining Thesis, he managed the Bristol operation for Towry Wealth Management specialising in advice for private clients in association with lawyers.

PAUL MILES

PRINCIPAL, SILVERBACK CONSULTANCY

Paul has been working within the financial services sector for some time, having run his own financial adviser firm for 20 years where he was an early adopter of platforms and the outsourcing of an investment proposition. Before setting up his own consultancy business, for 15 years he worked within the platform and DFM sectors where amongst other things he was responsible for the production of due diligence documentation and supporting the development of managed portfolio services.

MARK GEE

ASSOCIATE DIRECTOR, MRM

Mark has over seven years' experience in corporate and financial services PR. He has advised a range of leading organisations including Nucleus, Cofunds, Sesame Bankhall Group, Thesis Asset Management, SEI Wealth Platform, Legg Mason and Brewin Dolphin. Prior to working in PR, Mark covered business and general news as a reporter at the Hull Daily Mail.

The Issue

Since the RDR, there has been a rise in advisers outsourcing their investment propositions and this trend looks set to continue. Nucleus, for example, conducted some research with around 200 of its users earlier in the year and found that almost half (47%) were looking to increase their use of discretionary fund managers (DFMs) in the next 12 months. To debate this topic further, MRM was joined by an expert panel to assess the opportunities and threats for consumers, advisers and the wider industry.

Greater transparency

MARK GEE (MG): There have been calls to make quantitative data provided by DFMs easier for advisers to compare and assess. What steps can the industry take to improve this process?

GILLIAN HEPBURN (GH): There isn't really a simple solution. The real issue is that advisers use a mix of qualitative and quantitative measures to review DFM propositions and this can make direct comparison a challenge.

While better ways of comparing charges and performance would help, they are usually not the only factors when it comes to identifying the most suitable proposition for a client. There should be more standardisation of the disclosure of costs within funds, including managers' fees and other operational costs as well as dealing costs.

LAWRENCE COOK (LC): Third party providers like ARC and FE Analytics enable advisers to compare DFMs on a like-for-like basis, although whether the comparison points show exactly what the adviser is looking for is another matter. But comparisons are still difficult, as not all DFMs subscribe to ARC and not all portfolios can be analysed in FE Analytics. I do think it would help advisers if there were agreed standards to which all DFMs reported. For instance, DFMs could all use the same illustrative portfolio values and disclose the previous 12 months of transaction costs that would have been applied to a portfolio of each value.

LAWRENCE COOK, THESIS:

If everyone is obliged to 'pay to play', this could create unfair cost barriers to entry, especially for start-ups and niche wealth managers. The last thing we want to do is stifle innovation.

MG: Should it be compulsory for a DFM to subscribe to an independent service such as ARC so advisers and customers can adequately measure performance?

LC: Obviously anything that helps advisers make better, more informed decisions for their clients is a good thing. But it shouldn't be compulsory. If everyone is obliged to 'pay to play', this could create unfair cost barriers to entry, especially for start-ups and niche wealth managers. The last thing we want to do is stifle innovation. Plus we all 'subscribe' to the FCA in a sense already, so one option to consider would be having regulator-defined reporting standards, as is currently the case for reporting the performance of authorised funds to retail clients.

MG: Gillian, how do you see it?

GH: I don't think it should be compulsory, but measuring performance of bespoke portfolios in particular is a challenge. If portfolios are truly bespoke and designed to address specific client requirements such as an investment mandate, financial goals or a risk profile then it's difficult to compare performance other than against the agreed client objectives.

PAUL MILES (PM): I certainly do not think it should be compulsory but if the DFM wants to be in the financial adviser market, they would be wise to consider it. It's a case of making it as easy as possible to do business together.

GILLIAN HEPBURN, DISCUS:

While better ways of comparing charges and performance would help, they are usually not the only factors when it comes to identifying the most suitable proposition for a client.

MG: Gillian, how do you think advisers can safeguard against conflicts of interest such as overtrading and double-charging where the DFM has its own fund range?

GH: This is an interesting question, as many of the advisers I work with particularly want to understand the level of usage of the DFM's own fund range. Clearly the right thing to do is not to charge the DFM fee on managing own funds to avoid double charging. But it's not as simple as that. For many DFMs, the use of their own funds can increase diversification and enable clients in model portfolios to access securities within a fund structure to minimise dealing charges and potentially give tax advantages in areas such as CGT.

MG: Should advisers be doing more to hold DFMs to account?

STEPHEN GAZARD (SG): Yes, it is important they do so because that will minimise their risk. An effective way of doing this is to set out their parameters clearly at the beginning – this can prevent misunderstandings further down the line. They really need to understand what type of involvement they want to have with a DFM from the outset.

MG: Lawrence, what are your views on this?

LC: Advisers should be clear about what they expect from a DFM and hold it accountable for the particular service it provides and whether it is actually delivering the appropriate solution. During the process, advisers should be considering – amongst other things – key performance indicators, the warning signs that would trigger a DFM review and how frequently partnerships are typically reviewed.

Risk and return profiles

MG: How can we ensure the risk mapping process is robust and represents the best outcome for the customer?

PM: In my view, the risk mapping should be carried out by the DFM and not paid for by the DFM to a risk mapping provider. Part of the due diligence process is for the financial adviser to understand on what basis their clients' money will be managed to take risk into account; this is arguably the most important aspect of investment.

BARRY NEILSON, NUCLEUS:

I think we might see more instances of DFM businesses which are either evolved or created to serve the needs of a small number of advisers.

LC: DFMs should discuss with IFAs how different risk mapping tools interpret their portfolios, and what assumptions have been made both by the risk mapping provider and by the DFM itself. In turn, IFAs should be prepared to disclose their own assumptions about risk and how they talk about it with their clients. If there is a disconnect between what each party deems as 'safe' or 'risky', then expectations can be quite far removed from the actual experience of the client. So a full disclosure of the basis on which any assumptions have been made is necessary, both at the time of initial investment and throughout the period the client stays invested.

MG: What can DFMs do to ensure the customer is getting value for money?

GH: This is all about defining the requirements at the outset and ensuring clarity around what actually constitutes 'value for money'. There needs to be a good understanding of the actual cost and it's important to set client expectations that value isn't just about investment performance. However, there are other factors which determine value for money, such as service and the provision of quality information, particularly during times of market volatility.

MG: Lawrence, what do you think?

LC: Key considerations are a robust, scalable investment process and a credible DFM proposition. Smaller DFMs should be able to demonstrate to IFAs that they don't carry key person risk, and that their resources are sufficient to maintain a reliable service. There should be a variety of portfolios to support the development of centralised investment propositions as well as bespoke services such as dealing with probate and legacy assets.

They need to provide clear and understandable reporting and timely commentary on market events so that IFAs are fully equipped to help their clients when needed. DFMs should be experienced in working in partnership with advisers and should be focused on client outcomes. This might mean providing IFAs with supporting material for their clients, or hosting educational events that are more than just a sales pitch.

MG: And Paul, what do you see as the most important factors to consider in whether the customer is getting value for money?

PM: For a bespoke offering, service is a huge aspect as well as managing the money to the agreed parameters. For a model portfolio offering, it also needs to be competitively priced.

PAUL MILES, SILVERBACK:

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MG: Are DFMs making it easy enough for firms to make adequate comparisons?

SG: This is a space that has seen growth and consolidation in recent years, so both DFMs and advisers are on a learning curve. DFMs can only answer the pertinent questions if they are asked them, as can adviser firms. However, there is always the question of 'unknown unknowns': areas that might be overlooked. A well-defined checklist should arm both sides with the information they need to make meaningful comparisons.

MG: Paul, do you agree?

PM: I think many are trying their best. Outsourcing to risk management specialists such as ARC is certainly a good starting point but I do have concerns over the impartiality of a service which is funded by DFMs. I'd be careful about relying too heavily on them for comparison purposes.

MG: Barry, what do you see as the biggest threats and opportunities to DFMs from a commercial perspective?

BARRY NEILSON (BN): I think we might see more instances of DFM businesses which are either evolved or created to serve the needs of a small number of advisers. A number of advisory businesses who know each other quite well but don't necessarily want to seek their own DFM permissions might get together to help set up and seed assets into a DFM. And that just plays to the whole theme around whoever best understands the client is in a position to design a more modern, relevant proposition that meets the needs of those clients and reduces the cost.

Regulatory issues

MG: Do you have any worries about advisers using DFMs? - i.e. advisers rushing to outsource without adequate due diligence?

SG: Outsourcing to DFMs is always going to be a hot topic with the regulator because of the level of risk involved. If a firm hasn't undertaken correct due diligence, or inadvertently steps over the boundaries into areas that are outside their remit, they could find themselves under the regulator's scrutiny.

MG: Barry, what do you think?

BN: We're getting a real sense that the standards for due diligence on DFMs probably have to get higher. This is a learning curve for advisers really, and many are still fairly early on in the process of adopting DFMs on platforms. So I think we'll see the level and depth of questioning around due diligence on DFMs evolve in the coming years.

MG: And what about you, Lawrence?

LC: I think there may actually be more of a risk in the opposite direction! For instance, IFAs who manage their clients' portfolios on an advisory basis might, year on year, see ever more variants on the original model and an increasing number of portfolios drifting away from their mandate. These advisers would almost certainly be better off thinking about using a DFM.

MG: Gillian, what do you see as the biggest threats and opportunities to DFMs from a regulatory perspective?

GH: MiFID II could be a challenge in terms of clarity of charging and unbundling research from charges – and despite the recent Brexit vote – any regulation due to be implemented in the next two years will still go ahead. Undoubtedly further communication on TR16/1 [a report published by the FCA in January which focused on assessing suitability and the role of due diligence in outsourcing] could potentially provide threats or opportunities. It would also be remiss not to consider whether the further FAMR consultation may also have an impact.

STEPHEN GAZARD, SESAME BANKHALL GROUP

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MG: Stephen, what is your overall view on how good advisers are at doing due diligence on DFMs?

SG: At the moment, we're seeing a complete mixed bag. We are concerned that some advisers and firms are unsure about just how much due diligence they need to do when it comes to looking into outsourcing options. This is a real worry given the direction of travel we have seen since RDR. Some advisers we speak to erroneously believe outsourcing eliminates risk. They need to be aware that it is the specific agreements between the DFM and the adviser which will dictate where the risks and ensuing responsibilities lie.

MG: Barry, what procedures are in place to ensure compliance with regulatory issues and updates?

BN: The regulations in place around DFMs are quite interesting because the FCA has so far been very focused on the fact that the adviser still has the responsibility for suitability of third party products. So if an adviser is outsourcing to a DFM, the adviser still has responsibility for making sure the DFM is being used with the right clients in a manner that looks like there is no potential for shoe-horning.

MG: What do you see as the main risks for advisers of not doing adequate due diligence?

SG: The main danger is detrimental outcomes for clients, if they haven't gone through the appropriate due diligence and have failed to understand what the firm needs. In the worst case scenario a client's portfolio can be drastically changed – and that is, of course, something both the adviser and the DFM want to avoid. Not only could this lead to pressure from the regulator, it could also damage the reputation of the adviser firm.

MG: Lawrence, is there anything you want to add?

LC: A major risk is that the adviser will then communicate to their client an expectation for the way the client's money will be managed that is completely different from the reality – leading to potential disappointment all round. Advisers need to know what they are letting their clients in for, and DFMs need to know what is expected of them. Matching expectations as closely as possible to actual outcomes is largely what establishing suitability is all about.

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