Vertically integrate or die: advisers becoming institutions

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Vertical integrate or perish... **Illustration Sam Bennett**

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About a year and a half ago, Profile Financial Services changed from being just an advice practice to an investment management and advice business.

Sarah Abood of Profile Financial **Photo Jim Rice**

The Sydney-based firm, which has four planners, has had its own Australian Financial Services licence (AFSL) since 2002 and has a proud lineage as an advice business dating back to 1989. However, 16 months ago, Profile started building its own multi-manager funds.

To get to this point, the practice's managers have been busy. They have registered as a managed investment scheme (MIS), hired a full-time head of investments, set up an investment committee and selected an asset consultant that also serves as responsible entity (RE).

A structure that was a year in the planning finally came to fruition in April last year, and now about 70 per cent of the $300 million in client funds is managed within Profile's own in-house multi-manager and multi-asset products.

Growing numbers of advice practices in Australia are either considering taking over more of the investment of their clients' assets or have already gone a long way towards doing so, primarily under multi-manager structures. These firms join the few that have been doing it for quite a while, including ipac securities, which had one of the leading independent multi-manager advice models until it was acquired by AXA in 2002 and later folded into AMP.

Fiducian managing director Indy Singh started Fiducian Portfolio Services in 1996; it was one of the first independent manage-the-manager structures and it still remains.

Since then, consolidation has led to the market dominance of vertically integrated financial services institutions, and a majority of AFSLs are now owned by product manufacturers, which invariably have their own multi-manager or fund-of-funds structures built in.

At last count, 10 per cent of the advisers in the industry were operating under an independent AFSL, while 33 per cent were under a licence that had an institutional backer with less than a majority stake, according to Investment Trends data; 44 per cent operated under wholly owned "aligned" dealer groups and 13 per cent were in bank branch structures.

Although research firms such as van Eyk, Lonsec and others – in addition to the traditional multi-manager providers, such as MLC – have positioned themselves to provide a range of model portfolios and multi-manager fund options to suit clients with varying risk profiles, and independent financial advisers (IFAs) have continued to show interest in taking more of the investment management function in-house.

For the chief executive of Profile Financial Services (PFS), Sarah Abood, the decision for her practice to "take a view on investing" came about because of what she saw as the disconnect between risk profiling and strategic asset allocation, highlighted in her clients' portfolios in the aftermath of the GFC.

Abood believes that constructing investment portfolios using a mix of different asset classes that are said to have consistent and predictable return characteristics, and matching them with an investor's risk profile, is a flawed approach. "We wanted to adjust our clients' portfolios far more frequently than they were being adjusted under the old [outsourced multi-manager] model, and as our investment philosophy grew over time, we were not happy with what seems to be the commonly held view that risk profile equals asset allocation," she says.

PFS now has four categories or "buckets", which the firm's investment committee actively manages and partner Select Asset Management implements.

For Abood, the new approach allows the group to provide clients with access to the best possible advice proposition.

In addition to the disconnect she perceives between risk profiling and strategic asset allocation, Abood is not convinced multi-managers have the ability to move out of their own funds quickly when necessary.

"Our experience has been, if you go to a manager that has, say, a big Aussie equities business, it's hard for them to move away from [that] and dial up international," she says.

Philip La Greca, technical services director at administration services provider Multiport, recognises the growing trend towards investment functions among IFAs.

"Licensees are certainly thinking about how they can account for the missing revenue that could happen as a result of FoFA [the Future of Financial Advice legislation]," he says. "They're asking themselves: 'Can I take on some of the investment responsibility?' "

Although some components of FoFA are still uncertain, the potential end of volume rebates from product issuers to dealer groups is expected to have an impact on the revenue and valuation of advice businesses. Investment functions have appeal as a way to earn back some of that lost income. However, not all advice businesses have the skill to run multi-manager funds, and taking control of investment management may create conflicts of interest. "You have to ask yourself what's happening here and whether IFAs are just replicating what exists in the vertically integrated model," La Greca says.

The chief executive of Select Asset Management, Andrew Fairweather, says the conflicts that potentially arise from multi-manager structures at IFAs are different to those that come up at institutions. For IFAs, the conflict isn't at the portfolio level but within individual products, he says.

If advisers are selling their own funds at prices substantially higher than consumers pay for an off-the-shelf product that does the same thing, then "that's where they'll come unstuck", Fairweather says.

The Australian Securities and Investments Commission says it's "aware of an emerging trend in the market where independent AFS licence holders are becoming either platform operators or responsible entities".

An ASIC spokesman mentioned work the regulator has done in identifying conflicts, in both the white labelling of investment products and in the "responsible entity for hire" business model.

"We are aware of the conflicts of interest that may arise where advisers direct clients into in-house products through vertically integrated structures," ASIC states in its 2010-11 Annual Report.

"AFS licensees have an ongoing obligation to manage their conflicts of interest and, in the future, will need to ensure that they act in the best interests of clients when providing financial product advice and address any conflicted remuneration issues arising from such relationships as a result of the incoming FoFA legislation."

Select and other firms, such as Mercer, provide what Fairweather describes as the "virtually integrated" model – that is, they offer components of an investment management offering that independent financial advisers can pick and choose from to build what could resemble a vertically integrated financial services business.

Taking a "best solutions approach" to the investment management component is a key part of creating a successful internal multi-manager structure, Select chief investment officer Dominic McCormick says.

In terms of addressing the potential bias on the product level, PFS's Abood says her clients still have the option of choosing alternative strategies and similar external products, instead of the firm's own investment options.

Van Eyk's Blueprint multi-manager fund options are available on PFS's recommended list. Also, some of PFS's clients have a more passive approach and they don't need to be put into the house funds.

However, Abood admits the "house view" on investing is shared by the advisers and now permeates the business. The take-up "exceeded our expectations", as 70 per cent of clients' funds are now invested in the products. "We continually compare our funds with other [total return funds that have similar target dates]," she says. "And some of those [external] funds are very good but they don't give us the control over manager selection and when you look under the hood, they're investing in a lot of their own funds," she says.

Fairweather says under the "virtually integrated" model, advisers may take 100 per cent of the investment management fee but then pay separately for custody and other components, such as asset allocation. Under this scenario, an adviser might look to dial the advice fee up or down depending on the cost of the service, so it keeps the end expense the same for the client.

Advice businesses with an institutional-style investment management hub, such as Centric Wealth, provide clients with an alternative to their own in-house multi-manager funds, but back their investment capabilities over what's in the market.

Centric Wealth's advisers have the ability to use external funds but generally stick to in-house options because they offer more diversity, says Kieran Canavan, Centric Wealth's head of products and services.

Centric has a managed discretionary account (MDA) licence, and advisers who use the group's platform to access assets outside the corporate structure use a statement of advice, he says.

Outside the institutionally owned dealer groups, there are very few advice businesses in Australia that should consider taking any part of the investment process in-house, says Robert Camilleri, an investment manager with Realm Investment House, which manages customised fixed-income funds in partnership with advice firms.

"There are a lot of advisers that want to be investment managers but there are very few that have the ability to do it in their own right," Camilleri says.

"There's a limited number of practices that could do it … You'd need at the very minimum $100 million in funds under advice; you'd need to set up an investment committee and have your own AFSL, usually with around four or five advisers," he says. "You can't do it with just one person sitting in a room."

Abood believes PFS, with about $300 million under advice, is on the cusp of being too small, based on her experience setting up the investment process and the pooled funds that underlie the structure. However, there's no turning back on the investment model she has built into the practice, because to her, all the alternatives seem conflicted or broken – and don't stack up.

McCormick notes that most advice businesses considering starting funds would be unlikely to act as their own responsible entity because of the cost and given the numerous RE-for-hire options on the market.

Angela Ashton, a consultant with Fundhost, says registering a fund costs at least $20,000 if it is in partnership with another party that has built funds before, and closer to $50,000 for groups just starting. She says the expense and ongoing compliance issues involved in taking over investment management functions can be onerous but are essential.

"If you're going to be an investment manager, you need to resource the area properly," she says, adding that an independent investment committee, a suitably qualified investment staff, a well enunciated philosophy and a well-managed process are essential.

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