INTRODUCTION

WEALTH MANAGERS STILL ASSESSING INDEX INVESTING

ETFs have yet to gain the popularity among private clients that they enjoy with instituational investors. But a combination of active and passive management could prove ideal, writes Elisa Trovato

The fast growing number of ETFs (exchanged traded funds) available to investors is perhaps the clearest signal of the relevance which the core-satellite approach – running a passive core of assets with more aggressive strategies on the fringes – has acquired in portfolio management.

Given that the percentage of active managers underperforming their benchmark can be as high as 80 per cent, there is a case for wealth managers to move to cheaper index investing in areas where active management does not add extra performance. But ETFs have not yet gained the same popularity among private clients that they have achieved in the institutional world.

There is a question whether banks are willing to give up higher margins, often in terms of front end commissions, obtainable from more remunerative funds or structured products.

However, legislation such as Mifid, the European Markets in Financial Instruments Directive, requiring banks to offer more transparency to clients in terms of fees they charge, is certainly set to have huge implications on product distribution.

The reluctance of European wealth managers to move from a commission-based model to an independent fixed fee model is one of the major hurdles preventing a higher use of index products, according to Andrew Fisher, chief executive officer at independent UK-based private and corporate wealth advisers Towry Law. "Wealth managers and private banks don't tend to use index based funds because they don't pay commissions or retrocession. I would say until they move to an independent or fee basis, they are unlikely to use them," says Mr Fisher who introduced the fee based model at private bank Coutts when he was chief executive there.

"It is hard for a very small firm to make this transition, because they don't have the capital to keep them going when they move to the new remuneration structure. On the other hand, one of the reasons big firms don't do this is because they prefer to make short-term profits, and they find it quite hard to look out to five and ten years," he says, referring to the high turnover of senior managers in big banks.

"WEALTH MANAGERS AND PRIVATE BANKS DON'T TEND TO USE INDEX BASED FUNDS BECAUSE THEY DON'T PAY COMMISSIONS"
ANDREW FISHER, TOWRY LAW

While charging a fixed fee does not guarantee the same amount of short-term profit, investors will give more of their wealth to manage and stay longer with the bank, once they understand the new proposition, says Mr Fisher.

"The fee you charge more than compensates for the reduction in commission. And, most importantly, the

"OVER THE NEXT 12 MONTHS WE THINK ACTIVE MANAGERS COULD ADD VALUE"
GARY DUGAN, MERRILL LYNCH

performance of the client has improved," says Mr Fisher. "I think there are benefits [in moving to a fee based model], but it is a leap of faith that banks and IFAs (independent financial advisers) find quite hard to do."

Towry Law, which manages £2.4bn (€3.2bn) and operates on a fixed fee basis (1 per cent annual fee), uses index funds, largely ETFs, to invest in gilts, (UK government bonds), large caps UK and large caps US equities. These are very efficient markets where it is hard for managers to add value, says Mr Fisher.

"Index investing is the most efficient way of buying beta in certain assets and it is value for money for a client," explains Mr Fisher. On the other hand, in more exoteric or more inefficient asset classes such as small cap or emerging markets or hedge funds, you can clearly add value by selecting active managers, he says. But the decision to use whatever is thought the most appropriate vehicle should be entirely disassociated from the fee or the revenue that is generated.

The percentage of the assets of a client's portfolio managed passively varies from client to client at Towry Law. It could be as high as 30 per cent for those who hold quite a few gilts, says Mr Fisher. If investors are less risk averse and involved in more esoteric asset classes, it could be 15 per cent.

MANAGING RISK

Opposing this theory, Gary Dugan, chief investment officer at Merrill Lynch Global Wealth Management in EMEA, believes the decision of employing index investing in clients' portfolios "truly comes down to risk management."

He warns about the correct allocation of risk in client portfolios and against wasting high-risk, high-fee active management on those areas where it cannot add any value.

"We take a very active view on whether to use an index or active product virtually for any asset class. There are certain asset classes where it is very difficult to add value through active management and there are other asset classes where there is a substantial opportunity," he says.

"Here you are prepared to pay a higher fee but in the pretty secure knowledge that you got to see really true good added value."

So for example in the pharmaceutical sector, an active managed fund is certainly favoured over index products. "Regionally, typically managers of US equities underperform large cap indices and therefore we are more likely to use an index product if we want to capture the S&P 500. In the Euro area, we still believe that Euro portfolio managers can add good value over the longer term, so there we would typically use an actively managed portfolio."

A small percentage of European equities are invested in ETFs for tactical asset allocation, as it is a very cheap way to go over or underweight European equities in the short term, given that many private clients don't use futures, he says.

Mr Dugan emphasises that the often reported research results on the high percentage of active managers not beating the benchmark can be the result of looking at data selectively. During certain periods of time, it can be the other way round, he says.

"Over the next 12 months we think active managers could add value. We will switch between an active and an index product based upon what kind of signals we are getting from our model."

IMPACT OF MARKET CYCLE

Investors need to examine economic variables to decide if the time or asset class is right for indexed management, believes Mr Dugan. "For example, in emerging markets, where markets are going up rapidly amid strong growth, index managers outperform active ones. But where the markets are collapsing, falling in absolute terms, investors had better be in active management."

What tended to happen over the past 12 months is that in emerging markets, during the latter stage of the big rally, share prices of very poor quality companies go up, just because the large amount of money available tends to circulate down into the worst managed companies, he says.

"When things are tough, the quality companies come out; obviously they are the safest place to be, but they are also managing their risk a lot better. So good active managers can see where the quality is, and therefore their portfolio is more defensive than an index product can be."

A combination of active and passive management is

the winning formula. For example in the UK space, instead of just buying an FT All shares index product, a FTSE 100 index product combined with an actively managed risk-taking mid cap and small cap fund can work well, says Mr Dugan.

He explains that all discretionary accounts at Merrill Lynch are managed in this framework, including this kind of decision, but it is just recently that they started a more structured approach to using passive managed products, although conceding they are "still fairly marginal in portfolios." Within discretionary accounts with absolute return targets, index products represent 20 per cent of equity exposure, he estimates.

Mr Dugan predicts that within two or three year the use of index investing could be more substantial, but this is not driven by client demand. "In fact when we first introduced index products there was a lot of hesitation from clients," he says remembering that clients were demanding that the bank add value. But what Mr Dugan says to clients is that their added value is "making the distinction between when to use an index product and when to use an active product."

Luca De Biasi, head of multimanagement and centralised mandates at Banca della Svizzera Italiana (BSI), holds a similar view.

GOVERNMENT BONDS

At BSI, the Generali Group's Swiss bank subsidiary, which acquired Banca del Gottardo from Suisse Life at the end of 2007 and now manages SF100bn (€62bn) of total assets, the use of ETFs is "still limited," says Mr De Biasi. "We are moving towards the use of these instruments, mainly in the management of funds of funds and in the area of Euro government bonds," he says.

The Euro Government bonds area is a very efficient market, says Mr Biasi, and managers do not have many opportunities to add value, unless they make big bets on rate or duration. Moreover these instruments are very precise.

"ETFs, especially those on the Government bonds, enable us to make very precise bets on the curve. If we bought a fund, we would not have this certainty, because any manager that operates in the bond European market is a generalist, and will operate on all type of maturities," he says.

Mr Biasi believes in a core satellite approach, where ETFs are used in clients' portfolios in conjunction with active managers. For example, in the fixed income area, his team has added managers who employ quantitative techniques enabling them to examine trading duration, in order to generate a significant level of alpha.

The same combination of passive and active management can be implemented in the very efficient large cap American market. Mr De Biasi says that in the past in this market he has used ETFs or trackers in combination with active managers; at the moment only the latter are employed, because they are very active and employ very specific investment style.

"The managers are really stock-pickers and their stock-picking activity justifies their use in the portfolio," says Mr Biasi.

The main managers in this area that BSI uses are Henderson (American equity), Morgan Stanley (American Franchise), Nordea (North American value), Vontobel (US value equity), JP Morgan (US value), Oyster (Oyster US dynamic).

ETFS VERSUS SEMI-PASSIVE MANAGERS

ETFs will have a huge impact on the fund industry, especially on so called semi-passive managers, estimates Mr De Biasi. He believe they will drive the polarisation of the industry and only active managers and ETFs or tracker funds will be left, with no intermediate category.

"It is true, a lot of managers systematically do not beat the benchmark. These fall within the so-called semi-passive category. They take high management fees but the innovation in the management activity is really very poor. For those, ETFs are evil," he states. "The proliferation of ETFs will drive the specialisation of the fund industry. Semi-passive funds will not exist anymore; they will have no reason to exist."

"But we try and select only those active managers which we know very well and those that are expected to beat the benchmark."

The ability of a firm to add value by selecting active managers is the true discriminating factor in the use of ETF or index products, not front end commissions or

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LUCA DE BIASI, BSI

regulation, Mr De Biasi says. "If a firm is able to add value by selecting active managers, ETFs can be important but they become secondary in a core-satellite approach."

The use of index products in clients' portfolios can be affected heavily by the core area of competence of a bank's asset management division.

Thomas Tilse, head of portfolio strategy for private clients, at Commerzbank's asset management arm Cominvest, explains that Europe is the core area of expertise of the German firm's active management. Consequently the bank relies greatly on its active managers there. However, they would consider using passive products in any investment that is not Continental European, such as Japan, United States, Canada, or part of Asia, he says.

USE OF CERTIFICATES

Currently, at the Frankfurt-based division running discretionary wealth management portfolios, index certificates, favoured over ETFs, are used to cover Japan and United States. Similarly to Merrill Lynch, they also use index certificates to track DJ Euro Stoxx 50 for asset allocation purposes, as "they are fast and good instruments to get higher market exposure and for quick asset allocation decisions," explains Mr Tilse.

Investing in Japan through index products aims to capture major market moves, he says. "We get stock-picking returns or extra alpha from our core markets in Europe and we get asset allocation returns out of Japan, so we don't need the extra risk to have an active manager there."

Commerzbank's private wealth management arm has a long history of using passive instruments, says Mr Tilse. They used to employ basket funds tracking major indices, but this has now changed to embrace all types of certificates. And interest in other geographical areas, such as Asia, could drive a rise in index investing in the future.

The German firm currently employs fund of funds to invest in Asian emerging markets. "There we think there might be enough alpha for the local asset manager to generate," explains Mr Tilse.

"When you look into next year, with the diminishing growth rate, we might come to the conclusion that we trust the fund managers less to find alpha, because of the changing environment and then we might decide to go more passive."

Also, index investing could be particularly interesting for covering particular themes, rather than specific geographical markets.

"I think that sector or theme baskets are going to be a major trend, because they give the fastest exposure and they are cheap," says Mr Tilse.

"Say biotech stocks are running. If I decide today I want to have some exposure to biotech stocks, then I will buy some passive investments and I am sure I am with the trend." In total, the percentage of index investing is currently around 15 per cent in a standard discretionary portfolio at Commerzbank.

"IT IS HARD TO TELL CLIENTS THAT YOU HAVE COVERED THE WHOLE OF US AND JAPAN PASSIVELY, THAT IS USUALLY A TOUGHY"

THOMAS TILSE, COMINVEST

Asked to forecast the level of index investing among private clients of the German bank over the next few years, Mr Tilse says it depends on the performance of their active managers. "Whenever you have the feeling that active parts are not performing, you substitute it with passive investing. I would work under the assumption that for the next three years, it will be in the range of 15-20 per cent."

Yet Commerzbank relies heavily on European active managers, employed in the core parts of client portfolios, to generate extra performance. In popular pure equity portfolios, European active managers run up to 70 per cent of total assets. "As long as our managers are successful, index investing is capped at Commerzbank," says Mr Tilse.

He dismisses any idea that commissions affect any decision on using passive products..

"I would say it is more down to the clients. Private wealth management clients expect active management from their bank, they expect it to do active bets. At any time you use passive investments, especially if the performance is average, they ask why you are not using more expertise. So it is hard to tell them that you have covered the whole of US and Japan passively, that is usually a toughy."