STRATEGY SELECTION

STEERING CLEAR OF THE PITFALLS IN SUB-ADVISORY RELATIONSHIPS

Creating a successful sub-advisory partnership is no easy task, requiring careful strategy selection, an alignment of interests between both parties and the involvement of information technology staff in the construction of a suitable infrastructure

By all accounts, the sub-advisory business in Europe is growing strongly. In contrast to the US where the sector is plateauing after a decade of growth, banks, insurers and fund managers in Europe are warming to the idea. Attracted by the possibility of shoring up deficiencies in product line, reducing fixed costs or demonstrating "openness", these groups are approaching institutional firms to establish sub-advisory relationships. To be successful, they must first confront some organisational schizophrenia.

Some inside the firms will see the move as emasculating. They are typically on the asset management side of the business. Remembering hard hours spent poring over Shakespeare in their youth, they are anxious not to re-enact King Lear by handing over the keys of the Kingdom and thereby losing control of their destiny. For them, outsourcing even a small amount of asset management responsibility represents a partial abdication of their empire, the thin end of the wedge, as it were.

The distribution side of the firms typically has a more sanguine perspective. The philosophy of open architecture is hard to shake, even if its practical implementation has sometimes proved disappointing. They often see sub-advisory as a way to insulate the sales cycle from the performance cycle – if the sub-adviser underperforms, it can be replaced in a way that an internal team cannot. And by picking well-credentialled specialists, the overall fund offering may gain some additional credibility, too.

Of course the reality lies somewhere between the panacea, on the one hand, and King Lear's madness on the other. There are five ways of making sub-advisory relationships work:

ARTICULATE WHAT SUCCESS LOOKS LIKE

This is more than just a list of platitudinous bulletpoints on a PowerPoint presentation. Success probably includes elements of both commercial success and strong investment performance, but with what emphasis?

There may be other considerations, too, such as competitive positioning and brand identity. Crucially, it should highlight the timeframe over which success will be measured – is this a long-term partnership, an interim solution or a rolling appointment contingent on performance? A concrete description of success that is shared between the parties will help to make the objectives explicit and should tease out nuances in understanding. It also serves as a useful benchmark once the relationship is established.

BE CLEAR WHAT YOUR CHOICE OF SUB-ADVISORY STRATEGY MEANS FOR YOUR BRAND

Brand management is rising on the agenda of senior management. The discussion is becoming increasingly sophisticated as decision-makers at the top of funds management firms realise that branding is more than just advertising and that marketing is not just a fancy name for sales. The nuances of positioning, product design and messaging are all being carefully considered as part of business strategy. The sub-advisory strategy throws in a few complexities of its own, not the least of which is the fact that there is now more than one brand to consider, the distributor's and the sub-adviser's.

There are many different co-branding strategies, each of which is appropriate in certain circumstances. Each has downstream implications. To highlight, somewhat crudely, some of the considerations:

A **white-labelling** approach, in which the sub-adviser is more or less invisible to the end investor, offers least threat of brand confusion in the mind of the consumer but it does little to insulate the salesforce from the performance cycle. The performance of the fund is attributed to the distributor brand even though the distributor can do little to affect the performance as it unfolds. As Lear would have it, the distributor is "tied to the stake and ... must stand the course".

This may be one reason why several large-scale distributors in the UK have chosen either passive or multi-manager firms as sub-advisers – the performance patterns are much more predictable and reliable than those from individual "star" manager funds. Brand damage from maverick performance is not something that large multi-product distributors relish.

A more transparent **outsourcing**, one in which the underlying customer is more aware of the presence and name of the sub-adviser, insulates the sales cycle somewhat from the performance cycle. However, it exposes the distributor to any bad press that befalls the sub-adviser. In the aftermath of the US mutual funds scandals, a number of distributors in Europe have found that to be an uncomfortable situation. This approach also imposes on the distributor an ongoing burden to demonstrate a continuing due diligence process.

Therefore in addition to the due diligence that is inherent in any sub-advisory appointment, the distributor must be able to show a credible ongoing manager selection process that is independent of the commercial interests of the distributor. This consideration is one reason why many distributors defer to external consultants, or multi-managers in the sub-advisory realm.

A pure co-branded **multi-manager** approach allocates responsibility for performance cleanly but forces the distributor to position another company's brand very carefully. Since few of the potential sub-advisers are household names, this poses a few challenges. On the one hand, there is little chance of competition between the brands (a good thing) but it also materially increases the training and communication burden for the distributor.

ALIGN THE INTERESTS OF MANUFACTURER AND DISTRIBUTOR

In a world of asset-based fees and no capacity constraints on the investment strategies employed, this is relatively simple. When the distributor raises assets, both sub-advisor and distributor benefit. However, performance-based fees and capacity constraints make this much harder objective to achieve. In a sense, the sub-adviser wants to maximise its net revenue for each scarce unit of alpha. Successful boutiques, one of the favoured types of sub-adviser, have to consider this very carefully. Equally it is a factor that distributors, and multi-managers who appoint the boutiques to their funds, have to consider.

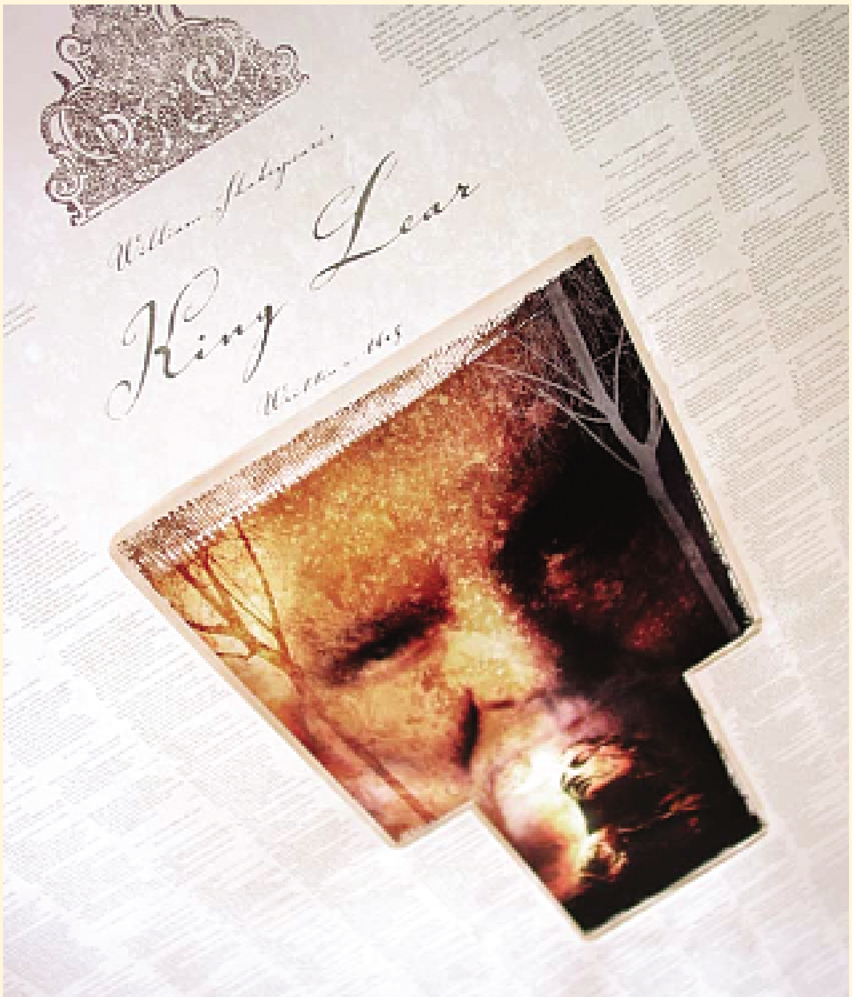
INVOLVE THE OPERATIONS AND IT PEOPLE EARLY ON

The infrastructure that supports sub-advisory relationships is critical for success but seldom figures in the decision-making process. Perhaps that is as it should be; the interests of the end investor are much more affected by other factors, notably the competitiveness of the sub-advisor's investment process.

However, the consequences of inefficient back and middle-office relations, and sloppy implementation affect all parties. The strains on information flows will also be increased as end investors demand greater and greater transparency in the reports they receive, a traditional weak spot for most sub-advised and outsourced models. Addressed early, the chances of success are much higher.

BE REALISTIC

Extracting alpha from investment markets is not easy and doing it consistently is even harder. Investment professionals know that different strategies pay-off at different times and that markets behave capriciously. Expecting even the most skilled sub-adviser to outperform in every time period is unrealistic and, ultimately, counter-productive. Ironically, most end investors understand this, so long as their expectations have been set appropriately.



'The risks perceived by the would-be King Lears are real. Clumsily implemented, sub-advisory solutions can backfire with devastating commercial effects'

Once again, therefore, attention turns to the communications realm. Paying close attention to the way sales materials express the investment proposition and how end client reporting reinforces the main messages is absolutely key. This is not, to borrow again from the unlucky Lear, "that glib and oily art, to speak and purpose not". The communication must present reality, optimistically if need be, for it to act as a foundation for a healthy client relationship.

Sub-advisory relationships can be a very effective strategy for fund distributors and manufacturers. Clients can benefit from access to best of breed investment skills, distributors can exploit others' economies of scale and sub-advisers can gain access to far wider distribution that they could achieve themselves.

However, these relationships do need to be established on a stable foundation. The risks perceived by the would-be Lears are real. Clumsily implemented, sub-advisory solutions can backfire with devastating commercial effects: client confusion leads to brand erosion and, ultimately, loss of control over the business. Clarity of purpose, strategy and communication can contain these risks and turn what is essentially a defensive strategy into a positive, enterprise-building force.

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