Boutique fund managers: strange bedfellows

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Boutique funds management firms burst onto the scene earlier this decade, with big-name principals promising their nimble teams would outrun the investment giants. The premise of the boutique environment was that it would allow skilled fund managers to excel, unconstrained by institutional mandates and free from cumbersome levels of funds under management (FUM). Through ownership of the business, a stronger alignment between the investment manager and the end investor would also create a winning dynamic. In most cases, it has proved successful.

Bennelong Funds Management chief executive Jarrod Brown argues the continuing surge of new boutiques suggests there's some dissatisfaction with the larger institutional players. Brown, who himself moved from the big to the smaller end of town, believes the boutique boom points to a continued desire of investment professionals to "work in an entrepreneurial culture free from many 'institutionally-common' distractions".

The entrepreneurial spirit of a boutique operation has remained an attractive proposition. But it does come with significant financial and administrative pressures that are largely avoided by investment managers in big institutions. Stand-alone boutiques must: maintain the capital requirements of their Australian Financial Services Licence; ensure they have adequate back-office compliance and marketing functions in place; and fund shelf-space fees to gain entry onto investment platforms. While institutions can act as dead weights at times, they can also offer capital strength and provide back office support that allows investment managers to focus on their core skills. For some managers during the recent market depression, that capital and support may have been a prerequisite for survival.

Above The Index Asset Management (ATIAM) chief investment officer Simon Burge said back in the 'old days' the potential financial pressures facing boutiques weren't necessarily front-of-mind – either for those establishing the businesses or the researchers and asset consultants assessing them.

"In the earlier days, that question wasn't asked too much. It was all 'where have you been?'" Burge said.

"Previously I could have gone out with my principals, kept 100 per cent of the equity between us and pitched for money without a corporate backer. We've been around for five years now and in that time a shift has happened in front of my eyes."

Incubator models, where institutions take minority stakes in boutiques – providing them with capital as well as distribution, management and compliance support – are on the rise. **National Australia Bank** takes stakes in boutique funds through nabInvest, as does **Westpac** through its wholly-owned subsidiary Ascalon Capital; while listed financial services company **Treasury Group** hold stakes in boutique fund managers such as Investors Mutual. Australian Unity is another manager that creates joint-venture partnerships with specialist managers. **Colonial First State**, while not running an incubator business, does have a 30 per cent interest in Peter Morgan's 452 Capital.

A partnership between a boutique fund manager firm and a bigger company doesn't only benefit the small. Institutions may be slow at times to react to emerging trends, but by now many have decided they're not going to miss out on the lucrative returns to be made in boutique funds.

By taking a stake in boutiques, institutions can also stem some of the outflow of experience and talent witnessed during the boutique boom. The equity opportunity available to principals in boutiques remains one of the most successful ways to retain talented staff. **BT Financial Group** negotiated a version of this theory when it spun-off BT Investment Management, listing it on the **Australian Securities Exchange** to allow it to retain its top investment managers and analysts.

Boutiques under scrutiny

The startling collapse of the internationally renowned investment firms and banks in 2008 focused attention on the 'behind the scenes' operations of financial services companies, rather than just their headline products and investments returns.

Ascalon Capital managing director Andrew Landman agreed ratings agencies are now paying more attention to how corporate entities, not just their investment products, are performing.

"It's always been a component of their due diligence but I think in order of priority, it hasn't been number one," Landman said.

Landman said in the past there had been less consideration of the impact on a fund where the responsible entity couldn't meet its financial requirements.

"Investment performance was always number one, but I think the sustainability of the business is absolutely critical."

Burge – whose company, ATIAM, Ascalon has a stake in – believes the institutional backing has assisted his group in obtaining easier access to all important investment ratings and has opened doors with institutional asset consultants.

"Having Westpac or Ascalon's presence has allowed us to get introductory meetings and move towards ratings. Without them I think, despite the fact that we've had great performance, it would have been a lot harder," Burge said.

"There's certainly a lot more focus on your underlying ownership structure and your profitability."

In 2008 ratings house **Standard & Poor's** (S&P) introduced an 'annual business sustainability survey' as part of its research process. S&P fund analyst Justine Gorman said this survey allows the research house to "pick up on any concerns we may have about any of these boutiques that may be suffering from lower levels of assets under management".

The business sustainability survey considers issues such as revenue structures, costs, break-even points and the level of debt on a firm's balance sheet. While this research doesn't officially form part of the ratings process, where issues become apparent they will be considered in the final outcome.

Gorman said the survey had thrown light on issues with some boutique fund managers in the last 18 months.

"It did highlight companies that were getting very close to the wire with revenue. One in particular has since collapsed," Gorman said.

Gorman adds that from an investment perspective, S&P assesses boutiques and institutions using the same process – with a focus on the quality of the investment staff and management, investment capabilities, the size of team, its processes and approach to risk management.

Burge said the increased focus on balance sheets and corporate backing was creating higher hurdles.

"I'd imagine it's getting pretty hard for those people not aligned with a large parent, and I think that will prevail for a few more years."

Gorman's assessment is that, on the whole, across both institutionally backed and completely independent boutique managers, only a relatively small amount struggled during the crisis.

"It's very hard if you're a boutique and you only have one asset class that you're managing, so you don't have that diversity when markets fall.

"If you're not running other asset classes to diversify you can get caught out."

Restraint required

While both boutiques and institutions can benefit from business partnerships, the key is having the restraint required to maintain the elements that make a boutique just that.

Ascalon, for example, has a 37.5 per cent stake in ATIAM with the remainder owned by staff.

"Westpac has two people on our board, and [neither] of them have any input into the investment management process – so their input is clearly about the running of the business as a business," Burge said.

"They don't get involved in the investment management side and that's why it's still boutique."

Burge says that while his institutional backers provide direction and leadership at the board level, he and his eight-person investment team "do what we do and make our decisions".

For Burge, it is the best of both worlds.

"We have equity, and we have our own decisions about what we do – we live and die by the choices we make, but we also have their support when we need it."

Landman, as managing director of Ascalon, is charged with choosing and investing in the boutiques that will go the distance. Part of his evaluation process is assessing whether those involved display "the essence of a boutique mindset".

"The guys have got to treat it like a family business," Landman said.

"It needs to be a 24/7 passion for them to grow the business and they really need to respect the end client."

"For me, the ones that don't succeed – and the ones that I quickly file into the bin behind me – are the ones that are looking for their own wealth to increase by starting the boutique."

These managers will look for capital injections not to grow the business, but to take as profit.

"They ask for the money – literally," Landman said.

"We buy equity, but we don't buy the equity off the founders. The amounts we pay go into the business to build the business, not to make the founders independently wealthy on day one."

Standing alone

Certainly not all boutiques require this model – particularly those with substantial FUM and those managing across various asset classes, allowing them to spread their risk against sector-specific market falls.

Integrity Investment Management, established in 2007 by former **UBS Global Asset Management** managing director and head of equities Paul Fiani, now has several billions in FUM and is standing steadily on its own feet. Integrity staff own 100 per cent of the business. Fiani and his team of former UBS executives have won substantial institutional mandates as well as retail support.

In accepting the 'Rising Star' award in *Money Management*'s 2009 Fund Manager of the Year Awards, Fiani said strong investment performance from boutiques had continued the trend of investors choosing boutique managers rather than the traditional institutionally owned businesses. The fact that many boutiques had proven to be stable organisations had delivered credibility to this segment of the funds management arena.

"The current trend for investors to use boutiques has not changed despite the economic outlook," Fiani said.

"Many research houses are still backing boutiques for investment choices."

Most boutiques were dragged to the market bottom along with their institutional counterparts, but they did to some degree keep their performance promises.

Gorman said the majority of boutique Australian equities funds did match or outperform their institutional counterparts in recent years. See the tables for a rundown of performance.

Personality plus

One factor favouring boutique fund managers in the current environment is the reappraisal by some investors of the benefits of active management. While all boats rose with the tide during the boom, the current choppy conditions are allowing proficient stock-pickers to showcase their talents.

"Everyone was really spooked in 2008, but institutions have come back into the market more quickly than the retail landscape in the past six months," Landman said – although not all boutiques are benefiting from this trend.

"I don't think the retail market's getting back into hedge funds yet – there's still a brand issue there."

The personal brand held by those stock-pickers is key to a boutique's success. The boutique boom is essentially a cult of personality. Boutiques trade on the names and achievements of their leaders. But investors must assess process alongside personality.

"Key-man risk is always an issue in a small team. That's one thing we look at – to ensure that the experience and the process are embedded in the other individuals in the group," Gorman said.

But it seems the big names that broke the mould earlier this decade have no intention of fading into the shadows.

"I'm not picking up on any that are looking to exit early," Gorman said.

"They've set up their own businesses and they're quite happy. They're passionate about investing, and a lot of them will probably do it until they can't do it anymore. This is what they really love doing."

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