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Research Roundtable International 2016 - key takeouts

Will Jackson | PortfolioConstruction Forum | 02 February 2017

PortfolioConstruction Forum Research Roundtable International 2016 saw 10 senior Australian fund analysts travel to the US west coast for an eight-day continuing education program of academic briefings and half-day investment committee meetings analysing a variety of investment strategies.

Inevitably, outside the meetings, the group debated their views on many issues - including fees and integrity (perhaps unsurprising given the rapid growth of low-cost passive funds the public mistrust of the financial services industry) as well as portfolio diversification via illiquid assets, and links between academia and investment management.

FEES

Several delegates raised concerns about fees in relation to the alternatives sector, where they said complexity and high fees increase the difficulty of identifying products which offer value for money.

Peter Eichmann, a financial adviser at Sydney-based Park Street Group, pointed to the example of the First Quadrant Global Alternative Return strategy - a systematic long/short currency strategy which the group assessed during the course of its research. While billed as competitively priced, versus similarly risky alternatives, in Eichmann's view, its 1.5% and 20% performance fee structure seems expensive when viewed alongside systematic strategies which he believes offer greater alpha potential. "There are different business models out there, and at times [management expense ratios] can be more related to the business model than the actual [investment] strategy, or the complexity of it," Eichmann added. "There doesn't seem to be a nice correlation between how complicated the strategy is, versus the fees. So you are left wondering: what is the breakdown of the fees? And how are the fees justified?"

The appropriateness of fees across all levels of the funds distribution change came up for debate, with delegates debating whether there are "too many snouts at the trough".

Will Burkitt, head of investment product and research at ANZ Wealth, echoed Eichmann's concerns over the cost of alternative strategies, but believes new technologies will likely improve efficiency within the funds distribution chain over time, resulting in lower costs for end investors. "There's the adviser, the adviser licensee, the platform, the fund manager - [and] sometimes with the fund manager there's a sales or distribution party as well," Burkitt said. "All of these players take a fee. And when you add it all up, the fee is too expensive;

too cumbersome. Robo-advice, however it manifests, is highly likely to be able to cut out at least a couple of these parts of the chain, and hence fees will be driven down. It's ripe for digital disruption."

Leanne Milton, head of advice research at AMP Advice, argued that active managers face a tougher task to prove their worth, given the outlook for muted returns. "Finding strategies with consistent alpha is more important in a low return environment," Milton said. "For example, are there factors that tend to deliver performance consistently? How do we get greater return from fixed income portfolios without taking on significantly more risk? Strategies that can provide this are gold but fund fees must be reasonable."

In contrast, David Wright, managing partner at Zenith Investment Partners, noted the downward fee pressure exerted by low returns and exchange traded funds, but suggested that such forces may weaken. "I can't help thinking this will reverse in time when active managers outperform, particularly in bonds," Wright argued.

Meanwhile, a fellow delegate proposed that advisers who successfully reduce overheads may enjoy an additional side benefit – greater freedom in product selection, compared with cost-constrained peers. "Among the [Roundtable] group, it is interesting to see how the business dynamic represented by the participants is changing," he said. "The more retail-focused members [argue] the fee levels being asked by some of the products [are] an impediment for them. Whereas others in the group, who are accessing these capabilities at a lower price point by occupying more of the value chain, were understandably not having the same reservations. As a consequence, [they] could look at the respective capabilities in a different and, arguably, more objective light."

The focus on fees also prompted discussion of how professional investors may extract maximum value from their actively managed exposures – including by distinguishing genuine fund manager alpha from factor betas which are achievable at lower cost, via index strategies. Kyle Lidbury, head of investment research at Perpetual Private, noted that "the battle for active management to stay relevant continues" and that fee pressures were leading some active managers to tackle passive funds head-on, by substantially reducing their fees, or by moving into non-traditional strategies. Other groups, including BlackRock, were increasingly abandoning costly fundamental analysis, he added.

Wealth managers will similarly be required to raise their game, to compete with low-cost investment options, Lidbury argued. "Returns are getting harder to come by and risks are becoming larger. It's clear that return expectations are going to come in under historic norms, and we need to be prepared to have these conversations with clients," he said. "However, it's also incumbent on us as investment professionals to cast the net further and wider than what has been done historically. [There are] more strategies and techniques available to investors today than ever before and, in my view, it means that investment is becoming a more specialised field. There is pressure on us as an industry to evolve, particularly on us as investment specialists within the wealth industry," he argued. "We need

to get smarter, more knowledgeable and ultimately prove [our] value to clients – that we can build superior portfolios and deliver better outcomes compared to the passive, low cost, unsophisticated static approaches that have been predominant to date."

INTEGRITY AND TRUST

The themes of integrity and trust also ran through discussions, as delegates debated the standards expected of individuals and companies within the financial services industry.

Most controversial was a debate on whether behavioural bias affects the objectivity of fund selectors – a topic raised by Michael Furey, managing director of Brisbane-based quantitative investment research company, Delta Research & Advisory. Furey outlined several concerns, including that product choices may be skewed by personal preferences on investment style, or the "slickness" of fund manager presentations.

"We have our own preferences, and preferences for style. And, if we're assessing managers effectively, we ideally need the ability to ignore style preferences and look at a single attribute on its own," Furey noted. "I probably need to do a bit more number-crunching – because that's my own style – to prove it. But it appeared to come through with a few managers [reviewed] this year. There was one that rated highly across the [group], including on performance. Its performance was actually, in a relative sense, no better than anyone else's. And yet, it had the highest rating, which for me was somewhat illogical. But, they had their marketing down pat. They delivered on those softer aspects very well."

Burkitt and Mirko Cugara, director of Melbourne-based financial advisory business, Innate, agreed that investment committee members should be aware of potential unintended biases. "While it should be possible to put our behavioural biases to the side when assessing funds, it is often not the case," said Cugara. "At the end of the day, the same way that researchers are people, so too are the end users of these investments. Leaving these biases at the door of the meeting room is incredibly difficult to do."

Milton also noted such concerns, but emphasised that personal interactions enable investment committee members to gain confidence in portfolio managers, and to build a clearer picture of corporate and team culture.

Similarly, brand integrity emerged as a key discussion point. Several delegates raised the topic in relation to Analytic Investors, a Los Angeles-based quantitative fund manager which was purchased in 2016 by financial services group, Wells Fargo. Shortly after the acquisition was agreed, Wells Fargo became embroiled in a scandal that ultimately resulted in the resignation of its CEO, as it was revealed that employees had created large numbers of fake customer bank accounts to inflate sales figures. While the activity occurred in the banking arm of Wells Fargo, it caused Roundtable delegates to query the broader culture of Analytic Investors' new parent.

"Brand is still important," said Lidbury. "[This was] somewhat relevant given the currency of the Wells Fargo scandal during the program. However, it was clear that this event had completely reversed the group's view of Wells Fargo from three years ago and, by association, the two strategies that were attached to it," he observed. "[It's] a hugely relevant topic, given the scandals that we've seen in big institutions in Australia. It's intolerable for our industry, as wealth management is essentially a relationship that's built on trust."

Wright and Furey similarly noted the impact of the controversy on investor perceptions.

"We should never have been having the conversation about what happened in Wells Fargo Bank," Furey argued. "It's pretty obvious – that;s the bank, and their bad behaviour around the cross-selling of banking products has absolutely nothing to do with the funds management strategies and their execution. Except for one thing – it has damaged the brand."

Furey said the episode highlighted one of the biggest problems facing large, diversified financial companies – the ability of individual business units to tarnish the group brand, and the reputation of other subsidiaries. "Vertical integration brings up these leftfield risks that muddy the waters. We're seeing it play out in the USA as well as [Australia]," he noted.

DIVERSIFICATION, THE ROLE OF ACADEMIA AND SOCIAL INEQUALITY

While the delegates expressed scepticism on the fees levied by alternative funds, there was considerable interest in non-traditional portfolio diversifiers.

Milton expressed an appetite for lowly-correlated liquid alternatives, while Wright and Lidbury saw a growing role for illiquid assets.

"Illiquidity is still an untapped return source for Australian investors," said Lidbury. "While we only had one insight into this space [during the program], via Invesco, it was clear that higher returns are still possible through access to illiquid and inefficient markets. This is something that retail investors in Australia do not have any access to and it could prove to be a huge detriment to individual investors. Superannuation as a long-term vehicle has capacity to bear some modicum of illiquidity that is not being utilised."

Also in relation to alternatives, Furey observed that US systematic fund managers often foster close ties with universities. For example, Pasadena-based First Quadrant is located within walking distance of the California Institute of Technology (Caltech), one of the world's leading mathematics schools, and therefore has "access to the genius that flows through" the institution. The Australian fund management industry has failed to cultivate similar links with academia, Furey noted, and therefore risks creating a brain-drain, as highly-qualified graduates seek work overseas. He cited the example of Andrew Ang, an Australian who began his tertiary education at Sydney's Macquarie University, but who subsequently relocated to the US, and now serves as head of factor investing for BlackRock. "There's some

really great strategies and smart people [in Australia] but I'm not seeing the academic linkage," Furey said. "I don't tend to think the Australian culture is prone to capturing innovation."

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