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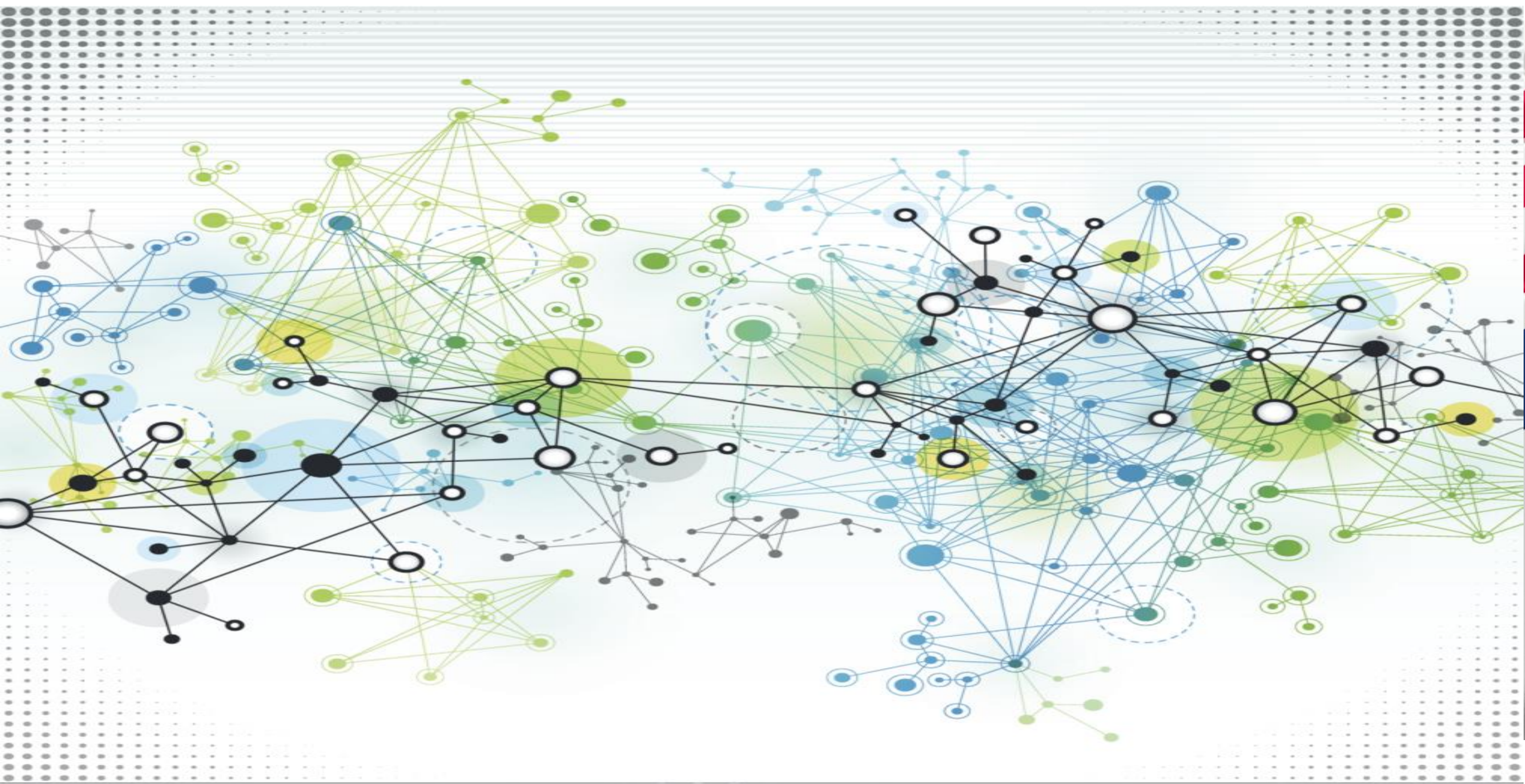

The New Boutique Asset Manager:

Transparent, Efficient and Accountable

As the rotation from bonds to equities continues unabated, the world of boutique asset management is evolving in tandem. The entrepreneurial investment blueprint of old – switching strategies as new opportunities arise – is coming under pressure from the continuing onslaught of regulation. Assumed norms are being challenged, rewriting the boutique asset manager's priority list and threatening traditional business models as a result.

Regulatory compliance remains the greatest concern for boutiques and the complications of operating across multiple jurisdictions are leading to local entrenchment. But this may prove to be a temporary measure; solutions are emerging. Three quarters of participants surveyed for this analysis are looking to technology providers for assistance with compliance.

Only fully automated front- to back-office processes will deliver the regulators' required transparency in a timely manner. The resulting efficiencies will not only reduce operational costs and limit unnecessary risks, but new levels of transparency and accountability will deliver improved client service, and expansion of product and geographic location. However, these changes are not without their challenges. The new era of boutique asset management is unfolding at a rapid pace, altering both the participants involved and the individual roles they perform.

Rebecca Healey

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Introduction

Just when boutique asset managers believed their roles could not become more challenging, yet more regulation has emerged this year in the form of Markets in Financial Instruments Directive (MiFID) II, Alternative Investment Fund Managers Directive (AIFMD), Markets Abuse Directive (MAD) and European Market Infrastructure Regulation (EMIR). While the industry has traditionally focused on niche offerings to ensure the necessary returns and continued growth, encroaching regulation is creating significant roadblocks. Time-consuming and labor-intensive, the cost of regulatory compliance globally is now considered the main challenge to expanding a firm's footprint or product range. As such, business models are being impacted, forcing change on even the smallest of firms.

Nevertheless, with change comes opportunity. While some firms are choosing to rein back to core expertise, new investment models are emerging to cover different products and geographies, even shifting to tangible goods that require physical delivery. However, it will be through the formation of new unique partnerships that firms will be able to successfully navigate the precarious balance between the demands of emerging waves of transitional change while ensuring regulatory compliance.

Historically, the once proverbial asset management Goliaths held a significant advantage in being able to spread increased compliance costs across a larger revenue base. Greater scrutiny of asset management firms, together with the growing complexity of compliance, due diligence and regulation, continue to burden smaller players to a greater extent due to their lack of people, processes and administrative firepower. However, the ability to outsource creates an opportunity to circumvent these obstacles, provided third-party providers focus on flexible and cost-effective technological solutions to level the playing field. Achieving critical mass may still be essential for long-term viability of funds, but technical solutions have the potential to offer smaller firms the ability to punch above their weight in terms of geographic reach and product scope.

The evolving surrogate relationship between firms and providers is encouraging a growing number of market participants to outsource. As this practice continues to become mainstream, competition increases, driving down costs and delivering solutions that are more user friendly to solve complex issues. Client requests are evolving from vanilla solutions to new ideas based on systems compatibility, such as sophisticated customer relationship management (CRM) with advanced technical aspects of asset management. Education about market structure, as well as demands for improved transaction cost analysis (TCA), are now as critical to boutique asset managers as traditional out-of-the-box straight-through processing solutions and menu pricing. As demands increase on asset managers to deliver the requisite transparency and accountability, the more they will choose to lean on outside partnerships to ensure compliance, and the more an increasingly efficient and adaptable industry will emerge.

The following report, co-funded by SunGard's Asset Arena 360, details the findings of a survey conducted in May 2014 with more than 100 participants. Reflecting the make-up of the global asset management industry, the location of participants is concentrated in the US and Europe. However, a third of responses represent several emerging markets, as well as Canada (see

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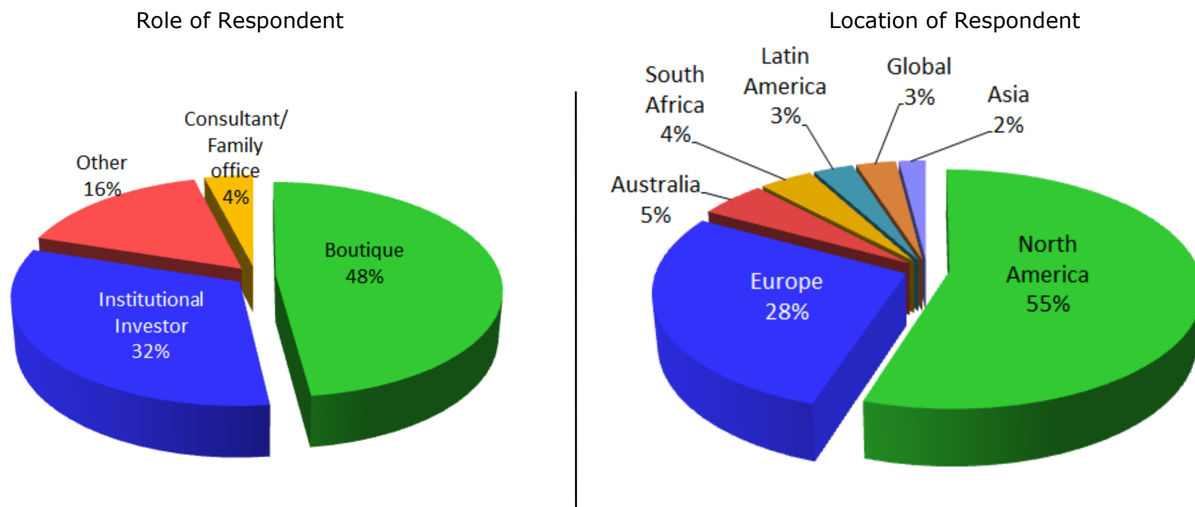
exhibits 1 and 2). Furthermore, 48% were boutiques and a third comprised institutional investors, split between US and European firms trading global products. The quotes accompanying this analysis all came from boutique asset managers who participated in the survey.

Exhibits 1 and 2
Survey Participant Demographics



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Back to Basics

"Investors are now looking for truly alternative investments, with no high fees nor the liquidity constraints associated with the usual long/short hedge funds"

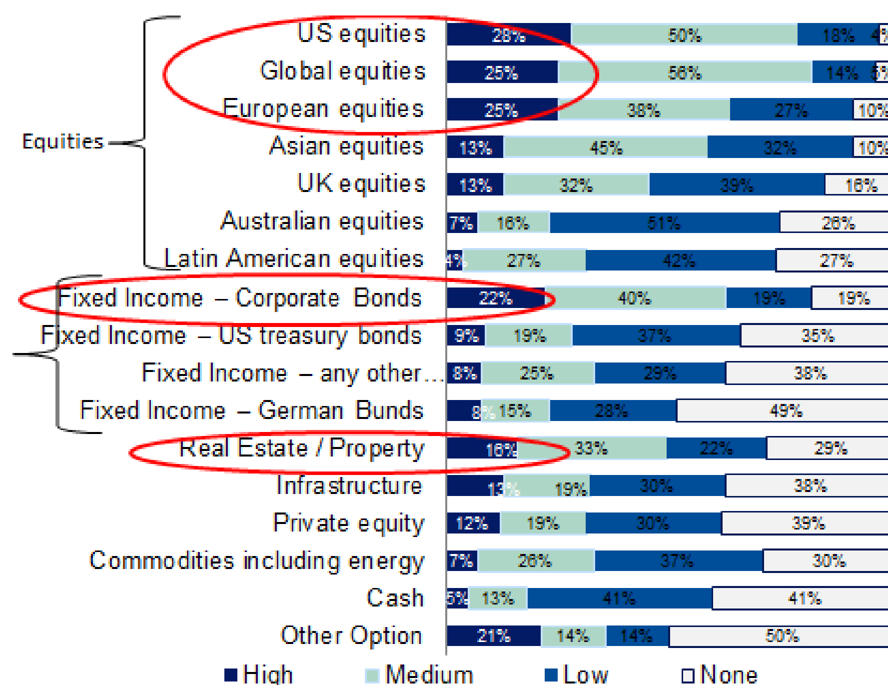
US Boutique Asset Manager

Having differentiated themselves from the asset management Goliaths, the boutiques' unique niche focus on specific sectors or geographic regions has enabled managers to play to their strengths as the bond run ends. One fund switched their entire Asian assets out to invest in US equities in one hit, something an institutional manager can only wistfully dream of.

However, understanding and staying ahead of global regulation is becoming a gargantuan task. Discovering you are no longer compliant in one market versus another is seeing firms retrench to their core competency, thereby limiting both the potential downside risk and burgeoning regulatory expense. As regulation becomes more onerous, the ability to switch asset class or geographic location is now becoming both more expensive to maintain and increasingly demanding in terms of workload.

Investor demand is currently highest in developed equity markets, with corporate bonds the sole exception in fixed income as global companies switch to international capital markets to capitalize on low borrowing costs. Yet the underlying investors' appetite is also polarizing. Those on the perimeter are seeing a significant shift to the alternative side, with products such as property or even physical assets increasing in demand (see exhibit 3) as the benefits of investing in supposedly "safer" assets incur higher fees and rising implicit costs of execution.

Exhibit 3
Are You Experiencing Investor Demand in Any of the Following Asset Classes?



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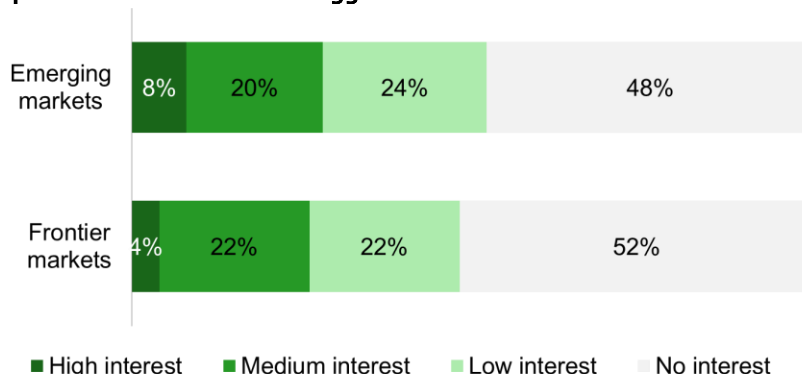
Staying At Home

Recent crises in developed markets – most notably Europe – have not yet transferred to a broader geographic investment strategy for boutique asset managers. Only 4% showed high interest in frontier markets and more than half had no interest in either frontier or emerging markets, which is in direct contrast to the divergent investment strategies seen in the institutional space (see exhibit 4).

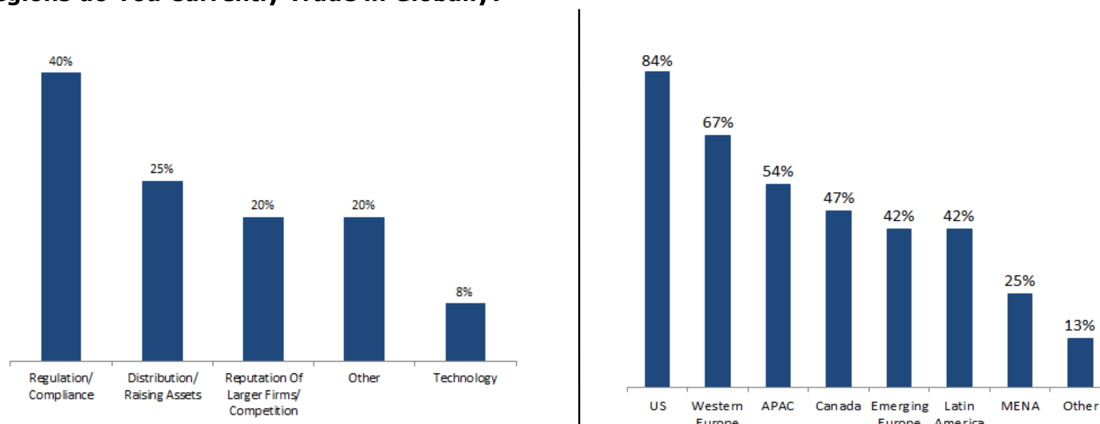
Exhibit 4
Have Crises in Developed Markets Acted as a Trigger to Greater Interest in:



Source: TABB Group

Once again, the strain to stay compliant with regulation was highlighted as the top challenge for expansion (see exhibit 5). As the regulatory burden multiplies, the increased level of competence required to zero in on a single unique area of specialty continues to focus investors' attention on their home market or more accessible US markets. Despite the US accounting for barely half of the respondents interviewed for this survey, US products were traded by 84% of respondents, illustrating the potential challenge for global regulators to ensure markets remain attractive and accessible, while also meeting compliance objectives (see exhibit 6).

Exhibits 5 and 6
What Challenges are You Now Facing if You Are Expanding Your Footprint and Product Base? / What Regions do You Currently Trade in Globally?



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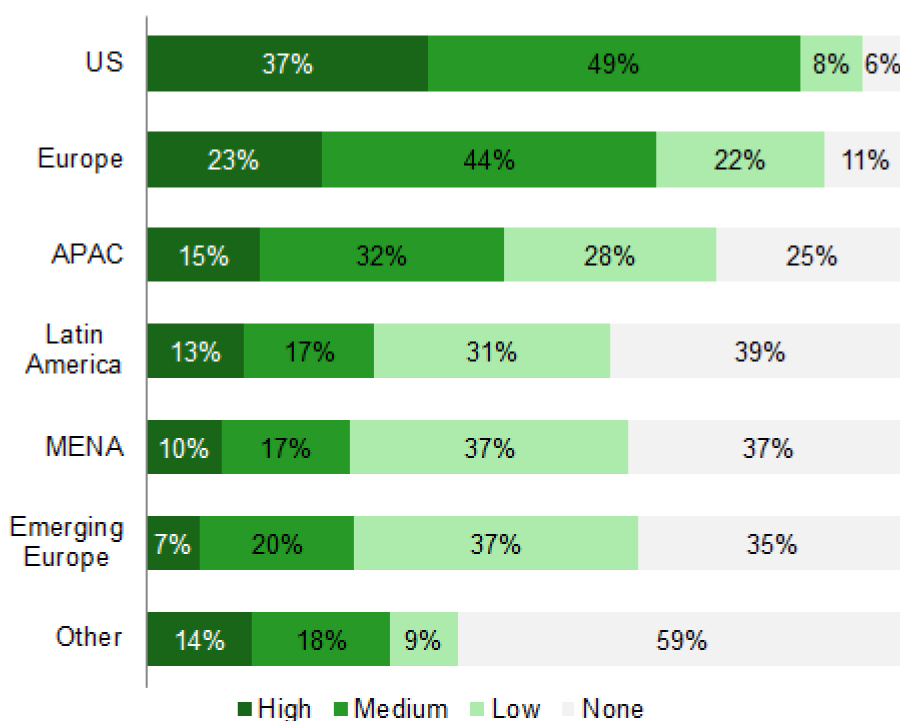
The choice is stark – return to what you know and concentrate on your core strength with minimal unnecessary deviation or risk, or make the jump entirely to focus on absolute returns. The majority of boutiques are clearly seeing an increased demand for core US and European offerings However despite the wider European recovery story, only just under a quarter of respondents registered a high interest in European product (see exhibit 7).

This strategy ironically places boutique investment managers at increased risk. The lack of diversification places more weight on risk management systems and their ability to pursue effective hedging strategies, keeping managers more exposed to central bank strategies, as well as raising the performance bar required to retain the initial investment. Lower volatility strategies are safer but also run the risk of lower alpha, making standout performances harder to achieve.

Exhibit 7
Are You Experiencing Investor Demand in any of the Following Geographies?



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The Real Cost of Compliance

Regulation as the main factor to make or break a firm has jumped in focus from just 17% of participants in 2013 to 42% in 2014, highlighting the significant challenge boutiques now believe they face (see exhibit 8).

Exhibit 8

What do You See as the Main Factors that Could "Make or Break" Boutique Firms in the Next 12 Months?

Source: TABB Group

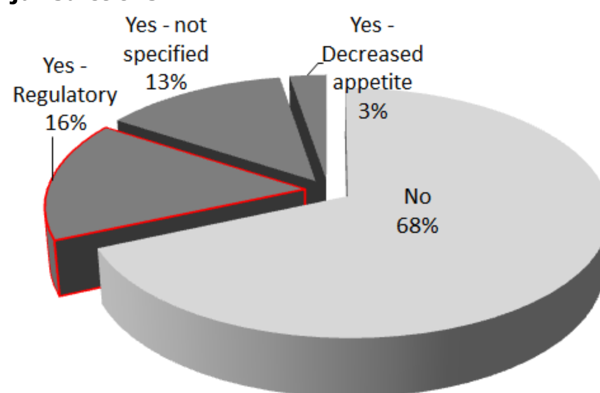
"Regulation is still the greatest challenge. I know of other small managers who have now just given up marketing in Europe entirely"

Boutique Asset Manager, Singapore

In addition, burdensome regulation was also cited as the main reason to now step away from an area of investment (see exhibit 9). While less than one in five respondents explicitly cited regulation as the reason to pull back from offering certain products or operating in particular jurisdictions, this was compared to just 3% who noted decreased investor appetite. Unsurprisingly, Europe was cited as the jurisdiction where participants felt regulations were most onerous. Some claimed their ability to market product to

Exhibit 9

Are you pulling out of certain products or jurisdictions?



Source: TABB Group

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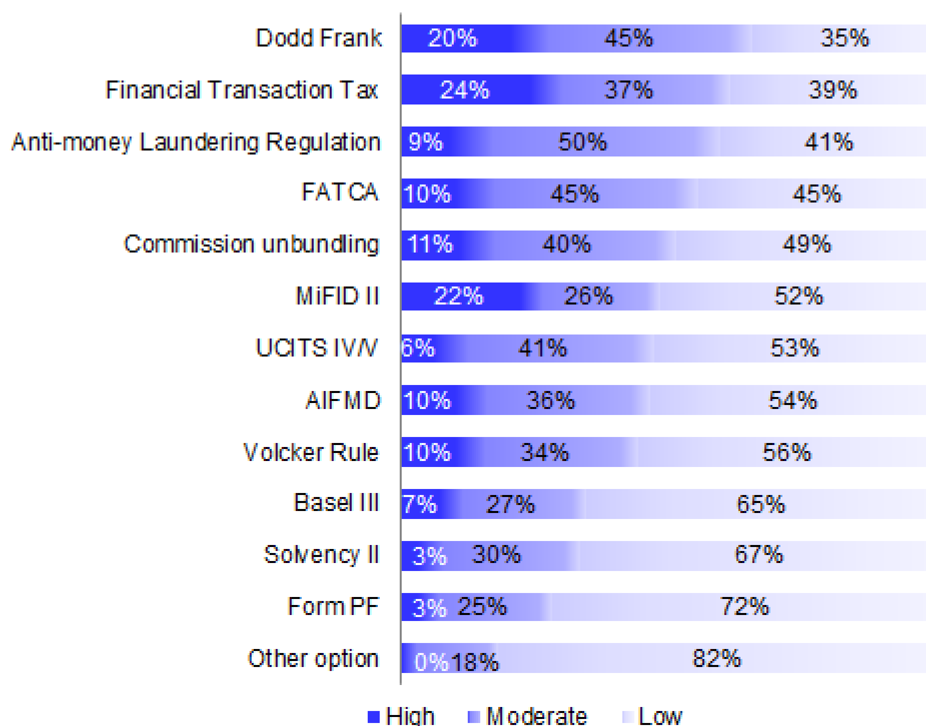
European investors was becoming increasingly constrained, as larger funds can afford the infrastructure to satisfy European regulations, while smaller funds cannot. For example, the requirement for detailed daily risk reporting verified by an independent third party is either too costly or onerous for smaller firms to manage internally. A large firm with multiple funds can spread the cost across its fund portfolio to meet increased costs, but smaller funds focused exclusively on performance will incur relatively higher fees, thereby impacting investor returns.

While boutiques remained most concerned about the Dodd-Frank Act in terms of overall impact (see exhibit 10), new regulations such as anti-money laundering regulations (AML) and the financial transaction tax (FTT) were highlighted across the globe as growing areas of concern for boutique firms.

Exhibit 10
Which Piece of Regulation will have the Biggest Impact on Your Business in the Next 12–18 months?



Source: TABB Group

"Administrative burdens are all costs that add up and impact our fund performance"

Boutique Asset Manager, Europe

The desire to outsource exists, but this is seen as time-consuming, labor-intensive and expensive. There is still more third-party providers could do to make this an attractive offering for smaller firms.

Typically, these services are charged irrespective of the level of activity. Again, larger funds with high volumes can outsource, but the service for smaller firms with intermittent activity can become an unnecessary and considerable expense.

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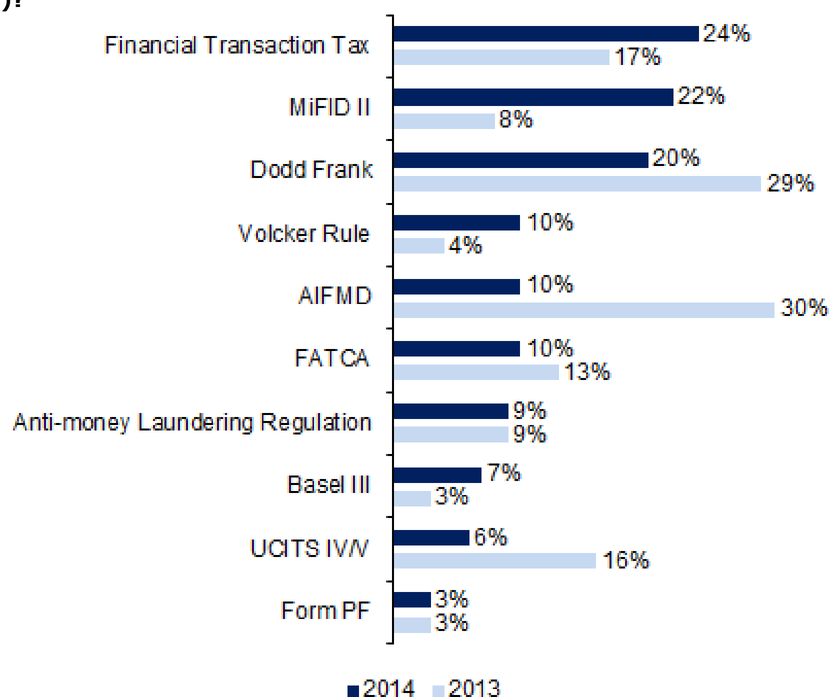
Funds with larger irregular trades find themselves discriminated against and are forced to rely on their chief compliance officers to stay on top of global regulation; no mean feat for just one individual.

Shifting Priorities

The regulatory focus of boutique asset managers has shifted geographical location from the US under Dodd-Frank in 2013, to Europe, with both the FTT and MiFID II seen as the primary concerns this year (see exhibit 11).

Exhibit 11
Which Single Piece of Regulation will have the Biggest Impact on Your Business in the Next 12–18 Months (2013 versus 2014)?



Source: TABB Group

The European Parliament's proposals for an FTT include certain exemptions for hedging transactions for non-financial companies; sovereign debt and market making; a reduced rate of 0.05% for sovereign bonds and pension funds until 2017; a reduced rate of 0.005% for derivatives until 2017; and a reduced rate, by 0.01%, for repos above three months. The Parliament also expanded the product scope to include spot foreign exchange and contracts for difference, as well as providing the option for individual countries to apply a higher rate for over-the-counter transactions.

For derivatives, current discussions are around minimising the risk of any circumvention of the equities tax and ensuring any "speculative" derivatives trading activity is taxed. Given that the European Council is currently under the Presidency of the Italians, it is unsurprisingly that current proposals are similar to the Italian FTT structure (i.e. equities and equity derivatives), however concerns have been raised over the legality of a similar structure to the Italian FTT as

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a model for the eleven participating Member States. Under this structure OTC equity derivative contracts agreed between two non-FTT zone parties would also be taxable, which is currently not admissible under the issuance principle in the current Commission's proposal.

Given the current confusion and the limited progress Member States seem to have made thus far, it is clear that industry participants will have little advance warning as to what will be required when – memories of the Italian FTT implementation are still strong in European participants' minds. The potential regulatory options for the FTT remain a significant minefield for a small fund to maneuver through and are likely to have a detrimental impact on international appetite to trade European products unless a cost-effective manner to administrate the tax is found.

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New Challenges

New areas of concern however are only just emerging, with many firms as yet unaware of the significant impact of forthcoming regulation.

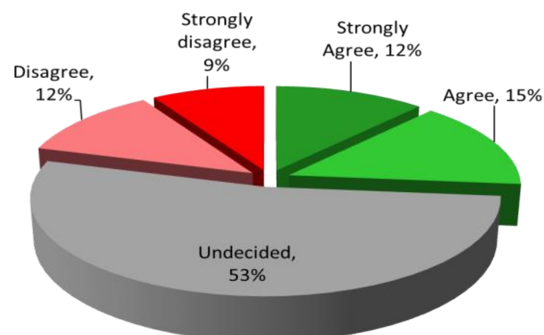
"It's a nightmare. I don't think anyone has figured out exactly how they are going to split this out yet, how they should approach it – what should or shouldn't be done"

UK Asset Manager

The latest initiative is around the use of dealing commissions. The traditional method of paying for research through client commissions is set to be radically altered by the UK's Financial Conduct Authority. However, many respondents remain undecided as to how this will impact their firm (see exhibit 12).

Exhibit 12

Will regulatory changes around commission unbundling from the UK aid the boutique asset manager's ability to compete?



Source: TABB Group

Some firms in the UK have already chosen to formalize this process using commission sharing agreements (CSAs) where a portion of the commission charged by the broker is segregated into a client account. A portion of the money in the CSA "pot" may stay with the broker, but the remainder is allocated to other brokers and third-party research houses. Commission management is already a laborious process, however the process is likely to become more onerous from January 3, 2017 once rules concerning the use of dealing commissions to purchase bespoke research of a minor non-monetary benefit come into force.

"When you are a boutique it is very difficult to write any sort of check for research"

UK Boutique Asset Manager

Regardless of the final time line and exact requirements, changes to how commissions are both generated and paid for will require the buy-side to account for what they choose to purchase and why, as well as manage the process efficiently. Again, larger firms will survive – probably by employing their own analysts and by their ability to pay for research with hard dollars – but the ability for small boutique asset managers to survive will be struck another blow.

Of Flash Boys and dark pools

"We all hate latency arb-ers; they add zero value. But it's too much of a sweeping statement to say all HFT is bad"

Boutique Asset Manager, UK

The latest furor over HFT and dark pools yet seems to have passed the boutique investor by (see exhibits 13 and 14). However, it appears that both practices will face increased regulatory scrutiny – and that will have significant impact on all participants.

Small- and mid-cap names are becoming almost impossible for the buy-side to trade in the traditional manner. Sell-side small- and mid-cap desks have closed down and traditional risk capital is becoming an increasingly scarce resource.

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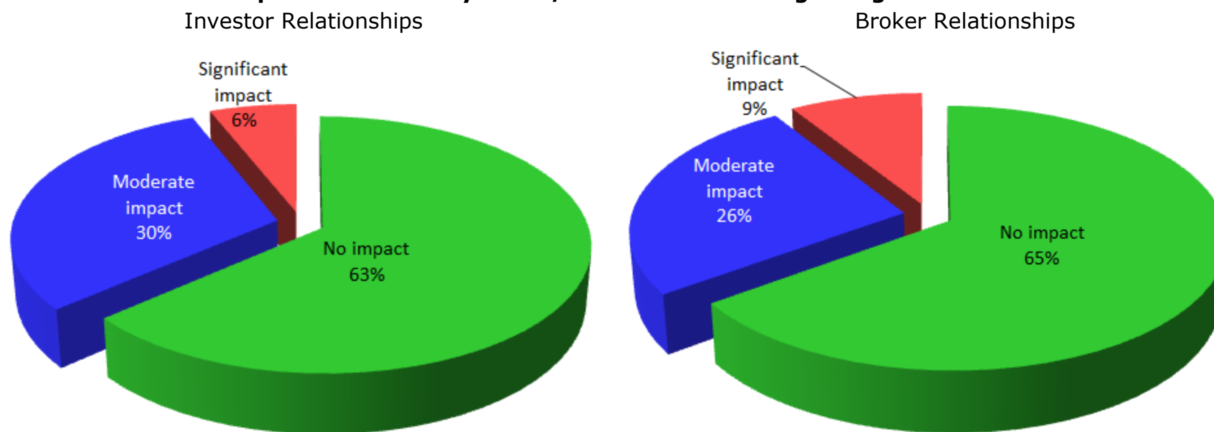
As orders become harder to execute without incurring market impact, the buy side have responded to the issue, either by trading dark or by choosing to execute against HFT or ELPs – electronic liquidity providers.

Exhibits 13 and 14

What has been the Impact of "Flash Boys" and/or the Concerns Regarding HFT?



Source: TABB Group

The focus for boutiques must now be on the explicit versus implicit cost of trading, requiring greater analysis of routing behavior, venue analysis and, ultimately TCA, in order to deliver best execution. Only a complete audit trail provides the ability to track and monitor behavior, assess risk more efficiently, monitor poor performance and even flagrant abuse.

Greater use of technology and analysis will provide the protection required but this will be a dynamic process. Venue performance can fluctuate according to external market conditions as well as the individual order being executed. The underlying activity of individual pools needs to be understood and continually reexamined.

As trading becomes further divorced from the research process and the buy-side becomes more autonomous from the sell-side, the requirement to demonstrate best execution will increasingly fall onto the buy-side. While larger asset managers are able to make the requisite investment in technology, smaller boutique players will need to rely on third-party relationships to bridge the gap.

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T+3, 2, 1

"The window to settle trades from the time you execute to the time you settle is continuing to shrink – if you are not set up with an electronic end-to-end solution, it puts more pressure on your loopholes, particularly with the time differences there is more pressure on the whole value chain – you always end up having to cobble a solution together"

US Boutique Asset Manager

Twelve European countries are switching to a T+2 settlement cycle in October. The benefits of reduced counterparty risk for smaller firms in reducing potential risk in unsettled transactions are clear; potential costly errors now can be rectified before they have a larger, more damaging effect. But, the switch to T+2 will affect not only settlements but also cash and currency positions, rebalancing of portfolios, stock loan and even corporate actions. All of these processes will need to occur within a faster time frame, highlighting the requirement to automate processes in order to compete with large firms and anticipate intraday risks.

The greatest opportunity to reduce risks and unnecessary expenditure will be through the elimination of manual workarounds. Manual rectifications and resubmissions are both timely and expensive. Fund managers no longer have the luxury of waiting until the end of trade date to allocate and confirm a trade: allocation details now need to be confirmed ideally pre-trade – but at the very latest same day – to reduce the overall number of exception reports that must be addressed. Getting any of this wrong now involves expensive consequences no participant can afford.

T+2 is fast becoming the norm, with several regulators eyeing T+1 as the optimal solution. In Asia, the Japanese Financial Services Agency implemented a move to T+2 settlement for the Japanese government bond market in April 2012 and Australia is reviewing T+2, while China has already implemented a T+1 trade settlement cycle. A recent white paper published by the Depository Trust & Clearing Corporation illustrated that a shortened settlement cycle in the US would substantially reduce risk across the industry by more quickly freeing up funds for reinvestment, and would reduce credit and counterparty exposure.

With multiple source systems capturing differing information for any firm (trade booking systems, valuation systems and collateral management systems), the ability to efficiently collate, link and report multiple strands of information will be critical to deliver the right information to the correct location at the requisite time. Once more, larger firms will be able to rely on internal resources, whereas boutiques will need to be more creative with the resources and relationships they have to manage.

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Better Together

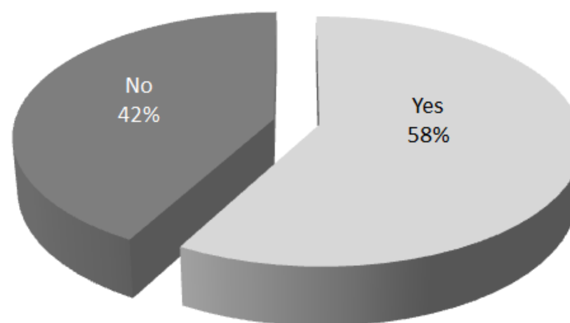
"For my European investors I need a third-party risk manager, third-party fund administrator, third-party valuer. It would be so much easier if I could get one third party that does all three. I end up having to go back and forth between providers sending the same information three times. It gets very burdensome and expensive"

Asian Boutique Asset Manager

Technology is now deemed the critical solution to meet regulatory compliance, limit risk exposure and efficiently manage existing resources more effectively.

More than half the participants in this survey now rely on the use of technology to expand their product offering (see exhibit 15). This offers third-party service providers the critical opportunity to deliver cost-effective alternatives to the current physical manual processes.

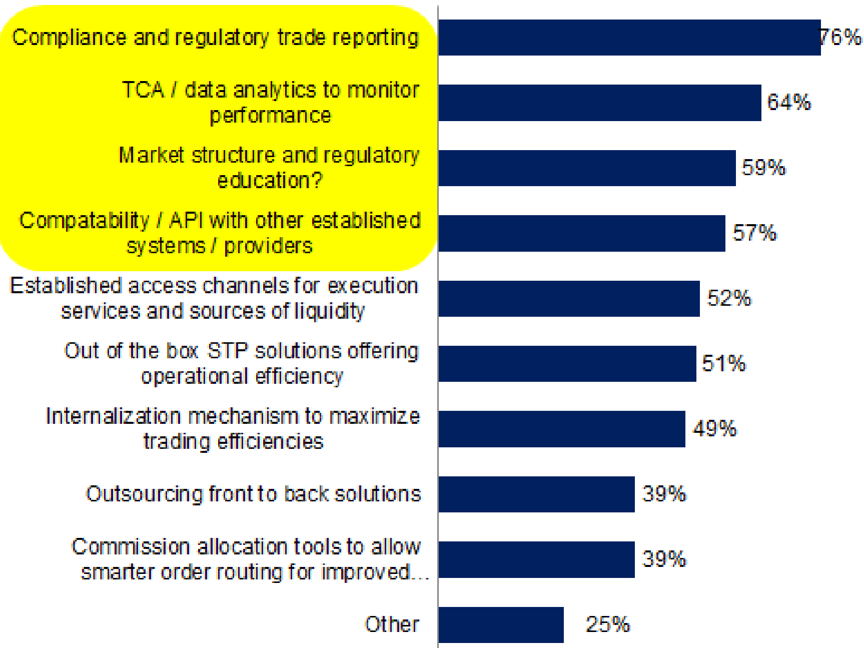
Exhibit 15
Has Technology Assisted Your Ability to Expand Your Product Offering (for Assets and Geography)?



Source: TABB Group

Offerings exist today but the majority of participants felt there was more that could be done to provide automated processes as an integrated and cost-effective solution (see exhibit 16). As yet no single provider delivers the solution that covers all assets to the level required, there are still too many disparate systems that need to be cobbled together. The challenge remains finding individuals who are aware of all the elements required to pull a true end-to-end, front to back solution across multiple asset classes.

Exhibit 16
Which of the Following Items do Technology Providers need to Focus on in order to Best Service your Needs?



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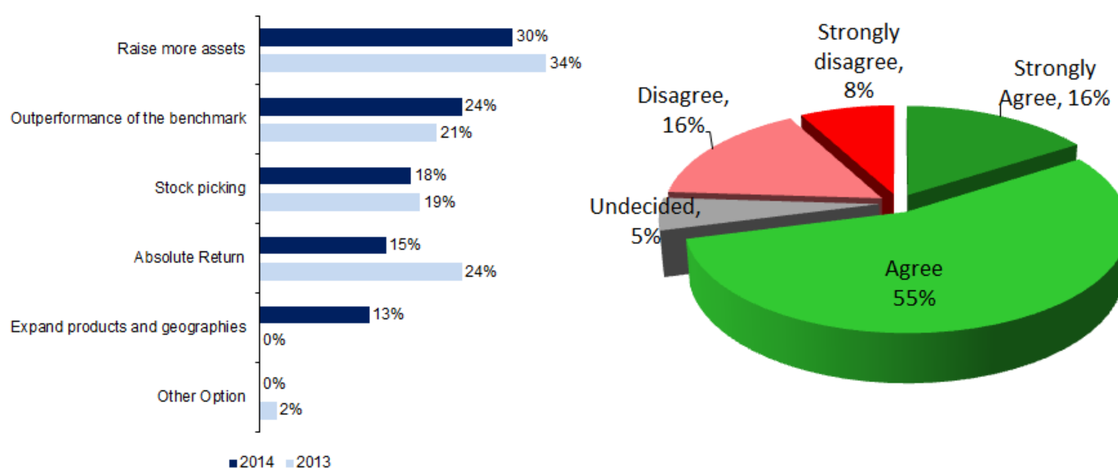
The Road Ahead

The cost of regulatory compliance is the main challenge to expanding a firm's footprint or product range. Current responses may well involve retrenching to a shorter list of products to ensure more homogenized investor due diligence. However, this could be only be a short-term measure. While some firms are choosing to rein back to core expertise, new investment models are already emerging to cover alternative products and geographies.

Relatively speaking, the raising of more assets is seen as less of a concern versus 2013 (see exhibit 17). While boutiques once believed the number one hurdle to expansion was the lack of a track record, operational stability is now viewed as ensuring boutique managers not only attract assets but maintain them.

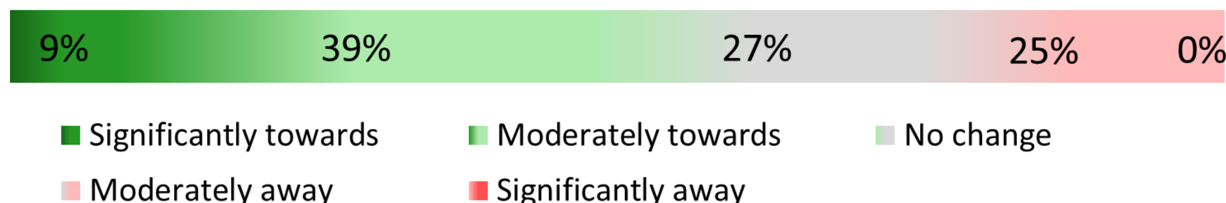
Exhibits 17 and 18
What will You Focus on to Grow AUM (2014 versus 2013)?/ Is size still a key factor in determining success?



Source: TABB Group

Defined by their entrepreneurialism and niche focus, the ability to outperform and to expand across product and geography are increasing as boutiques look to the future. Over half of the respondents felt that size remained a factor in determining success, but nearly a quarter felt that this was now no longer as relevant (see exhibit 18) particularly as the appetite for actively managed funds looks set to increase (see exhibit 19).

Exhibit 19
What type of shift does your firm expects regarding investor appetite for actively managed funds?



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To achieve this divergence of investments within the new global regulatory framework, the most likely cost-effective solution will be in the form of hosted, front-to-back enterprise-wide vendor offerings that can fully integrate trading, risk and operations.

Through the formation of these new unique partnerships firms will be able to successfully navigate the precarious balance between the demands of new transitional change while ensuring regulatory compliance today. Whether efficiency comes from internal technology, managed services or outsourcing, boutiques believe these solutions will enable them to focus on their core strengths. From asset gathering, operational efficiency, increased regulatory transparency and the ability to deliver stable, risk-adjusted returns, the ability to maintain a resilient infrastructure to ensure operational stability throughout the life cycle of the investment process will be critical.

While behemoth asset managers once had the advantage of scale and breadth, regulatory constraints may yet play into the hands of the boutiques as niche funds continue to attract capital from investors seeking outsized returns. Although only fully automated processes will deliver the necessary transparency, accountability and efficiency for boutiques to survive in today's competitive environment, the new era of boutiques will not only be a more selective one, but with the right partnerships could yet prove to be a more profitable one.

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About

TABB Group

TABB Group is a financial markets research and strategic advisory firm focused exclusively on capital markets. Founded in 2003 and based on the methodology of first-person knowledge, TABB Group analyzes and quantifies the investing value chain, from the fiduciary and investment manager, to the broker, exchange and custodian. Our goal is to help senior business leaders gain a truer understanding of financial markets issues and trends so they can grow their businesses. TABB Group members are regularly cited in the press and speak at industry conferences. For more information about TABB Group, visit www.tabbgroup.com.

The Author

Rebecca Healey

A recognized thought leader in market structure, regulatory reform and financial trading technology, Rebecca Healey joined TABB in March 2011, bringing over 15 years of direct industry experience in e-trading and financial services. Widely quoted in the financial, business and trade media, she has appeared on TV and radio discussing ongoing changes in capital markets for the *Financial Times, The Wall Street Journal, The Times, DeTelegraaf, Het Financieele Dagblad, IlSore24*, *Handelsblatt, Finanz und Wirtschaft, L'Agefi, Le Monde, Les Echos*, CNBC TV, BBC TV, BBC Radio, Bloomberg and Reuters, among others. In 2012, Rebecca was invited to provide evidence for the UK House of Lords review into electronic trading and regularly contributes to wider debates on regulatory reform.

Rebecca has held various sales and trading positions with Bankers Trust, Goldman Sachs and Credit Suisse, where as vice president she was instrumental in launching the firm's successful Advanced Execution Services product to hedge funds from its inception in 2002 until 2008. Prior to this, she was the first electronic trader at Credit Suisse to be registered for all electronic European cash equity markets and covered sales trading into Asia and then Europe between 1997 and 2000. More recently, she was based in the Middle East from 2008 to 2010, employed by the British Embassy in Bahrain where she successfully launched the UK Government's financial services strategy and set up the Bahrain Financial Services Roundtable, which remains a key source of information for the UK Government today, especially in relation to Islamic finance.

Rebecca holds a Bachelor of Arts degree in Spanish and Latin American History and Politics from the University of London.

At TABB Group, Rebecca has authored an expanding catalogue of research papers and commentary covering European equities, FX, fixed income, dark pools, TCA, HFT, FTT, market surveillance, market structure and regulatory reform.

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