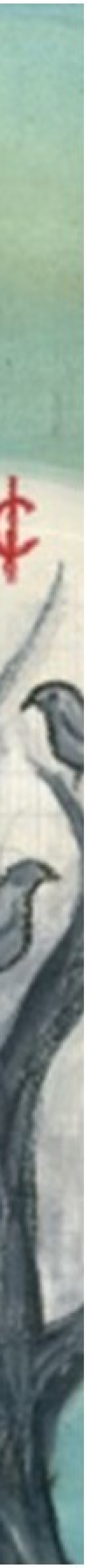
Adapting For The Future:

Boutique Asset Management Post-2017

Rebecca Healey | V13:031 | July 2015 | www.tabbgroup.com



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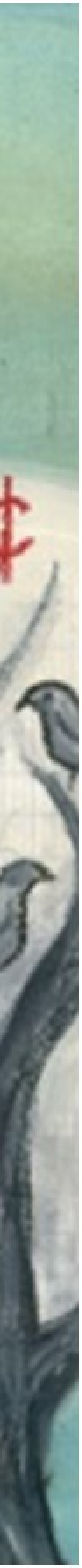

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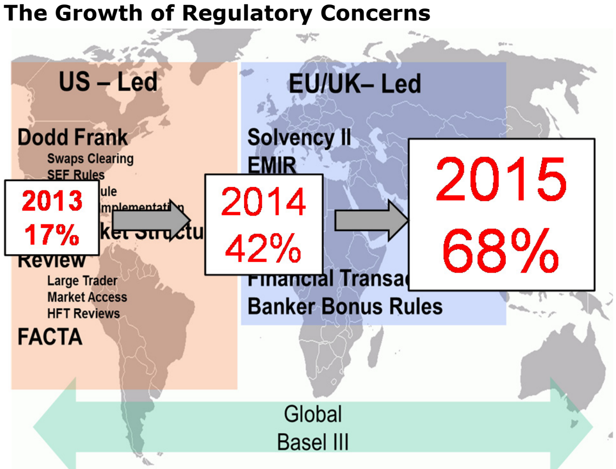
Vision

A three-pronged attack of encroaching regulation, lower returns from actively managed funds and the rise of passive investment appears to strike at the heart of the boutique asset management industry. Yet the opportunity for boutiques has never been greater. Their size, ability to specialize, and level of flexibility puts them in a prime position to deliver growth where larger competitors may struggle.

The recent rise of tracker funds, designed to diversify against risk, have benefited from global quantitative easing (QE) and central banking strategies. However, the hunt for investment alpha in an era of near-zero interest rates will favor boutiques that offer agile active management portfolios. Recent global macro events may create increased volatility and therefore opportunity, but successfully managing increased levels of risk will require flexibility and experience, as well as an increased use of technology to placate nervous investors.

However, boutiques not only have investor concerns to address. The intention to shine a light on opaque industry practices and provide end investors with greater transparency has resulted in a global web of regulatory complexity. Meeting this regulation is a now the top concern for 68% of boutiques in 2015, compared with just 17% in 2013 (see Exhibit 1). There will be huge data demands on firms of every size, requiring greater knowledge and comprehension of regulation by every employee, not just the compliance officer. All of this will affect business models and processes, and even investment strategies.

Exhibit 1:
The Growth of Regulatory Concerns



Source: TABB Group

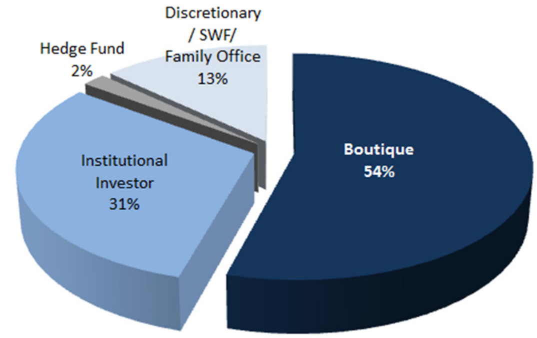
Regulatory complexity has become so great that any firm that tries to tackle it alone will struggle to meet the requisite resource requirements in staffing and investment in technology. Traditionally, boutiques would be at a disadvantage due to smaller resources and more manual processes, while asset management Goliaths could spread compliance costs across a larger revenue base. However, technological innovation is paving the way for new and unique partnerships that enable even the smallest of firms to balance the demands of transitional change with the certainty of regulatory compliance. This possibility levels the playing field and may well tip the balance in favor of the boutiques' ability to compete. Larger firms may have had an advantage over resources, but their investment strategies are less agile, and legacy technology can be cumbersome, inflexible, and expensive to replace.

Investment strategies are also shifting for many reasons, including continued globalization, the rise of technology, urbanization and an aging population in the developed world that coincides with a rising middle class in Asia. Nevertheless, pure geographical asset allocation is no longer sufficient; investor appetite for accountability is changing. Investments that blindly hug benchmarks may include companies that have insufficient governance policies and practices.

Environmental, social and governance factors in the new era of responsible investment will require managers to investigate investment decisions, as opposed to buying the most transparent assets on the assumption that they carry the least risk. A greater use of technology will enhance access to information and allow managers to interrogate better quality of information. The result will be more mature investment strategies and a broader scope of investments unfettered by asset class or geography.

These developments may well support boutiques ahead of other asset managers. Their ability to react nimbly to investment opportunities as they arise is diametrically opposed to the diminished risk appetite of the sell side and the cross-border, cross-asset restrictions and conflicts of interest that hem in institutional asset managers. As global investment strategies change, boutiques are increasingly in a position of advantage, provided they can leverage trusted partnerships to deliver efficient and robust processes that meet regulatory obligations. As a result, competition is increasing among third-party providers who have a major role to play in the new era of boutique asset management, but there is still more they could do to provide flexible and cost-effective solutions.

Exhibit 2:
Participants by Type of Firm

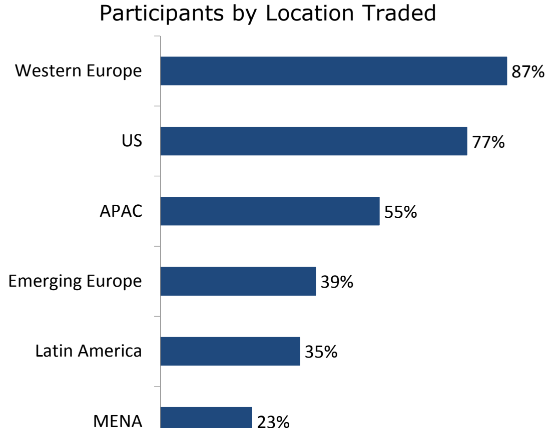


Source: TABB Group

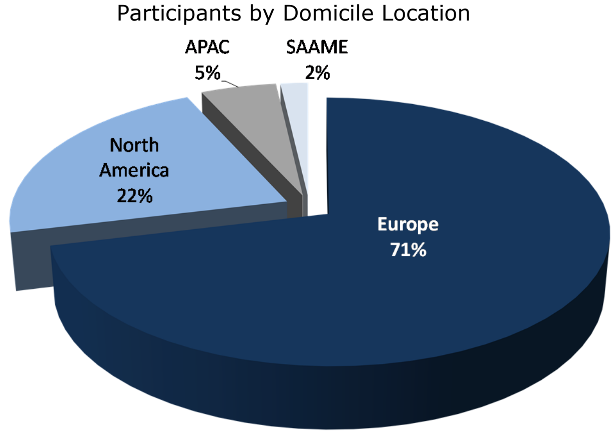
This report sponsored by SunGard's Boutique Asset Management business details the findings of an independent survey conducted in May 2015 of 110 industry participants. More than 50% were boutiques and a third were institutional investors who trade global products (see Exhibits 2 and 3), with nearly 90% trading in Europe and over three quarters trading US product. The geographic domicile of the respondents was also indicative of the recent level of change seen in Europe: Seventy-one percent of those who chose to reply are based in Europe (see Exhibit 4). Nevertheless, as boutiques become more geo–agnostic the breadth and depth of European regulation is set to impact asset managers irrespective of their home location.

Exhibits 3 and 4:
Demographics of Survey Participants

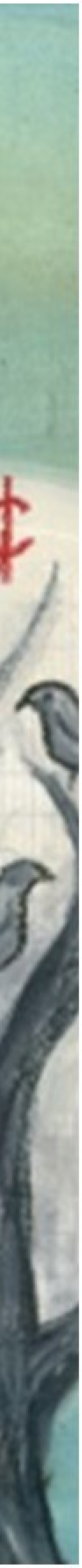
Participants by Location Traded



Participants by Domicile Location



Source: TABB Group



Key Points

1. Regulatory concerns have increased from just 17% in 2013 to 68% in 2015 as rising fines, increased demands and growing complexity challenge a boutique's ability to operate across multiple jurisdictions.

2. As US investors lose their home market bias, European regulation is becoming centre stage - 57% of US participants are now trading European equities versus a demand of just 33% last year and 21% in 2013.

3. Consequently 59% of US respondents saw regulation and compliance as a major concern; 57% saw MiFID II in particular as having a significant to moderate impact on their firm.

4. Aside from regulation, the search for new alpha opportunities and raising assets still remains a high priority for 55 and 54% of respondents respectively.

5. In terms of a strategy for growth, 51% of respondents now see operational efficiency as second only to stock picking in 2015.

6. Fifty-two percent are investing in infrastructure and personnel to achieve operational efficiency, with one-third focusing on regulation and compliance in particular.

7. Compliance and regulation tops the requirement for vendors to provide technology with 66% of respondents having a significant demand.

8. In adapting to the changing regulatory landscape, 54% of respondents are now looking to third party providers to assist with new services such as market structure and regulatory education.

9. Fifty-eight percent of respondents anticipate an increase in end investor appetite for actively managed funds versus 48% in 2014.

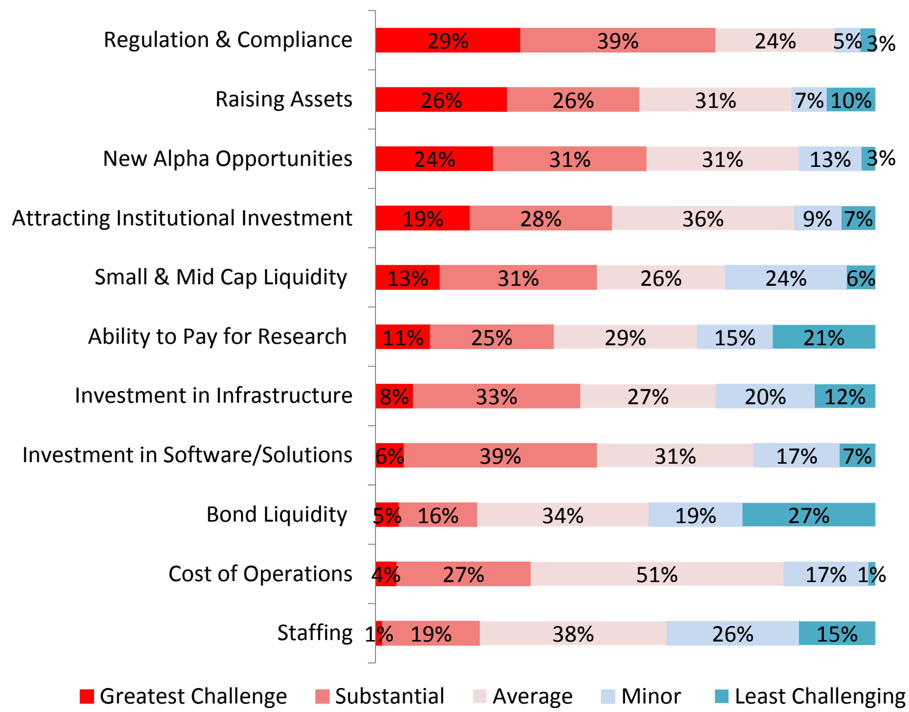
10. There is room for optimism. Agility in investment strategies means that boutiques can potentially find a route forward faster – 44% now believe that size is no longer a key factor in determining success, and of these respondents, 84% see agility as being the major advantage.

The Big R

Regulation and compliance have overtaken longstanding concerns about raising assets and seeking alpha opportunities as the greatest challenge facing boutiques in 2015 (see Exhibit 5).

The unique ability of boutiques to react to opportunities in different sectors or geographies has been the hallmark of their success. US equity markets are trading near record highs and valuations exceed historical averages while there are growing liquidity concerns in the bond markets over rising US interest rates. This combination leaves the investment environment ripe for new sources of alpha. Efficiently hedged long/short equity strategies are an attractive proposition for investors who seek diversified sources of return in the current QE-laden, low-yield world.

Exhibit 5:
Top Challenges for Boutique Asset Managers in 2015

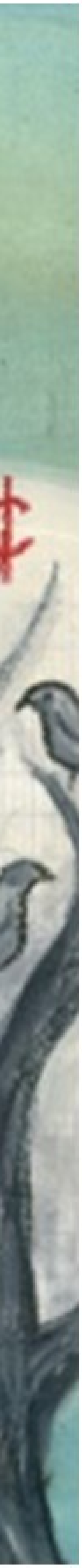


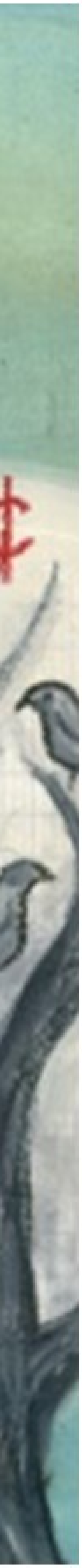
"We are still focused on regulation that impacts Singapore but we are becoming more aware of global shifts. The increased cost of compliance is becoming disproportionate to the AUM."

–Asian Boutique Asset Manager

Source: TABB Group

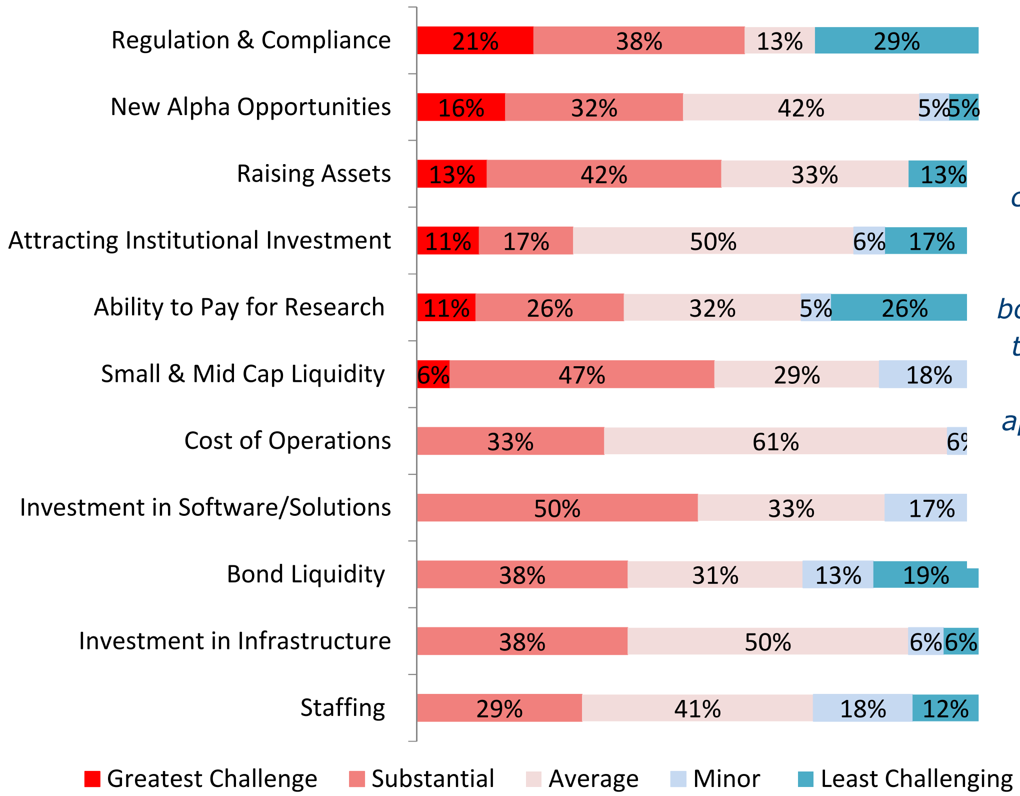
Shifting investment strategies cannot be limited to the search for better alpha opportunities but must also encapsulate regulation. Attracting and retaining investors requires boutiques to ensure compliance is watertight to avoid concerns over avoidable risk. Switching investments or geographic location may require an exponentially greater workload to meet this regulation and ensure compliance, but in order to reach alpha and grow performance, it is a challenge that must be overcome. In addition, as new regulations are implemented, regulators demand more information and compliance costs soar, so firms must also grow revenue faster to cover rising expenses.





Irrespective of geographic domicile the major concerns remained the same. When looking at US respondents alone, regulation and compliance once again top the leader board, with the hunt for alpha and raising assets as the next concerns (see Exhibit 6). It's interesting to note that the proportion of respondents most concerned about payment for research stood at 11% for both globally and in the US, highlighting how quickly this latest regulatory issue has expanded geographically.

Exhibit 6:
Top Challenges for Boutique Asset Managers in 2015 – US Based Respondents Only



"It's a constant challenge to keep up with different regulations. As a boutique you need to make sure you maintain your appeal as investor appetites shift."
-US Boutique Asset Manager

Source: TABB Group

Change in Investment Appetites

As QE runs its course in the US, asset managers are increasingly becoming geo-agnostic and focusing on favorable stock-picking opportunities. The hunt for mispriced value stocks with good dividends, strong balance sheets and fewer debts requires a greater level of due diligence, specialization and in-depth research well-suited to a boutique's investment strategy. This has been particularly evident in Europe during the last year as a result of the recovery story, but also in the Chinese and Indian economies, where economic and monetary stimuli are creating valuable equity upside (see Exhibit 7, next page).

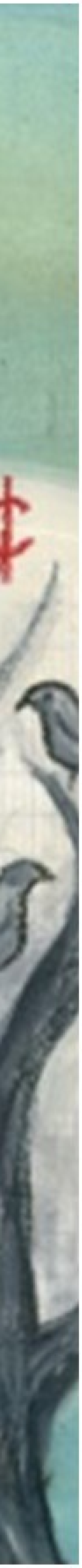
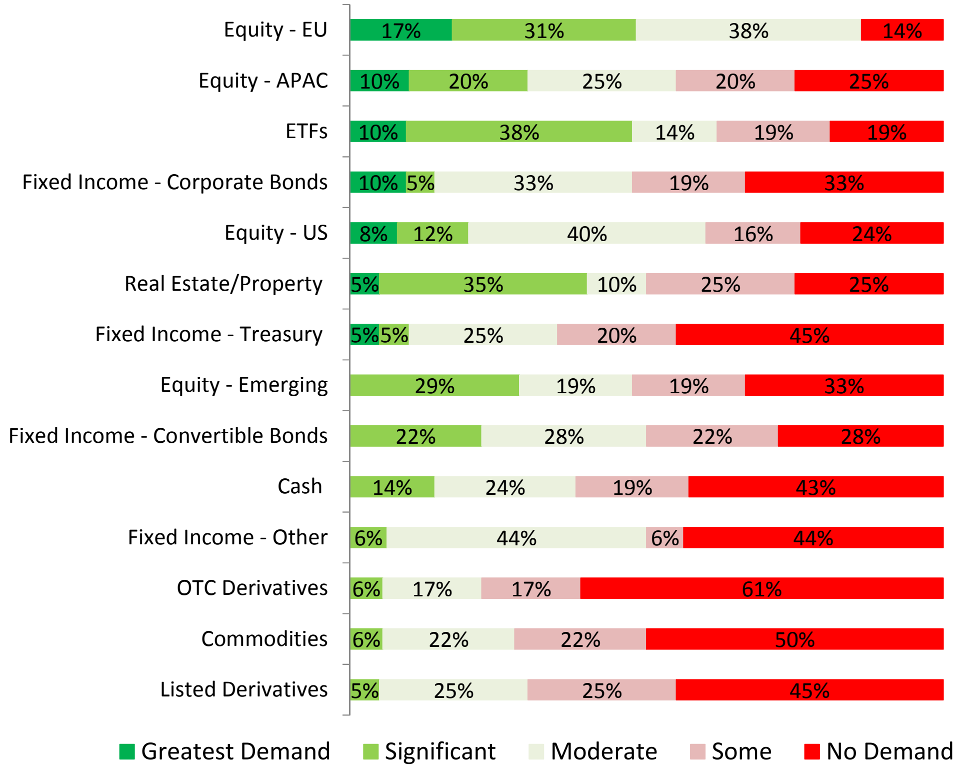


Exhibit 7:
Areas of Greatest Investment Demand in 2015



Source: TABB Group

"It's only now that US investors are thinking about the transition from a US to a global mandate."

–US Boutique Asset Manager

"We no longer offer services in Europe as brokerage services are getting more and more constrained to funds such as ourselves; we can't even get research now."

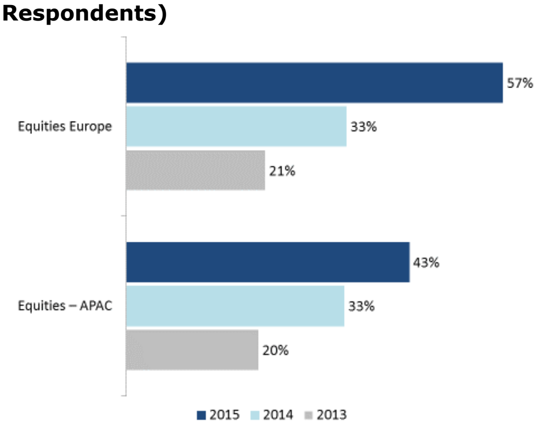
-Asian Boutique Asset Manager

While the demand for ETFs remains strong, a boutique's ability to seek out regions or sectors where there is opportunity to generate alpha is now translating into higher equity exposure in Europe and APAC.

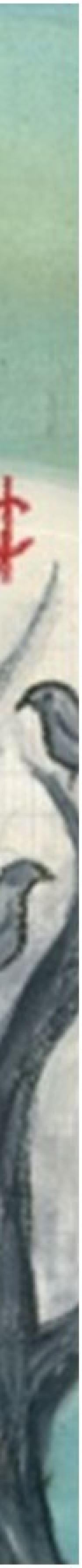
Given individual European and Asian markets have smaller market sizes, liquidity concerns have required asset managers to lose their home-country bias with many looking further afield to meet investment requirements. In comparison, US asset managers have been shielded from making these decisions due to the size of the US market and its relatively higher liquidity. US boutiques are now losing their home-country bias and switching to a global mandate in greater numbers this year, versus only a third of recipients in 2014 (see Exhibit 8).

Among US respondents the investment appetite for European equities soared in the first six months of

Exhibit 8:
Geographic Appetite for Equities (US Respondents)

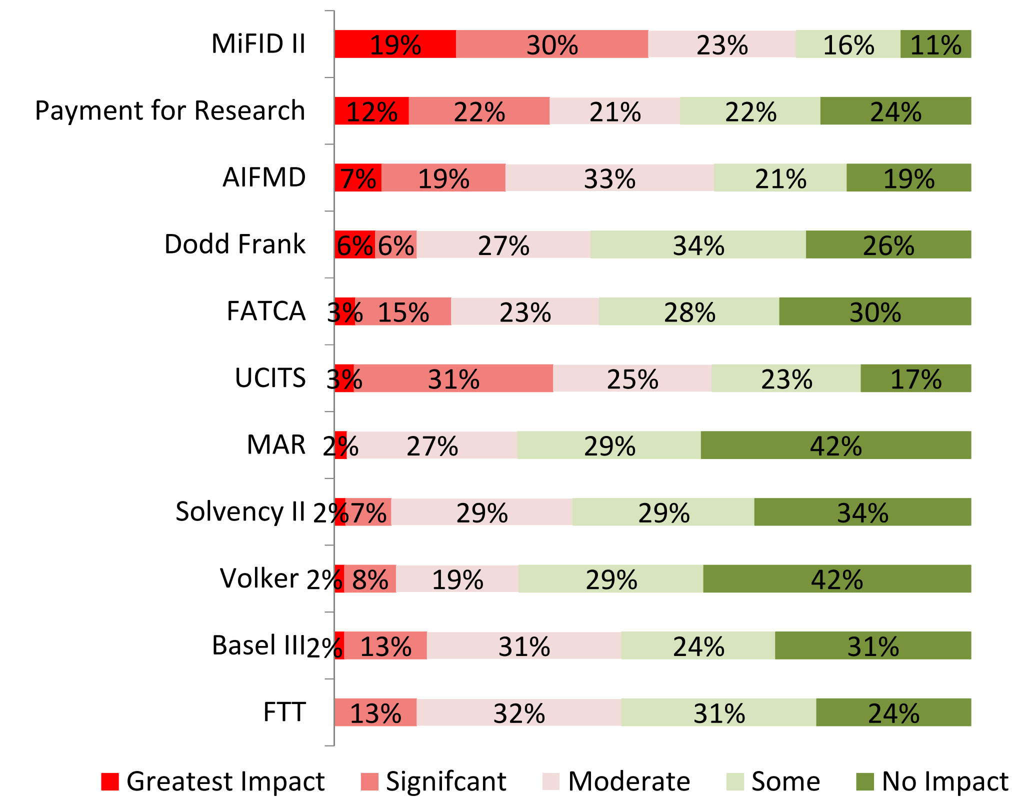


Source: TABB Group



2015. As a result, even though firms still registered their concern over Dodd Frank, FATCA etc., the extensive range of requirements under MiFID II means European regulation is now taking prime position on the leader board of worry (see Exhibit 9). Firms in the US and Asia may still initially focus on local regulation to ensure compliance, but increasingly the wide scope of European regulation is having global ramifications, such as the inclusion of all the asset classes under MiFID II. Asian respondents also cited incidents of secondary issues relating to European regulation. For example, regulatory changes are impacting the level of brokerage services boutiques can expect to receive from brokers based in Europe, such as the provision of research, which in turn impacts the services Asian boutiques are able to offer their end clients.

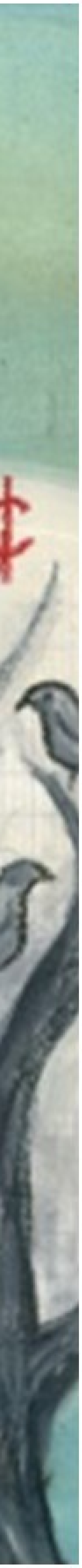
Exhibit 9:
Which Regulation will have the Biggest Impact on your Business in the next 12-18 months?



"MiFID II will have the greatest impact on our firm particularly in relation to transaction reporting"
–European Boutique Asset Manager

Source: TABB Group

Across the globe, boutiques must now educate themselves in short order about multiple pieces of global regulation, simply to understand where their obligations lie as opposed to relying on their broker. For example, one key area was the level of transaction reporting requirements that now fall under an asset manager's regulatory obligations. Historically the responsibility of the sell-side, these new obligations require asset managers to make significant investment in technology, systems and processes that until now have not been considered necesssary.

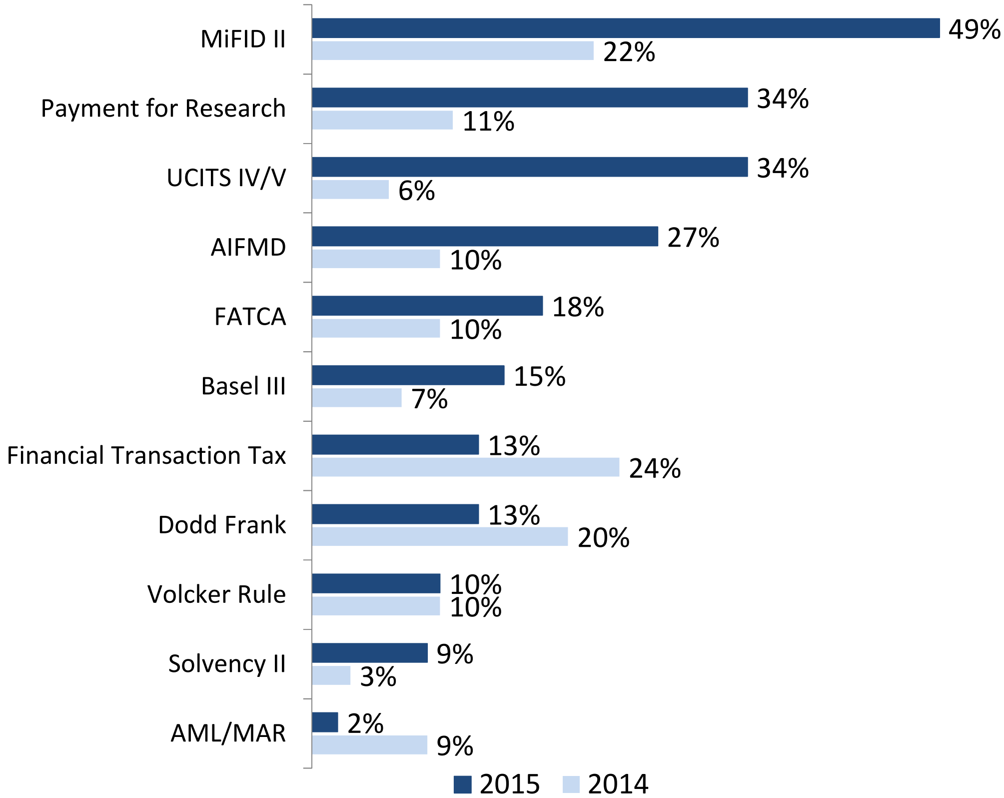


Key Regulatory Challenges

When boutiques sit down with lawyers and advisory firms to understand their obligations and the additional administrative workload they now face, certain key areas are emerging for consideration. Despite an element of proportionality within MiIFD II, the regulation covers a wide expanse of topics including transparency, market structure, investor protection, organisational requirements, transaction reporting and conduct of business rules.

Given the level of evolving regulation, many firms are struggling to see beyond the biggest and most immediate issues dominated by MiFID II. As a result, Market Abuse Regulation (MAR) has tended to fall down the list of immediate concerns, despite MAR becoming law six months earlier (see Exhibit 10). In addition market abuse has most prominently been associated with big banks, which is creating a false sense of security and non-applicability amongst many buy-side firms.

Exhibit 10:
Which Regulation Will Impact Your Business the Most in the Next 12-18 Months? (2014 vs 2015)



Source: TABB Group

European boutiques that have previously focused on the Alternative Investment Fund Managers Directive (AIFMD) are also now realizing that European regulators expect all market participants to become subject to both Markets in Financial Instruments Directive and Regulation and the Markets Abuse Regulation (MAR), irrespective of the size of the firm.

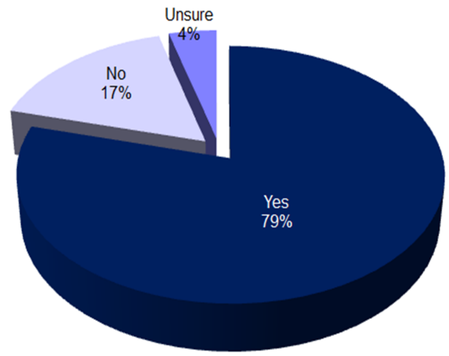
While MiFID II is expected to impact firms most of all, the most prominent single element within MiFID II was in relation to payment for research and inducements to trade.

Unbundling

Under ESMA's current proposed Delegated Acts for the Implementation of MiFID II, firms will need to pay for execution and research under separate arrangements. These arrangements must have a pre-agreed budget, which will be either paid for directly or via a ring-fenced research account funded by a specific charge. Key elements of unbundling include the following:

- The research charge cannot be linked to the volume and/or value of transactions.
- Budgets cannot be exceeded and unspent funds have to be repatriated or offset against the research budget/charges to be calculated for the following period.
- Any increase to the research budget can only occur after the client has received clear information.
- Firms must set and regularly assess the research budget as well as review research received.

Exhibit 11:
Will the Proposed Regulatory Changes Disadvantage Smaller Asset Managers?



Source: TABB Group

Boutiques that are aware of these changes are very concerned with the level of coverage they could expect from brokers in the future. Given a boutiques focus on picking individual stocks, even many institutional asset managers acknowlege that smaller firms will be disadvantaged disproportionately if their access to available research declines (see Exhibit 11)[1].

"It is very worrying. We currently take research from 16 brokers. If we now have to pay for what they send us we will have to cut several brokers and it will make the cost of investment higher."

-European Boutique Asset Manager

Any decrease in research consumption by the buy side could potentially lead to a decline in investment in research provisions by the sell side, which will lead to a fall in revenue for brokers, which will in turn make the provision of research an expense few on the sell side

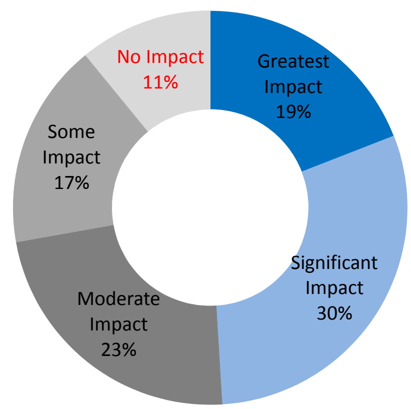
[1] TABB Group, *European Equity Trading Part One: Payment for research (2015)*

can afford. Less attractive stock sectors may also suffer. We have already witnessed the widespread closure of small-cap execution desks and few global investment banks will be motivated to produce research on SME firms if it is not profitable. Without available research, funds will be less likely to invest. The contra argument is that the market will be more open to competition from more bespoke research providers and sector specialists facilitating a flight to quality.

Unbundling will provide greater transparency but will also add administrative complexity to the research process. Boutiques may require third-party providers to administrate the research payment process in a similar manner to fund administration today. However it is not just paying for research, firms also face the question of how to establish the cost of research and how to budget for it. Previous consumption of research will not provide an accurate indicator of the budget required because the value of the research can only truly be established after the fact (ex-poste) and research requirements change over time dependent on both market and client activity.

Firms will need to demonstrate a sufficiently robust process to justify both their research choices and the price for services they intend to use. They will also need to demonstrate how they have chosen to allocate these costs fairly across their client base, to ensure clients are aware of what they are paying for, why, and where value has been added.

Exhibit 12:
What Impact Will MiFID II Have on Your Business in the Next 12-18 Months?



Source: TABB Group

Transaction and Trade Reporting

Eighty-nine percent of respondents anticipate MiFID II will have an impact on their business to some degree (see Exhibit 12). The increased level of reporting requirements – pre-, post- and at-trade – is also high on the list of individual concerns. This is set to become another substantial administrative burden for firms that have previously delegated the responsibility to their broker or prime broker.

The complexities are numerous. They include understanding what needs to be reported and to whom (the reporting obligations versus transaction reporting oversight); what can be outsourced to data-reporting services; and what remains the responsibility of the asset manager.

The additional 81 data fields include information such as passport, client, trader and algorithmic ID's, all of which throw up basic issues, such as how to populate a data field when a passport expires. Each data field needs to be sourced and validated. Providing data across multiple providers for multiple requirements requires far more standardized formats and processes that the industry has yet to resolve, in particular the lack of instrument

> *"Transaction reporting is very complex and challenging. Putting together reports from Excel will be a definite no-go. Firms can't afford to treat each regulation in isolation."*
>
> -UK Boutique Asset

identifiers in derivatives. Currently, firms use a mix of Bloomberg codes, RICS, Market Tickers and PIC codes. Without standardization, sending confirmations and affirmations alone will be an impossible task.

Firms will now need to source, manage, store, and retrieve relevant data promptly and efficiently. They must report, correct, and amend any reports in a timely manner, as well as demonstrate that the data and the underlying workflow processes are robust.

"Rules on client assets, EMIR, forward FX reporting and reconciliation, and broker-dealer reporting throw up a whole host of challenges. There's securities lending and net-stable funding requirements; I just don't even know where to begin."

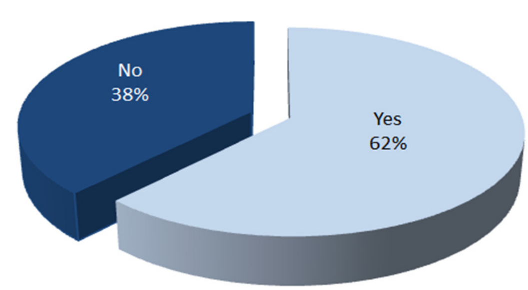
-UK Asset Manager

There are a number of interdependencies and overlaps among the new reports. Much of the same data will be required, just in a different context, such as the risk reporting regime under CRD IV (capital adequacy, group solvency, counterparty risk, operational risk, market risk and exposure); MIFID II transaction reporting (trade reporting, short sale or position reporting); Investor Protection (client disclosure); or market abuse under MAR (suspicious activity, governance reporting). However, the process is complex, and any previous industry-wide practices of aggregating Excel reports will be insufficient. To provide up-to-the minute, flexible data aggregation and analysis of granular data sets at varying frequencies, firms must have a holistic overview of their data. Where legacy technology is not fit for purpose, boutiques will have to choose between investing in systems internally or working with a third-party provider, be it a technology provider or a larger asset manager looking to outsource their dealing desk. Given the complexity of the requirements and the level of technological investment, smaller boutiques cannot attempt this gargantuan task alone.

The New Responsibilities of Best Execution

Any investment in technology for reporting requirements will also need to satisfy the new Best Execution requirements that are slowly filtering into every aspect of fund management. End investors are continually demanding more evidence of how investments are covered by due diligence, of the investment process itself and of how firms monitor their performance post-investment.

Exhibit 13:
Does the Regulatory Focus on Investor Protection and Market Integrity Impact End-Investor Relationships?

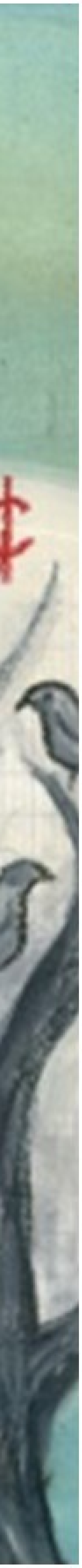


Source: TABB Group

The requirement to demonstrate Best Execution is peppered throughout European regulation. From Investor Protection rules governing the recording of telephone conversations and electronic communications, to MAR's rules on product selection and market abuse, the responsibility lies with all firms to have appropriate compliance policies in place. The delivery of fair and positive outcomes to end investors will

"We have recently introduced random sampling of trades to validate our best execution process in London and Hong Kong, but we are meeting considerable resistance in the US."

-UK Hedge Fund



require many firms to alter current practices, particularly in relation to non-equity assets.

Previously, some smaller firms took the view that best execution was the duty of the counterparty to whom they had sent the order. However, the recent growth in fiduciary responsibilities and demand from trustees for evidence of best execution is driving behavioural change on the buy side to demonstrate compliance.

Industry practice in Europe continues to move steadily toward improved policies and procedures that address end-investor concerns (see Exhibit 13). Best Execution in Europe incorporates many factors such as speed, likelihood of execution, settlement, size and nature of the order and any other considerations relevant for achieving the best possible result for the client.

"Clients are continually asking us for more evidence that investments are covered by thorough due diligence (as well as) what our investment process is and how we monitor this post-investment."

-UK Boutique Asset Manager

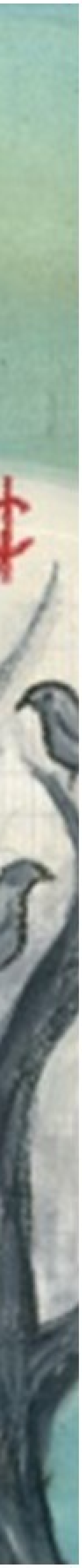
As such, firms' policies are now assessed on a myriad of additional factors such as the security in question, the size of trade relative to current existing volume, the trading venue chosen, current market volatility, a broker's willingness to provide capital, the client's need for anonymity and the likelihood of final settlement.

Increasingly, firms are making use of Transaction Cost Analysis (TCA) from third-party providers to demonstrate delivery of best execution and to analyze total costs and timings against those of competitors. Real-time metrics are now aggregated into end-of-day reports, which incorporate peer data and benchmarks. Post-trade back testing enables firms to compare order execution including venue costs against other alternative venues where the execution could have occurred. Incorporating this data into the review process will then further enhance execution decisions and investigate any underperforming areas.

"The challenge has been getting set up on FIX to install broker monitoring processes such as TCA. The next stage will be outsourcing the dealing and looking at best ex/broker monitoring."

-UK Boutique Asset Manager

New referral routes in the wake of the pension freedoms in the UK will result in additional responsibilities for asset managers in terms of end clients. For example, the Financial Conduct Authority's (FCA) definition of vulnerability, which includes financial ignorance. This regulation focuses on ensuring the fair treatment of so-called vulnerable customers but also on customers with insufficient knowledge around complex products, which requires an understanding of which products are likely to fall into this category. This theme is replicated under Investor Protection requirements under MiFID II. The assumption that end investors understand the risks they undertake is no longer sufficient; asset managers now have a duty of care towards their clients.



Expansion across Asset Classes

One of the greatest changes under MiFID II will be the shift across asset classes. FX is already in the firing line after recent scandals, but the next level of scrutiny is reserved for fixed income. Bonds fall under the scope of MIFID II's transparency requirements once they become liquid. Processes such as collateral management, posting margin and conducting risk analytics will need to take place ahead of trading.

"If we have to manage margin on mark-to-market we would struggle for operational reasons."

-European Boutique Asset Manager

The debate lies around liquidity classification based on the classes of financial instruments approach (COFIA) versus the instrument-by-instrument approach (IBIA). COFIA is a simpler approach that requires less data to perform the calculation but also risks including illiquid instruments within the scope of the regulation. If an instrument is then required to be traded, it will be subject to pre-trade transparency, on-exchange dealing rules, and so forth. Moreover, asset classes that fall under MiFID II also fall under all other European regulation such as Central Securities Depositories Regulation (CSDR), where there are mandatory buy-in rules. Given current bond liquidity issues, this could throw up exceptional challenges in sourcing and locating the necessary assets.

MAR - The Wake Up Call

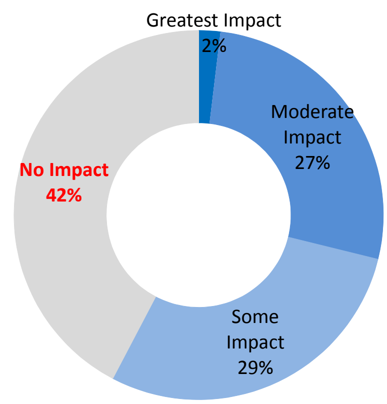
The new Market Abuse Regulation (MAR) is set to come into force in July 2016 and the onus is firmly on market participants to improve market integrity and to detect and deal with potential market manipulation. The issue is that this comes hot on the tail of multiple regulations and thus it risks getting lost in the noise. 42% of respondents believe MAR will have no impact at all on their business over the next 12-18 months (see Exhibit 14).

"MAR probably should be on my radar, but it is yet another piece of regulation – it's impossible to keep track."

-UK Asset Manager

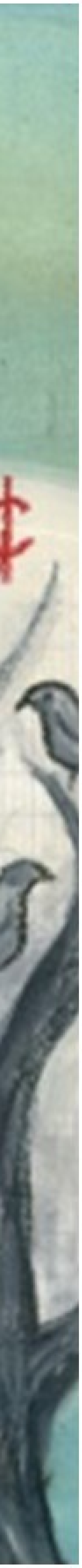
Unlike the Markets Abuse Directive, MAR will cover all orders, modifications and cancellations, not just executed trades. And the extension of market manipulation to include "attempted manipulation" as well as deliberate manipulation will require an exponential increase of data analysis. All orders to trade must now be put in context and no interaction can be viewed in isolation. This will require holistic oversight of a firm's activity across borders and asset classes, and in particular of the global multi-asset aspect of trading such as commodities trades, which could be at risk of price-fixing.

Exhibit 14:
What Impact Will MAR Have on Your Business in the Next 12-18 Months?



Source: TABB Group

The scope of the manipulation offence also includes benchmarks as well as spot commodities and emission allowances, all of which came under the recent



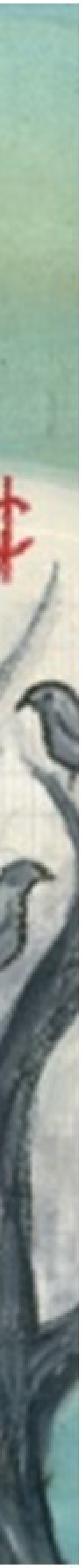
regulatory spotlight as a result of the inappropriate behaviour highlighted in the LIBOR scandal. This concept is taken further under the Free and Fair Markets Review (FEMR), the results of which were announced by Mark Carney, the Governor of the Bank of England in June 2015. Its 21 recommendations include the creation of new laws on civil and criminal abuse on the spot foreign exchange market, and maximum criminal penalties for market abuse will be extended.

"We are also spending more on the compliance department, increasing the staff levels, asking more of the team in terms of training and internal education. There is now a greater firm-wide engagement right behind our compliance team at every level."

-UK Boutique Asset Manager

Under MAR, manipulation of benchmarks (Article 3) includes false or misleading signals; price securing and indicators related to the employment of fictitious devices (Article 12); and person(s) who act in collaboration to commit market abuse (Recital 39). Examples of behaviors and activities considered as market manipulation are set out, for example, acting in collaboration to secure a dominant position over the supply or demand of a financial instrument.

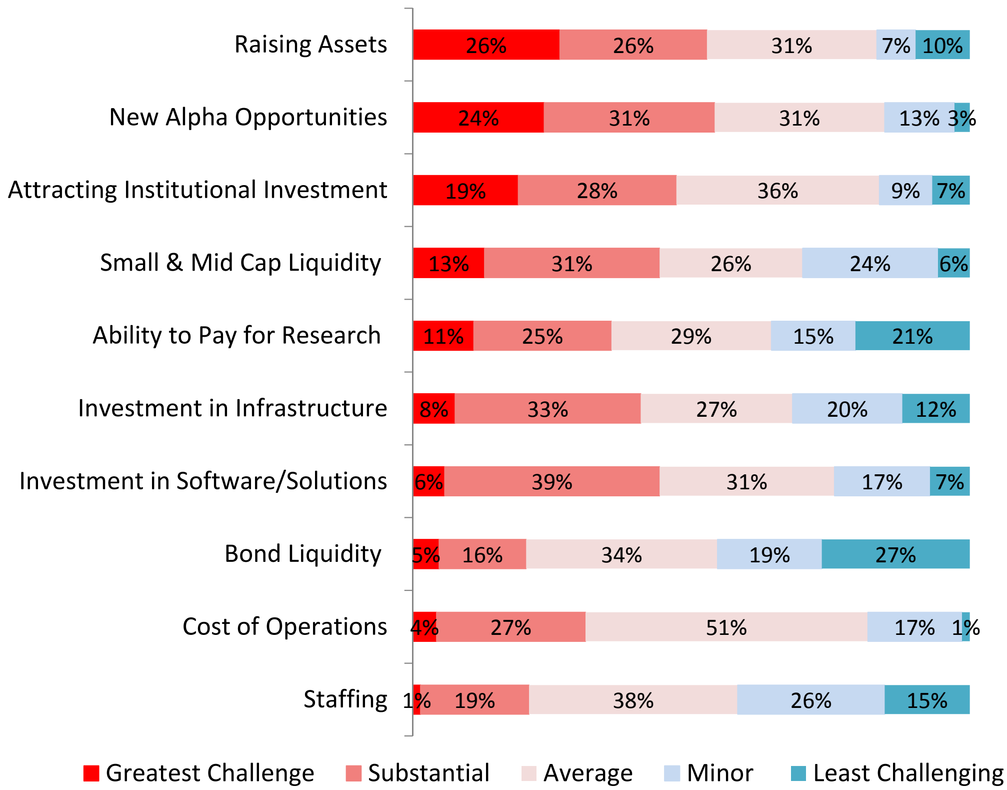
Rigorous surveillance is essential and vital for any firm's survival in the new era of accountability. Creating effective surveillance tools enables firms to ensure they meet risk and compliance requirements. Moreoever, greater effective and contextualized analysis creates anew opportunity for firms to tap into additional value in their hidden data.



Far More Than Just Regulation

Growing regulation may be requiring firms to reshape businesses but raising assets, seeking new alpha opportunities and attracting institutional money remain the top concerns for boutiques (see Exhibit 15). This was particularly evident in Asia where regulatory concerns have yet to dominate asset managers conversations.

Exhibit 15:
Top Concerns for Boutique Asset Managers in 2015 (Excluding Regulation/Compliance)



Source: TABB Group

Across the globe better performance still drives asset growth. Firms know well that investments in technology, internal processes and training staff all contribute to enhancing performance and thereby making boutiques more attractive. Compliance has now become the framework behind all aspects of the business.

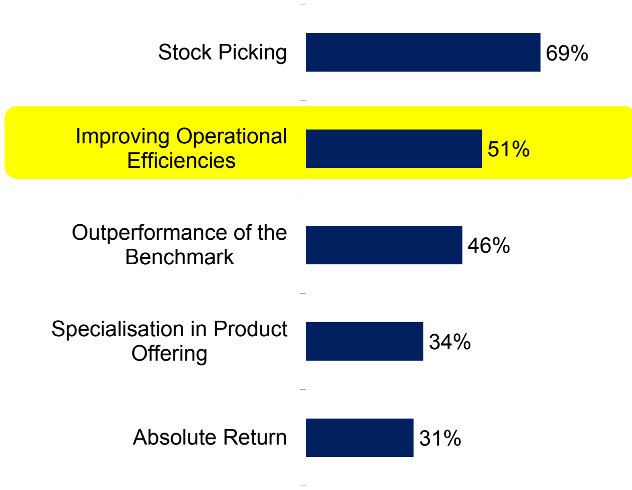
As firms attempt to stem the tide of assets out of active management and into passive funds, operational efficiencies will underpin growth strategies. Firms are reprioritizing operational budgets, increasing surveillance and monitoring tools, and streamlining operations to improve efficiency, eliminate errors and increase productivity. A key element of their strategy is better use of vendor technology, and TABB Group expects increasing demand for hosted IT services to drive cost savings, lower fees, and improve trading performance and governance structures.

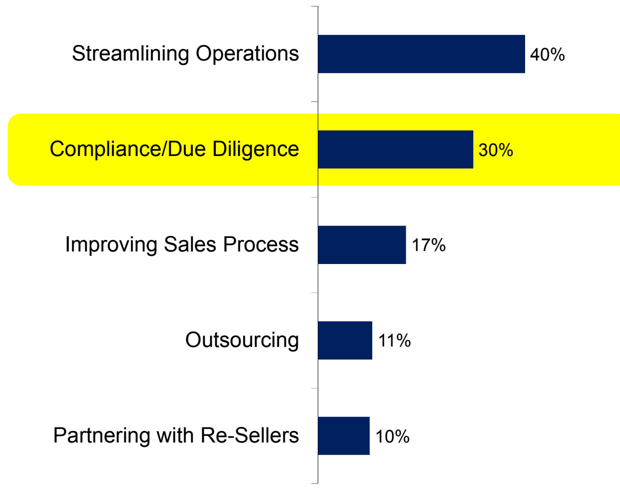
Operational Efficiencies and Growth

Operational efficiency now includes nearly a third of participants concentrating on their compliance obligations (see Exhibits 16 and 17).

Exhibits 16 and 17:

Growth Strategies / Areas of Focus for Operational Efficiency





Source: TABB Group

"Two or three years ago, we were still using paper tickets. Now we have full straight-through processing to eliminate errors and increase productivity. Improving performance means operational efficiency and management of resources as well as alpha generation."

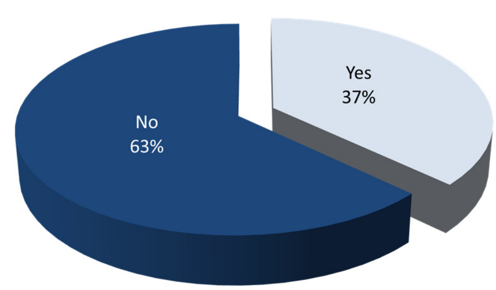
-UK Boutique Asset Manager

While the majority of firms are focusing on data gathering to meet regulatory obligations, some are starting to see the emergence of data as business intelligence. Holistic views with high visualisation and intelligent interrogation through streaming analytics provide a unique source of intelligence. When the analytics are made available along the entire trade lifecycle (i.e. portfolio managers, analysts, economists, traders, trade support and trade-reconciliation teams), there is a heightened risk awareness both internally and externally and a reduced chance of exposing the firm to risks that may hurt performance.

Although larger asset managers clearly have an advantage when it comes to resources, current legacy systems typically lack sophistication and flexibility, which leaves the door open to boutiques to take advantage of shifting investment strategies (see Exhibit 18).

Flexible business models can also benefit from the ability to reduce costs to survive. As outsourcing continues to gain in popularity, competition will drive down costs, enabling boutiques to benefit and focus on their core strengths.

Exhibit 18
Do You See Boutiques in an Increasingly Advantageous Position?



Source: TABB Group

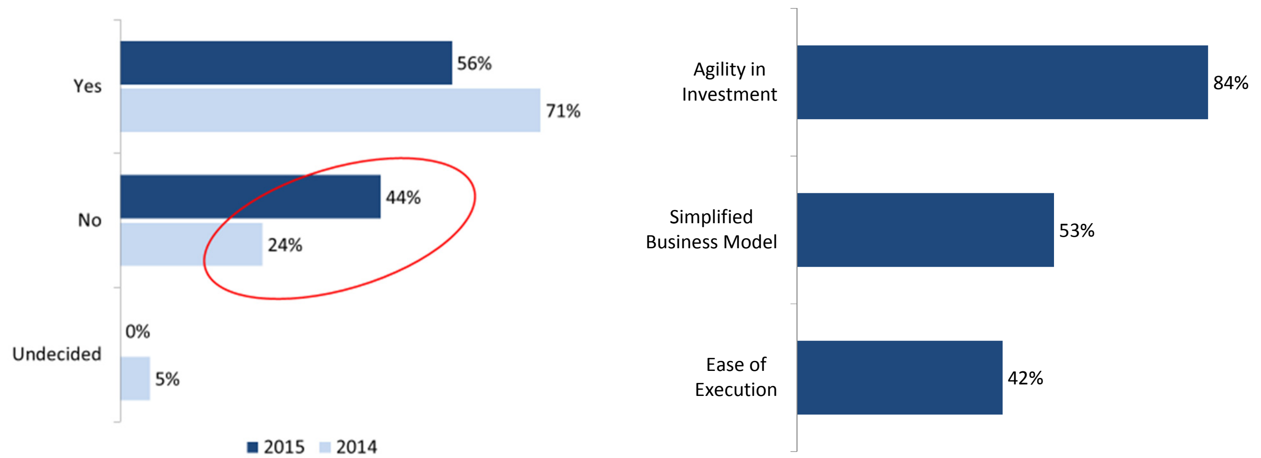
Active vs Passive Opportunities

Defined by their entrepreneurialism and niche focus, boutiques are set to increase their ability to outperform and expand across products and geographies. Nearly half of the respondents felt that size is no longer a key factor in determining success, versus only a quarter in 2014 (see Exhibit 19).

"Investors are focusing on funds with greater flexibility; you can be too big to adapt to opportunities for greater returns."
-UK Boutique Asset Manager

Developments in technology and globalization of markets will support boutiques ahead of other asset managers by allowing the former to quickly take advantage of opportunities as they arise. A large majority see their agility as their key asset in an environment of diminished appetite for risk (see Exhibit 20).

Exhibits 19 and 20:
Is Size a Key Factor to Determine Success? (2015 vs 2014) / What Advantages Do Boutiques Have?



Source: TABB Group

Recent concerns over greater transparency and accountability have resulted in a rise in strategies designed to diversify against risk, such as absolute-return, multi-asset and low-volatility funds. Being a fund manager has become more difficult as the size of funds grows. Managers become more risk averse once they gather assets. Underperforming might once have led to an awkward telephone conversation, now it can end a career; hence the appeal of investing in an ETF or hugging a benchmark. Low fees suit in the low-interest rate, low-return environment.

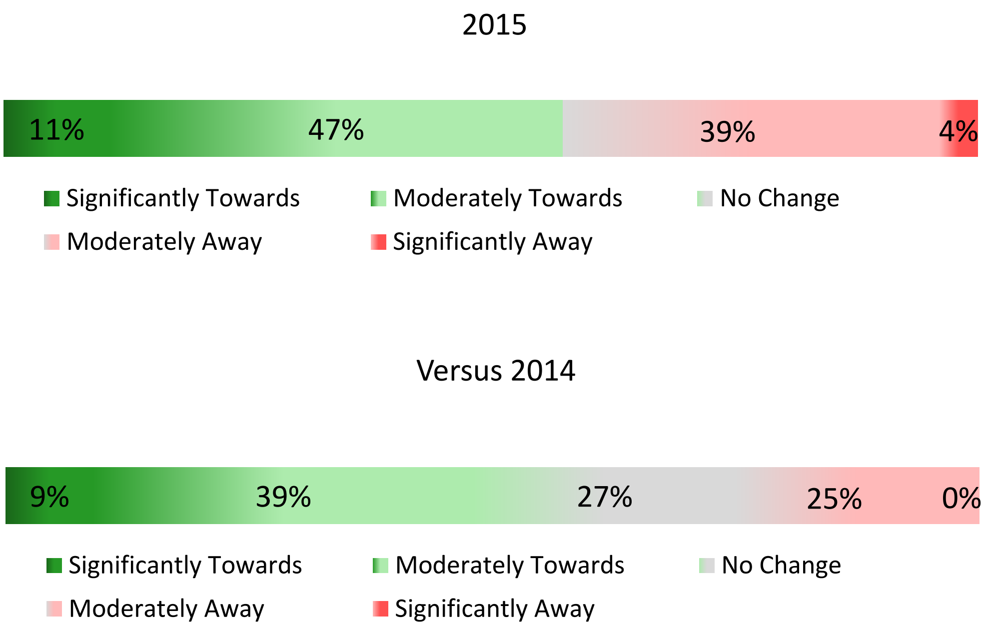
If maintaining strong active-managed performance is not easy, even buying into the most transparent indices may not be as risk-free as previously believed. Passive investing may incur lower set-up costs but necessitates a momentum-investing strategy because indices are weighted by market cap – the bigger a company is, the larger the investment.

"Passive success rides on the back of active funds. There will be a natural equilibrium as passive will only do okay if active is matching; at some point we will reach the tipping point."
-UK Boutique Asset Manager

If the market is moving up, performance improves by following market momentum, not through intelligent investing. This is causing some investors to shift strategy.

Smart Beta is on the increase. Passive and active investment are mixed by buying all the constituents of an index in equal portions, rather than by market cap alone. Additional beta strategies such as low volatility ensure the biggest weightings to the least volatile shares. Screening according to yield or price-to-book ratio ensures that investors own more of the most undervalued shares. This enables funds to provide equity-like returns without the risk. However even then the new investment concerns such as corporate responsibility are also creeping in. Simply lockstepping with indices may mean investing in companies with weak governance policies and practices.

Exhibit 21:
What Kind of Shift Do You Expect Towards Actively Managed Funds? (2015 vs. 2014)



"There is room for both passive and active funds. The challenge will be for the mid-size closet trackers. They are now exposed."
–UK Boutique Asset Manager

Source: TABB Group

In reality, unprecedented monetary policy has led to negative interest rates and corporations issuing debt at close to zero coupons, forcing investors further out along the risk curve. Some investors have moved out of bonds and into equities with a seemingly increased appetite for active management (see Exhibit 21).

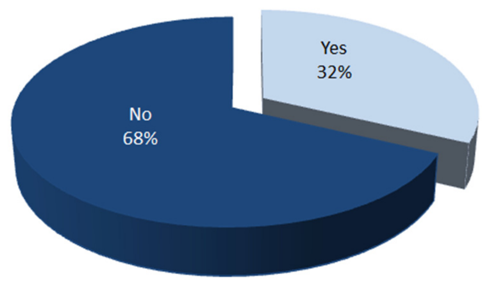
There will always be a place for specialist fund managers but the ability to qualify and quantify performance will allow those who are delivering better fund performance to be more easily recognized. Investments are only worth their salt when the deal has been done. Technology will enable managers to differentitate between the quantity and quality of information and to make better investment decisions rather than automatically buying the most transparent assets because at first glance they appear less risky.

Partnerships Ahead

The focus on regulation is such that technology is viewed by many as critical; not only to fulfill compliance obligations but to limit risk exposure and manage existing resources effectively. Only 32% of respondents see technology as an enabler of their product expansion plans, with the majority focusing on their ability to meet compliance concerns (see Exhibit 22).

For two thirds of respondents, compliance is the top technology requirement vendors must deliver on (see Exhibit 23). Firms face significant challenges as they seek a divergence of investments within the new global regulatory framework and meet the regulators' timeframes for compliance.

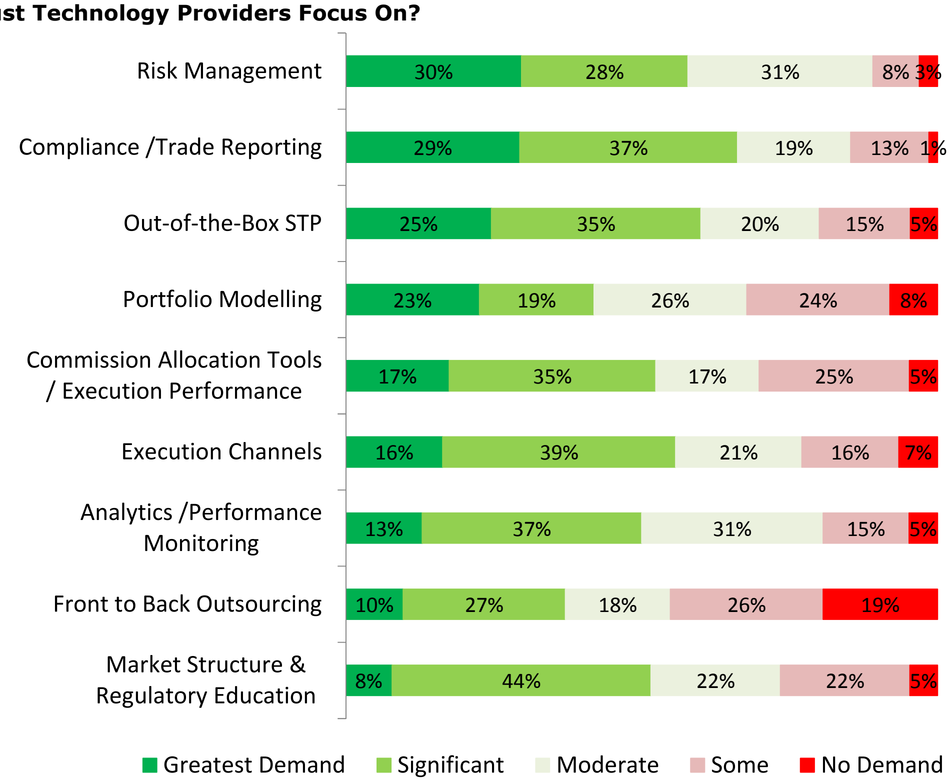
Exhibit 22:
Has Technology Assisted Your Ability to Expand Your Product Offering (for Assets and Geography)?



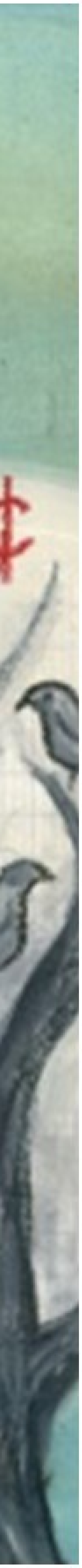
Source: TABB Group

"Our tech budget has increased second only to our legal and compliance budgets."
-UK Boutique Asset Manager

Exhibit 23:
What Must Technology Providers Focus On?



Source: TABB Group



Outsourcing Concerns

Greater use of technology will also enhance access to information and facilitate mature investment strategies that are based on personal outcomes better aligned to individual risk appetites. This facilitates the ability to invest agnostically rather than be limited by asset class or geography.

"We are reshaping our business. The challenge has been getting set up on FIX to install broker-monitoring processes such as TCA. The next stage will be outsourcing the dealing and looking at best ex/broker monitoring."

-European Boutique Asset Manager

Implementing new technology remains a hurdle. There are already cost-effective solutions in the form of hosted, front-to-back, enterprise-wide vendor offerings that can fully integrate trading, risk and operations and will provide one of the few viable technology solutions. Yet the desire to outsource is tempered by the perception that doing so is time-consuming, labor-intensive and expensive. Outsourcing received the highest "no demand" score in our survey and the onus is on third-party providers to prove this is a viable and obvious solution for smaller firms.

A secondary issue of outsourcing relates to charging for services irrespective of the level of activity, which becomes wasted overhead for smaller firms. Funds with larger irregular trades find little to meet their needs and must rely on their lone chief compliance officer to stay on top of global regulation.

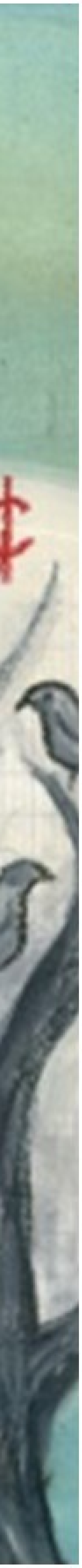
Amongst our participants, those firms that have embraced technology highlighted a wide range of benefits from having done so, not least of which is freeing up time to spend on marketing the fund. They cited

- Improved communication (internal and external)
- Lower cost to launch new funds
- Better ability to deploy funds at multiple venues
- Improved investment process and analytical research
- Real-time comprehensive views of risk
- Greater client reach globally through increased scope of distribution
- More sophisticated and geographically broader product offerings
- Improved screening technology
- Cost reduction and better returns from automated back-office processing.

"For us it is all about more hosted IT services and putting everything in the cloud. It's a combination of cost savings, better product, minimizing on-site server data, and better governance in terms of back-up of trading data."

-European Boutique Asset Manager

As trading increasingly covers multiple regions, assets, products and strategies, the need for fluid data across silos and business lines increases. This fluidity is a prerequisite to effective risk management and intensifies with the unique regulatory demands of each region. Ultimately, whether efficiency comes from internal technology, managed services, or outsourcing, technological advances will enable boutiques to focus on their core strengths of asset gathering and delivering stable, risk-adjusted returns. The ability to maintain a resilient infrastructure to ensure operational stability throughout the life cycle of the investment process will become ever more critical to boost performance and ensure a fund's survival.



The Flight to Freedom

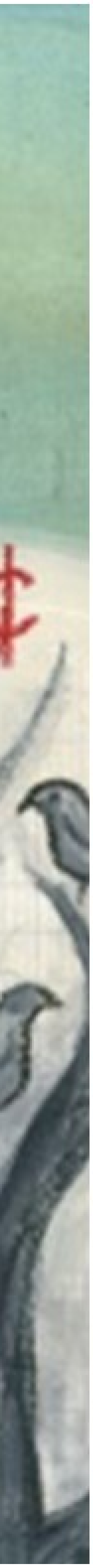
The growing complexity of regulation may yet have a silver lining for boutique asset managers. More effective and contextualized analysis will enable firms both to safeguard against unnecessary risk and market abuse and to transform bytes of data into a valuable stream of actionable intelligence. By moving risk from being of a compliance function seen only by a few to a proactive decision process practiced by all employees, business advantages will be gained from what was once regulatory necessity.

Aggregating data into an intuitive, flexible and easy-to-process format, companies have the ability to analyze far greater quantities and types of data in a shorter span of time, including both structured data and unstructured datasets. To create that single source of truth in both a consistent and robust manner firms will need ultra-fast access to data (messaging) from many and varied systems, real-time processing, and on-the-fly calculations that require large volumes of in-memory data. Having these will lead to more accurate analysis and easier validations and reconciliations.

This speed of analysis will ensure greater and more rigorous research is conducted earlier in the investment process. Technology can now provide insight into how processes and decisions can be optimized, both pre- and post-trade. Predictive analytics, performance monitoring, and even behavioral analytics can now be incorporated to mitigate risks and improve investment and trading processes in ways that have previously been considered impossible. TCA has been in place for a number of years in the equities markets but is now moving across the asset classes and can include estimations of how successful managers are at timing exits irrespective of market and behavioral conditions. In this way, it creates predictive capabilities that minimize risk and maximize returns. By monitoring the investment process systematically, managers can continuously improve their performance without incurring higher costs or risking a breach of compliance.

Surveillance now encompasses far more than unauthorized trading or deliberate market manipulation. Predictive analytics can highlight successful investment strategies and show patterns and commonalities when given a consistent collection of data including physiological as well as transaction data. Firms using algorithms can employ a more consistent application of decisions and behaviors to identify winning strategies. While this is a world away from boutiques’ behavior today, the capability for predictive analytics relating to traders' and portfolio managers' behavior has greater potential than just compliance monitoring and the prevention of rogue activities within financial institutions.

As asset managers become more geographically and asset-class agnostic to maximize returns from end investors, the ability to switch in and out of investments at the optimal moment will require intelligence on when, where and how to act. While institutional asset managers once had the advantage of scale and breadth, recent liquidity constraints and the growing raft of regulatory complexity and technology demands are starting to hinder their progress in comparison to smaller managers. Boutiques may yet prove to have the shortest flight path out of regulation into the new era of asset management.



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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