The squeeze on fees

The current state of the discretionary fund management market

Over recent years, asset growth has been a challenge for many discretionary fund managers (DFMs). And the rising popularity of cheap passive solutions mixed with the recent appetite for money market funds only exacerbated the squeeze on DFMs. We're now in a "race to the bottom" paradigm where DFMs are being pressured to slash fees in order to compete for assets whilst still offering value for clients.

The challenge for DFMs

Advisers today have the luxury to shop around, typically with the DFM's investment capabilities steering the adviser's allocation decision. Yet, and understandably, additional emphasis is placed on the cost of a proposition when deciding who to give business to.

It's also no secret that passive strategies provide a lower cost alternative to active management. And rightly so as no active decisions are being made, with less oversight required when tracking an index. However, their growing popularity is putting some DFMs in a tough spot, especially those with no passive proposition to offer. Left to either lower fees or deliver compelling active management to justify their higher cost active solution. And as you know, there were very few managers that managed to outperform the market in 2023.

Balancing between active and passive strategies

Active and passive funds both have benefits in their own right. Active funds typically deliver higher returns and if managed by a good manager, are capable of exploiting market inefficiencies. Alternatively, passives are a cost-effective way to reach a larger slice of the market. As such, an appropriate blend between the two should be incorporated within a portfolio as a tool to manage underlying fees and to offer the best value for clients. If access to US equities is required for example, and an exchange-traded fund can provide the same exposure and deliver comparable returns, a passive solution may be best suited. And in instances where the market landscape is opaque, using an active fund manager could be a more viable solution to uncover investment opportunities.

A meticulous approach is therefore required when deciding to use either a passive or active strategy. Combining the two to construct a portfolio that gives room for active managers to run their best ideas whilst knowing when a passive strategy will 'do the job.'

Relationships are key
Strong relationships with fund houses can play an integral role in lowering the cost of a DFM's proposition. Access to cheaper share classes, allow DFMs to pass this onto end clients in the form of lower fees. However, "access" may be dependent on the strength and long-term relationship a DFM has with the fund house. Often the overall amount of assets you have with a fund manager could grant you access. With this dynamic in play making it even more difficult for new players to compete in today's market.

Seed investing
In the early stages of capital raising, fund managers often provide investors access to founder share classes that give investors a low-cost option to invest in a fund via discounted fees. In effect, these early investors seed the fund launch. This comes with advantages but also some risks investors should be aware of.

- Advantages: Access to a cheaper share class in perpetuity, and a positive story to tell clients if an early-stage investment turns a profit.
- Disadvantages: A fund with no track record makes it difficult to analyse performance and risk, placing more emphasis on the DFM to take a macro or market view instead. It could also open up the DFM to concentration risks if further fund raising becomes stagnant.

Conclusion
In our view, the debate between active and passive solutions has no basis. Rather the two should be seen as firstly, a way to manage portfolio fees, and secondly, a tactical trading tool depending on whether markets are operating efficiently or not. In the same way, seed investing and strong relationships can provide DFMs cheaper routes into the funds they like. Something we at TAM use to our advantage, with clients being the immediate beneficiaries.

If you would like to speak with us about anything in this note, or to discuss our discretionary investment management services in general, please get in touch with our UK business development manager David Terry today.

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