How to select a DFM: 7 critical questions

analytics

Summary

After completing a review of your financial practice and deciding that you need the support of a DFM, the next part of the process is to select the most appropriate DFM to partner with. Every advisor should carefully consider seven critical questions before making the decision to enter into an arrangement. The seven questions include issues such as detail regarding the ownership structure, size of assets under management, information regarding the investment and operational team, detail regarding the investment process, relevant performance comparisons, clarity on fee structures and whether the DFM offers any specific value-added services.

Introduction

You've just completed a review of your financial practice and have come to the conclusion that you need the support of a Discretionary Fund Manager (DFM) in one or more of the following areas:

- Required licence and experience managing model portfolios.
- Added rigour to investment and operational processes.
- Freeing up time to service existing clients and build new relationships
- Obtaining access to cost-effective investment products.
- Ensuring clients are invested in appropriate risk-profiled solutions.

Congratulations are in order – you are halfway there! The next part of the process is to select an appropriate DFM to partner with.

We would recommend that you ask your short-list of DFM candidates the following seven critical questions:

- Detail regarding the ownership structure?
- What is the size of the assets under management?
- Information regarding the investment and operational team members?
- Detail regarding the investment process followed by the DFM?
- Performance comparisons of the portfolios managed by the DFM?
- Fee structures of the DFM and the underlying funds in portfolios?
- Does the DFM offer any other value-added services?

In the following sections we will explore these questions in more detail.

Q1: Detail regarding the ownership structure of the DFM?

Is the DFM completely independent or does the DFM form part of a corporate?

We would argue that an independent DFM has no shackles and is free to provide independent advice, perform due diligences on any investment proposition and more importantly, be able to include or exclude any investment fund from the portfolio.

It is also important to determine the culture of the DFM and whether it is compatible with that of your advisory practice. Will you be able to form a good relationship with the firm and the team supporting your clients' specific requirements?

analytics

Q2: What is the size of assets under management?

A larger asset base implies that the DFM is able to support a larger investment team with diverse skills to construct more optimal portfolios; a larger and more efficient operational team to engage with the LISP platforms regarding any administrative queries; the ability to subscribe to expensive, but necessary systems such as Bloomberg, FactSet and Morningstar Direct; and the scale of the DFM's investment business could potentially aid in negotiating favourable fees from underlying asset managers used in investment portfolios.

How many clients does the DFM have – the more clients, the higher the probability that the DFM is adding real value; however, too many clients could impact how much time the DFM could afford you in terms of their existing commitments to other clients.

Q3: Information regarding the investment and operational team members?

You will interact regularly with the investment and operational team members. Do you know whether the investment and operational teams are staffed with appropriate team members with relevant qualifications and sufficient experience? How accessible are the members of investment and operational teams? Who will be your main point of contact and how natural is the fit between you and this person?

Q4: Detail regarding the investment process followed by the DFM?

Ensure that the DFM's process includes:

- Economic research to inform strategic and tactical asset allocation decisions.
- Fund manager research on both qualitative and quantitative characteristics and research on passive, smart beta and active (established and boutique) fund management strategies.
- Portfolio construction which ensures optimal blending of uncorrelated fund managers.
- Regular performance reviews of funds and portfolios.
- Utilising decision-support systems such as Bloomberg, FactSet and Morningstar Direct.

Does the process make sense; do you feel it is robust and should work in most economic environments and are you comfortable that the process translates seamlessly to the performance of the portfolios managed by the DFM?

Q5: Performance comparisons of the portfolios managed by the DFM?

Enquire regarding the performance of a range of model portfolios managed by the DFM. How does the performance of the portfolios stack up against relevant benchmarks over appropriate time periods?

Try and determine what ranges of returns you can expect from different model portfolios. Ask about reasons for large outperformances and underperformances in specific periods and ensure you also evaluate rolling time periods for consistency in return profiles. Last, but not least - do scrutinise the volatility and drawdown statistics of the underlying funds and overall portfolios.

analytics

Q6: Fee structures of the DFM and the underlying funds in portfolios?

How does the fee structure compare to those of other DFM's? Is the DFM able to use cost-effective structures to decrease overall costs, without sacrificing returns or increasing risk of the overall portfolios?

Does the DFM proposition promise value for money in terms of the level of service you will receive on an ongoing basis?

Q7: Does the DFM offer any other value-added services?

Enquire about other value-added services in the DFM service suite.

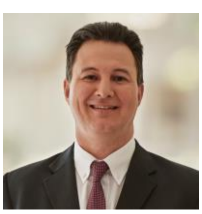
Does the DFM offer:

- Insights on relevant topics that you can apply with ease in your business?
- Performance, risk and fee simulations to enable you to compare current client portfolios to your set of model portfolios?
- User-friendly systems to translate difficult concepts into practice?
- Availability to engage with your clients on the markets, funds or the portfolios – if you so wish?

In Summary

We believe that DFM's should be able to add demonstrable value to any financial advisor's business in an age of ever-increasing investment and regulatory complexity.

After weighing up the answers to the seven critical questions from each of the short-listed DFM candidates, you should be in a much better position to decide which DFM would provide the best partnership and business fit with your practice.



Daniel Schoeman MSc, CFA
Daniel is currently CIO of the Analytics multi-manager funds of funds. He has more than 19 years investment and portfolio management experience, and has previously worked at three of the largest multi-managers in South Africa, first at Investment Solutions, then joined Momentum MultiManagers which later merged with MCubed to form Advantage Asset Managers, His main responsibilities include economic research, tactical asset allocation, investment manager research, portfolio construction, monitoring and risk management, system development and innovative investment research, He is also a member of the Investment Committees of some of the largest advisor networks in South Africa, providing investment consulting services to these groups on an on-going basis.