Should financial advisors use a DFM?

An exclusive *Blue Chip* discussion with three of the country's top investment and financial planning professionals focused on Discretionary Fund Managers and how advisors can best utilise their services.

EXPERT PANEL

Our three panellists come at the topic of DFMs from different perspectives.

Barry O'Mahony, CFP®, Founder, Veritas Wealth Management

Barry O'Mahony came from Ireland to South Africa in 1993. He joined Appleton as a portfolio manager and later moved to Brait Unit Trusts and ipac SA. O'Mahony was the 2013 FPI Financial Planner of the Year. Veritas Wealth is a Category I (Cat I) advisor business with an outsourced Discretionary Fund Manager (DFM).

Dean De Sousa, Portfolio Manager, Equilibrium

Dean De Sousa started his career as an analyst in healthcare actuarial consulting before moving to Equilibrium (previously Momentum Investment Consulting) as an investment analyst in 2017. After two years, he moved into a portfolio manager role and is responsible for the construction and ongoing management of various bespoke multi-asset-class client portfolios. Equilibrium is Momentum's DFM.

Ebrahim Moola, Senior Financial Advisor, Bobats Wealth Solutions

Ebrahim Moola is the founder of Sterling Invest (a Cat II discretionary investment manager) where he fulfils a senior portfolio manager role. He is also MD and senior FA at Bobats Wealth Solutions (a 94-year-old wealth-management business). Sterling Invest makes use of an external DFM advisory business that assists in putting together its model unit trust portfolios for Bobats clients.

DFMs free up time and build a better process that is a deeply researched and properly implemented part of your business.

MODERATOR

Ian Jones, CEO, Fundhouse
Ian Jones has been with Fundhouse for 10 years. He is a qualified actuary who started in the investment industry in 2001. Jones has extensive experience in fund research, portfolio construction as well as the broader asset management and financial advisory industries, globally.

IAN JONES (IJ): What do you see a DFM as in our industry?

EBRAHIM MOOLA (EM): For us, partnering with a DFM felt like we could focus on what we were getting paid to do as a Cat I financial planning (FP) business, and that's putting together proper financial plans; really understanding and helping our clients achieve their financial planning goals. DFM solutions or the services they offer are quite specialised within the investment management field of the broader financial planning landscape.

We very quickly realised that the complexities involved within the FP process necessitated us to work with an investments partner to do the specialised work required for putting investment solutions together. And we didn't necessarily want to have to make additional investment decisions, given that in the 21st-century, investment management has become quite sophisticated. We felt we'd rather partner with an outsourced DFM to help us with this investment solutions aspect of what we need to put together for our clients.

IJ: Dean, as a DFM, how would you describe what you do? How does a DFM differ from the traditional multi-manager?

DEAN DE SOUSA (DDS): There is no one-size-fits-all definition that applies to all DFMs. It depends on the value proposition that a DFM has. We see ourselves as a partner to advisors to enhance the investment advice value proposition offered to clients. This comes in many forms depending on what that advisor's primary value proposition to their clients is. Where we (and most DFMs) primarily differ from traditional multi-managers is that it is more of a service rather than an off-the-shelf product. Where wrap funds or model portfolios are offered as off-the-shelf solutions, this would be very similar to traditional multi-managed fund of fund (FoF) solutions. But typically, we take it a step further by creating a much closer relationship with an advisor, developing a good understanding of their advice proposition and then tailoring our offering to align to and integrate into the advisor's value proposition to generate the most value for the clients.

IJ: Ebrahim, when you first decided to partner with a DFM, was there an aha moment when you realised it was the right thing to do?

EM: The aha moment probably came when going through the painstaking initial process with our outsourced DFM partner in putting together the various models for our clients. There's so much nuance and specifics that came up. The DFM raised issues in coming up with these mandates that we hadn't even considered. From that point on, I can say with confidence that the decision-making (by the outsourced DFM partner) that went into selecting the fund managers, into the asset class allocation, into the various investment styles incorporated into these baskets of funds, that a lot of work had been done behind the scenes. I can hand-on-heart say that we're putting the client in the best possible position from an investment perspective by working with an outsourced DFM partner.

We can add value as financial planners on the fluffy stuff of relationships and partner with investment specialists (outsourced DFM partners) whose life's work is building model portfolios in the context of our client base and business.

We're fortunate to have our own Cat II business so we are still the final trigger-puller on what gets into the models and any changes that are made. But 99.9% of the decisions that are used within the model portfolios are the DFM's decisions and we know the work has been done behind the scenes by experts in fund manager selection, asset class allocation and review of macro-economic data to understand which style of investment is best suited for the medium to longer term.

We have that comfort that we've partnered with experts and in this complex environment that we find ourselves in where there are countless investment options available for clients, our outsourced DFM helps us demystify and simplify them into one of our 12 model portfolios. An overwhelming majority of client objectives can be catered for within these model portfolios that we've created.

IJ: What are the core factors an advisor should consider when looking to partner with a DFM?

DDS: An advisor should first understand their own business, their investment advice proposition and where they can possibly improve. Understanding the components you can and want to improve simplifies the process of identifying an appropriate DFM. Then it comes to selecting a credible partner, which goes back to those five Ps of selecting an asset manager:

People. Their qualifications, experience in the industry and through different market cycles, the depth and breadth of the team.

Philosophy and Process. From a philosophy perspective, do you believe in their philosophy of investing? From a process perspective, how do they model asset classes/do they follow a balanced fund construction versus more specialised funds, depth and breadth of their manager research etc? Does this align to my financial advice philosophy and process?

Performance. Are they successful in what they have been trying to do? Don't just chase the supposed best-performing DFM because a lot of DFMs purport to be the best but their

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performance comes in the context of a range of factors. Performance must therefore be appraised appropriately and that the profile of returns is aligned to what the DFM says they do.

Price. There's a range of services that the client ultimately pays for, and the fee must be commensurate with the value received, otherwise client returns are eroded to a certain extent.

Then perhaps more broadly, with the changes to Regulation 28, a DFM that has a global presence is increasingly important. If roughly 30%+ of your assets are going to sit outside of South Africa you would want a DFM that can select the best opportunity set from the global space. Finally, consider the operational benefits that enhance your value proposition, such as institutional levels of reporting, frequent communication, the ability to bulk switch investments within a model portfolio, access to restricted funds/fee classes and the tools they offer to make an FA's life easier.

IJ: Fees are a prickly issue when returns are low and fees across the value chain have come under pressure. How does a DFM fit into the value chain with the amount of pressure on fees now?

EM: Historically, the DFM's layout fees weren't there and now there's a new entity that's taking a sliver of the fee that the client pays. For the discerning or fee-sensitive client, the appropriateness of the fee is questioned, but it has never been a case of, "I don't want to use the DFM because I am not willing to pay 20 or 30 basis points for the services they offer".

DDS: DFMs play a big role in driving down that overall total investment charge and the total charge is what the advisor should focus on. Although there is an additional fee line, it does not necessarily translate into a higher level of fees for clients because the DFM does a lot to push the investment management fees down, and so bringing down the total fees for clients.

Trends in the UK show the use of DFMs has allowed advisors to focus on their main value proposition (being financial advice) and to charge more for it given the lower overall investment charge. Clients are thus benefitting from the better fee experience and so are the advisors.

EM: In my opinion, the FA fee should be the highest as a percentage of total followed by the DFM and thirdly the asset manager with the platform fee last. So just in this value chain, I feel the DFM fees are reasonable relative to their value.

Barry O'Mahony (BOM): And the value, the reason that the FP fee is higher, is because an FA is limited in the amount of clients that they can deal with. A DFM allows us to receive rather than investigate information. Because they are ahead of the game, we receive that information much earlier. DFMs allow us to spend more quality time with our clients in the FP area and that is where the value is added.

EM: The value proposition that you advertise to your client base is probably the biggest factor in deciding whether or not

to work with a DFM. If you purport to be an investment specialist and want to be involved in the investment decision on behalf of your clients, an outsourced DFM may not be a good idea.

But then I look at what we've done. We set out within the industry wanting to be inherently involved in the investment decision. Within the model portfolio space, there's a certain skillset of choosing fund managers, asset class allocation and reporting on model portfolios. We weren't comfortable making a group of decisions on behalf of our clients.

We focused our investment management capabilities on stock-picking, where our Cat II business develops its process. On the model portfolio side, which is a very different skillset to individual stock-picking, we felt that a third-party outsourced DFM was the better solution.

It comes back to that value proposition you're purporting to your clients and how you want to add value. An FP business is not that scalable, only a specific number of clients can be serviced within a limited amount of time each day.

The best FP practices truly understand and engage with clients in meaningful ways that add value to their long-term goals, help them achieve their ambitions and invest in the right products. We believe in working with partners who do it better than us and act in the clients' best interests.

BOM: A DFM it is not the panacea for all investment problems.

EM: I don't necessarily want to say it's the flavour of the month but right now, based on all the tools and options available to the independent FA, it does feel like the DFM solution makes the most sense for our practice. It could be that a multi-manager solution or choosing your own funds works best for you but right now, for us, the DFM solution makes the most sense.

IJ: Does a DFM impinge on the FA's independence?

DDS: I would argue the opposite is true – DFMs allow FAs to potentially be more independent. Given their level of expertise and the breadth and depth of coverage, DFMs can appraise asset managers more objectively and find the most appropriate asset manager or fund for the solution as opposed to an advisor sticking to the few managers/funds they know well due to limited time/capacity.

If advisors themselves particularly strive for independence, then that should be made apparent from the start. There is a commercial argument for a DFM tied to a life office/asset manager/manco, for example, to use their own funds. You need to understand from the outset to what extent that will be the case and if you are comfortable with that.

I speak for Equilibrium here – there are solutions and funds that we have access to, being tied to Momentum, that aren't offered to the greater industry and which we believe give us an edge within our solutions.

So sometimes that tied nature works to the advantage of the clients, but the advisor must ensure that it is not to their detriment. Advisors should continuously interrogate the DFM's independence and make sure that anything that makes its way into your client solutions is there on merit rather than for a commercial reason.

BOM: I don't think independence is a big issue. Most DFMs are smart enough to know that if they start overusing their own funds, they'll blow themselves out of the water.

It's still the advisor that must continually reassess if they made the right decision. Should I use a multi-manager/share portfolio/property trust/passive balance funds/this DFM? Does it all add up or am I falling behind here? And if you are falling behind then stand up and address it.

EM: As long as we remain independent internally or as an FP business, that we've done our checks and balances to confirm the outsourced DFM we've selected is independent and if I have the option to dismiss the DFM at any point, independence is not an issue.

IJ: Any advice for those considering a DFM?

DDS: Understand your value proposition first and foremost, know where it is in your business you can improve and then set up a meeting with a DFM (or a few DFMs) to see if they can add value to your practice. They can even highlight areas to improve you may not have been aware of. The investment and regulatory environments are becoming increasingly complex and cumbersome, so if you can make your life easier by partnering with a DFM you should consider doing so.

EM: Ideally, it needs to make sense for you as a practice to partner with a DFM. Once you're at a certain scale or looking to grow and you need more time to meet with more clients, it may be time to consider an outsourced DFM.

If I consider the impact it has had on our practice, I feel totally justified working with an outsourced DFM. In 2023, it's the right thing to do based on the complexity of our work.

BOM: The overarching focus in your job is giving advice. DFMs free up time and build a better process that is a deeply researched and properly implemented part of your business. For example, as a Cat I if we decide to switch out of a fund that all our clients have, who do we start with? The biggest clients, the smallest ones?

If we do nothing else except switch our clients out, it will probably take two months to solidly review our client base. That's ridiculous, it's not a value add. It could take two years by the time we get all our clients out of that fund, whereas DFMs bulk-switch. ■

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