NEXTWEALTH

An Adviser Guide to Working Effectively with Investment Partners

Insight from financial advice firms on the when, what and how of managing DFM partners in light of the Consumer Duty

May 2023

Letter from Charles Stanley

Consumer Duty will introduce a new principle (Principle 12) that all UK regulated firms must act to deliver a good outcome to retail clients. All aspects of the business that impinge on quality and cost will be put under the microscope: platforming, reporting, compliance, administration. But for many financial adviser firms it is their centralised investment proposition (CIP) that will be integral to delivering a good outcome to their clients.

In response we are seeing many financial advisers review their CIP from a different point of view. Whether deciding to manage investments for clients themselves or looking to outsource to a third-party investment house, it is essential financial advisers are able to demonstrate the value their CIP is delivering to their clients now and in the future.

As an active partner to many firms, we have had many conversations with financial advisers about the coming changes. They have been telling us about the challenges the review and selection process can bring. There are many propositions on the market to choose from, and partnering with the right investment house for their clients and their business is a big decision.

Although we have plenty of anecdotal evidence of the how Consumer Duty could impact existing and future relationships, we wanted to understand the depth and breadth of these challenges.

With this in mind we partnered with specialist research firm NextWealth to help us uncover some of the experiences financial advisers have had over the past couple of years to better understand the reasons for working with external investment partners and some of the important considerations to focus on when reviewing potential partners.

In this guide, we aim to show how advice firms are working with investment management partners to improve the value they offer to their clients and build efficiencies within their businesses.

Report methodology

NextWealth independently interviewed 15 advice firms representing a range of sizes, business models and attitudes to investment management. Our sincere thanks to those individuals who contributed their time and insights to help other firms who may be looking to evaluate their investment proposition and perhaps select or review their partnerships with DFMs.

Tom Hawkins
Head of Strategic Partnerships

The value of investments can fall as well as rise. Investors may get back less than invested. Charles Stanley & Co. Limited is a member of the London Stock Exchange, is authorised and regulated by the Financial Conduct Authority and is part of the Raymond James Financial, Inc. group of companies.

Letter from NextWealth

The Consumer Duty is accelerating advice firms to focus on cost, to seek to reduce risk and improve efficiencies.

We are seeing particular growth in tailored models as firms tighten their propositions and focus on delivering a cohesive and consistent customer journey.

Our interviews for this guide uncovered four main reasons that firms might choose to work with an external partner to deliver their investment proposition:

- Firms are seeking to enhance the value they deliver to clients by concentrating on where they can do more to understand and meet client needs. That means reducing time spent on other tasks such as rebalancing, fund switching, reporting.
- Firms that would identify themselves as more planning-led than investment-led are decoupling investment performance from their adviser-client relationship.
- Working with an investment partner reduces investment risk for the adviser.
- A good investment partnership brings access to research and resources, including in specialist areas such as impact investing.

Several interviewees suggested that these drivers are accelerating as a result of Consumer Duty. In some cases this was because of a root and branch review prompted by the new Duty. In others, it was because of the increased focus on delivering and evidencing value for clients.

We hope this guide is useful for any firm who may be exploring how to get the most value out of current partnerships or perhaps seeking new ones.

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1/ Methodology

The findings presented in this guide are based on qualitative research conducted by NextWealth between 7th February and 13th March 2023. The research consisted of in-depth interviews with 15 financial advice firms, selected independently by NextWealth to represent a range of businesses by size (AUM and number of advisers), directly authorised or appointed representatives and with a variety of investment models from those managed by an in-house investment committee to those where investments are fully managed on a discretionary basis by an investment partner.

2/ Introduction: Why firms do and don't partner with a DFM

Prompted by the Consumer Duty, there is a good deal of discussion about the nature and value of financial advice. The industry is squarely focussed on value and good outcomes for clients and many financial advice firms are taking a fresh look at the service offered to clients.

What goes into delivering the best possible outcomes for the best possible value?

When is it worth adding to the fees clients already pay to bring in a partner to deliver the investment proposition: what does it deliver for the firm or for the client in terms of added value or efficiency savings?

Perceptions of working with an investment partner can be very polarised. Some firms are already advocates of the benefits:

> *"No business is going to continue to succeed if clients are loss making. We need to spend less of the allocated budget on rebalancing, getting the same outcomes, so we can provide additional services in other areas and partnering allows us to do that."*
>
> *"Unless you're of a larger size firm and you can have a proper Investment Committee and meet regularly and you have someone that is qualified and knows what they're doing...being a DFM is hard. So outsourcing to a DFM for us and the type of business we're operating, it just makes sense. It allows us to have that support of these professionals behind this that give us all the literature that we need in order to speak to our clients."*

Others are strongly opposed, generally because they consider that the cost and/or the loss of control over investment decisions outweighs any efficiency or risk gains.

> *"I think there's a real polarisation in the market at the moment between those advisers that almost see investments as a bit grubby, a bit dirty. They say, we don't want anything to do with investments, it's not our job, we're pushing it outside. Well, we take a different view. We don't want to outsource, because we have quite strong views on certain geographical regions or asset class attractiveness."*
>
> *"I generally think a well-run CIP will deliver far better value than outsourcing to DFM unless it's for serious amounts of cash, when it's properly bespoked: either the portfolio's bespoked or it's accessing a bunch of products that are unavailable to the general marketplace."*

The growth of 'insourced' and tailored investment solutions presents a middle-ground option in which portfolios can be co-branded and the investment proposition may be customised to some extent, for example, mapped to an existing risk framework.

In the course of our interviews, we came across some long-held beliefs about working with investment partners that we think merit a second look and we cover these in our 'Myth Busting' section on page 16.

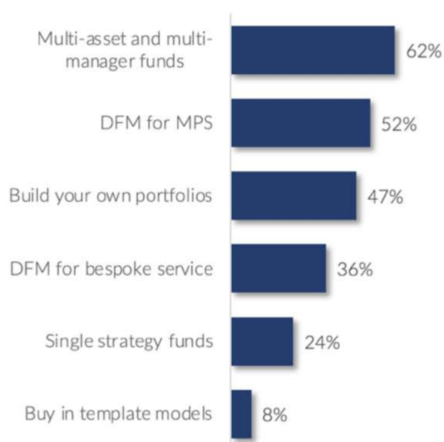
We've compiled our research findings into this report to help advice firms evaluate their investment proposition and revisit whether they and their clients would benefit from a specialist partner.

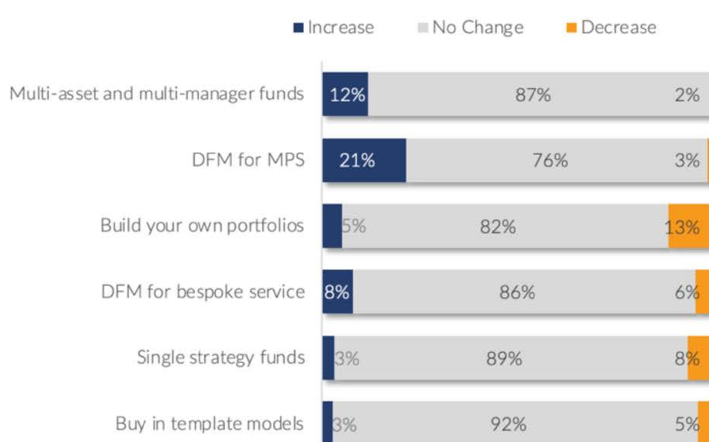
For those firms who are re-evaluating current partnerships or contemplating a new partnership, we share insights into how other firms are approaching the due diligence process, and what's working well or not so well. We also explore lessons in successfully onboarding a new partner and managing the ongoing relationship.

3/ Current trends in advice firm investment strategies

Research points to the continued rise of outsourced MPS and insourced Chief Investment Officer (CIO).

At NextWealth we are tracking a continued shift from adviser models and bespoke discretionary to discretionary MPS:





Source: NextWealth MPS Proposition Comparison Report 2022

NextWealth research reveals:

Discretionary MPS is the second most used investment strategy and over a fifth of advisers plan to increase use of discretionary MPS in the next 12 months

Two thirds of financial advisers with over 6 client-facing financial advisers use discretionary MPS.

The number of DFMs that advisers use peaked in 2020 at an average of 2.5. Since then, advisers have been shrinking the number of external partners they work with and we think this will continue as they develop fewer strategic partnerships to meet the needs of defined target markets.

We are in no doubt that assets in discretionary MPS will continue to climb. NextWealth's research points to three main sources of growth, all of which are accelerating as a result of Consumer Duty. Advice firms are focusing on cost and seeking to reduce risk and improve efficiencies:

- Assets moving from bespoke discretionary to MPS
- Advisers professionalising their businesses and moving away from adviser models that come with a significant admin burden and execution risk
- The rise of tailored models.

Advisers interviewed for this guide point to key benefits for clients in having their portfolios managed more efficiently and rebalanced in a more effective way as well as benefiting from valuable time freed up for their adviser to focus on their planning needs.

We now turn our attention to making this increasingly important partnership work best for financial advisers and their clients.

4/ Selecting and reviewing a DFM partnership

In compiling the following list of key considerations against which advice firms can evaluate external partners to help deliver their investment proposition, we heard from firms at a variety of stages in the due diligence process.

Some firms are looking at working with an external partner for the first time, or changing partners, as part of a general drive for efficiency or business growth. NextWealth's MPS Proposition Comparison Report 2022, notably highlights that growth, with 21% of advice firms planning to increase use of DFMs for MPS, and 8% planning to increase use of DFMs for bespoke services, over the next 12 months.

Others have completed a segmentation exercise and are considering investment partners for a particular group of clients that could potentially benefit.

Key considerations in choosing a DFM partner

1 Financial strength and stability

Advice firms are looking for financial strength and consistency from a potential long-term partner.

"We wanted them to be in a financially good position, because it was important we could find a firm we could form a long-term partnership with."

Another interviewee mentioned, *"You clearly want to make sure that they were well-resourced."*

2 Culture and values

Interviewees listed cultural fit high on their priorities.

"They had to fit with our culture and values in order to feel like we respected them as a partner, we could work with them and they thought similarly to us. We are a B Corp, they didn't have to be a B Corp, but we wanted them to demonstrate some of that kind of thinking."

3 Platform-availability

Platform availability is a practical consideration that appears in the top three criteria for our interviewees. For those currently in the due diligence process, availability hasn't "dramatically" reduced their long list of potential DFM partners, but "it did a bit" and its can be important when delivering a consistent proposition.

"They needed to be platform agnostic - available on not every single platform, but on the ones we predominantly use."

"Platform availability is obviously key, we use two or three platforms, but it's obviously key that they are across all the ones we use."

4 Investment style

Interestingly for a partnership decision based on delivering an investment proposition, investment style and process don't quite make the top three due diligence criteria.

One adviser we spoke with went as far as to say this is *"quite a big issue for the whole industry"*. He continued: *"One of the key parts of due diligence is, 'explain your investment process, do you understand it, is it repeatable? Is it written down? If you fell under the 42 bus, could somebody else do it tomorrow? These are the salient questions. If you're an IFA firm looking for an outsourced partner, you never ask how they manage the money. Because you don't necessarily have the expertise to judge whether the answer that you've been given is valid or not. So actually, this is quite big."*

Advisers who do describe the investment approach as an important factor commented:

"It was important that [the DFM] understood our investment philosophy. We don't expect them to only do our investment philosophy, because that would be naive, but to understand our investment philosophy, and somebody who could balance that,

providing us challenge and making sure that we're not missing things, and that our thinking is appropriately challenged and evolves.”

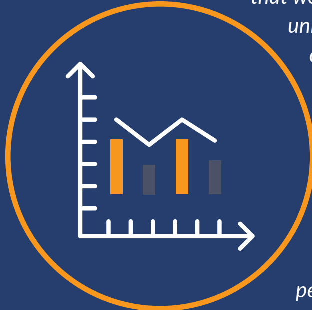
“You would want to make sure that they have a collegiate, team environment, with very seasoned investment managers, and it wasn’t all down to one person. You want to make sure there is a lot of independence and they weren’t just buying their own funds. You will want to look at their mix of active and passive to see whether it makes sense. You clearly want to see how they stood up through difficult quarters, and during different years. You want to make sure that they were very global in their scope and not tied to that more old-fashioned home bias.”

“We certainly don't want to partner with someone that's deviating and flip flopping between different styles. We want a very much long-term, robust approach that, if it's passive, they stick to it. They might obviously do strategic tweaks here and there, but generally don’t tinker with it too much. Some DFM firms are changing their philosophy on the back of the market, whereas I'd rather they stick to their principles on that side of things.”

5 Passive and active funds

Advisers are looking for clear justification of the exclusion or inclusion of passive funds in client portfolios:

“Something that I've taken more seriously in the past couple of years, is the debate between active and passive funds. What we do now for example, if we're looking for a global equity fund, is that we will do our full review of the universe, and shortlist a couple of active funds that we think screened really well, but we would make sure that we include then viable passive options. Because you may find, and we have certainly found this recently, that there is a perfectly viable passive option that has done just as well, if not better, at like a third of the cost. And so I do find that some DFM's are wedded to active funds, and therefore incurring unnecessarily high costs, when there could be a perfectly good passive option out there.”



“[We] want to look at their mix of active and passive to see whether or not they were trying to keep costs down purely with passive but did it or did it not make sense?”

6 Cost

Cost arose frequently as part of the decision to work with an external partner or not.

At the due diligence stage, it becomes more about the trade-offs between cost and other added value from the partnership:

“[Consumer Duty] has given us the ability to justify one provider over another not solely based on cost. So previously, if a provider was cheaper, ultimately, the FCA would think that's probably better for the client, and might often opt for what's cheapest for the client. But now building out our documentation we can clearly define, ‘okay, Provider A costs £10, but there's no integration, provider B costs £12, but there is an integration. What does that integration give us? It gives us a better client experience and outcomes.”

Cost becomes more of a factor for advisers seeking passive solutions:

“The one thing you absolutely can control in passive is cost.”

7 Integrations

This is a fairly wide-ranging criterion. In general “the IT of the DFM is actually quite important”, and in practice that can range from those who can “provide easy access to us as a third party to a range of client accounts”, to the ability to run off CGT reports, to providing a live data feed:

“Anybody we put on panel has to be able to integrate with the data feed into Intelliflo. That's important for us as a business and evaluation of our own business and everything else, to have those efficiencies. And to be able to effectively run our business and see where the business flows are going. That is becoming more and more important when so much of the business is becoming around integrations and efficiencies and how to make life easier for clients and for administrators.”

“They need to have a clear and easily articulated proposition to a client and streamlined onboarding. There are certainly some DFM's where their whole process meant that they couldn't accept our AML. And the client’s like ‘why, what's going on here?’ Streamlined onboarding is important, but that's only at the start.”

For other advisers, this is marginally less important given they get their data from the platform rather than relying wholly on the DFM.

8 Tailoring

NextWealth's latest MPS Comparison report points to tailored models as a key area for growth and predicts an acceleration as a result of Consumer Duty.

In our Investment Proposition Ladder, advised client assets are predicted to further shift from adviser models to third party discretionary MPS and then to tailored MPS.

Source: NextWealth MPS Proposition Comparison Report 2022

Under this approach, DFMs may create a tailored range of models for an advice firm. They might be mapped to the firm's risk framework or have a particular OCF cap or geographic weighting.

In all cases, DFMs emphasise that they are responsible for the strategic and tactical asset allocation of models. Advice firms, while they may have seats on the investment committee, do not have voting rights.

Tailored models can help overcome objections to working with a DFM as it creates more of a partnership and allows for flexibility of implementation of models. It allows for an easier transition period from adviser models to MPS and allows the adviser to retain input and a greater level of involvement.

One of our interviewees, who ruled out fully outsourcing investment decisions at this point, described seeking a balance in which the DFM "is not coming in and saying, 'Oh, you've got it all wrong we need to start again', because we don't think we have."

Other advice firms spoke about the importance of retaining an element of control over the investment approach.

"It needs to assist our process rather than detract from it. If we're always butting heads and disagreeing, that's not necessarily helping us achieve anything, it's going to take as much time to unpick what's been said, and work out whether there's any interest in that rather than augmenting our process and adding to it. We want someone that's flexible enough to work with us in the way that we work."

"We see it as we're still working alongside people, particularly where we're looking at the tax side of things and the structures that we want to be using. We want a third-party DFM to be open to that sort of relationship. If we believe something should be most simply in an Isa rather than a GIA then that's what it should be, or an investment bond or a SIPP or whatever else it might be. That's important, I think potentially a range of investment solutions may be important for us. Some do single stock, some do fund, some have contrarian approaches to investment. We are looking for diversification and difference in approach."

9 Distinction

The comments from our adviser interviewees could be summed up as wanting something that *"you can't just get off the shelf"*.

For some, that means diversification and access to asset classes that couldn't be easily granted otherwise:

"A range of investment solutions is important for us. We are looking for diversification and difference in approach. Particularly where let's say a client wanted access to private equity, they're not going to get that through, certainly our model portfolios. So an ability to use asset classes that couldn't otherwise easily be accessed is of value."

"I really like if they're trying hard to do something distinctly different, that you can't just go and buy off the shelf and it's a sensible price for an active solution."

Where we heard less favourable comments about working with outsourced partners, that tended to focus on the perceived lack of differentiation or added value.

"It's very difficult to really draw that much distinction from any of the active DFMs. Yeah, cost is always going to be under pressure. And I think a lot of people interpret Consumer Duty as a race to the bottom on costs. And then there's pressure on everything, in a good way."

Advice firms are interested to hear how DFMs deliver something for the firm and its clients that not only justifies any potential increase in fees but also adds value.

10 Sustainable/responsible investing

Advice firms may seek DFMs with the relevant specialisms to serve their clients' particular interests. A common example of this is in sustainable/ responsible investing.

"ESG is another consideration. It's not been huge, but there are certain clients where it is the overriding driver, really, it's that they want to make an impact. But the take-ups probably about 2-3% of our overall funds under management. It's not huge, but I can probably see it growing over time as we take on younger clients, I'd say a different demographic."

"I think the other area is ESG sustainable investment. I think actually, DFMs do add value in that market, active managers really can add value."

"We do outsource for sustainability, or where it's a very big client and we put a proportion of their money, particularly the tax elements there with the DFM partly for tax management. But also we think you might as well have one relationship with one manager, and it is quite useful from time to time to be able to call a manager into a meeting, and have a proper in-depth discussion with a client if they want to do that with all their money."

We heard from one interviewee who had a particularly positive experience of working with a DFM in responsible investing:

"I don't feel such high conviction with most other managers, but we got sent this email saying that these guys have identified less than one basis point of fossil fuel exposure in one of the medium MPSs. And it was like framed as an apology. They've produced a document that says they had zero exposure. And actually, that's not correct. Because it's there. It's less than 0.01. And that gives you that level of confidence. And the feedback from clients is, 'wow, that's actually very cool'."

11 Reporting

A further practical consideration that can help the relationship run smoothly is having customisable options around client reporting.

For example, one firm described a wish for aggregated quarterly reporting across multiple clients, *"because that allows us to look for any inconsistencies. If I've got 30 clients with the manager, I don't want 30 sets of reports."*

12 Client-ready

The better the DFM is at articulating a clear and consistent philosophy, the easier for advisers to help clients understand what they are paying for and whether it represents good value.

"They need to have a clear and easily articulated proposition to a client."

"They've got to be very clear about their proposition, what it's going to do not, it's like, if you're going to stick someone in front of a client, they can't just then sit there mumbling, they've got to be convincing and realistic, and make it something that a client is attracted to, because otherwise, what's the point? [A DFM firm] are exceptionally good at that as well, they are completely consistent in the way they talk and their messaging."

5/ Building a partnership with a DFM

Ingredients for a successful working relationship

Whilst the due diligence criteria (in section 4) are crucial when selecting potential investment partners, it was clear from our conversations with advice firms that there are other important factors to consider from a process and cultural perspective, if the partnership is going to be robust enough and worthwhile entering into. Firms shared the following insight into developing good, longstanding working relationships with investment partners:

1. Create a long-list of potential partners

It is important to start with a long-list of potential partners that can then be narrowed down. Our interviewees told us they mainly rely on word of mouth from other financial advice firms and research providers when producing that long-list.

This is the point in the process where we see advice firms using data inputs to screen potential partners on criteria such as cost and investment performance before getting into a deeper conversation at due diligence stage.

"We got that list together partly from talking to a couple of other firms that are similar in size to us. Partly from conferences, so the PIMS conference actually was very good, there were a lot of investment managers there. It's useful just to speak to different people and say 'look, is this something you offer in this space?' And then we've got quite a few people within the firm who are quite active in industry conferences and press and things like that, our head of technical data, even people who were part of the project team. We sat down, put our heads together and just put up a list by asking 'who are all the people we know that we think we know run MPS propositions' and then we did ask our consultants as well if they've got anybody they'd suggest."

"We use Defaqto to generate an initial list, because we find that quite useful for generating the fees and performance. So you can get that data from there, generally."

2. Evaluate a short-list of potential partners

The next step is to narrow the short list. Our interviewees typically narrowed the long-list by sending a due diligence request to DFMs that was then reviewed by the investment committee. Several emphasised the need for robust third-party data to support this process.

One interviewee was keen to share that the due diligence process took a lot longer than initially expected, and recommended narrowing down potential partners before an initial meeting:

"Our first approach wasn't to meet with all 15, but was to send them a questionnaire and make sure that our red lines were being met, because otherwise you're wasting your time speaking to people if they don't actually meet one of your key criteria."

Another emphasised the growing role of robust data analysis:

"Due diligence, data, probably doesn't get done properly. I think there'll be a lot more emphasis in compliance files and document checking, and evidencing and third party data is going to become more important. Whether or not advised firms actually really get into the weeds and look at the data. We've all been very guilty of – you can run a comparison and really not read that 66 pages. Evidencing will have more emphasis. And therefore, data providers will offer more products and push up more services. People like DD|Hub, and Morningstar and FE become integral. And there's a big market in that. And I think that's the change."

3. Onboarding a new DFM partner

Selecting a good partner is important but integrating that partner into the business is critical to successful implementation. The ability to integrate into a firm's processes is also a key consideration for the due diligence process. Two key considerations we heard from firms who had recently onboarded new DFM partners were training and integrations.

"Are they providing the training they've said they would provide? The DFM we've chosen has definitely been quite clear that it's in their interests to provide as much training as is needed, because they really want the advisers to be persuaded."

"There needs to be streamlined on-boarding. There have been some DFM's, whose process meant they couldn't accept our AML and the client just wants everything simple as we said at the introduction, but they're having to pull teeth again. It should be easy to take on somebody's money."

4. Ongoing relationship management

The investment committee will want an agreed process to measure success and manage ongoing relationships with DFM partners. These measures will of course include customer outcomes (i.e. performance and volatility), but also take-up among advisers, service and support. One firm also highlighted reviewing processes and controls to ensure suitability.

"Measures of success in some ways will be nothing going wrong. But also, it'll be take-up our side, in some ways, measures of success are more internal. We'd measure their success by 'are they providing the training that they've said they'll do?' 'Are they really providing resources, that they're generally being helpful?' 'Are they meeting all of the things they're contractually obliged to, not making any errors in the rebalances, etc.?'

"But then really, the success or the project will hinge a bit more on making sure that we've internally got the right processes and controls in place to ensure that when it is suitable for the client that it is being recommended. And the advisers are not trying to make their life easier and not recommend it."

Ongoing review of the partnership is essential. One interviewee commented on the propensity for firms to allow an embedded partnership to drift along provided there were no major red flags:

"Once firms have settled on a DFM partner, it tends to be there and provided that DFM partner a) doesn't try and steal the client and b) can report on the assets in a sensible way that is regarded as being a sensible relationship that can go on. That tends to be the principal filters."

Others identify a shift, largely attributable to Consumer Duty, from ongoing due diligence as a box-ticking exercise to a more rigorous re-evaluation, where the value of the partnerships is assessed on a much deeper level.

"In terms of reviewing the relationship with a partner, we've got an FE license now and a Morningstar license and we run data monthly that will feed into evaluations of existing managers every 12 months. That isn't a box ticking exercise, it never was, but Consumer Duty has put the onus on moving on from more simply kicking the tyres and being confident about it, to using all the data we've got, going deeper and really assessing 'have we got this right?'"

"We'll meet as frequently as we need to in the first year whilst we're onboarding and, definitely they'll be at least at two of the four meetings as an investment committee, maybe even all four in the first year. And then as we get more embedded the frequency might reduce to two meetings a year that they come along to."

6/ Why work with an investment partner?

Client and business benefits of investment partnerships

Five key business benefits of working with an investment partner

1. Financial planners can focus on what they do best: understanding and servicing client needs

The advisers we spoke to were keen to point out the importance of maintaining focus on the client plan, ensure the suitability of recommendations and that they will meet planning needs. Working with and delegating responsibilities to external partners with specialist expertise is seen as crucial in this context, in order to ensure clients achieve desired outcomes and protect the on-going client relationship.

"Outsourcing reduces the time spent rebalancing, so that you can focus on other aspects of the service that you deliver, like goal setting and cash flow planning, listening to what the client really wants and what's happened."

2. Small businesses can grow supported by a robust investment proposition

Among the smaller financial advice firms we interviewed, several mentioned that partnering with a DFM can help them offer a more professional service to clients and give them time to focus on growing the business.

"When we started a couple of years ago, we didn't have the expertise or time to run our own investment proposition, nor did we have time to make rebalances and fund switches, it's a hell of a job to keep your finger on the pulse. Using a DFM allows those experts in that area to focus on their job. For us and the type of business we're operating, it just makes sense."

"It allows us to have the support of those professionals behind us who give us all the literature and all the time that we need in order to speak to our clients."

While the value of financial planning is not about portfolio performance, consumers consistently say that it is among the most important factors considered when assessing the value of financial advice. A robust investment proposition is a core element to delivering value to clients.

3. Deliver efficiencies for the business

External discretionary investment management can allow advice firms that have not reached the scale threshold needed to obtain their own discretionary permission to tap into expertise efficiently. Minimising the costs of managing portfolios, without the regulatory (cost) burden associated with the process of adopting in-house discretionary permissions was seen as an important benefit by one adviser.

"Five years ago, there was some confusion around the capital adequacy requirements, which were changing at the time. And we were not getting any clarity on what that was going to look like for us. And I think the post permissions reporting was maybe a little bit daunting for us at the time. And we've partnered with 360 partners, who laid it out in black and white and the requirements are actually quite significant…So we thought, while we look, we've got a good relationship with [a bespoke MPS provider]. Let's just leave things as they are and come back to it again."

4. Add specialist expertise and research resources

Several firms told us that representatives of DFMs and investment research houses sit on their investment committees. This can augment decision-making by supporting the oversight of fund selection and imbuing more credibility and confidence to investment choices for clients. Advisers added that insourced individual who sit on the investment committee can bring more benefits, including connections to additional specialist expertise which further augments the investment process.

> *"I'm not making that investment manager and fund selection decision alone. We've got an investment committee, which is a pretty experienced team."*
>
> *…"We've got 'A' from [a firm] which do fund research and have their own DFM arm. They will do background research for us around client requests. 'A' is very much an active member of our investment committee. Then we've got 'B', who's got more of a history in private equity. We've got 'C' works for [an] investment office. And then 'D' who works for another research and investment management firm. We have a very long once a quarter meeting, where we go through all the funds, what they're doing, what the managers are saying, topics like inflation or what we're expecting from interest rates, but also talking about other funds that might be better than what we have because it's always about making sure that you don't just have what works, but that there's not a better alternative."*

5. Meet individual client needs

Firms may look to add bespoke options to the client proposition. These are typically used for clients with specific requirements that fall outside of centralised in-house investment strategies.

> *"We're comfortable with the best thinking of asset management. However, there are going to be a not insignificant number of groups of clients where that is not going to always be appropriate. Whether that's U.S. based funds, whether that's Sharia, whether that's some particular need or desire, such as single stocks but not funds, then we have a whole investment proposition document that sets out that flow. Or it might be actually we've got somebody with 30 million pounds, that requires a more tailored approach. So we also use DFMs for diversification reasons."*

One adviser told us that they are looking at partnering with DFMs more for clients with simpler needs and who don't want as much communication. They see as a way of reducing the time required to get clients with lower levels of engagement to sign off on changes to their portfolio, in turn reducing costs and providing more value to the client.

> *"We are looking at a light touch proposition where outsourcing that DFM investment management service would benefit us and also the client in that there's less touch points. I think the biggest work for us is the advisory rebalance…Obviously DFM's can rebalance and change investments as they see fit."*

Four key client benefits of working with an investment partner

In our interviews, financial advisers told us there were five client benefits to working with investment partners.

1. Adds value to what the client would get from the advice firm alone – they're getting the planning plus specialist expert investment management.

"DFMs can have a lot of resources, and in a big team, then you get that expertise for clients"

"I think the other area is more active play like ESG and sustainable investment? To add value in that market, active managers really can add value...At the end of the day, ESG, sustainable investing needs the likes of Charles Stanley, because they can focus specialist areas and offer value in that way."

2. Value to clients is embedded in the amount of time planners have to spend on matching investment options to client goals.

"The biggest overall benefit of bringing the partner for the firm is operational efficiency...so we'll free up time to take on more clients and spend more time on existing clients"

3. Frees up the advice firm to spend more time with clients themselves understanding their needs and helping them achieve their objectives.

"The client has our focus on what they really want, what's happened [in their life], so for example we can discover if they've got particularly complex estate planning needs"

4. Partnering with external discretionary fund managers can mean quicker, more decisive action is taken to adjust the client's portfolio where necessary around market movements and changes to the client mandate.

For example, changes to personal circumstances such as any reduction in income and a weaker attitude to risk as a result; switching away from exposed investments during market downturns as well as capitalising on unforeseen market investment opportunities.

"I always find you can see the true value of a DFM in a declining market, that's where they come into their own. There are some DFMs out there that do very well in a growing market, but generally, from a client's point of view, they have value in a declining marker because of the amount of shifts that happen combined with the support we have to give to clients, which we've seen in the last 12 months."

7/ Myth Busting: Dispelling common concerns about working with external part

Partnering with a DFM is not the right choice for all firms and all clients. Our interviews uncovered six common objections to partnering with DFMs. Some of these are based on misunderstandings and we dispel some of the most common myths below.

Working with an external investment partner isn't right for my business because...

... our investment ideology won't match

Some firms rule out working with an external partner because they have strong views on how to structure a client's wealth:

"Our view is that you should spend your money before you die. I'm not saying you die bankrupt, so you still have property and you still have assets, but unlike a [DFM], where quite frankly, they want you to keep all your money because they're charging you a percentage of that."

Working with an external partner does not mean giving up stewardship of the client's financial plan. Discretionary assets can be managed to an adviser's mandate and switched to a different mandate as circumstances, life stage or risk profile changes. A good DFM will help you deliver on your client's objectives.

... our ideas on asset allocation will be too different

"Our difficulty is that we don't want to outsource, because we have quite strong views on certain geographical regions or asset class attractiveness. And if we outsource, there are invariably going to be instances where the DFM does something that we don't agree with. And then if it goes wrong, I've got to sit in front of the client and explain why something that I thought wouldn't work has then been done and then hasn't worked. And then it's trying to square that circle. So that's why we do everything in-house."

The reverse of this concern is one of the key benefits that some firms derive from decoupling their client relationship from investment management. In a good working relationship with a DFM, the adviser should get access to portfolio manager commentary to help keep both adviser and client informed on asset allocation and the reasons for any changes made. In volatile times, another benefit to discretionary management is the ability to make rapid adjustments without the need to contact each client individually and wait for their responses.

Some financial advisers characterise using a DFM as 'sitting on the same side of the table as the DFM.' Rather than defending the portfolio performance, the adviser represents the client in assessing value and success against desired outcomes, responsible for hiring and firing the portfolio manager.

... we want clients to have one point of contact – their adviser

"Obviously with DFM's, they can rebalance and change investments as they see fit. But we've built up that expertise in-house around that investment proposition. We're not outsourcing it, and the clients have that one point of contact. If a client does have any queries...they have one source of contact - the adviser - and they can respond accordingly. And our investment team in-house again, educates our advisers so that they're not having to bounce back to a DFM or another party to get those answers for the client. I think control is probably the core reason why we don't outsource that."

The issue of losing control over client journeys and relationships came up in several of our interviews. This is a key consideration. One of the reasons that firms using DFMs are shrinking the number of partners they work with is to streamline communication and processes behind the scenes. Firms that partner with a DFM, also argue that they have control over the client relationship and the adviser remains the client's point of contact. They are working together to deliver against desired outcomes. A key benefit of working with an external partner is to have more time to spend on developing that relationship.

... we would have to charge VAT

"We do not use a DFM, we are advisory. And part of that is because we would have to charge our clients more via VAT."

This is a specific concern raised by one of our interviewees and was true until 2020 when most DFMs removed VAT charges from portfolios as they were deemed a product not a service.

... we want to offer flexibility to meet client preference

"We have plenty of clients who are not exactly in a model and come to us with other funds that they want to keep. Because we are advisory, we can do what works for the client. We can be totally bespoke for the client."

The ability to tailor and bespoke service for clients is a key consideration for financial advice firms. Where clients want to retain a holding, this can often be held alongside an MPS. We often find that financial advisers use MPS alongside other solutions. For example, some advisers prefer to use multi-asset funds for the GIA and MPS for ISA and SIPP assets.

... we don't want to add cost for our clients

"Cost is a big thing for us and I'd be surprised if anything outsourced is below half a percent."

DFMs vary in their fees for portfolio management, however NextWealth research reveals fees tend to cluster under 30bps and the average MPS fee in 2022 was 21bps, down from 25bps a year ago. The average OCF for discretionary MPS was 46bps, 10 bps lower than average.[1]

That said, using a DFM can result in an increase in client fees. One of our interviewees recently appointed a new investment partner, and whilst this will result in a minor cost increase the firm is confident in presenting this to clients:

"Your portfolio might have one or two tweaks, making more fund updates and as part of doing that, we're also suggesting you partner with this discretionary manager who's going to help run the portfolios more efficiently, it's going to mean you get your portfolio rebalanced more frequently and in a more effective way. And there's going to be a minor cost increase, but actually, it's only a couple of basis points and we think it's in your interests."

[1] NextWealth Discretionary MPS Proposition Comparison Report 2022 and NextWealth Financial Advice Business Benchmarks report 2022

8/ Impact of the Consumer Duty

Every advice firm we speak with is committed to delivering a service to clients that fits their financial and life needs and helps them get the best outcomes they can for a fair price.

How firms go about evidencing that is under greater focus with this year's implementation of the Consumer Duty rules.

Some firms have already identified parts of their model that might stand up less well to scrutiny. It's not that their clients are unhappy; but the Consumer Duty is a good driver to Spring clean the proposition and tidy up any parts of the equation that aren't delivering as well as they could.

DFMs can help by clearly articulating the value added from the partnership against any additional costs involved.

Our research suggests that some firms are conducting a root and branch review of their approach to delivering advice, including the investment proposition and existing partnerships.

We therefore highlight five impacts of Consumer Duty on DFM partnerships:

Adviser as distributor or manufacturer:

This is a practical consideration that advice firms should reflect upon as the role of distributor or manufacturer implies a different set of obligations under the Consumer Duty roles.

Our conversations with advisers indicates that there may be some uncertainty about which activities define a manufacturer:

"We think we're probably okay and aren't a manufacturer, but it's grey."

Using a managed portfolio service (defined as a product by the Regulator) from a DFM means the DFM takes on the role of manufacturer of the product. However, if the advice firm has voting rights on the investment committee under certain arrangements this makes the advice firm a "co-manufacturer".

More rigorous reviews of new or existing partnerships:

As discussed above, we expect a tightening of new and ongoing due diligence processes to a more rigorous evaluation of the value delivered by external partnerships.

"Do I think our list of panellists is too long? Yes. Do I want to do something about it? Yes. Am I using Consumer Duty as a means of doing that? Yes."

"Just having Consumer Duty out there in the ether has made us question some of our proposition for clients. We've started questioning if that's the right thing to do. … Sometimes the benefits are more with us than with the client."

Delivering more value-add services to clients by working with an external partner:

Advisers we spoke to recognised the amount of time needed to run investment management processes within the firm and the impact that this can have on client planning.

One way to reduce the burden of managing the investment proposition and facilitate advisers within the firm to do what they do best in focussing on client planning, is to outsource the responsibility for managing investment portfolios to a discretionary fund manager. Tapping into these benefits (as outlined in section 6) can ensure that the value provided to clients remains foremost linked to the time that planners and advisers are able to dedicate to overseeing a continual progression towards their life goals and objectives.

"It's more about the DFM permission to help drive good client outcomes, but also will help us as a business to not spend so much time on rebalancing and things like that, which in turn, lets us focus on things which are going to add more value to the client and therefore improve client outcomes."

Reduction in the number of partners:

According to NextWealth research, the number of DFMs that advisers use peaked in 2020 at an average of 2.5. Since then, advisers have been shrinking the number of external partners they work with and we think this will continue as they develop fewer strategic partnerships to meet the needs of defined target markets and improve efficiencies in the business.

Collaboration on reporting:

Financial advice firms will need to evidence the decision-making process and actions taken on behalf of clients and this will require cooperation between advisers and their external partners. DFMs can help by providing transparency on portfolios and making data available on rebalances and historic changes to holdings.

9/ Conclusion

A great DFM partnership is a natural extension of an advice firm's process and investment philosophy. At its best, it enhances the value delivered to clients by the input of specialist expertise and additional resources. Advisers can balance their level of influence over clients' investment solutions with freeing up time and attention to focus on what they do most effectively.

We saw from our interviews that the clearer a firm has articulated its culture and values, the easier it is to find a good partnership that matches those values and supports the firm's key objectives. Indeed cultural fit is one of the foremost criteria upon which DFM partners are selected by our interviewees, topped only by the DFM's financial strength and stability.

Of course it won't suit all advice models; many firms with a well-run Centralised Investment Proposition and a good suite of solutions are meeting the needs of their clients without external investment partners.

However our research points to a growing number of firms who are using or considering increasing their use of discretionary MPS. These firms tell us they are moving away from adviser models and their associated admin burden and execution risk, and seeing increased value to clients in having portfolios managed more effectively.

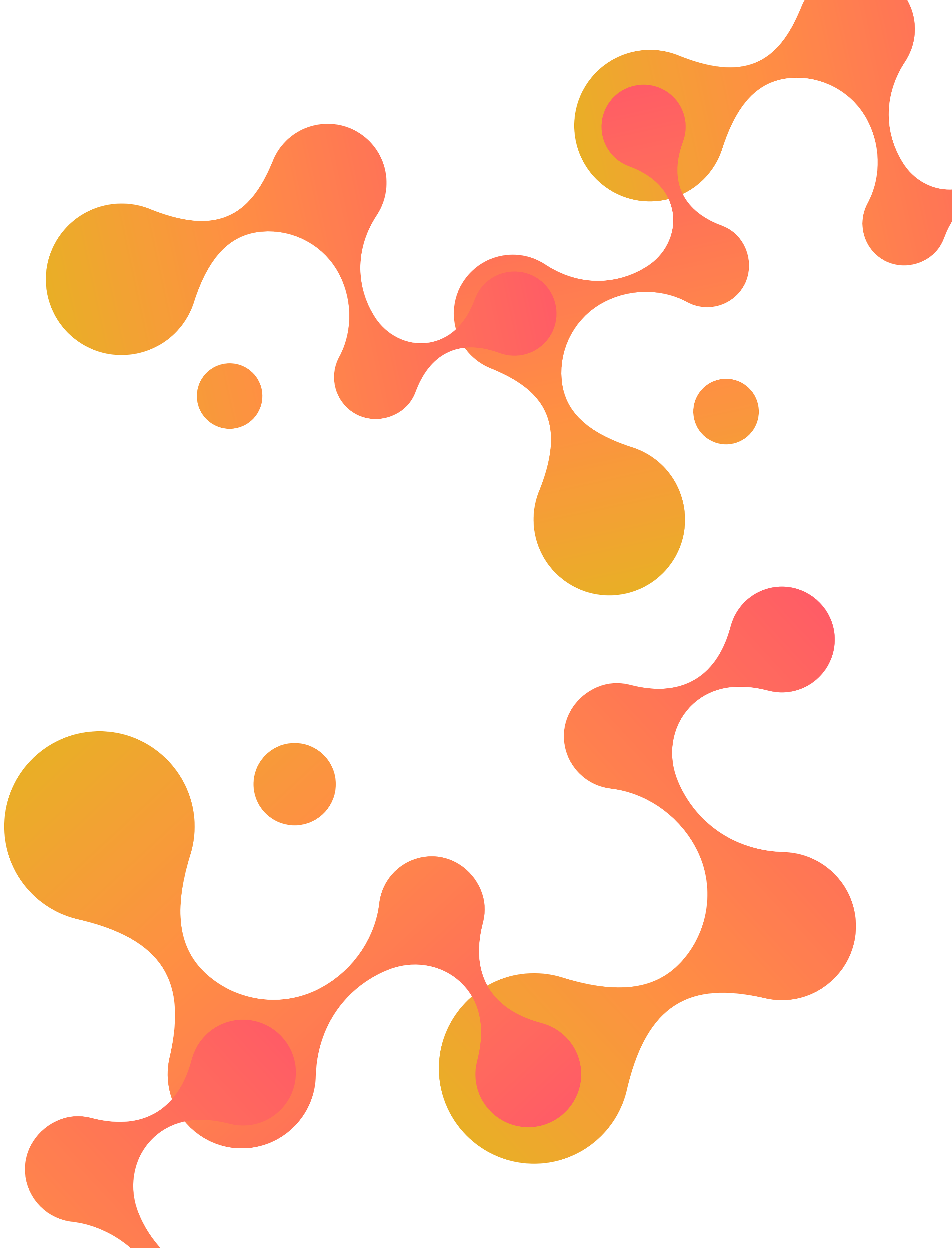
DFM propositions are evolving, particularly with the development of more tailored solutions that allow advice firms to retain input and a greater level of involvement. That was one of the key objections for firms who have previously ruled out working with a DFM. We explored other common objections in this report too and would encourage firms to take a regular review of what's on offer to make the most informed decision about what is right for their clients and their business. When conducting these reviews we recommend advisers challenge DFMs on how they can specifically help you to meet the needs of your clients and provide demonstrable value and deliver the all important good outcomes.

We hope the insights shared from other firms' experience in this guide will support advisers in considering how to establish or improve an external investment partnership.

As always, we welcome your feedback and suggestions for areas to explore in future research.

We partnered with specialist research firm, NextWealth, to create this guide. NextWealth independently interviewed 15 advice firms representing a range of sizes, business models and attitudes to investment management. Our sincere thanks to those individuals who contributed their time and insights to help other firms who may be looking to evaluate their investment proposition and perhaps select or review their partnerships with DFMs.

If you have any questions or comments, please contact Tom Hawins at Tom.Hawkins@charles-stanley.co.uk or 07970 301 677.



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