Investors and their advisors must be prepared that some investments could fail. Arterial is only available through professional advisers for HNW, sophisticated investors who genuinely understand and accept risk. Investors should only invest money they do not need access to, and which they can afford to lose. No investment may be entered into, neither in part nor in whole on the basis of this newsletter. This newsletter not an offer nor an invitation to subscribe. Arterial does not provide or imply investment advice.

arterial
capital management

The use of Discretionary Fund Managers – Hidden risks for advisers using DFM's

www.artcapman.com

arterial

Hidden Risks for advisers using DFM's

The unforeseen consequences of using discretionary fund managers

For a professional adviser, typically operating within the corporate framework of a sole trader or small business with a mere handful of employees, the identification, delivery and maintenance of consistent fund performance has led to the use of discretionary fund managers (DFMs) and model portfolios. Previous Arterial regulatory articles have questioned whether collective portfolios are indeed lower risk than single company assets – www.HYPER.com. Our Q4 2015 regulatory paper addressed the approach of the FCA and courts to advisers who rely on third party product reviews, where those reviewers have little or no experience in qualitative and quantitative financial analysis - www.HYPER2.com

Larger private client advisory groups such as family offices and the private client teams within the investment banks will typically maintain their own in-house discretionary permissions and execute and maintain portfolios (both collective and single company assets) according to their own risk models. Of course this adds a level of cost, beyond the reach of a typical professional adviser's balance sheet. The alternative for smaller professional adviser firms is therefore to outsource to a DFM. The rationale being that the DFM allegedly assumes responsibility for running risk managed portfolios, which crucially should therefore remove the underlying investment from the professional adviser's practice.

Take Enterprise Investment Schemes, for example, whereby far too many advisers assume that a brief third party review, or the recommendation of a pooled fund over a single company asset abrogates their risk and responsibility to the underlying investor; The same head in sand attitude sadly applies all too often to the selection of a DFM.

DFM selection is certainly one of the most important decisions that professional advisers will make. Yet naively, a surprisingly large number of professional advisers believe (incorrectly) that an appointed DFM will automatically retain all of the investment suitability risk, and that therefore, they the professional adviser need not worry about the underlying investment risk inherent within any portfolio. These underlying investment risks being of course the same investment risks highlighted by the Financial Conduct Authority (FCA) in their recent thematic review.

Of course such an outsourcing arrangement doesn't necessarily remove the risk from the professional adviser. It is essential that professional advisers carefully consider the tripartite relationship that exists (literally or in practise) between the DFM, professional adviser and the underlying investor. If the professional adviser refers the investor to the DFM and the DFM both directly engages with the investor for investment advice, and liaises with that underlying investor directly, then the on-going investment risks are likely to rest with the DFM.

Of course many professional advisers are understandably highly protective over their client relationships, a legal by-product of which is that they the professional advisers are the party seen liaising with the investor rather than the DFM. That protective approach leaves the DFM to deal with day to day portfolio management and not to deal directly (or at least only by proxy) with the underlying investor. Guess who is likely to be on the hook in the eyes of the FOS or FSCS?

There is a further added twist, again overlooked by many professional advisers. DFMs frequently refer in a seemingly innocuous (or ego massaging) manner to the professional adviser as a professional client, which isn't quite the same as a professional adviser. In just the same way as negotiating a trade discount for a car absolves the Arthur Daly dealership of responsibility and leaves the buyer on the hook, the classification of a professional adviser by a DFM as a professional investor/client normally absolves the DFM from any potential claim made to the Financial Services Compensation Scheme (FSCS) or Financial Ombudsman Scheme (FOS). In such a scenario, all such investment suitability responsibilities will rest with the professional adviser, despite the rather frustrating fact that the professional adviser has absolutely no control over what the DFM does in terms of underlying asset selection or asset due diligence.

It is important to review the legal framework and supporting documentation between the three key parties. Just as the reference to a third party product review is a worthless piece of paper and meaningless legal defence unless the author of that third party review is suitably qualified, or the selection of a collective fund isn't necessarily always lower risk (just think about some of the recent concerns raised over EIS, pension and AI funds), here the use of a DFM does not automatically absolve the professional adviser from responsibility and potential claims.

In summary, it is those professional advisers that adapt to and embrace these changing times who will be the ones to emerge stronger and better equipped to service their clients. Unsurprisingly the advisers who adapt to and embrace change are the same advisers who understand that good financial advice and robust risk management comes from knowing their client, listening to their client and only advising their client accordingly. Good advice for the client and risk management for the business never has been and never will be achieved by hiding solely behind a prescriptive process or computer programme.

ARTERIAL CAPITAL MANAGEMENT

e: info@artcapman.com
w: www.artcapman.com

Main Office
Suite 15, 1st Floor
Oliaji Trade Centre
Francis Rachel Street
Victoria
Mahe
Seychelles

Investors and their advisors must be prepared that some investments could fail. Arterial is only available through professional advisers for HNW, sophisticated investors who genuinely understand and accept risk. Investors should only invest money they do not need access to, and which they can afford to lose. No investment may be entered into, neither in part nor in whole on the basis of this newsletter. This newsletter not an offer nor an invitation to subscribe. Arterial does not provide or imply investment advice.

The views and opinions expressed within this document reflect those of our professional advisors, and are not necessarily those of Arterial. Professional advisers should ensure that their clients seek independent and suitably qualified advice before entering into such investment. Investment into biotech and pharmaceuticals is by its very nature high risk and investors may lose some or all of their money.