
Nucleus white paper

DFM due diligence: the questions to ask

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Introduction

Since the introduction of the Retail Distribution Review (RDR), it has been widely reported that advisers are moving away from researching and selecting investments for their clients and using third party providers for this. Typically these third parties are asset managers, research companies and discretionary fund managers (DFMs) who can provide a range of solutions often aligned to client risk profiles.

This has become commonly known as ‘outsourcing’ and in a recent survey, Defaqto indicated that 43% of advisers were now outsourcing their investment proposition and that this was continuing to rise.

With a backdrop of some challenging market conditions over the last few years and an increasing focus on financial planning, many advisers are therefore continuing to review their overall proposition and moving away from managing and maintaining their own model portfolios and selecting individual funds.

There are numerous investment propositions available in the market from multi-asset funds, manager of manager, fund of funds, model portfolios to fully bespoke portfolios provided by discretionary fund managers. Of those advisers choosing to outsource their investment proposition:

- 54% are using risk-targeted funds
- 14% are using return-focused funds
- 72% are using discretionary management services¹.

In particular, the use of DFM services through a platform predominantly using model portfolios or multi-asset funds are on the increase. Nucleus has an open architecture approach to DFMs and since 1 January 2014, there has been a 333.81% growth in volume of AUA held in discretionary portfolios on the platform.

Given the array of choice, a key challenge for many is how to select the appropriate solution for your client or client segments.

The purpose of this white paper is to look at some of the legislation surrounding the use of centralised investment propositions (CIPs) and discuss how model portfolios operate on platforms. It assumes that you as an adviser have already made the decision to outsource and therefore it has been written to help you consider the questions to ask when undertaking due diligence and selecting the appropriate solution.

Regulation: the key points

In July 2012, the Financial Conduct Authority (FCA) issued FG12/16 'Assessing suitability: Replacement business and centralised investment propositions'. These are defined as 'a standardised approach to providing investment advice'.

Some of the key points covered were as follows:

Shoe horning – The FCA was concerned that firms should not recommend a 'one size fits all' solution that is not suitable for the individual needs and objectives of a client.

Churning – The FCA indicated that firms might advise clients to switch their existing investments into the CIP without adequate consideration of whether the switch is both suitable and in the best interests of the client.

Additional costs – The use of a CIP might result in higher (and potentially less transparent) charges than the client's existing investments.

It is therefore important that where an adviser selects a CIP for customers that they understand these points and take them into account, particularly when undertaking due diligence.

While later in this paper we will review some of the detailed questions which could be asked when undertaking due diligence, taking each of the points on the left in turn, the following should be considered:

Shoe horning – Does the DFM proposition offer a flexible range of models which could meet the needs and objectives of a number of clients? This flexibility could be based on risk profile, objectives such as the provision of income or growth or strategy, e.g. active or passive.

Churning – Does the DFM provide adequate information about its proposition to ensure the adviser can make the appropriate judgement as to whether the switch is suitable?

Additional costs – Does the adviser understand the true cost of both the client's existing investments and the DFM portfolios which can include VAT, trading costs, fund costs and can the platform help them to demonstrate these?

Further regulation should also be considered and in the thematic review, TR14/5 (March 2014) 'Supervising retail advice: delivering independent advice', the FCA stated:

'We expect firms to carry out research on the whole of the market to identify the solution(s) that are in the client's best interests, then conduct detailed due diligence on the recommended solution'.

What is clear from this statement is that research is not due diligence and although the FCA has not been prescriptive, this paper will consider what good due diligence looks like.

Regulation: the key points cont...

DFM platform models

Before we start to look at how to undertake due diligence on DFM platform models (often also called model portfolio solutions or managed portfolio solutions) it is helpful to understand how they work.

There are a variety of ways in which DFMs can be accessed through platform technology, the option which is gaining popularity with advisers is where a range of model portfolios are set up and managed by a discretionary fund manager. This means that the client's money is directly held on the platform and not in the DFM nominee.

The other option available is where the client's money is invested on the platform through a tax wrapper e.g. Sipp or offshore bond and then the money is transferred to the DFM for them to manage. Valuations of the portfolio are then sent electronically to the platform in order for a consolidated statement of assets to be produced. One of the downsides of this is that the valuation is a static value and not a live data feed meaning that the valuation will become out of date very quickly. In addition, this is only a 'headline' value and doesn't contain any of the data which can be delivered from the platform such as asset allocation and performance.

This model is still used where bespoke portfolios are required for clients but the benefits of platform technology now means that model portfolios populated with investments from across a range of asset classes can easily be delivered and the assets can remain physically 'on platform'.

Many advisers use this technology themselves to set up a number of model portfolios which are usually aligned to the outputs of their selected risk profiling tool.

The challenge for advisers working on that basis is that when a rebalance is required, this usually requires agreement from the client in order to proceed. This is because most advisers do not have the required permissions related to managing investments which would enable them to make changes without client consent.

One of the benefits of a DFM managing the model portfolios is that they are able to rebalance and update the models (e.g. replacing funds) without permission from the client. In fact there is no direct relationship between the DFM and the client when using a model portfolio solution. This is different to a bespoke portfolio where the client signs an investment management agreement directly with the DFM. The DFM would also have regular meetings with the client and be responsible for regular reporting. These are usually issued directly to the client with a copy to the adviser.

When using model portfolios, if a DFM makes an adjustment to the fund selection or asset allocation, the investments for all clients who are invested in the same portfolio are also automatically updated. This means that there is no requirement for client confirmation, which can be time consuming and if no confirmation is received, then clients can end up being invested in different versions of the same portfolio.

When models are being used, it is important to understand that the relationship is between the DFM and the adviser who acts as 'agent for the client'. As a result, the adviser is the client of the DFM and not the end customer. This also means that the client reporting is produced by the adviser using the platform technology.

The table below highlights some of the key differences in terms of the DFM and client/adviser relationship:

Proposition feature	'On platform' portfolios	'Off platform' portfolios
Contract	DFM and adviser	DFM and client
Reporting	Platform-generated and issued by the adviser to the client	Typically produced by the DFM and issued direct to the client with a copy to the adviser
'Face-to-face' meetings regarding investment strategy and performance	None between DFM and client	DFM and client (adviser would often attend)
Investment suitability	Adviser	Could be an adviser or DFM depending on the business model

The adviser is responsible for selecting the appropriate model for the client but the DFM is unaware of who is being invested in the portfolios. They simply manage the investments based on the appropriate mandate, e.g. risk budget, volatility limits etc. This is a key point when using an 'outsourced' investment proposition – the adviser is not completely outsourcing the investment liability for their clients and should be clear where the responsibility for investment suitability lies.

The adviser is therefore responsible for assessing the client's attitude to risk and capacity for loss and ensuring that the portfolio selected is suitable and meets the needs and objectives of the client.

When using a model portfolio solution, there are administration and associated cost savings when rebalancing is undertaken as the adviser no longer has to manage this process.

There are also a number of other advantages of using model portfolios on a platform such as:

- ability to move client funds quickly and easily to a new proposition if, for example, the DFM is not performing or if charges become excessive
- consolidated 'real time' reporting from the platform for the client covering all tax wrappers and all assets whether held in the models or not. This would also include valuations, performance information and fund details. This may not be possible if the assets were held directly in the DFM nominee
- availability of tax reporting on all platform assets, i.e. DFM and non DFM
- transparent charges where the cost of the investments, DFM charge, platform charge and advice charge are all indicated separately
- the consolidation of assets on platform can often result in large fund discounts being applied to all of the client assets
- ability for the adviser to see exactly how the portfolios are being managed, any changes being made and the result of these
- the DFM may benefit from clean and discounted share classes due to platform arrangements with fund managers
- ability for the client to access a discretionary management service with a lower portfolio size as investment portfolios which are directly managed by the DFM often have a minimum investment of around £250,000. The minimum contribution for a model portfolio on a platform is usually set by the platform provider and very often there isn't one.

Research is not due diligence

There are volumes of documentation available on CIPs – but holding these documents 'on file' isn't sufficient due diligence. A good process needs to ensure that consideration is given to both the provider and the proposition but ultimately how well this proposition meets the client's investment requirements. It is also important to remember that outsourcing investment to a third party may result in the reduction of some investment risk but selection of the provider and responsibility for this still lies with the adviser.

As per FG12/16, the FCA expects the adviser to consider the following:

- CIP provider's reputation and financial standing
- range of tax wrappers in which the CIP can be invested
- type of underlying assets in which the CIP invests
- CIP's flexibility and whether it can be adapted to meet individual client needs and objectives
- CIP provider's approach to undertaking due diligence of the underlying investments
- CIP's charges
- suitability of additional charges including trading charges
- improved performance prospects in relation to the existing investment
- terms and conditions of using the CIP.

Unlike research, which is usually a 'one-off' exercise, due diligence should be carried out on a regular basis as customer requirements can change, market conditions might vary and the DFM might update their proposition or perform poorly.

For due diligence on platform model portfolios, it is also important that the due diligence on the platform has also been undertaken. There is a white paper available from Nucleus which can help and support this process. Please visit www.nucleusfinancial.com/financial-advisers/nucleus-publications/questions-advisers-should-ask-platforms-today

Suggested approach

It is important to be able to demonstrate that a robust process and framework has been followed when undertaking due diligence. Having this in place can also ensure that the process can be repeated at regular intervals although not all areas of the proposition might need to be considered every time a review is undertaken. For example, performance and charges might need to be regularly reviewed but information in relation to the provider might not, e.g. date founded, ownership.

It is also important that evidence can be provided in the form of documentation and the flowchart below might be helpful in order to get the research, analysis and documentation in place.

The first step in the process is key as the requirements to support the service and investment proposition need to be clearly understood before any form of due diligence can be undertaken.

These requirements will then drive the appropriate questions to ask of any potential DFM provider. The points which the FCA expect an adviser to consider and review for any centralised investment proposition are as follows:

- the CIP provider
- proposition
- regulatory issues
- charges
- performance
- service.

These are considered in detail in the next section.



The questions to ask

This section provides suggested questions which can be used when undertaking the due diligence process. The questions you select to use will vary depending on your client or client segment investment requirements but the key objective is to use them to help identify whether your requirements are being met.

It can be helpful to use some key criteria to produce the initial shortlist. While the following section contains a set of suggested questions, key criteria often focus on areas such as brand strength of the provider, range of models available, investment strategy and DFM charge.

Based on the answers received, it should be possible to exclude some providers or propositions in order that detailed analysis can be undertaken on a shortlist.

1 CIP provider

There are a number of measures which could be applied to the CIP provider which need to be considered but in particular, advisers are keen to ensure that their provider is here for the long term, committed to the market and has a positive brand presence. Cultural fit is often overlooked as the relationship is between the adviser and the DFM. It is important that you can work with someone you trust and have shared values which are vital ingredients of a positive working relationship.

The following may be useful questions to ask:

1.1

CIP provider

- When was the business founded?
- What do the year-on-year growth figures look like?
- How long have they been providing discretionary services?
- How many staff are in the business and in particular, what is the research capability?
- What is the ownership structure of the business and if appropriate, what size is the parent company?
- Please detail any changes in ownership over the last five years?
- What FCA permissions does the business hold?
- Have there been any FCA complaints in the last five years and what was the outcome?
- How would you describe the investment process?
- Is there an active adviser strategy, e.g. what percentage of the business comes from financial advisers?

The questions to ask cont...

1 CIP provider

1.2 Financial stability

- What are the credit and financial strength ratings?
- What are the assets under management and how is this split across model portfolios, funds and bespoke portfolios?
- What is the split between 'on platform' and 'off platform' assets?
- What is the split of AUM introduced by advisers or your own investment managers?
- How have these assets grown over the last three/five/10 years?
- Is any growth organic or as a result of the acquisition of other businesses?
- Please detail any significant partnerships or deals you rely on?
- Is a copy of the annual report and accounts available?
- What is the ownership structure of the business? Please detail any shareholders.

1.3 Cultural fit

- Will the CEO provide a 100-word description of your corporate culture to help us with this exercise?
- To what extent are customer outcomes embedded in the business and how would you evidence that?
- How can you evidence that everything you do is in line with my values as an adviser?
- What is the arrangement which needs to be put in place in order for me to use your service through the platform and how does this respect the relationship I have with my client?
- What routes do you provide for clients to move direct to you?

For some advisers, the availability of a range of propositions from the DFM both on and off the platform is important.

2 Proposition

The proposition itself has many facets which need to be considered and for some advisers, the availability of a range of propositions from the DFM both on and off platform is important. This could enable an adviser to offer a consistent investment process across a range of client segments with different requirements, e.g. from model portfolios on platform to fully bespoke portfolios provided directly by the DFM.

Accessibility across tax wrappers is also a key consideration as a client needs to hold assets in a tax efficient manner and therefore availability across pensions, Isas, bonds may be an important consideration.

Questions in relation to proposition have been divided into different sub categories as follows:

2.1

Accessibility

- How many model portfolios are available?
- Are they designed for different objectives, e.g. growth, income?
- Are the portfolios aligned to a risk profile tool and if so, which one(s)?
- If the portfolios are not mapped to the risk profile tool used, then is the DFM prepared to help with this?
- Are the portfolios available on all the tax wrappers on the platform?

The questions to ask cont...

2 Proposition

2.2

Investment process and approach

- What is the DFM's principle investment focus and area of expertise?
- How does the DFM differentiate the proposition from others available in the market?
- What is the investment philosophy and approach?
- How would the investment style be described, e.g. active, passive?
- How would the investment process be described?
- What governance surrounds the investment process and is there documentation available which describes this?
- What research methodology is used and what are the data sources?
- How is asset allocation managed? – strategic or tactical?
- If strategic, which tools and processes are used to calculate the correct strategic asset class allocations?
- Are the portfolios rebalanced on a regular basis, i.e. quarterly? Or are they managed on a more regular basis?
- Which benchmarks are used (if any), and why were these selected?
- Can you match your model portfolios to various risk-profiled asset allocation tools?

2.3

Investments used within the portfolios

- What asset classes are used?
- Which investment instruments are used within the proposition, e.g. Oeic's only or others such as investment trusts, exchange traded funds (ETF)?
- Typically what volumes of assets are being traded in the platform portfolios?
- What levels of cash are usually held within the portfolios?
- Are there any assets used where there might be liquidity challenges? If so, how are these managed?
- Are structured products used within the portfolios?
- To what extent are the managers' own funds used within the portfolio?
- What does a typical portfolio look like?

3 Regulatory issues

As outlined in an earlier section, the key legislation in relation to centralised investment propositions and many of the points raised by this have been covered by questions in other sections.

However, FCA policy statement PS13/1 which covers the following should be considered:

- disclosure of charges
- presentation of retail investment products to customers without bias
- payment for platform services by platform charges only.

While some of the regulation relates to the platform provider and is covered in the Nucleus due diligence documentation, the following questions should be asked of the model portfolio provider:

- Does the proposition use only clean share classes as per PS13/1?
- If not, where are any unit rebates paid and are there plans to move to clean share classes?
- Is the DFM charge explicitly presented?
- How are the investment charges presented and in what format?

In addition more generic questions could be asked, for example:

- Please confirm when your last supervisory visit was by the FCA/PRA and confirm any key issues arising.
- Please describe any disciplinary proceedings that have been made against you.
- What is your customer outcomes policy?
- Do you have a dedicated compliance team and who is your head of compliance?
- What procedures are in place to ensure compliance with regulatory issues and updates?
- What in your opinion are the key regulatory challenges facing DFMs at the moment?

More generic questions could be asked, for example: what is your customer outcomes policy?

4 Charges

It is sometimes an accusation of discretionary fund managers that their charges are complex and difficult to understand. This is often true when bespoke portfolios apply charges both for managing the portfolio and for dealing and trading. In those cases, the level of turnover within a portfolio will impact the charges (and therefore the performance).

Models being managed on a platform typically only have three charges:

- DFM management charge usually plus VAT
- platform charge
- cost of the investments.

The adviser will also add their own service charge in agreement with the client.

The following example questions can be used when assessing charges on DFM propositions:

- What is the DFM charge for managing the portfolio and does this include VAT?
- What is the frequency of this charge?
- Where is the charge taken from?
- What is the typical annual management charge for the investments and the associated TER?
- Does the charge vary across the model portfolios if the DFM offers a range?
- If the model portfolios use stocks and shares, investment trusts or ETFs, how are the dealing charges applied and what level are they?
- If applicable, are the dealing charges applied at portfolio or client level?
- Do you retain a margin on any cash investments?
- What level of interest is paid on client cash?
- Are there any exit penalties?

It is sometimes an accusation of discretionary fund managers that their charges are complex and difficult to understand.

5 Performance

Performance of DFM propositions is often difficult to assess particularly for bespoke portfolios where additional charges are applied for dealing and trading investments.

This is particularly important as in FG12/16, the FCA states 'where a firm recommends replacing an existing investment on the basis of improved performance prospects, we expect to see the firm justify specifically why the new investment is, in the firm's opinion, likely to out-perform the existing investment'.

Many DFMs will subscribe to Asset Risk Consulting (ARC) which is an independent company specialising in reporting and consultancy services for charities and investment institutions.

The ARC private client indices (PCI) provide insight into the actual returns being generated by investment managers for discretionary private client portfolios based on real performance numbers and levels of risk appetites.

However, for model portfolio solutions available on platforms, most DFMs will provide factsheets similar to those produced for funds. These will typically cover asset allocation, underlying investments, performance data, size of the portfolio, high-level commentary and charges.

In addition to the factsheet data, the following questions may also help when assessing performance:

- Do the portfolios have a one/three/five year track record? (either on Nucleus or another platform)
- Does the DFM subscribe to ARC and do you supply PCI data?
- What benchmarks, if any, are used to measure performance?
- Why have you selected this benchmark?
- Can any period of underperformance be adequately explained?
- How much discretion do investment managers have when looking to increase performance and how would you track this?
- Can you use client specific goals as a benchmark?

6 Service and support

As there is no direct relationship between the DFM and the client, the services are provided by the DFM solely for the adviser who may then choose to pass some of these onto the client depending on their agreed service proposition.

Much of the service surrounds the provision of reporting and commentary on a generic basis or applicable specifically to the models - for example when changes are made. It is also important that there is good support for questions, enquiries, valuations, performance data etc.

Many DFMs also have a range of good quality information readily available on their website which can contain:

- the mapping of the portfolios to various attitude-to-risk tools
- portfolio factsheets
- due diligence documentation
- investment process documentation
- explanations of how the portfolios are managed
- market commentary.

This content can often be accessed through various medium, e.g. documents, video, client-facing brochures to download.

Communication and reporting is extremely important for both the adviser and client and the questions which could be used are:

- Is market commentary provided on a regular basis?
- If so, in what format does the adviser receive this?
- How regularly is information provided regarding any portfolio updates and the rationale for any updates?
- Are portfolio factsheets available and if so, how often are these updated and what information do they contain?
- What website support is available?

As there is no contractual relationship between the DFM and the client, any 'face-to-face contact' with clients would be extremely unusual for model portfolio propositions however, in terms of additional services, the following questions should be helpful:

- Is there any adviser support on a 'face-to-face' basis?
- Is there any additional support provided, e.g. seminars, conference calls?
- How is technical support provided, e.g. telephony, email, face-to-face?
- If a client had a significant investment, would there be the opportunity for them to meet the DFM?

Final thoughts

In summary, there are many advisers who are now choosing to use third parties to manage client investment strategies and evidence suggests that this is a growing trend. As a result, there has been a rapid increase in the availability of propositions in the market and in particular, the use of model portfolios on platform which are managed by DFMs is becoming more prevalent.

It is likely that at some point there will also be growth in the number of DFMs accessing the adviser platform and managing individual bespoke portfolios on a direct basis. Some platforms are already starting to offer this capability and it will be interesting to see how this proposition develops in the market.

The regulator is also taking an interest in this activity and some of the recent legislation indicates their expectations of advisers when moving clients into new investment propositions. Coupled with the variety of model portfolio propositions available, there is an expectation that advisers will undertake some form of due diligence in order to select the appropriate propositions for their clients.

If you are undertaking a selection and due diligence exercise, we hope that this paper will assist you in considering the process which could be undertaken and the appropriate questions to ask of any potential provider in order to ensure the best possible client outcomes.

Opposite is a proforma to document the questions you may want to ask a discretionary fund manager.

Some of the recent legislation indicates their expectations of advisers when moving clients into new investment propositions.

Proforma to document your due diligence questions for potential model portfolio providers

Due diligence questions to ask	Priority – e.g. high/medium/low	DFM response
1. The CIP provider _____ _____ _____ _____ _____	_____ _____ _____ _____ _____	_____ _____ _____ _____ _____
2. Proposition _____ _____ _____ _____ _____	_____ _____ _____ _____ _____	_____ _____ _____ _____ _____
3. Regulatory issues _____ _____ _____ _____ _____	_____ _____ _____ _____ _____	_____ _____ _____ _____ _____
4. Charges _____ _____ _____ _____ _____	_____ _____ _____ _____ _____	_____ _____ _____ _____ _____
5. Performance _____ _____ _____ _____ _____	_____ _____ _____ _____ _____	_____ _____ _____ _____ _____
6. Service _____ _____ _____ _____ _____	_____ _____ _____ _____ _____	_____ _____ _____ _____ _____

We hope this white paper has helped you understand the due diligence questions to ask when choosing to outsource to a discretionary fund manager.

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If you'd like a word version of the questions in this document, contact communications@nucleusfinancial.com

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