

WEALTH ADVISER PROFILE

The founder of No Monkey Business on why active management is dead in the water

STUART FOWLER



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At the centre of the investment management industry – and indeed all money management – is a 40-year-old lie, says Stuart Fowler, former Hill Samuel director and now head of financial planning company No Monkey Business.

The lie is one that clients as well as managers are happy to perpetuate rather than face some pretty unpalatable truths: that risk is something that can be accounted for in traditional portfolio investment.

While the germ of this dawned on Fowler more than 25 years ago while running pensions schemes for the BBC and Ford, developing a way to get beyond it – for individuals as well as institutions – has taken longer, and has needed technology to make it cost-effective.

'The reason why our pension funds have long-term rather than mark-to-market shortfalls is because their actuarial assumptions are normalised from a statistical time series,' says Fowler.

'If you think of 40 years ago, pensions companies thought of pensions payments as an aspiration: they didn't have a legal requirement to meet a minimum.

Legislation turned it from an aspiration to a liability: only gradually have they been forced to address the fact that there is only a 50% probability of achieving a defined outcome.

'They have been forced to confront the nature of risk in occupational pension schemes. I don't think anyone is being forced to face up to the nature of risk in personal saving schemes.

'I can't think of anything in the traditional [client] conversation about risk where people sit down and say "this is the worst case scenario and how we can solve it: either we put more money in, bring the risk down, or we gamble". I see nothing in the conversations about risk tolerance that come near that, which is why the conclusion has been to make four or five portfolios that represent a factory model.'

Getting beyond this is more or less the business model of his advisory – which helps explain its small but dedicated following among hedge fund managers and McKinsey consultants – and goes some way to explaining its idiosyncratic name.

Drawn from a guide to financial markets and services Fowler wrote for a general audience in 2002, it was based not only on the industry's tendency to make monkeys of those it deals with, but our willingness to make monkeys of ourselves for a quick buck.

The book occupied his time between devising the outcome-driven investment model he believes offers a much more comprehensive assessment of risk in the late 1990s and the launch in 2004 of the business that has the model at its heart.

Six years later the business has around 40 clients and their families and manages around £70 million, paying fees equivalent to between 0.3% and 0.6% of assets, although these reflect a flat fee on a sliding scale between £7,500 and £25,000.

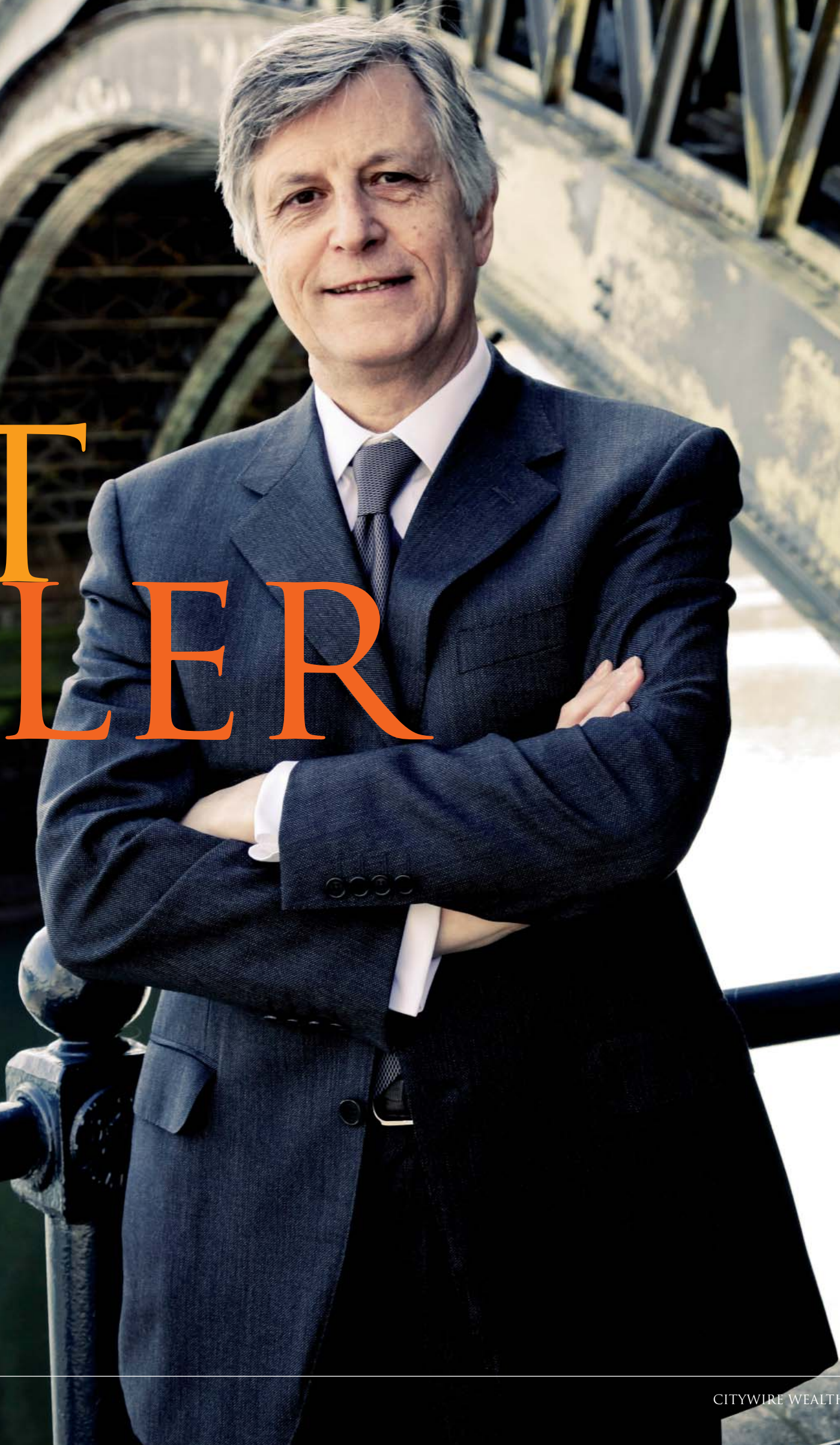
'As advisers we always tell clients not to leave themselves too exposed to market volatility and then build businesses with revenues exposed to asset volatility to point where we might have to start laying people off. We should take our own advice.'

The firm has been running consistent growth of around 30% in recent years, entirely financed by Fowler and partner Chris Drew, former director of adviser James Baxter & Co.

At the heart of the business is an exhaustive computer model, designed to chart the course of a portfolio tailored to match clients' aspirations, based on the mean variance of what goes into a plan and how it is invested.

Alongside the mean investment scenario are the best and worst case scenarios and

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the range of inputs designed to formulate the likelihood of particular goals being reached across the risk range – it sounds daunting but visually is no more or less complicated than many websites.

Originally designed in the white heat of the tech boom to be at the core of a mass affluent investment platform, by the time Fowler and Drew were happy with the model the market was beginning to pop and venture capital was drying up.

‘All our indicators were showing that equity was massively overheated so maybe we should have paid more attention to what they were telling us,’ he laughs,

He says the unique proprietary platform, using the range of variables defined by the client to automatically trade a global passive portfolio, is currently cost effective only for portfolios of £500,000 upward but with increasing economies of scale – and more importantly rapidly developing platform technology – this could fall to half that.

While his plans for the business remain that of a small self-financed organisation – he runs pensions seminars for professionals and is at an early stage of considering an outsourced investment service – the consequences of similar technology are huge.

‘It’s a horrible phrase, but this is as much of a paradigm shift as liability-driven investment has been – it destroyed 90% of the pension assets managed by people like Schroder. All that money has gone to businesses like BlackRock.

‘It was much easier to destroy the institutional system because it was just 10 managers, compared to the fractured distribution system of IFAs and asset managers, but it will happen.

‘It is a massive enabler for financial planners and asset allocators, however, who will be able to integrate portfolio planning and asset allocation in a way that deals with the nature of uncertainty and offers solutions for it.’

The equation is not a zero sum game for advisers however, who will have to prove that they have earned the right to be trusted with an investment portfolio. ‘I think most advisers who outsource asset allocation to businesses like 7IM or Brewin Dolphin, within a few years there are going to be some hard questions about why they are doing virtually nothing but picking up 50 basis points.

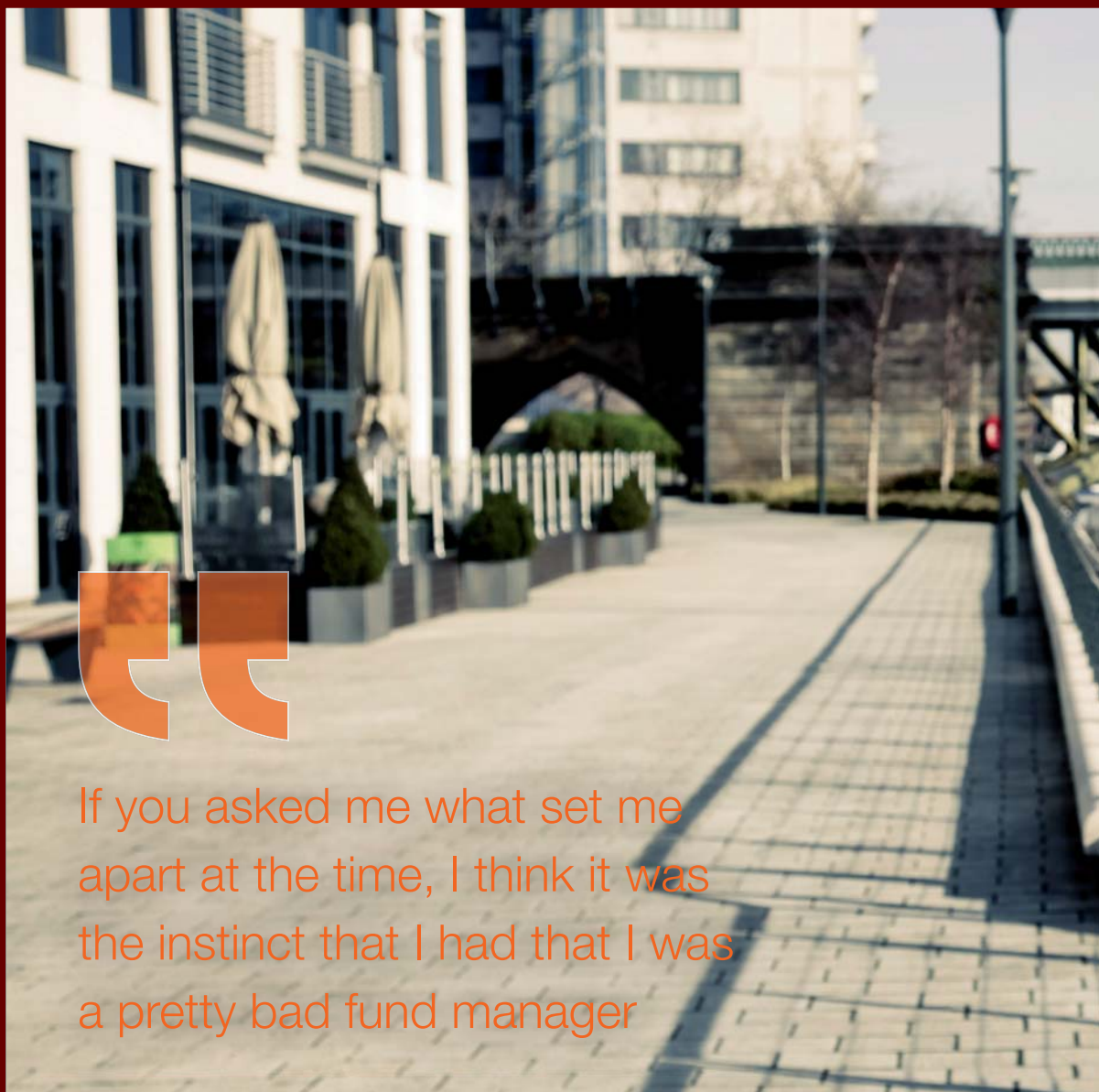
‘If you retain control of asset allocation then it is reasonable to say that you are doing a job and getting paid for it. But they will have to demonstrate an ability to do it... it is not about consolidated reporting or accounting, it is about your involvement in the process. Some will be able to cut the mustard, as they say, and some won’t.’

If advisers will have to learn new skills, he says that active managers are at risk of outright redundancy. A passive investment enthusiast since the early 1990s, Fowler says the professional role of asset manager doesn’t stand up to much scrutiny.

Testing the UK fund management industry on the basis of reliable alpha generation versus cost of investment reveals just a small handful of managers who have provided value for money over the long term, compared to low-cost passive access.

‘Strangely, the one exception was the equity income sector. I can only assume it is because the IMA constraints on the sector force managers to invest on a revolving value basis... houses like Neptune, Invesco Perpetual and Newton scored well.

‘If you think about the decision to invest and look at the cost, active management pushes up the cost



“If you asked me what set me apart at the time, I think it was the instinct that I had that I was a pretty bad fund manager”

of investment by between 2% and 4%. The price of that means you will struggle to match price to return.

‘That makes managers useless as a lever because you can’t tell the difference if you have made a right decision or not; there is so much noise about management style and risk and luck, the performance increment is just too small.

‘You have encumbered performance with a lot of risks and cost and even if you are successful it is not worth it. It is just not a long-term solution.’

The sole exception remains the alternatives sector where the cost of transactions for a small investor remains too great to be economical – although Fowler adds that this is a matter of scale rather than fundamental principles.

His scepticism about active management goes back to the mid-1980s he says, when his peers in the institutional sector were up in arms about the rise of quantitative systems as the cost of technology fell.

‘If you asked me what set me apart at the time, I think it was the instinct that I had that I was a pretty bad fund manager. Maybe it was the opportunity to make returns more consistent – if you could create a machine that would reproduce what is good in your decision making and remove sources of error, why wouldn’t you?’

Born in Sussex and educated in modern languages at Christ Church, Oxford, Fowler says his ambition was to enter the diplomatic service. He was turned down at the final interview however and turned instead to the world of banking which he assumed would offer the same ‘very clubby’ atmosphere and a ‘refuge from the world’.

This was similarly ill fated, however. With the ignorance of youth, the only one of his applications to meet a receptive audience was what he had assumed was a bank but was actually brokerage de Zoute Gorton.

He initially hated it, he says, but became seduced by the fun of the markets, although he lost a fair amount of money in the South American mining bubble and ended up in a form of bonded labour for several years at the company as he worked off his losses.

His language skills came to the fore in the early 1970s as Britain promised greater continental integration as preparation for membership of the Common Market and UK investors discovered that London was not the only exchange in northern Europe.

One of the only brokers with modern language skills he became the company’s ‘Mr Europe’, developing a niche bilingual role and moving to work on the Paris bourse with a French brokerage, as the exchange’s token Englishman, a role he cultivated.

This took him to Touche Remnant where he swapped brokerage and moved into asset



management as well as to New York, eventually working his way up to become head of US equity.

He moved through a succession of roles on both sides of the Atlantic and following an ultimately failed joint venture to develop one of the UK's first quant houses, launched a low-cost institutional pensions business with a former colleague Peter Miller.

At its core was the idea of global asset allocation using cheap index trackers. 'I am still sometimes mistakenly credited with inventing the idea, but I actually pinched it from Barings. They were running a little portfolio for the province of Saskatchewan or somebody, but no one really knew about it.

'I thought that was really clever. Running our asset allocation model was quick but the stock selection model had a tendency to fall over. It was an idea that Nikko Bank in San Francisco, which became BGI, was developing at the same time.'

The business was a success, but Fowler clashed with his co-founder, who was never as anti-active as he was, and was bought out with a non-compete clause in the mid-1990s.

He made a half-hearted attempt to establish an advisory alliance with a co-owned asset manager before he realised that most advisers don't actually retain ownership of client assets. Peter Hargreaves told him the idea 'leaves me not so much cold as bloody frozen'. It did bring him into contact with Chris Drew however, and the ideas they developed together led him to No Monkey Business.

He is now at a point in life where most people in finance have already peaked but he says the opportunities of the new business are more than enough to keep him engaged, and more importantly the fact that he is still learning keeps him fresh.

'I had a semi-holiday for several years, working on a book and on a consultancy when I felt like it. And we do all enjoy being here, we do have a laugh. If you have been taught a certain way to do something but you find that you need to change, it can take a long time to relearn things – it's like throwing away a pair of crutches.' ■

STUART FOWLER: WHY CHINA IS A VALUE TRAP

In the days when Fleming, GT and Gartmore were running Hong Kong funds, index funds posed no threat. Now there is an alternative, in the form of the iShares' FTSE Xinhua ETF which tracks 25 stocks, both 'red chip' Hong Kong companies and H shares in mainland companies.

With Fidelity launching a closed-ended China fund for Anthony Bolton, we have to consider whether our preference for the ETF is about to be challenged by a manager hunting differently from his predecessors, who have failed to justify management fees.

Conventional wisdom is that exposure to emerging or developing markets should be active, not passive, because they are less efficient. In a single-country emerging market fund, active management is about either security selection or market timing.

To test for plausible skill in beating the Xinhua index, we analysed HSBC Chinese, Gartmore China Opportunities, Invesco Perpetual HK and China, Jupiter China, Neptune China, First State Greater China and the closed-ended JP Morgan Chinese trust. We were mainly interested in the period from the start of 2006 as representative of China's 'emergence' in global terms.

Our expectation was that there would be little to choose between managers and that their own variance would be explained largely by the benchmark. Though counterintuitive, this is logical because managers have limited access to domestic issues and so are forced to fish in the same small pool.

In a narrow market we might expect to see managers make similar adjustments to sector weights to gain a more intuitive diversification than the benchmark.

Though this also forces managers to be similar, they might all offer lower variance than the index and that might be valuable.

The data supports both expectations. The proportion of their variance explained by the benchmark varies between 76% and 89% which implies that active bets are significant. But further analysis suggests they were not market timing. Other than the JP Morgan fund, the variance is indeed slightly lower for all of them. However, other than in the early part of the period, the divergence in relative returns between the funds is very tight so the payoffs to the active bets appear to be structural rather than idiosyncratic.

The only significant opportunities to outperform in individual funds have arisen because of earlier underperformance. This is to damn

active management with faint praise as it reminds us the requirement for skill is with the fund buyer, not just the share buyer, and that underlying share selection payoffs are hard to distinguish from noise.

The merit of Fidelity's closed-ended fund depends on believing the other active managers ignored opportunities, rather than that they were constrained by managing money in a small pool. Our hunch is that exploitable opportunities are not there and will not be for years of further development in the openness and breadth of Chinese companies.

The issue of how to get exposure to China really ought to be academic at a time when Hong Kong stocks sell at more than three times book value and mainland stocks at over five times. Overpaying for a growth story is a classic investment trap.