Observations on Equities

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Frontier Advisors Pty Ltd

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Frontier regularly conducts international research trips to observe and understand more about international trends, and to meet and evaluate first-hand a range of fund managers and products.

In conjunction with insights we share with our Global Investment Research Alliance partners, these observations feed into our extensive international research library.

This report provides a high level assessment on the key areas and observations unearthed during this research venture. We would be pleased to meet with you in person to provide further detail.

Our research team

In October 2014, members of Frontier's Equities Research Team travelled to Edinburgh, London and Copenhagen. A focus of this trip was to meet with global equity managers we either currently rate or which we could rate in the future. Discussions with managers covered a broad range of themes and gave us a variety of perspectives, providing us with a sense of the issues global equities managers are grappling with at the moment. While many issues are manager-specific, some are common across many managers. One theme that pervaded a disproportionate number of meetings is the subject of this International Research Issue: Generational Change.

Fraser Murray

Nathan Bode

Dan Hunt

Generational change

"This is my generation, baby."

Pete Townshend

As part of our assessment of managers, Frontier places a heavy emphasis not just on the few key investment personnel, but on the developing investors that support them.

The rationale for this is two-fold: firstly, and most obviously, the deeper team has a direct impact on the execution of the strategy in its current form; but, secondly, the future strategy leaders are likely to develop through the ranks over time.

The secondary reason is becoming more important as we are currently experiencing an unprecedented point in funds management history, where a significant proportion of successful and highly rated managers are grappling with generational change. This was a recurrent theme in the meetings we had during this trip. We believe the decisions these managers make to deal with generational change will prove pivotal to their future success or failure.

Our broad observation is that, as many fund managers have been established in the last 20 to 30 years, a large number of founders/senior investment staff are naturally approaching retirement.

Generational change is challenging for any fund manager, whether it has corporate or private ownership. However, there appear greater challenges for the privately owned managers.

A vexing issue that faces many privately owned managers is that, as a result of the increase in assets under management over this period, the equity in their business has rarely been more valuable.

This leads to a dilemma in transferring highly valuable equity to the next generation. Often the next generation cannot simply buy this equity, so we have seen numerous partial or complete business sales or stock market listings to exit the equity of a significant owner.

The circumstances and approach taken in managing generational change can have a significant impact on the manager's prospects for future success and how we view the manager. The disparity in approaches observed over the course of this trip was illuminating and have in some cases added to or detracted from our conviction in a manager.

Features of succession

Succession and generational change can occur in a variety of ways. We treat each set of circumstances differently as there are usually different factors at play, but it is important to distinguish between controlled and “surprise” transitions.

Controlled transition

In certain circumstances, managers provide considerable forewarning that a key investment team member will be leaving (this can be five or more years in advance in some cases) and that a gradual and logical succession plan has been put in place. We met Wellington Value on this trip who has adopted such an approach.

This helps alleviate the vacuum left when the key team member ultimately leaves the firm, as responsibilities have fully transferred on their watch.

Implications: This approach is our preferred succession approach. It allows investors and consultants to get comfort with the successor as the key person gradually relinquishes responsibilities.

It does not guarantee continued success, but we are usually encouraged by the planning process.

Surprise transition

In this scenario, a (seemingly) abrupt change occurs and promotions or external hires take place. In many instances, the marketing department is in damage control and we encounter some enterprising explanations that stretch the truth.

For example, the manager often dismisses the key departures as having been irrelevant for some time, or provides assurances that the new structure is merely a formalisation of an arrangement which has been in effect for some time.

We met several managers that have reshaped their teams in recent years following unexpected departures that created serious challenges, with varying degrees of success.

Implications: We are naturally cautious in any situation where an unexpected significant team change occurs. This applies even in circumstances where the successors have worked alongside the senior departures for ten years or more.

In a surprise transition, the importance of knowing and understanding the roles and capabilities of members of the investment team is most critical in this situation.

This enables an objective assessment at a time of change. In this scenario, it is most important to form an independent assessment of future prospects, rather than being coloured by the marketing spiel.

Features of succession

Succession-related ownership change

For privately owned boutiques, an ownership change may happen at the time of a staff departure or, with good planning, it may occur in advance.

We have observed that ownership changes have become increasingly prevalent, and challenging, where there is valuable equity and there is a need to exit a significant equity owner.

Third-party buyers have become increasingly involved in helping transitions from one generation to the next. US-based Affiliated Managers Group ("AMG") is one such firm and has taken a stake in three managers we visited in Europe on this research trip (Genesis, Artemis and Veritas), but also has stakes in well recognised US managers such as AQR, Trilogy, Harding Loevner, Tweedy Browne and First Quadrant.

Transactions occur with a variety of terms. However, we have observed the better managed transactions tend to reserve a meaningful level of equity which can be distributed to the future investment leaders in the firm.

Implications: If done well, an ownership change can help to address a key succession issue: due to strong growth in assets under management over the last 20 to 30 years, the equity in successful "boutique" funds management businesses can be prohibitively expensive for the next generation to purchase from the founders or senior investors within the business.

From our observations, it is important that the buyer incentivises the new generation and allows the manager to continue to operate as before.

However, deals do not always work as planned. Deals often tie in key investors for a few extra years but this can lead to a loss of hunger and intensity. We have seen key personnel cruise until a future vesting date is reached, such that succession would have been better at the time of the deal.

Conclusion

Given the size and sophistication of Australian superannuation funds, investment managers tend to bring their most senior and experienced investors to Australia to meet with Australian consultants and prospects.

This affords investors an opportunity to form an opinion on the key decision makers within an organisation.

It does not, however, allow Australian investors a chance to meet other team members, including the next generation of investors that might be running the strategy in five or 10 years' time.

The onsite visits we conduct are essential for us in forming a view of the whole investment team and seeing possible successors in advance. For some managers we visited, succession appears clear while for others, the future leadership looks completely uncertain.

We also encourage our clients to use our Mercury database or talk with Frontier about the next generation of investment team members at their chosen managers.

Given the high levels of generational change we are seeing in the industry, it is important to be proactively thinking about future succession, rather than reacting as it occurs.

Managers visited

Baillie Gifford Long Term Global Growth	Mondrian Emerging Markets	Veritas Global	Artemis Global	Marathon Global
First State Stewart Emerging Markets	Mondrian Global	Trinity Street Global	THS Global	AllianceBernstein Emerging Consumer
First State Stewart Worldwide	Hosking Global	Wellington Global Value	Investec Global Franchise	AllianceBernstein Global Value
Walter Scott Global	Morgan Stanley Global Franchise	Wellington Durable Companies	T. Rowe Price Global	Schroders Global Core
Dundas Global	Orbis Global	RWC Global	MFS Global	Generation Global
Martin Currie Global Emerging Markets	Independent Franchise Partners Global Thematic	Somerset Emerging Markets	Sarasin Global Thematic	Genesis Emerging Markets
Carnegie Worldwide	Artisan Global	William Blair Emerging Markets	Ardevora Global	AllianceBernstein Global Core

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