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20 years

The Frontier Line

Thought Leadership and insights from Frontier Advisors

Strategic partnerships

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The Frontier Line explores a range of investment issues and ideas to explain and illuminate areas for investors to be aware of and be thinking about. Our specialist and sector research teams constantly review and discover topics to provide new perspectives and enrich understanding of critical risks and opportunities.

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Strategic partnerships

In recent months, Frontier has observed an increasing trend among Australian institutional investors in launching (or at least discussing) strategic partnerships with their fund managers. The reasons for this are varied; but extracting intellectual property (I.P.), reducing fees and reducing the number of manager relationships; are three commonly quoted and perfectly valid reasons.

The common conception is that strategic partnerships are a concept restricted to large funds with large cheques negotiating preferred terms with large managers. However, cheque size is but just one factor and size is relative. Whilst the very largest funds in the world may enter into strategic partnerships with the world's largest fund managers, there exist opportunities further down the size scale perhaps with (for instance) local managers, looking for local partnerships, or smaller managers with capacity constrained illiquid funds. An ability and willingness to "be strategic" is arguably as important as cheque size.

What exactly is a strategic partnership?

From what we have observed, a strategic partnership means different things to different people. However, one common element is that it generally entails a relationship with a fund manager that goes beyond the traditional manager-client relationship (or "GP/LP relationship" in private markets). Examples might include:

- the client tailoring the specifics of the mandate(s) (for instance, a total return objective that is specific to the client);
- mandates across multiple asset classes with the one manager, coordinated into an over-arching mandate, generally with corresponding aggregate fee breaks (although we would argue this should be a natural outcome from increased scale with a manager, regardless of whether the partnership is deemed "strategic");
- access to the I.P. of the manager that goes beyond that of a typical client;
- the manager providing the client with preferential access to deal flow (e.g. in a co-investment or JV structure);
- the manager tailoring bespoke mandates for the client that are not available to the wider investor community and/or the investor seed funding a new capability for the manager (with corresponding seed investor fee deals);
- the manager assisting the client with challenges it may be dealing with – such as decision making and delegation structures, remuneration structures and IT systems; and
- at the extreme end, the relationship extending beyond what it is typical for a manager/client – for instance, the client seconding staff to the manager.

Two examples of US funds who have implemented strategic partnerships are the much discussed US$55 billion Alaskan Permanent Fund with its "external CIO partnerships" (with AQR, Bridgewater, GSAM, GMO and PIMCO); and the US$120 billion Texas Retirement System (TRS). In the case of TRS, its "Public Markets Strategic Partnership Network" began in July 2008 with four US$1 billion multi-asset mandates with BlackRock, JP Morgan, Morgan Stanley and Neuberger Berman, which have grown to circa US$1.6 billion each by June 2014 (a fifth manager, Barclays, was added in July 2011 and terminated in October 2013). In those cases, TRS sets the investment objective, the SAA and asset allocation ranges to its managers.

TRS also has a "Private Markets Strategic Partnership Network" with Apollo and KKR, where publicly available information is understandably more scarce.

Multi-asset investing and strategic partnerships

A number of Australian investors have moved (or moved back) to multi-asset relationships with fund managers in recent years. In many cases this is via a multi-asset pooled fund. A strategic partnership need not necessarily have any asset allocation element (for instance, the client may have an equities, bonds and cash mandate with the same manager, but with no asset allocation overlay).

However, a multi-asset class relationship with a manager with a DAA/TAA overlay is the intuitive next step for the strategic partnership, where the manager possesses those asset allocation skills. Indeed we are seeing many of the world's largest asset managers build or re-build those skills internally.

Going a step further (extending the "strategic-ness"), a common approach is to then give the manager the same challenges facing the fund.

For instance, the fund may give the manager the same long-term real return objective as the Fund (which looks challenging in the current environment), a sensitivity to negative returns, and some fee and liquidity requirements; to see how the manager tackles those challenges.

This is, in many respects, the genesis of the TRS approach. This is nothing new in many ways, as institutional investors have used balanced funds for decades that are generally coalesced with their own return objective. However, unlike a traditional balanced fund, clients should be looking for asset managers that tackle the challenge by introducing something the fund is not already doing and/or cannot easily do itself, rather than just combining a portfolio of long-only traditional assets with a DAA/TAA overlay. For instance, the manager may use hedge funds, commodities, derivatives (e.g. put and call options), shorting and leverage to tackle the challenge (where allowed, perhaps by establishing a "fund of one" rather than levering the fund).

We would observe the following differences between a strategic partnership (of the TRS variety) versus a multi-asset fund.

	Multi-asset fund	Strategic partnership
Product structure	Individual mandate or pooled fund	Individual mandate (almost by definition), but may be structured as a "fund of one" to allow shorting and leverage
Investment objectives	Generally set by the manager	Generally set by the client
SAA & AA ranges	Generally set by the manager	Generally set by the client
Intellectual property (I.P.) exchange	Variable, but generally limited to the client-manager relationship and I.P. needs to be extracted by the client	Can be very high, e.g. regular formal dialogue with the manager, regular reporting of positions and rationale for those decisions
New or removed sub-strategies	Typically added or removed without any consultation with clients (or no veto rights)	Typically added or removed with the approval of the client. New strategies that need seed capital should reward the client (e.g. with lower fees).

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So what makes a strategic partnership?

So what makes a strategic relationship? The obvious starting point is cheque size. It is undoubtedly true that the client/manager relationship is almost always vastly different at $1 billion versus $1 million. However, with an ever-increasing pool of "mega funds" globally (for instance, the growth of very large pension and sovereign wealth funds in Asia), cheque size alone is not the only "differentiator" for "buyers" in this market, especially where the "suppliers" have capacity constraints (e.g. in private markets).

However, size is relative. The world's largest asset managers may be looking for strategic partnerships with the very largest funds in the world (e.g. cheque sizes above US$1 billion). But smaller asset managers (certainly domestically-focused managers) will generally have appetite for smaller cheque sizes that still ensure a strategic partnership. The number of relationships is ultimately key and first mover advantages seem likely to exist. Can any asset manager truly have 100 strategic partnerships before they become "un-strategic"? We think not. At the very least, the largest and/or earliest strategic partners are likely to take priority, especially when it comes to accessing the I.P. of senior portfolio managers (PMs) with scarce time. Earlier strategic partners are unlikely to take fondly to their PM sharing I.P. with another 99 strategic partners, and invariably it is the portfolio that suffers.

Therefore, although it may sound odd, institutional investors need to ask themselves what they bring to the partnership other than capital (notwithstanding the importance of capital to fund managers). An ability and willingness to seed fund new ideas or new products is an example of the client "bringing" something to the relationship, with the benefit likely being low fees on that strategy in perpetuity. This may particularly suit managers who lack the balance sheet to seed-fund new ideas.

Taking the idea a step further, an ideal strategic partnership "creates solutions" for the client within a broader relationship, either at the manager or client's instigation. For example, the client may indeed initiate and seed-fund a new idea, for instance a product that doesn't currently exist, perhaps for a certain solution for "moment in time" allocations, which may benefit both sides of the relationship, as it should enable the manager to more easily fund raise with subsequent investors.

An example in the current environment may be a fund or mandate to take advantage of distressed opportunities in the energy industry. Whilst we do not know how long the opportunity will exist for (or indeed if it exists yet), it seems likely (perhaps sadly inevitable) that some energy funds will be launched after the sweet spot for the opportunity. When combined with the time taken to undertake due diligence on a new fund with a new manager, this type of opportunity may pass many investors by. In a strategic partnership, if the capabilities exist within the manager (be it listed or unlisted, equity or debt), the client has a natural opportunity to take advantage of such opportunities quickly.

As both partners grow more comfortable and spend more time with each other, it is entirely possible that the client will identify opportunities or talented staff within the manager who would not otherwise have a product created. It would not surprise to see a very engaged strategic partner creating a product within a manager that does not yet exist to the broader public – for instance, a small sub-portfolio with a talented portfolio manager.

Strategic partnerships

However, all these initiatives require a "whole of fund" mindset.

Over Frontier's 20 years in existence, we (like everyone else) have noticed an increasing level of specialisation within the industry (even within our own business). With this comes an increasing tendency to search for "best of breed" managers in every sector and sub-sector. Whilst this undoubtedly had merit, many large funds are now faced with huge numbers of manager relationships (100+ manager relationships has been reported amongst the world's largest pension funds). And although many pension funds have the resources to monitor this number of managers, the Fund generates very little synergies or economies of scale.

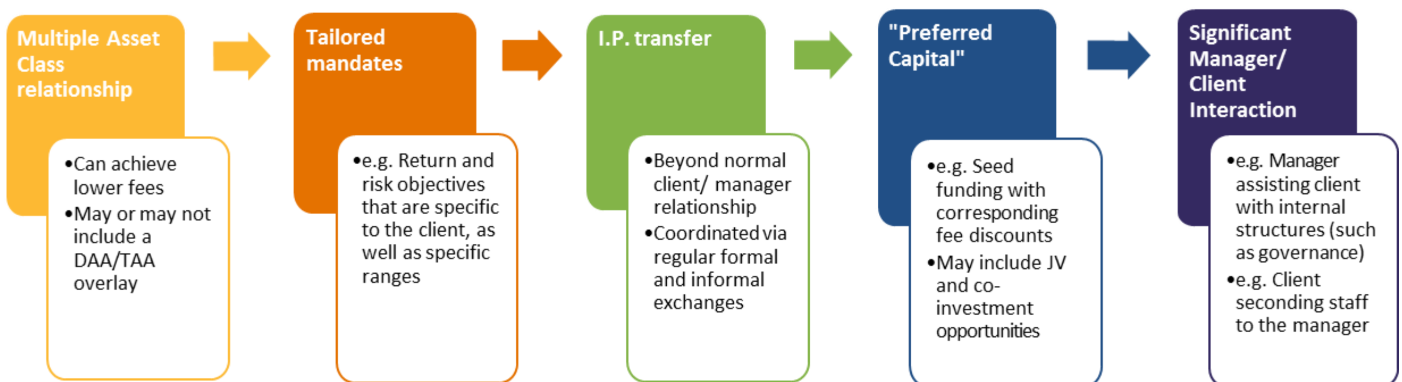
There are clearly areas where specialist managers are best placed to exploit specific sectors or sub-sectors. For instance, we would observe that the best emerging markets managers (be they equity or debt) have tended to be emerging market specialists.

The central issue is probably whether the market opportunity at hand is sufficient to justify trying to exploit it with a strategic partner. That partner may not be best of breed in that specific sector/sub-sector, but speed, lower fees, and/or ease of execution may be more important to the end outcome than manager selection.

So an important question then arises – who "owns" the strategic partnership where it encompasses a number of asset classes? Who suggests that a new idea (such as an energy mandate in our previous example) is explored with the strategic partner (who may not be "best of breed") rather than an energy specialist manager? Addressing these questions is likely a critical first step.

The degree of "strategic-ness" in strategic partnerships is perhaps best shown in the following spectrum. Note that large cheque size and large internal team resources need not be a key criteria of the factors at the left-hand end in particular.

The spectrum of "strategic-ness"



Strategic partnerships

Seed capital versus "guinea pig capital"

Frontier and many of our clients have been sceptical about internal fund of funds being used to seed-fund new ideas. Unfortunately a number of examples justify that scepticism, across a number of asset classes.

However, when done well, we believe seed-funding has powerful abilities to reduce fees and secure capacity in potentially capacity constrained sectors, but more importantly, should have the ultimate aim of generating strong "first mover" returns in niche markets. The nature of the relationship (especially a veto right on behalf of the client and an ability to ensure it is right-sized) hopefully moves the dynamic from "guinea pig capital" (with a blind capital nature), to a true seed capital relationship.

It does however require a tolerance to take risk on untested ideas, a certain mindset and a level of trust that, to be frank, does not exist in many manager-client relationships. Even if the required degree of trust can be built, it requires regular oversight of the Manager by the client to ensure that seed capital strategies make sense for the client, not just the manager, and that the client is seeing the best opportunities – i.e. ensuring that scarce opportunities are not being allocated to other clients.

It also requires consideration of the whole, rather than a focus on each line item. That is, small strategies in and of themselves may not work and may be an annoyance. However, they can grow to something substantial and we would observe that most institutional investors have hugely diversified portfolios and can generally afford a seed investment in an embryonic idea within a broader relationship.

Take for instance a $1 billion strategic partnership for a $50 billion client. A $25 million seed investment within that $1 billion mandate comprises 0.05% of total Fund assets, a relatively small amount for the client, but potentially enough to seed a new strategy for the manager, with corresponding benefits (e.g. fees and capacity concessions) to the client.

The strategic investor needs to understand that small initial strategies may not work, but may be worth the seed investment. These take patience, but they also take the ability to cut when not working, if it is clear the small strategy has not developed and is not going to form a meaningful role in a portfolio (from a return or size perspective), or indeed if the opportunity has played out exactly as planned and the opportunity window has passed.

Otherwise, the mandate develops a "rats and mice" portfolio. This is typically a conversation with the fund manager, who may need to cut the capability from its business. If strategic partnerships have an "R&D" component, it would not surprise to see more small strategies not work than work, which can still be beneficial, so long as the "winning ideas" grow to be a more material component of the portfolio than the "losing ideas".

Fees - it's not just about scale and "buy in bulk"

One benefit of a strategic partnership should certainly be lower fees, and the whole should obviously cost less than the sum of the parts. Scale discounts, or special offers to induce consumers, such as "buy 3, get the 4th free" is a phenomenon that exists in almost every other industry.

Whilst cheque size is obviously a key determinant of fees and a large strategic partnership would be expected to pay less than the equivalent small strategic partnership, scale is not the only factor. As we discussed in an earlier section, even large institutional investors should ask themselves what they "bring" to a strategic partnership. Whilst not exhaustive, we would suggest the following factors may assist to reduce fees, in addition to simple cheque size:

- an ability (and proven willingness) to seed-fund new ideas, to the potential benefit of both parties;
- an ability (and proven willingness) to invest for the long-term and provide patient capital;
- Whilst most large clients will look to reduce fees, a certain mindset to reducing fees may assist (e.g. reducing fees with scale discounts or seed investments, rather than just an arbitrary request to reduce fees each year);
- an ability to transact quickly (for instance, in the case of co-investments and JVs); and
- an ability to offer counter-cyclical capital to the Manager (rare for most investors, especially those with an increasingly pro-cyclical membership base, but possibly still true for those with fairly recession-proof cash flows).

Ultimately, the very best managers with a number of potential strategic partnerships and a general unwillingness to have multiple strategic partnerships (before they become "un-strategic") will pick and choose their partners. Whilst cheque size (and the expected growth of that cheque) is likely to be the key determinant, it is not the only determinant.

Extracting I.P. from a strategic partnership

Whilst "extracting I.P." is often cited as a key beneficiary of strategic partnerships, in order for an investment to move beyond that of a traditional manager-client relationship, funds need to ask themselves how they will extract that I.P. from the investment. This means having the investment team size and mindset to do so. If contact is limited to a once per annum presentation to the Investment Committee, it certainly seems unlikely that I.P. will be extracted beyond the typical client -manager relationship. Meeting with the manager regularly, meeting multiple personnel at the manager, reviewing the manager's positions/models questioning those decisions, are all key, and are all services that need to be performed by the investment team and/or asset consultant, in order to extract I.P. from the relationship.

But in addition to team size, team mindset is also critical. Most investors and their consultants tend to enter into a fund manager relationship with a somewhat cynical mindset (and indeed a healthy degree of cynicism is often required, even in a strategic relationship).

However, in order to extract most value out of the relationship, an open mindset is often required. A willingness from all members of the team to extract the synergies from fewer manager relationships is also key, most likely driven by the "owner(s)" of the strategic relationship(s).

The degree to which institutional investors are prepared to get involved in the manager's business is also critical to the success of the partnership.

Taking a strategic partnership to the next step, this may involve encouraging the manager to build out capabilities in an area of weakness, acquire a promising team from a competitor (and provide seed capital), shut down a weak capability or provide support to a capability undergoing short-term underperformance but still with good long-term prospects.

Taking the partnership a step further is the concept of part-owning the manager, which a number of funds globally already do. It seems likely that, globally, mega funds will take more "ownership" (either implicit or explicit) in the asset managers they partner with, which is a logical step, but a dynamic that needs to be carefully managed, especially where the views of different strategic partners differ.

From our observation, the initial round of strategic partnerships in Australia (seen mostly via the return of multi-asset funds) is in many ways "Phase 1" of the strategic partnerships development. As fund investment teams continue to get to know their multi-asset managers better, we would expect the "strategic-ness" to grow, with better I.P. exchange and funding of bespoke investment strategies a natural evolution of that increased understanding.

In addition, the investment management industry globally is moving down a path of greater customisation, especially as demographics move from accumulation to decumulation. Although the industry is quick to bring new product to market, we would contend that the products we use in 20 years' time may look nothing like the products we use today.

With the continued emergence of large global investors, it seems that product design may be driven more by the investors rather than the manufacturers. Tailoring products for specific investors and building products to suit their specific outcomes seems likely to continue. A strategic partnership seems an obvious way to facilitate this development.

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Conclusion

Strategic partnerships between investment managers and clients continue to increase in popularity worldwide. The rationale varies, but typically includes a willingness to reduce the number of manager relationships, reduce fees, or an increasing appetite for I.P. transfer.

Strategic partnerships are an obvious way to address all three issues and extract synergies by consolidating manager relationships. However, they require a change of mindset in many ways. As the industry continues to specialise and as we all search for “best of breed” managers in sectors and sub-sectors, reducing relationships to a smaller number of managers (who might not be the perceived best option in each asset class) may seem like a retrograde step to many and the benefits from synergies need to combat this.

We believe the synergies that can be gained can outweigh these shortcomings, especially for funds who are willing to bring more than just capital to a strategic partnership. For instance, a willingness to seed new investments can have benefits for both parties, but this may also require a change of mindset and more trust in the relationship. However, this is an approach where some funds will rightfully be “once bitten, twice shy”, with blind capital from loyal clients having been misused in some instances in the past.

For the next evolution of seed funding, a greater degree of oversight and veto rights (and exercising those rights) is likely to be critical. Whilst trust is an important element of a strategic partnership, a healthy degree of scepticism is still required and screening potential investments to ensure they are the right “fit” for the fund is still an important element. This may include approving new investments and regularly reviewing opportunities that did not end up in the client’s mandate, as oversight is a multi-layered endeavour.

A “blind mandate” with blind capital and blind trust in the manager is unlikely to be a successful strategy in the long run and unlikely to achieve many of the benefits of a strategic partnership anyway, such as I.P. transfer. Structuring these mandates with the right level of oversight, either directly or with the fund’s consultant, is likely to be important in the success of the strategy.

Perhaps the greatest “wins” from a strategic partnership can come from alternative assets and private markets, where synergies and economies of scale have been lacking when compared to traditional assets. Whilst these benefits may not be abundant in the current environment, they may come in time to those who provide long-term patient capital, especially as the cycle turns.

A critical question exists for a fund to ask who “owns” strategic partnerships within the organisation, for instance, who decides to focus on new strategies with existing partners ahead of “best of breed” manager options within each sector or sub-sector.

As the industry moves down a path of increasingly tailored solutions for specific clients, strategic partnerships are a natural evolution to facilitate the “next solution”, which may come from within a pre-existing strategic partnership.

Ultimately, a strategic partnership is likely to be whatever the fund makes it.

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