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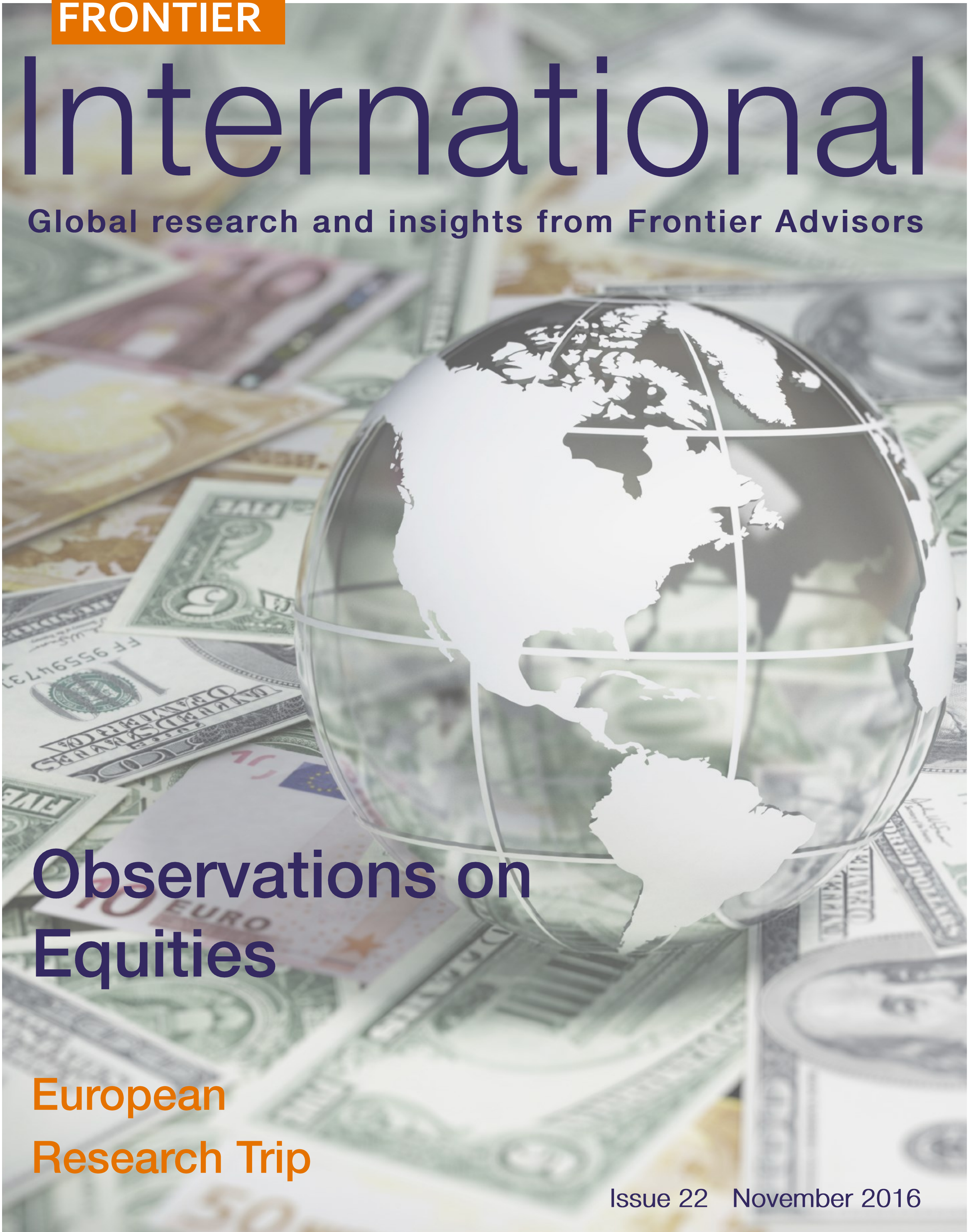

Observations on Equities

European Research Trip

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FRONTIER ADVISORS

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 recent research venture. We would be pleased to meet with you in person to provide further detail on these observations.

AUTHOR

Fraser Murray

Fraser Murray is Director of Research at Frontier. In this capacity, Fraser leads the Research Program within Frontier and is the Head of Equities.

Fraser joined Frontier in 2012 and is well known and highly regarded within the investment and funds management communities having previously worked at Ibbotson Associates/Intech Investments for nearly 15 years where he held a variety of roles including five years as Head of Manager Research and five years as Head of Equities and Property. Fraser started his asset consulting career at Towers Perrin in 1994 as a Research Associate in its Melbourne and London offices.

Fraser holds a Bachelor of Commerce with Honours from the University of Melbourne and a Graduate Diploma of Applied Finance and Investments from Finsia, and is a Fellow of Finsia.

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Zong Aw

Zong Aw is a Consultant at Frontier, having joined as an Associate in 2014 before being promoted earlier this year. At Frontier Zong is responsible for providing analytical support to clients and manager research with an equities focus.

Prior to joining Frontier, Zong was a Consultant in the Transfer Pricing team at Ernst & Young, where he was responsible for assisting MNEs with the compliance and structuring of related party dealings consistent with OECD and Australian transfer pricing standards. Previously, Zong also worked as a tutor for the Investments and Business Finance courses at the University of Melbourne.

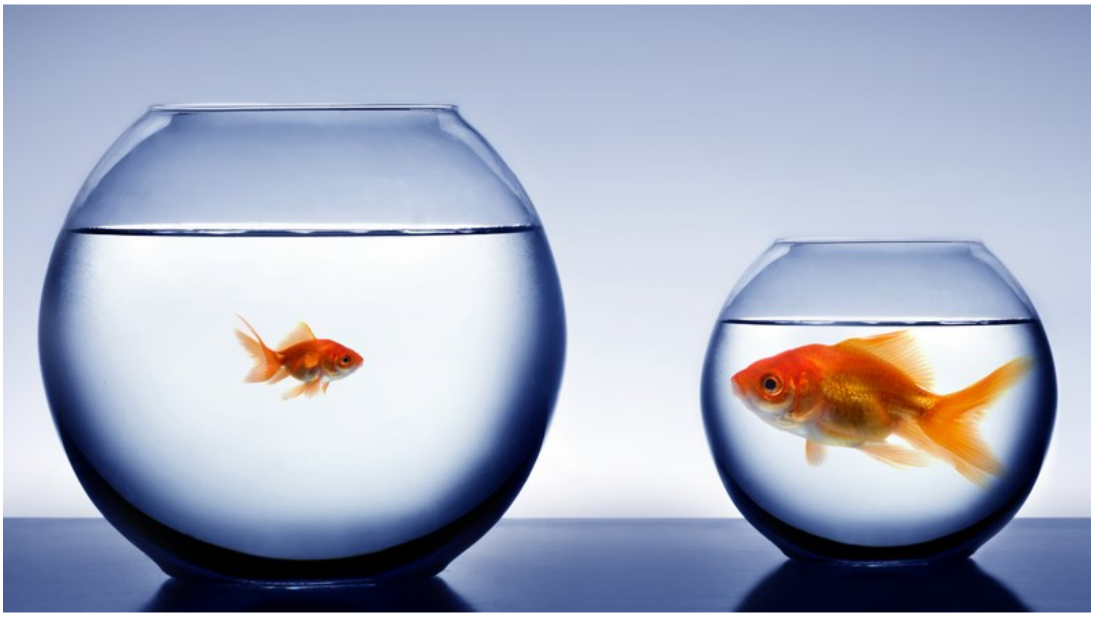
Zong holds a Bachelor of Commerce (Hons), majoring in Finance from the University of Melbourne, and has completed level 3 of the CFA program.

Boutiques versus large investment managers – what does the future hold?

Members of Frontier's equities team recently visited more than 30 investment managers over a two-week period, mostly in London and Edinburgh, but also in Copenhagen and Rotterdam. We met with a broad spectrum of managers, including managers with varying ownership structures (ranging from privately owned boutiques to large listed companies).

Australian funds have historically been accustomed to investing with both large organisations, as well as the smaller privately owned investment boutiques. We think Australian funds are amongst the world's most receptive to investing with the small, entrepreneurial boutiques. This may be because of the Australian spirit of backing the underdog and supporting those that have a go. Or perhaps, more likely, it is because Australian funds have often had better experiences with these small privately owned, entrepreneurial investment managers.

At Frontier, we think there are certainly grounds for both large and small organisations to have a place in client portfolios. Our discussions on this trip enabled us to gather insights from managers along all points of that continuum and get a sense of how the future might look for boutiques verses large investment managers.



The impact of regulation

Why is this particular topic relevant given our recent travels around the UK and Europe?

There was a range of themes that emerged during our discussions across the UK and Europe with often quite different perspectives provided by different managers. Ultimately each of those perspectives finds its way into our collective thinking. However, there was one recurring theme that generated quite consistent responses from virtually all of the UK managers we met with and that was the increased regulatory regime that managers are now facing. The impact on their businesses has been, and will continue to be, significant.

Many readers will be aware of the UK regulator – the Financial Conduct Authority (FCA). The FCA was formed on 1 April 2013 and replaced the preceding agency – the Financial Services Authority (FSA). This has proven to be a substantive change to the investment management community in the UK.

To cut a long story short, the FCA has initiated reforms designed to ensure the UK funds management industry is fair, transparent and competes effectively. The FCA's published operational objectives (from its website) are:

- *"Protect consumers – we secure an appropriate degree of protection for consumers*
- *Protect financial markets – we protect and enhance the integrity of the UK financial system*
- *Promote competition – we promote effective competition in the interests of consumers."*

In practice, this has meant increased scrutiny of UK fund managers. On the one hand, this would seem a good thing as it should assist in achieving the first two objectives of the FCA. On the other hand, the burden of regulation has increased quite dramatically for UK fund managers and this trip contributed to our view that this may not be good for competition (or the end investor).

We talked to many managers about the impacts of the FCA's requirements. There were two key reasons for doing this. Firstly, we think this has the scope to change the nature of the funds management businesses that operate in the UK (i.e. it will make it very hard for new boutique managers to be created). Secondly, we think this is not just about the UK. We believe other regulators around the world are watching the initiatives of the FCA and we envisage other regulators will head in a similar direction over time (i.e. with greater regulation and placing higher demands on investment managers).

Manager Views

The smaller firms

For the smaller boutique managers we met with, increased regulatory compliance is a major issue to manage due to the nature of their businesses. The benefits that come from the smaller, nimble and hands on approach a boutique can take to investing are potentially eroded by the need to divert attention and energy toward compliance.

We discussed the requirements of regulation with numerous small boutiques. There were common observations and views expressed by these smaller firms:

1. They would not have started their entrepreneurial businesses if the existing regulatory requirements were in place due to higher start up costs
2. Many consider themselves to be fortunate that they had a sufficiently established and profitable business before the regulatory burden increased
3. The numbers of staff supporting operations and compliance was larger than the numbers in the investment teams
4. Incremental hires continue in the areas of operations and compliance, and this trend is set to continue, to meet regulatory demands
5. The investor who is also the part-time business manager will become less common, as running a fund management business has become increasingly complex and requires full-time dedication. Some boutiques are starting to adopt similar structures as the larger fund managers (albeit at a smaller scale)
6. The most positive point expressed was that these firms see a significant barrier to entry blocking future boutiques from entering the industry and adding to competition.

We also met one fund manager experiencing outflows (but with what would be a sustainable and profitable level of assets by Australian standards) who has chosen to fold into a larger firm, due to higher regulatory costs and its weakened profitability.

The larger firms

At the other end, the challenge of dealing with increased regulation poses a set of headaches for the large funds management firms as well. Many of the observations to be made from this group were quite consistent with their smaller counterparts.

1. They notice the burden of regulation and have similarly been hiring considerably in their operations, legal and compliance departments to satisfy the demands of the UK regulator
2. They wonder how the smaller firms can survive dealing with the burden of regulation
3. They think that regulation is contributing to medium-large managers looking at mergers. We met with both Henderson and Janus (who announced a merger earlier in October). The benefits of scale (amongst other things) are a clear factor in this merger decision. We suspect that those scale benefits are amplified by the requirements of the UK regulator.

How is the future shaping up?

It will be interesting and important for investors to observe how the funds management sector in the UK evolves through the short to medium term. New regulations will help achieve some of the stated objectives of the FCA (e.g. there will be far more transparency over brokerage spend). However, there may well be an adverse effect on the level of fees the sector passes through to investors as a direct result of increasing costs of compliance. This clearly would not be a desired outcome of the FCA, though this seems a distinct possibility.

We think the UK investment management industry will certainly look different in the future as a result of the impact of regulation and we expect that will be in the following ways (be it intentional or unintentional):

1. There will be more investment manager mergers as investment management organisations seek to spread the operational and compliance costs across a larger pool of assets
2. There will be fewer new entrepreneurial boutique firms being created. Those that do start a new business will likely require the backing of a significant seed investor, or wealthy founder
3. We think the incubator operating with a series of boutiques will become the more likely model to engage the entrepreneurs of the future.

There is also the potential for meaningful cultural change within boutique organisations as the total headcount is likely to being dominated by non-investment personnel. On this international trip, we already saw this with the numbers of investment personnel far lower than operations and compliance resources amongst the boutique firms.

The UK regulator and its decisions are leading to changes in the nature of how UK based funds management organisations will look in the future. We think that regulators in other parts of the world will be watching and need to consider what they want the funds management community in their own jurisdictions to look like as they consider and introduce any reforms of their own. Equally, funds management businesses around the world would also do well to look at the UK experience and appreciate the impact regulations can have on their businesses as a potential future business challenge.

The last word

We think that the role of regulation is well-intentioned to bring about some of the positive changes sought in the FCA's objectives. However, we believe there are potentially profound ripple effects that will hinder the creation of new, entrepreneurial ventures (and ultimately result in less competition and more money managed by big goliaths). Perhaps because we are an Australian firm and also an advocate of clients investing in selective entrepreneurial boutiques, we feel disappointed that the scope for new boutiques has dramatically lessened. A funds management community dominated by big goliaths is not the direction we wish to see. Further, additional costs preventing a downward shift in management fees is also inconsistent with the progress we hope to see in the industry.

The wildcard is whether the incubators of boutiques can do a sufficiently good job at housing the entrepreneurial businesses in a manner that enables them to feel like privately owned boutiques. This potentially involves innovative structures enabling these entrepreneurs to have equity stakes and, as importantly, to feel and act like owners of their own business, while at the same time, easing the burden associated with regulation.