



HOW TO SPOT THE

In search of superior returns? Jackie Pearson talks to the experts to learn how investors can

If you're tired of fund managers that seem to be cut from the same cloth, take heart. There are now more than 50 boutique fund managers operating in Australia, handling nearly \$45 billion in investors' money and offering an alternative to the big managers.

The count is even higher if you don't subscribe to researcher Morningstar's tight definition of a boutique: that it must manage less than \$5 billion and be more than 50 per cent owned by staff.

But the debate about how to define what's boutique pales into insignificance next to the arguments about what makes a good one.

"First-wave boutique managers – like Kerr Neilson from Platinum Asset Management (PTM) – were highly successful at generating excellent returns for investors and creating wealth for themselves," says David Wright, Zenith Investment Partners director. "Others

have seen such success and decided to leave institutions to start up on their own – but not all have been of that high calibre."

The trick for investors is to shop at the top while avoiding the duds. With this in mind, *AFR Smart Investor* has put together a list of the top-performing boutique fund managers of the past three years for small-cap and large-cap portfolios, which you'll find on page 64.

But we also wanted to give you the tools to spot the up-and-comers. So we asked research experts, chief investment officers and boutique managers themselves to nominate the qualities that make one firm a star and another a fizzer. Here are their top 10 tips.

Skin in the game

Some boutiques are 100 per cent owned by key staff. Other managers may have 50 per cent or even less equity in the business.

Brian Eley, from fund manager Eley Griffiths, says the optimum model is 100 per cent ownership by senior personnel. This is known as having maximum skin in the game. It's attractive because it means key staff are putting their money on the line along with yours. It can also mean lower turnover of investment staff. If their capital is tied up and they have control of their work environment, key people are unlikely to leave.

"It's a very good idea for the fund manager to be invested in the fund," he says.

Size matters

Boutiques can become victims of their own success. The better their returns, the more money they attract, which can make it harder to continue to produce strong performance.

Simon Ibbetson, director of investment consulting for Standard & Poor's, says he



ARTICLE

Identify the difference between a haute couture boutique fund and an overpriced impostor.

asn't counted the recently listed Platinum as a boutique for some years. The same goes for high-profile group Maple-Brown Abbott. Both manage more than \$15 billion.

Ibbetson says smaller boutiques have more opportunity to outperform the market because decisions can be implemented more quickly.

"In a large institution," he says, "the portfolio manager may have to consult an investment team and a decision may have to wait for a monthly meeting, especially if they're making a call on moving out of a market sector. The process is well-informed and robust but slow."

"With a boutique manager running a \$300 million portfolio, the stock sizes are small so they can trade \$5 million in five minutes. But brokers may not give the same level of service to smaller boutiques because they don't get the same brokerage."

Jeff Rogers, chief investment officer with ipac

Securities, thinks size is the most important characteristic for a boutique. "The best performance by boutiques on average is when they don't have many assets to manage," he says.

One positive sign is a manager's willingness to close their books to new investment when they reach an optimum level, to ensure that they don't get too big and run out of investment opportunities.

Lonsec's general manager of research, Grant Kennaway, says you have to be quick to get into a well-managed boutique fund because they shut up shop at a lower capacity.

Behind the scenes

The whole idea of boutique fund management firms is that they free investment professionals from the bureaucracy of large financial conglomerates, allowing them to do what they do best – manage money.

But, ironically, many bigger institutions are now getting in on the action by funding boutique start-ups. Eley is critical of this development, arguing that once an institution has a 50 per cent stake, it dilutes the amount of authority senior personnel can exercise.

But Jerome Lander, head of research at van Eyk disagrees. "Institutions are increasingly providing the backing, the working capital, administration and distribution so that key personnel can focus on investments," he says.

S&P's Ibbetson says some organisations specialise in starting and backing boutiques, including Challenger (CGF), St George Bank-owned (SGB) Ascalon and Treasury Group (TRG).

Australian Unity Investments head David Bryant says the company has entered 50-50 partnerships with three boutique managers because "investment is all about the people,



NEED TO KNOW

You'll usually pay a premium price for a boutique fund. Base fees are typically marginally higher than average and you may also have to pay a performance fee – a percentage-based fee charged for beating a predetermined performance benchmark. Watch out for the following traps:

- Some managers double-dip – make sure the base management fee is taken out before the performance fee is calculated.
- Make sure the charge for overperformance is reasonable. The manager should outperform its target index by a reasonable amount before it starts to charge a bonus for superior performance. For instance, if the target index is the Small Companies All Ordinaries Accumulation Index, the hurdle for performance fees could be 10 percentage points above the index return. If the index gains 20 per cent in a year, the manager would have to gain 30 per cent to charge a performance fee. It would then charge, say, 15 per cent of that outperformance.
- Some managers set the performance fee benchmark at zero per cent above the index. In the above example, a zero per cent hurdle would mean the manager makes 15¢ of every dollar earned above the index return. This is definitely not an incentive for outperformance.
- Make sure you don't have to pay a performance fee if a manager has a negative return. The index might fall 20 per cent but the fund might fall only 10 per cent – some firms would charge a performance fee for this 10 percentage point "outperformance".
- A so-called "high-water mark" can protect you from overpaying. If the manager achieves the benchmark one year but loses money the next, a high-water mark means they can't charge a performance fee again until the unit price is higher than the last time they did so.

and if you want the best people you have to offer a value proposition, and that has to be an ownership proposition".

Donald Williams, chief investment officer for Australian Unity partner Platypus, agrees. "If you choose the right partner the only split worth considering is 50-50," he says. "With a 49-51 split, if something goes wrong it gives one party the opportunity to evade responsibility. A 50-50 partnership makes it a very long-term interest for both parties."

Float your boat

The highly successful float of Platinum Asset Management recently has intensified debate about how boutiques should be structured.

Lander says a publicly-listed boutique can have the advantage of being able to offer stock options to its investment staff.

"Platinum is now in the money," he says, "so it's worth it for staff with those options to stick around."

On the other hand, critics say the extra

scrutiny that comes from being publicly listed can have negative consequences for a firm's investment process. They argue that the rigours of having to make regular reports to the sharemarket can force fund managers to concentrate on short-term investment to keep their stock price buoyant, rather than working to ensure long-term success.

It's a sensitive issue and Platinum's Kerr Neilson went to great lengths before the firm's float to stress it would not change its investment philosophy.

House special

Most Australian-based boutiques specialise in Australian equities. However, more are moving into international equities and there are some successful property boutiques.

Specialisation is essential for boutiques, because typically they don't have depth of research across several market sectors.

Rogers of ipac Securities predicts that Asia will be the real growth area for boutiques,

citing Treasury Asia Asset Management as an example of a firm with strong potential. The group is 41 per cent owned by the Treasury Group, a listed company behind other well-known boutiques, such as Investors Mutual.

Rogers says property and infrastructure will also be popular sectors for boutiques.

People power

In considering a boutique, it's important to look at the history of the people behind it. Lonsec's Kennaway says many investment managers have earned their reputations at big institutions before setting up on their own.

Consider whether key personnel have been through a number of different market cycles, not just a bull run, he says. The last bear market was in 2002-03, so it's vital that key people have been around for at least that long.

Boutique style

According to Zenith's Wright, a good boutique will have a distinctive investment



TOP 10 RETAIL BOUTIQUE AUSTRALIAN SHARE FUNDS

Name	Net assets \$m	Start date	Min. invest. \$	Morningstar category	Return 1 yr %	Return 3 yr %pa	Return 5 yr %pa	Fee %pa	Performance fees
Large cap									
Prime Value Growth	132.23	Apr 10, 98	40,000.00	Aust large blend	21.12	32.48	27.52	1.44	20.5% of perf > S&P/ASX 300 Accum
Ausbil – Australian Active Equity	2059.00	July 31, 97	50,000.00	Aust large growth	17.43	30.78	20.40	0.90	—
Prime Value Imputation	79.82	Dec 20, 01	40,000.00	Aust large value	26.76	26.55	31.64	1.44	20.5% of perf > S&P/ASX 300 Accum
Austock Australian Equities	16.37	Mar 18, 04	25,000.00	Aust large blend	17.19	26.43	—	1.08	—
Parker Asset – Enhanced Leaders	54.84	Apr 20, 94	5000.00	Aust large blend	18.79	23.12	14.34	1.69	—
Col First State FC Inv – CFS 452 Australian Share*	248.15	Feb 28, 03	5000.00	Aust large value	23.55	22.58	—	1.86	—
PM Capital – Australian Opportunities	489.49	Dec 1, 99	20,000.00	Miscellaneous	22.56	21.09	17.00	2.49	20.0% of positive performance
Navra Blue Chip Aust Share Retail	114.24	Apr 28, 03	1000.00	Aust large blend	17.97	20.70	—	0.31	0.395 of return > S&P/ASX 200
Advance Imputation (Maple-Brown Abbott)	701.81	May 19, 86	2000.00	Aust large value	17.80	20.16	13.26	2.05	—
BT Investment – Investors Mutual Australian Share	64.70	Jul 23, 03	5000.00	Aust large value	17.99	19.79	—	1.00	—
Small cap									
Eley Griffiths Group – Small Companies	377.63	Sep 12, 03	25,000.00	Aust mid/small blend	31.83	34.91	—	2.09	0.92% of perf 6.0% > Small Ords Accum
Hyperion Small Growth Companies	5.50	Jan 1, 95	50,000.00	Aust mid/small growth	32.14	31.92	21.68	1.70	—
Hyperion Australian Growth Companies	28.24	Jan 31, 94	50,000.00	Aust mid/small growth	25.94	31.86	18.30	0.95	—
Ganes Focused Value	9.75	Oct 14, 02	20,000.00	Aust mid/small value	38.40	30.23	—	2.01	18.64% of perf > S&P/ASX 300 Accum
Aust Unity Acorn Capital Ws Microcap	247.48	Feb 27, 01	50,000.00	Aust mid/small blend	23.73	30.20	26.27	1.65	—
Aust Unity Acorn Capital Microcap	13.57	Dec 17, 02	1000.00	Aust mid/small blend	22.33	28.80	—	2.50	—
Souls – Australian Equity	17.30	May 29, 98	25,000.00	Aust mid/small blend	27.30	27.72	22.02	0.70	—
Souls – Australian Small Companies	67.40	May 31, 98	25,000.00	Aust mid/small blend	36.14	26.28	24.76	0.70	20.0% of perf > Small Industrials Accum
Advance W'sale Australian Smaller Companies	88.47	Aug 5, 02	10,000.00	Aust mid/small value	23.68	24.54	—	1.13	—
Opis Capital Dynamic Equity	156.54	Dec 20, 00	45,000.00	Aust mid/small blend	26.73	24.45	22.54	1.72	20.5% of perf > 15.0% pa return

Figures as at April 30, 2007 *Fund only available through CFS First Choice platform. Source: Morningstar

philosophy and style that should remain consistent. “They need to demonstrate they’re getting stock ideas in a structured way,” Wright says.

Boutique managers with a loose investment style that alters every time market conditions change should be avoided, he says. Good boutiques stick to their guns even when the market is against them. “We need people to be true to label. You don’t want a value manager to do well at the top of the market, for instance,” he says.

Your bottom line

Most boutique managers charge above-market management fees with an additional performance component, so it’s reasonable to expect above-market performance.

The manager should be concerned with both absolute returns and risk-adjusted returns. The absolute return is the increase in the portfolio from one year to the next. Risk-adjusted return is the manager’s ability to generate returns above the benchmark index without taking large speculative risks.

In our table we rank boutique fund managers on the basis of three-year returns. It’s important to look at investment returns over at least that period, ignoring managers that do very well in one year but offer no indication they can repeat the performance.

Morningstar’s head of research, Anthony Serhan, says one of the biggest mistakes

investors can make is to judge a manager on past performance alone. “There are some good managers with very ordinary three-year numbers,” he says. “That doesn’t mean they don’t deserve your money.”

Start-up boutiques

New boutiques can be hard to assess because they won’t have a track record. But Zenith’s Wright says start-ups can be worth considering if the investment team behind the firm has a solid background. “For example, [look for] a portfolio manager from a major institution with a good record,” he says.

Mercer’s head of Asia-Pacific fund manager research, Marianne Feeley, says it’s important to consider the individuals’ histories. “If a high-profile person in an institution decides to start their own boutique, there are different conditions for success,” she says. “We’d need to consider how they’ll manage their operations.”

Too much of a good thing

“Don’t use boutiques just because they’re boutiques,” Serhan says. “Be convinced they’re good managers in their own right and, most importantly, that they work within your portfolio. The classic mistake of a few years back was building a portfolio of high-performing boutique managers that were all value managers. Investors Mutual, Perennial Value and 452 Capital are all good boutique managers but they’re cut from the same cloth,

and using them together is often just doubling your bets instead of getting diversification.”

Wright says you also need to be mindful that a rising tide raises all boats. In recent market conditions, you’d have to be a pretty poor stock picker not to do well. It may take a bear market to determine which boutiques have what it takes in the longer term. **Si**

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Large institutions are catering for the growing demand for boutique funds by offering exclusive access to some managers through wraps and master trusts. A growing number of boutique funds are no longer offered direct to the public but are available only through platforms.

Morningstar head of research Anthony Serhan says you can assume a reasonable level of due diligence has been done before a boutique manager appears on a platform menu. So when picking a boutique fund it may be worth looking at the names on the investment menus of the big platforms.

However, investing directly in boutique retail unit trusts means you can usually start with less money (as little as \$1000) and you have a greater level of control over selecting the best funds.