Re-imagining Investment Services

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Introduction

The broad industry of investment services is on the cusp of an important evolutionary change because many parts of the industry are no longer fit for purpose. Evidence for disruption potential abounds—many incumbents are extremely profitable and there is a significant subset of unhappy customers.

Customers are unhappy for a number of reasons:

- They aren't getting everything they need to ensure they save adequately for retirement
- Their most basic concerns regarding safety and good value are not fully addressed
- It is difficult to get straight answers and relevant information
- Their satisfaction is not a priority for many incumbent investment businesses
- Their best interest has not been broadly embraced as a meaningful standard of service
- It is easy to get overwhelmed with details and to miss important big picture insights
- The value they receive from investment expertise is often overwhelmed by high fees, excessive compensation, and inefficient cost structures
- They don't feel as if they have much control over the investment process

Underserved investors

The most underserved investors share a number of characteristics. In short, they want to get the most out of their investments and are willing and able to do something about it.

- They are proactive in seeking out the solutions that best serve their needs
- They are good consumers and conduct research in order to identify the best services at the best prices
- They are open-minded and will consider unconventional strategies as long as they are reasonable
- They have long time horizons and realize that a consistent, methodical approach to investing is the best way to get ahead

Part of the problem is that investors are often mischaracterized. The industry shorthand is that institutional investors are sophisticated and individual (retail) investors are unsophisticated, but this belief is a vast oversimplification. An important group of individual investors is well-educated and/or intelligent enough to understand important investment concepts quite well.

This often results in a mismatch between services demanded and services supplied. Those with large sums of money have access to high quality services and the ability to negotiate fees and terms, and those with smaller amounts have access to decent low cost services such as index funds and roboadvisors. Those with significant, but not huge, amounts to invest have some access to high quality services but very little ability to negotiate terms. They are often frustrated in efforts to find high quality service at a reasonable price.

These shortcomings are exacerbated by the fact that it is hard to evaluate investment professionals and their offerings. The reality is that front-line professionals are business development/sales people masquerading as advisors. They get paid to hit revenue targets and to retain clients (h/t finance industry veteran, Ben Armstrong, Conifer Bay Capital). The professionals with genuine investment expertise often have little contact with clients. The distinction in these roles is obstructed by the fact that there is no singular, widely recognized credential or "brand" to help differentiate levels of expertise in investing.

Further, conflicts of interest are rampant across the industry and constantly threaten to dilute or completely undermine the value of otherwise useful investment expertise. Big banks and large investment firms, for example, have institutional incentives to charge higher fees (the *business* of investing) at the expense of producing better investment results (the *profession* of investing). Although large firms normally enjoy the greatest benefits of scale and resources, the services they provide also tend to be exposed to the greatest conflicts of interest.

Changing conditions

The days of "business as usual" are numbered. The confluence of changing consumer preferences, improving technological capabilities, and increasingly uncertain investment conditions promises to significantly reshape the landscape for investment services.

The theory of “convergences” provides a useful framework from which to identify "new opportunity hotspots" and to flag situations for contemplating "truly new, unfamiliar things". In regards to investment services, key factors include:

- **Improved technology.** Technology is facilitating many improvements in costs, transparency, convenience, and reliability. Ubiquitous and affordable internet access allows consumers to conduct research cheaply and easily. Consumers already do this for many products and services and it is just a matter of time before expensive distribution channels are also disintermediated in investment services.
- **Tougher investment landscape.** The investment landscape is far less attractive than it has been in the past. The combination of high debt levels, weakening demographics, and high stock valuations all point to the probability of a very different, and much harsher, investment landscape over the next few decades.
- **Ill-prepared investors.** Among the issues likely to cause the biggest problems are insufficient management of systemic risk, insufficient appreciation of the history of investment returns, excessive trust in those with little training or experience, and inability to opportunistically extract the limited gains to be had.
- **Industry shakeout.** Existing firms will find it difficult to adapt to a harsher environment. They are artifacts of an era when returns and inflows were strong while cost scrutiny and client regard were weak. It is unlikely that incumbents have the cultural attributes to successfully adapt.

- **Changing values.** Younger investors are emphatically rejecting traditional investment platforms and business practices and in doing so, will fundamentally change the way services are delivered. It's not a matter of "if", but "when".

Points to consider:
- What if technology really is making nearly every aspect of managing money cheaper and better? Shouldn't you be able to benefit from those trends?
- What if the next time the market goes down it stays down? What if it takes several years to start inching back up?
- What if conventional asset allocation and diversification strategies are woefully ill-suited to the existing investment landscape? Who can help?
- What if your managers/advisers all have mandates to be fully invested all the time? Do you believe in the market as much as they do? Who has more to lose?

History lessons

Changing conditions will create opportunities to better serve investors yearning for something better. Helpfully, there are clear indications of the path that those approaches might take.

The first step to improvement simply entails resolving industry flaws that were tolerated in the past. There is a substantial and well-documented body of knowledge regarding both harmful and helpful active management practices that serves as both a warning and a guidebook for providers. Improvement does not require radical innovation; it just involves making different business choices.

Practitioners and thought leaders such as David Swensen, Warren Buffett, John Bogle, Ben Graham, Charlie Ellis, Rob Arnott, Paul Woolley, and many others have collectively diagnosed the problems with active management. In doing so, they have also highlighted problems that are pervasive across all types of investment services.

For example, key features of quality active management efforts include "skin in the game", high active share, reasonable fees, focus on less efficient markets, limits on managed assets, and independent ownership. Most of these principles can be widely applied to a variety of investment services. Specific opportunities for improvement include:

- **Fees can be lowered.** The most direct way to lower fees is to eliminate sales and marketing expenses that don't help investors. Transparency also helps.
- **Trust can be improved.** Structurally eliminating conflicts of interest, increasing transparency, establishing reasonable fees, endorsing fiduciary standards, and recognizing high standards of professional expertise all help to build trust.
- **Friction can be reduced.** Increasing active share for active managers, prioritizing smaller funds that still have the capacity to outperform, and improving client dialogues by way of better education all serve to enhance the effectiveness of investment expertise.

General opportunities for improvement

- **Demonstrate better leadership.** Leaders can be much more forceful in "advocating for improvement" and making the types of tradeoffs that favor investors over business development.
- **Provide better perspectives and insight.** Most investors don't need more information. What they really need is a distillation/synthesis of knowledge and broad perspectives that are relevant to them.
- **Empower investors to be better consumers.** By providing better education about how to select various investment services the industry can reduce the costs of evaluation, increase customer engagement, and reduce the chances that services get mismatched with needs.
- **Sustainably build trust.** The industry as a whole has lost touch with the notion of providing services that are useful to society. Reversing this condition will involve embracing the principles of stewardship, focusing on improving client outcomes, and eliminating waste and inefficiency.
- **Make better use of active managers.** Active managers provide value by identifying critical market insights and by keeping the market reasonably efficient. This creates an opportunity for them to deliver their insights not just through managing portfolios but also by making their knowledge more broadly accessible.

Re-imagining investment services

In contemplating changes to the industry, it is important to keep in mind that it comprises an ecosystem of different types of providers, most of which provide value in some form. Therefore, the real challenge is to determine the value of each function and to create packages of various functions that meet the needs of investors in an economical way. In order to accomplish this, we believe most services will need to adapt by some combination of partnering or recombining in different ways, reorganizing, or paring back.

The efforts large asset owners are making today to improve investment effectiveness provides useful insights into what smaller investors can aspire to tomorrow. Most notably, many large asset owners are:

- **Re-evaluating existing provider arrangements** (and often finding they are no long fit for purpose)
- **Outsourcing low value activities**
- **Insourcing** investment activities that can be performed more cost effectively in-house.
- **Making use of active managers** for a broader array of activities including idea generation, problem solving, and knowledge transfer

These activities provide a template for the type of actions individual investors and small institutions can start taking in order to get a better return from their investment services. They imply implementing a hybrid/combination strategy. Relying on one single provider risks overpaying or missing important expertise while relying on too many providers increases complexity and fees. A reasonable compromise is for self-directed implementation of basic, commodity functions while selectively hiring investment expertise to provide guidance and insight for more difficult challenges.

(For a description of how Areté addresses these challenges, please see the Appendix)

Points to consider:

- What if some of the most important investment needs such as synthesizing research from various sources and distilling ideas into key priorities are best fulfilled by active managers?
- What if fee structures were unbundled so that you could receive a la carte services that were tailored to your needs?

Offsetting forces

While several forces are creating a path towards significant improvement in the industry, there are also forces working to inhibit this progress.

Dispassionate investors. Perhaps the greatest obstacle to improvement is the dispassion of investors. Since most investors have good relationships with their advisers/managers, the hurdles for change are high. Few investors regularly monitor their providers or even have criteria for doing so, even though such arrangements may no longer be "fit for purpose". As a result, it normally requires a significant impetus, such as some kind of crisis, to reveal when trust is misplaced and to motivate change.

Price insensitive buyers. The continued growth of price-insensitive buyers also threatens to forestall improvement. Several important entities such as central banks, passive funds, and companies themselves have purchased massive amounts of risk assets for reasons other than valuation and expected returns. These activities undermine price discovery by artificially boosting asset prices and suppressing volatility. In doing so, they have the side-effect of creating a "mirage" of market well-being and therefore reducing the urgency for change.

Points to consider:

- What if you have a sneaking suspicion that something isn't right about your investment plan—and you're right?
- What if taking a "wait and see" approach to your investments causes you to be too late in making important changes that ensure your retirement security?

Conclusion

Change is coming. Unhappy customers, improving technology, and increasing investment challenges are increasing the demand for quality services at a fair price. Taken together, these trends promise to induce important evolutionary change in the landscape for investment services.

Better solutions demand new vision. The good news is that virtually all of the components for much better investment services already exist. Part of the challenge is that legacy providers have little incentive to change. As such, it will be important to envision new ways to combine and configure various investment functions so as to achieve better outcomes.

Proactiveness will be rewarded. Many investors will be unable to adapt to the changing landscape before existing arrangements prove costly to them. The investors who fare best will be those who actively reject services that don't offer good value and who research and explore new ones that do. Likewise, service providers who recognize and act on these trends early can build trust and displace others that fail to adapt.

Points to consider:

- What if you don't trust the market and don't trust many providers, but aren't ready to pounce on opportunities when they eventually do arise?
- What if systemic risk really is increasing and the single most best thing investors can be doing is re-examining all of their risk exposures and seriously considering their investment horizons?

Action steps

For individual investors:

- Actively seek out good value. Consumers normally pay a premium for convenience even though it may only require a modicum of effort to do much better. It is cheap and easy to do google searches.
- Actively seek out the knowledge and expertise you need in the quantity you need. If regular meetings are wasted on you, look for something else.
- Look beyond the big firms. Small firms often work harder for you. Don't assume that the services that are easiest to find are the best.

For financial advisers:

- Seek out independent research. Your clients trust that you can provide them with thoughtful insights on major market topics. Don't just repeat what they can easily find on their own.
- Seriously re-evaluate your approach to risk management. Conventional models grossly underestimate downside risk at turning points.
- Consider partnering or outsourcing to ensure that your clients have access to the investment expertise they need when they need it. If you aren't regularly doing research, your best clients will know it.

For small institutions and retirement plans

- Re-evaluate the suitability of current provider arrangements. Are all investment committee members satisfied with existing arrangements and approaches, or are they mainly just comfortable with a big name provider?
- Be more proactive in seeking out ways to provide education to, and answer questions from, decision makers and beneficiaries. Favor independent and objective sources.
- Experiment with ways to generate more robust discussions about key investment topics. Focus on the issues that matter most for your beneficiaries.

Appendix

Many investment services providers prefer to maintain the status quo and avoid consideration of the industry's changing dynamics. Some providers recognize the need for changes and discuss them, but do not follow through with meaningful action. Areté has never been satisfied to just be an observer; when we see a problem we are compelled to fix it. As a result, we have incorporated these ideas into an investment approach and business design that provides a useful prototype for a new breed of investment services. This is how we do it:

Purpose

It all starts with defining our purpose because high quality services don't just happen by luck. By doing so, we also create the standards which provide guidance for making difficult tradeoffs which, in turn, minimizes the temptation to act purely out of expediency or self-interest.

Areté's purpose is to efficiently convert investment expertise into client well-being. In general, we believe most investors primarily want to get a fair deal from their investing experience—which is reasonable given that it is their hard-earned capital that is being put at risk. Fairness is achieved through "efficient conversion" which entails eliminating unnecessarily high fees, avoiding unnecessary exposure to high levels of loss, and implementing an approach that provides a real chance to get ahead. It also helps when a provider's activities are transparent so that clients can monitor them and ensure their needs continue to be met.

Client well-being addresses the desired outcomes from investment activity. Goals often revolve around the notion of providing a certain level of future income, but there are many others. Client well-being can also include unstated assumptions such as having a high probability of meeting retirement goals and being able to adapt to changing conditions. The goal of client well-being is closely related to conversion since any inefficiencies in the process necessarily come at the expense of well-being.

A great deal of investment expertise is required in order to accomplish these goals consistently over time. At a bare minimum, investment expertise consists of literacy in key financial and investment topics. Higher education, professional certifications, and years of work experience further enhance expertise. Finally, the highest levels of expertise can only be attained through an ongoing effort to maintain, develop, and grow investment knowledge by constantly investing in research.

Best practices

The building blocks of a quality active management effort are no mystery; there is a substantial and well-documented body of knowledge available for anyone who cares to look. In founding Areté, we studied these best practices and incorporated them into our business design.

First and foremost, Areté serves the best interests of its clients. This is a standard embraced by every major profession and in the investment industry is a commitment made by all CFA charterholders. Independent ownership also helps to minimize conflicts of interest that can arise between outside owners that favor higher fees and investor clients who favor lower fees. Other examples of how Areté serves the best interests of its clients include avoiding soft dollars and applying GIPS which is the highest standard for performance presentation.

Areté also ensures its interests are aligned with those of its clients by having a lot of “skin in the game”. The key stakeholder, David Robertson, owns 95% of the company's equity and also has a significant portion of his wealth managed by Areté.

Areté has a clearly defined investment philosophy which describes how and why performance is generated. For one, we believe the most persistent and reliable path to outperformance is by identifying and exploiting mispriced securities. In addition, we prioritize the attainment of knowledge and insight over the aggregation of information. Finally, we focus on attracting investors with similarly long horizons in order that our investment approach can be maintained even in difficult times.

Areté embraces the core rationale for active management by means of its willingness to depart significantly from the benchmark. We employ a “best ideas” approach which results in relatively concentrated portfolios with high active share. In addition, we apply our valuation expertise to calibrate exposure to stocks based on their absolute level of attractiveness. We do not slavishly maintain exposure regardless of the magnitude of risks and opportunities.

We emphasize strong customer service by way of transparency, education, and access. Our belief is that if investors are willing to do some basic research on their own, they ought to be able to avoid the high costs of physical distribution and unnecessary human interaction - as they already can in every other industry.

As a result, we provide easy analysis of the investment process through our website and also provide detailed investment analysis and regular updates. In addition, we regularly share key insights via the website and blog.

Fees are completely transparent and clients have 24/7 access to granular account detail which can be fully reconciled to statements. Finally, clients have access to the portfolio manager at any time.

Customer orientation

Areté’s approach to the market is shaped by a deep consideration of strategic marketing principles which provides a key point of differentiation. This means that Areté’s investment approach and business design were developed by considering critical customer needs first and then working backwards to determine how to fulfill those needs in an economically viable way.

One manifestation of this approach is that all costs are scrutinized relative to their benefits in order to keep fees as low as possible. In particular, we regularly employ new technology tools for the sake of reducing costs, but also for improving reliability, transparency, and convenience.

Marketing and sales costs receive special attention at Areté because they normally constitute a significant portion of total management fees and provide virtually no ongoing benefits to investors. We minimize such costs by focusing on inbound marketing efforts and by providing investors as much useful information as possible on our website.

Areté focuses on a niche audience that values a long term investment horizon, independent research and unique insights. This allows us to maintain long term investment theses through difficult times when other managers lose significant assets.

<u>**Adaptability**</u>

Areté recognizes that things change and as they do, the business needs to change and adapt in order to continue to serve clients well. We are always scanning the landscape for investment services in order to identify new and economically viable ways to share insights with investors. One important trend we have observed, for example, is the migration of idiosyncratic (security-specific) risk to systemic (broad market) risk. Insofar as this assessment is correct, it will leave a lot of investors much more exposed to losses than they currently believe.

In response to these trends, we created a Personal CIO service that provides access to high level investment expertise on an a la carte basis. Because the active management business is one of the few that can devote significant resources to "figuring things out", it effectively serves as the R&D center for the industry. This service is designed to eliminate many of the barriers that individual investors and small institutions have in getting direct and focused access to such expertise.

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