**DFM Due Diligence**

**Month 20\*\***

**Introduction and background**

Our market position

ABC LLP (ABCL) provides independent financial advice to private clients. We are authorised by the Financial Conduct Authority and specialise in financial planning.

We deliver comprehensive financial solutions that are based on individual client needs to help them live the lifestyle they desire. We look after over 200 clients.

Platform

Separately, we have undertaken a due diligence exercise that established the authenticity of our platfrom of choce, Wealthtime. There are also a few clients on other platforms. This due diligence exercise sits outside our work on platforms.

Centralised Investment Proposition and its operation

We have a centralised investment proposition. We outsource fund management to a DFM. We selected DFM XYZ Ltd (XYZ), because their investment philosophy largely mirrors ours.

It is now necessary to review the DFM market to ensure our choice of DFM remains fit for purpose.

This document sets out our approach to selecting a DFM. The aim of this document is to provide a detailed record of our DFM selection process and is also designed to assist in demonstrating that we continue to provide independent whole of market advice to our clients.

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# Our Due Diligence (DFM) Requirements

Our aim is to ensure that our chosen fund manager (DFM) delivers value for our clients and meets their needs, in line with regulatory requirements. Therefore, when using a DFM, we take account of our business and client needs and our primary considerations, in no ranking order, are as follows:

* **Safeguarding Clients’ Assets**: It is very important to us that our clients’ assets are securely held. We will consider the financial strength, reputation and sustainability of the DFM of choice, although we also recognise there is no asset custody with a DFM in our case, and a strong balance sheet is of marginal importance.
* **Support for our Client Proposition**: It is important that the DFM fits our service proposition and supports our investment processes. This means the ability to manage clients’ portfolios effectively, including reporting, rebalancing to a risk mandate, and providing relevant management information.

**Support for our Investment Proposition**: Our investment proposition (see separate documents for detail) requires a suitable DFM to

* + Have a blended investrment style;
	+ Offer a bespoke asset allocation model.
* **Service Delivery and Client Reporting:** To enable us to deliver a professional service to our clients, our selected DFM must provide user-friendly reporting to us and our clients. A prime motivator for the appointment of an external fund manager is to free up our time to devote to maintain a robust and efficient client service, while improving the consistent performance of investments over time.
* **Costs:** Cost is a necessary evil and we need to contain it, in so doing giving assets breathing space to do their work.

# Market Review

We have used Defaqto Engage as a proprietary, independent tool to assess the DFM market and source our due diligence.

Defaqto tells us there are about 198 DFMs in the market.

# Strategic Selection and Sifting Process

To shortlist potential platform providers, we started by reviewing the market. We then examined DFMs through a sifting process which involves scrutinising them to ensure they are fit for our clients and that they can support our investment proposition.

The following criteria represent our key drivers for DFM selection, in no ranking order. In performing these sifts we were mindful of the position of our current DFM. There is no purpose in a selection that doesn’t at least replicate our current position.

## Sift 1: Cost

We have excluded DFMs with a core cost of in excess of 25bps, excluding Vat, and with no additional custodian charge.

This is because, in addition to the DFM cost, we need to add platform charges (30-35bps), adviser charges (100bps) and fund charges (tbd). Anything higher than 25bps would be too high.

## Sift 2: Platform access

Separately we have conducted due diligence on platforms and have ascertained that the platform of choice (123) is fit for purpose.

Consequently, it is crucial that the DFM of choice should be available through those platforms.

## Sift 3: Managed Portfolio service

Our experience is that investment managers warrant client investment risk to us. It is therefore critical to us that the DFM takes on the responsibility for risk maintenance and control once funds are with it. We believe this is best achieved through a managed portfolio service predicated on risk managed funds.

## Sift 4: Investment philosophy

We have an investment philosophy which is broadly predicated on the efficient market hypothesis (see separate document on the evidence supporting our position). We believe that a consequence of taking this position is that we must invest the markets, but that Alpha is available. This requires a belnded investment strategy.

This sift also allows us not to be pre-occupied by manager expertise and tenure, which we believe are themselves the subject of significant risk.

## Sift 5: Financial Strength / profitability

It is a paradoxical truism that a healthy DFM that doesn’t hold client assets, needs a very light balance sheet, and possibly low reserves / retained profits.

As a result, we would not necessarily be persuaded by a strong balance sheet, simply because it doesn’t matter - the DFM is not the custodian, has no access to the clients assets, and cannot prevent them from moving elsewhere. All the DFM needs is a small run off reserve to facilitate a run on the money and smooth client transition to another manager.

We therefore are more persuaded by assets under management. This indicates the ability to generate strong repeatable revenues easily converted to cash, which makes sound, simple business sense, generates profits which can be, at least in part, reinvested. We also like size because the model is one which allows less expensive platform costs (which are largely fixed) and therefore a benefit to clients.

Our qualitative decision regarding AUM size is that we will not entertain the selection of a DFM managing less then £1bn.

## Strategic Sift output

Given the above, our strategic Sifting output delivers nine DFMs for further scrutiny, as follows:

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| **DFM** | **Assets Under Management (£Bn)** | **Service Fee based on £500k investment % (incl VAT)** | **Portfolio fee (%)** | **Total cost (%)** |
| A | 2.043 | 0.24 | 0.15 | 0.39 |
| B | 9.4 | 0.25 | 0.12 | .037 |
| C | 2.862 | 0.24 | 0.30 | 0.60 |
| D | 9.7 | 0.20 | .25 (Est) | 0.45 |
| E | 2.32 | 0.00% | 0.42 | 0.42 |
| F | 1.01 | 0.12 | 0.25 | 0.37 |
| G | 3.1 | 0.3 | 0.19 | 0.49 |
| H | 25 | 0.24 | 0.30 | 0.54 |
| I | 10.43 | 0.36 | 0.25 | 0.61 |
| J | 8.3 | 0.30 | 0.18 | 0.48 |
| **Source: Defaqto Matrix + Fund fact sheets** |  |  |  |

As we already have a DFM / Portfolio global cost base of approximately 0.42%, we have decided there is no point at this time in looking at anything more expensive. We will re-visit this later if further analysis determines that remaining DFM’s cannot facilitate our preferred asset allocation within a portfolio.

The revised population therefore is as follows:

| **DFM** | **Assets Under Management (£Bbn)** | **Service Fee based on £500k investment % (incl VAT)** | **Portfolio fee (%)** | **Total cost (%)** |
| --- | --- | --- | --- | --- |
| A | 2.043 | 0.24 | 0.15 | 0.39 |
| B | 9.4 | 0.25 | 0.12 | .037 |
| D | 9.7 | 0.20 | 0.25 (Est) | 0.45 |
| E | 2.32 | 0.00% | 0.42 | 0.42 |
| F | 1.01 | 0.12 | 0.25 | 0.37 |
| **Source: Defaqto Matrix + Fund fact sheets** |  |  |  |

# Tactical Selection and Sifting Process

## Sift 1: Return relative to risk

A DFM review would not be complete without an assessment of returns relative to risk. In this we are not looking for past performance, only the historic efficiency of the manager in delivering risk adjusted returns.

Consequently, we wish to measure the Sharpe Ratio of each manager in our selection at 3.6 above. We are looking for a number in excess of 0 (the zero-risk position), the higher the better, which is similar across 3 different risk rated portfolios (low, medium, high).

|  |  |
| --- | --- |
| **DFM** | **Sharpe ratio – 3 years** |
| **Low risk** **(40% equity)** | **Medium risk** **(60% equity)** | **High risk (80% equity)** |
| ***Benchmark*** | ***0.35*** |  ***0.59*** | ***0.70*** |
| A | 0.40 |  0.48 | 0.60 |
| B | 0.31 |  0.51 | 0.57 |
| D | 0.54 |  0.60 | 0.57 |
| E | 0.40 | 0.38 | 0.44 |
| F | 0.43 |  0.55 | 0.61 |
| **Source: Defaqto Matrix** |  |  |

We have highlighted the 2 worst performing managers at each risk level in red.

A, B and E occur in at least 2 of the 3 risk categories and are therefore discounted from further consideration.

## Sift 2: Asset allocation correlation

We are looking for a DFM which invests in a negatively correlated strategic asset allocation model, operates a blended strategy with style tilts (value and potentially, emerging markets / small cap), and uses equities and debt for growth and defence respectively.

This is the broad asset allocation of our existing portfolios. This due diligence seeks to find an alternate manager with the above tenets. Our process for identifying such a manager is simply to examine the portfolio correlation between our existing portfolios and the remaining manager in our sift.

|  |  |
| --- | --- |
| **DFM** | **% correlation to existing funds** |
| **Low risk** | **Medium** | **High** |
| D | 88% | 89% | 92% |
| E | 100% |

This is a high correlation and so selecting D above our existing manager would impact our clients to an insignificant level.

Consequently, at this point we are potentially uncomfortable with de-selecting D. A further sift is necessary.

## Sift 3: Maximum Drawdown

We are of the view that drawdown (the maximum peak to trough fall in the value of a portfolio over 3 years) is a relevant sift for consideration.

|  |  |
| --- | --- |
| **DFM** | **Drawdown** |
| **Low risk** | **Medium** | **High** |
| D | 3.89 | 6.09 | 8.25 |
| E | 4.29 | 6.51 | 8.67 |

# Conclusion

Our investigtion has estblished that our current DFM is competitive. It has also established however that D is currently a marginally superior proposition. The question then is whether it is in our clients best interests to move.

We have therefore reverted to all the sifts with an exponential focus on costs and find that

* D have delivered marginally superior returns relative to volatility and drawdown risk;
* D have significantly more assets under management and therefore are less of a financial risk;
* E’s costs are 32% less expensive than Ds.

For the forthcoming year we have decided that D’s marginal gains in performance and risk, together with their relative financial strength, are outweighed by E’s significant cost advantage. This is mainly because 2 of the 3 considerations are variable, backward looking and subject to uncontrollable and unknown market forces, whereas E’s advantage (costs) is forward looking and a controlled, fixed item.