The rise of the boutique asset manager

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From hotels to haute couture, the concept of "boutique" implies the same characteristics in a business whatever the sector in which it operates: Exclusivity, focus, quality, and often a high price. These factors are said to apply, just as much to boutique asset managers as any other business. The question is, 'Is this a case of style over substance, or is there really a benefit from "buying boutique"?'

This article examines the boutique business model: Why has it grown so rapidly? Is there a superior value proposition for investors in boutiques? And finally, what are some of the challenges investors face in trying to access this superior value proposition?

Defining "Boutique"

A good place to start would be to define "boutique" in the context of asset management. Boutiques cannot be defined by a set of quantitative criteria, such as a firm with less than $5bn assets under management, as boutiques appear in many different shapes and sizes. Instead, it is much more important to consider factors such as motivation, control over the product and alignment of interests. Being a boutique is more about state of mind.

However, boutiques do generally have some or all of the characteristics listed below:

- Part or wholly owned by the investment team
- Spin-off from larger investment house, often with private equity backing
- Outsource non-core functions
- Products on performance-based fees
- Products are capacity constrained
- Focused, highly specialist products
- Fewer stocks, i.e. more concentrated portfolios.

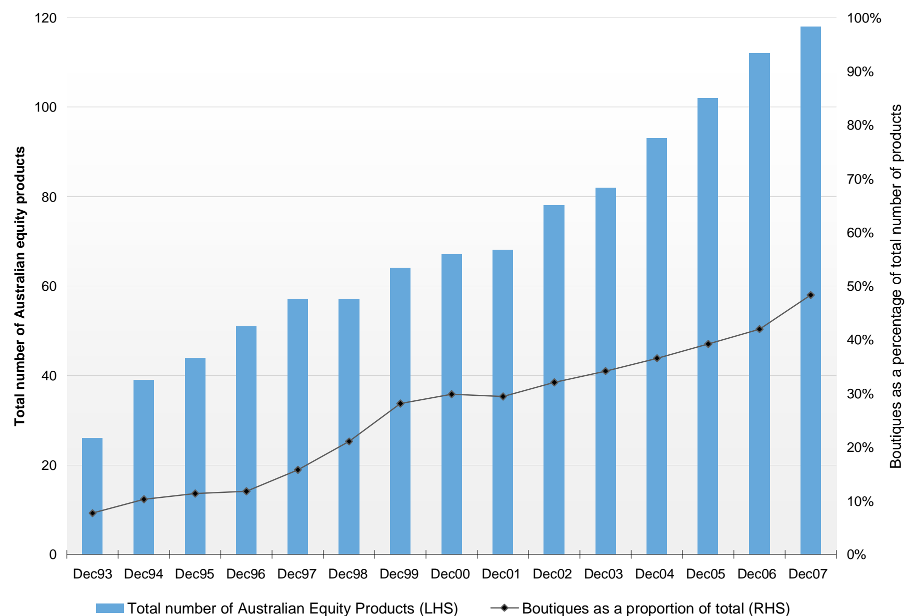
The growth of the boutique

Both the boutique business model and the growth in the proportion of the asset management market represented by boutiques are prevalent in all major markets from the US to Europe to Australia (see Figure 1 for Australian experience). But what is it that has caused so many boutiques to launch in recent years?

There is one particular market which is very useful to study when investigating boutiques. The universe of active Australian equity managers is broad enough at about 120 to form a statistically significant data set but is small and discrete enough to enable full coverage of the manager universe. Furthermore, Australia has a strong history of entrepreneurial business practices which has encouraged the growth of the boutique manager in recent years. For this reason, much of the analysis discussed in this article uses the Australian market as an illustration.

We also use analysis derived from the universe of managers hired in Russell Investments' Dublin range of multi-manager funds. Of approximately 180 mandates managed across global and regional equity and bond markets, around 80 of these are from boutique managers. Considering both data sets allows an in-depth study of one equity market, and a broader study of a multi-asset product set which adds additional perspective.

Figure 1: The rise and rise of boutique Australian Equity managers



Source: Russell Investments

Driving the boutique trend

Throughout the 1990s and on to the present day, the asset management industry has become more specialized. Particularly as the hedge fund market grew, asset managers started to think beyond the boundaries of the larger and often bureaucratic financial institutions within which they sat. Why be subject to the financial and political volatility experienced by many of the global banks when you can have control over your own destiny? Why be forced always to grow, grow, grow - even into areas outside of your core sphere of expertise - when you could be in control of a more focused product range?

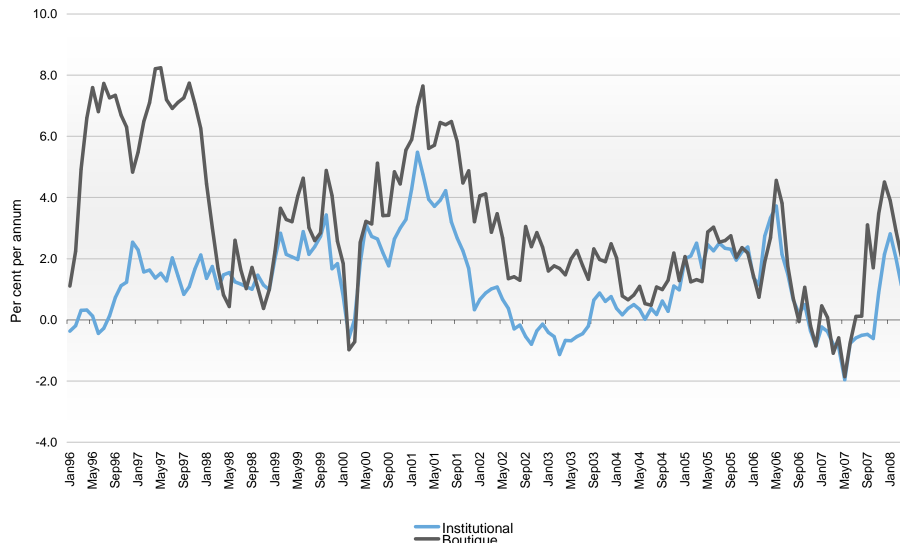
As global assets under management grew the market could support more participants, and top performers began to consider the possibility of setting up their own autonomous boutiques, independent of, and in competition with, their previous employers.

Measuring the "boutique effect"

But what about the "boutique effect" - is there a value proposition in these organizations over and above their larger, more institutional peers? We can see in Figure 2 that the typical Australian boutique has delivered some attractive performance for investors. The median rolling excess returns for boutique managers have exceeded (or at least broadly matched) those of institutional managers over most of the last 12 years. Over this period, the median yearly

excess return for boutiques averages 3.1% per annum versus 1.2% per annum for institutional managers.

Figure 2: Median rolling yearly excess returns of Australian equity managers



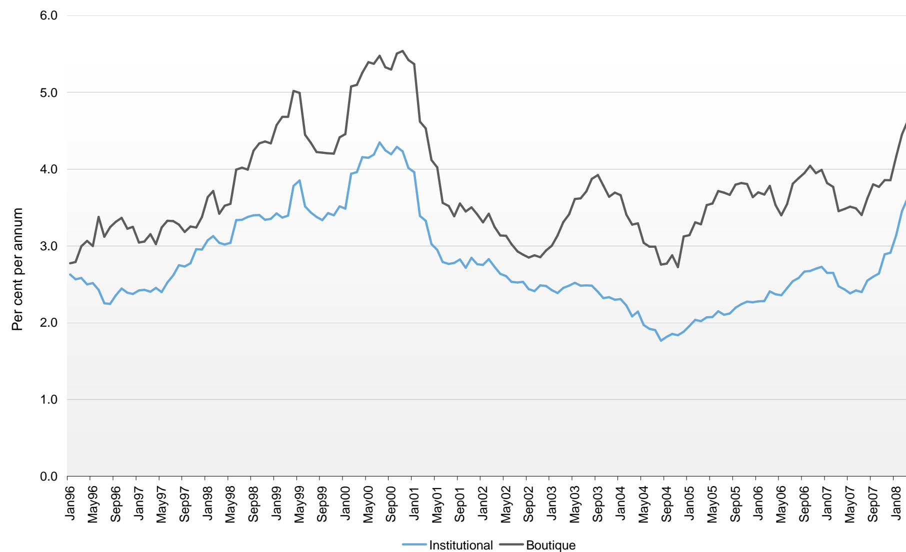
Source: Russell Investments, gross of fees. Past performance is not a guide to future performance

This observation is supported by the data from the managers in Russell's multi-manager fund range in Dublin. Over the 3 years to 31 December 2007, the average added value from the group of boutique managers exceeded the added value from the group of institutional managers by 2.4% per annum.

Of course the amount of risk taken to generate these returns is important to consider. From Figure 3 below you can see that whilst boutique managers have generated higher returns in Australia, this has come with a higher average ex-post tracking error. The same results are seen in Russell's Dublin manager universe, where the 2.4% of additional performance discussed above has been achieved by taking 1.8% per annum additional risk.

Importantly though, the results demonstrate that this additional risk is being rewarded – and in an environment where returns on equity markets are expected to be relatively modest compared to the last 20 years, this is highly beneficial. If you couple this with the fact that boutiques often chose to focus and become experts in highly specialist areas of the market, it is easy to see why investors have become extremely attracted to the boutique segment of the market.

Figure 3: Median rolling yearly tracking error of Australian Equity managers



Source: Russell Investments. Past performance is not a guide to future performance

Challenges around capturing the "boutique effect"

Unlike asset management teams of institutional firms, bad boutiques tend to go out of business fast. They therefore disappear from the data set much more quickly than those managers which have the support of a large parent company. Thus any analysis of performance numbers should be informed by their likely survival bias. Equally, we know that past performance is often a highly unreliable indicator of future return patterns.

This means that manager selection in the boutique area remains critical. Identifying those boutique managers with real skill requires great expertise, especially since you often have to dig really deep to get the answers you need, as boutiques are not set up to answer standard research questionnaires, for example. Research into boutiques favours those manager selection firms with significant on-the-ground analyst resource which can visit these boutique firms where ever they are based in the world. Given how much of the value proposition of the boutique manager hinges on the founding investment team, there is no substitute for an in-depth knowledge of the people involved.

Second, because of the focus that boutiques have on investing rather than asset gathering, it is often quite onerous to do business with these firms. A boutique manager with a great reputation will fill up available capacity quickly and investors need to be there at the beginning if they are to secure some of this capacity. Equally, the boutique model is often not one that individual investors can access as many boutiques prefer to foster a small number of larger, institutional-type clients rather than offer funds for the retail or high net worth markets.

What about the future?

We are entering an unprecedented time of flux in the asset management industry. Dramatic declines in equity and bond markets, coupled with endemic underperformance in areas like hedge funds and other absolute return products has led investors to challenge their current investment choices. Money will be quite slow to flow out of the hedge fund market initially due to gates and lock-ins, but when it does, it will be significant (over $30bn of redemptions in Q3 2008 alone with much, much more to come)[1]. At this point investors will be looking for increasingly specialist, diversifying investment opportunities in which to invest – and this plays right into the hands of the more focused boutique asset manager. For those making strategic investments in this area now, the future is likely to be bright.

[1] **Hedge Fund Research, Sep 2008**

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