PRACTICALLY SPEAKING

INVESTMENT COMPANIES WITHIN CENTRALISED INVESTMENT PROPOSITIONS

A market insight report from the lang cat

November 2020

THE LANG CAT

PRACTICALLY SPEAKING:
IN NUMBERS

1 =
Seneca Global Income & Growth plus. The first investment trust to be risk profiled by Dynamic Planner

SENECA INVESTMENT MANAGERS

4 =
the number of mainstream adviser platforms that are cost neutral across funds and exchange traded assets

1 2 3 4

16 =
the % of advisers who don't know the proportion of investment trusts within their DFM portfolio

DINNAE KEN

53 =
the % of advisers who think that trading charges on platforms are a significant or tangible barrier to using investment trusts on platforms

TRADING CHARGES...

58 =
the number of different asset sectors listed by the AIC

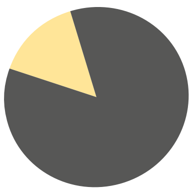
aic

68 =
the number of years since Markowitz Modern Portfolio Theory published

82 =
the % of advisers who agree that there is an inherent bias towards mutual funds in the retail investment sector

82

85 =
the % of firms who run more than one Centralised Investment Proposition type



393 =
the total number of investment trusts

393! GONNA GET THEM, GONNA FACT CHECK IT

CONTENTS

Before we get going

This paper was commissioned by the Association of Investment Companies (AIC) to look at Centralised Investment Propositions (CIPs) and how investment companies (the most common of which is the investment trust) fits within these [SPOILER ALERT – IT'S VARIABLE].

As the entity responsible for championing the use of investment companies (otherwise it would have a terribly unsuitable name), the AIC has a clear interest in this subject. However, while this is a sponsored analysis, it is free from influence and editorial control by the AIC.

Organisations hire us for projects like this because of our independence and for the honest, direct and sometimes difficult opinions that come with it. We will never compromise on this.

A note on research

This paper is underpinned by a combination of different elements of research coming together.

In late summer 2020, we surveyed 192 members of our advice panel on their views of investment trust usage within the context of CIPs.

In parallel to this, we held a number of conversations with key gatekeepers across the sector; platforms, DFMs and software providers.

We also lean on our annual omnibus study, State of the Adviser Nation, using data from wave 2, where 404 members of the advice profession took part in winter 2019.

Lastly, this paper builds on previous lang cat engagements with the AIC, including our two white papers "We have trust issues" and "You can do it".

ONE: A BRIEF HISTORY OF CIPs

Hello. Nice to see you again. What you're about to read is a look at how investment companies are currently being accommodated within Centralised Investment Propositions, some of the underlying issues – particularly in the platform space – and what needs to change within the sector to unlock some of the barriers to adoption that currently exist.

But, before we get into all of that, let's take a brief look at how we got here…

CIPs have been a feature of many advice firms for over a decade. The concept of a CIP was first introduced, at least in regulatory terms, by the FSA (as they were then) in the run up to the RDR. In particular, 2012 saw the publication of an almost seminal finalised guidance paper, "Assessing Suitability: Replacement Business and Centralised Investment Propositions"[1], or FG12-16 to its friends. This paper set out example of good (and poor) practice for firms looking to implement their own CIP, and whilst it's over eight years old most of the guidance not only still stands, but has more recently been embedded as rules via PROD[2].

This rise in the use of CIPs to the point of attracting the attention of the regulator had come about from a number of factors. On the demand side, advice firms started to move away from the practice of picking single "managed" funds for each individual client, towards a model of constructing portfolios. This, in turn, brought the question of consistency to the fore. Consistency not only of advice, but of outcome and delivery. If the same client saw different advisers within the organisation, they would receive the same outcome. A well-constructed and implemented CIP is a great way to achieve this.

PRE-RDR

Advice firms are starting to move away from insured to fund supermarket models, all with bundled charging. Fund picking dominates; few have portfolio structures.

2000-2010

2012

FG 12/16

FCA-finalised guidance on replacement (transfer) business defines regulatory expectations for advice firms running a CIP.

1. https://www.fca.org.uk/publication/finalised-guidance/fg12-16.pdf
2. Introduced in January 2018, the FCA's Product Intervention and Product Governance Sourcebook (PROD) rules aim to make sure that the investment solutions and products being recommended to clients meet the needs of one or more identifiable target markets, are distributed appropriately and deliver good customer outcomes.

OUTSOURCERS HAVE FEELINGS TOO

The attractions of building a CIP extend beyond mere consistency. Many advice firms prefer to focus their attention on financial planning and the overall service the client receives, electing to use a third party for investment management. This can mean the client benefits (in theory) from the specialist knowledge and experience of the investment manager, who in turn will often have access to resources that a small advice firm is unable to source directly.

RDR came and went at the end of 2012 and, whilst the wider impacts for many advice firms were profound, it was the increasing focus on professionalism and suitability that further accelerated the use of CIPs. In addition, with the introduction of adviser charging, many advisers found it an easier conversation with their clients if they were discussing a portfolio (containing a wide range of funds) as opposed to one fund. The "single line on the valuation statement" challenge remains an inhibitor for the use of multi-asset funds to this day.

Just as advice firms started to get really comfortable in their post-RDR skins, George Osborne stood up on THAT budget day and announced the Pension Freedoms. This was like rocket fuel for the advice sector, increasing the demand for advice and financial planning. This emphasis on financial planning, with the heightened complexity of income generation and cash preservation for at-retirement clients, increased the demand for outsourced investment solutions. Advice firms wanted to concentrate on managing the client's income and cashflow, leaving the investment solution to be run by a third party.

As the demand from advice firms grew, product providers and platforms did what product providers and platforms did, do and will do till the dust of Armageddon and evolved to supply a range of solutions. Open architecture wraps gave advisers the ability to use a wide range of funds and investments within their portfolios, and many platforms and product providers started to offer risk profiling and asset allocation tools to help firms build portfolios for their clients.

The ability for platforms to administer model portfolios, created either by the advisory firm or a third-party investment manager, meant these portfolios could be used with a large number of clients – a one-to-many investment process previously unavailable within a firm. Any changes (rebalancing, trades) are made at portfolio level, with the changes subsequently applied to every client who is linked to the portfolio. Most platforms will now have functionality to offer model portfolios from a range of third-party investment managers, meaning advisers are able to work with whoever they deem fit.

RDR

Lots of impacts but a commission ban, and the introduction of explicit adviser charging are the most profound.

MiFID II/PROD

Major new rules on disclosures and suitability of investment propositions.

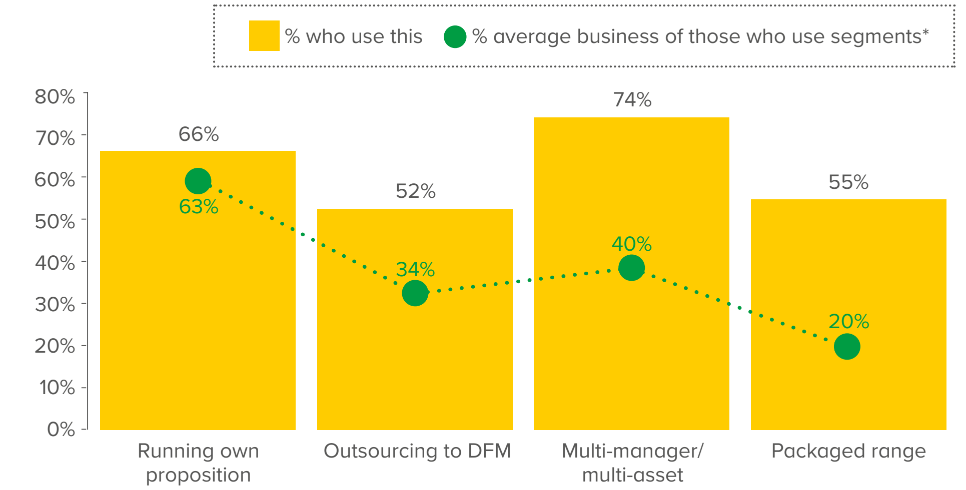
2012 **2015** **2018**

PENSION FREEDOMS

Game changing for most providers and advice firms. Advisers increasingly focused on at-retirement clients and financial planning.

TWO: CIPs IN 2020

Whilst the majority of advice firms are operating a CIP, it's important to look inside the CIP to see what is really going on. And when we do, we see a lot of different service models and solutions being adopted.



* For example, while 74% of respondents use multi-manager or multi-asset funds to some degree, those respondents place a mean average of 40% of business via this segment and 60% elsewhere.
Similarly, over half use packaged ranges to some degree but only for 20% of the business they place, on average.

DEFINING THE SEGMENTS

With 82% of firms running a CIP it is rare to find an advice firm who is building a bespoke portfolio for every client. It is equally rare to find a firm who is only offering one type of investment solution. Firms will typically offer a range of solutions, designed to meet the needs of their typical clients.

The most dominant model, in terms of new business flows, is the advisory self-build model, where 66% of firms operate this model. Here, the advice firm is building its own model portfolios, and running them on an advisory basis. This means any changes and/or rebalancing post sale will need to be authorised by the end investor. Advice firms will typically use a range of planning and risk profiling tools to help them construct these portfolios, and by using a platform's bulk portfolio functionality the advice firm can have many clients invested into the same model. On average, across all advice firms, 42% of new business flows are into these models.

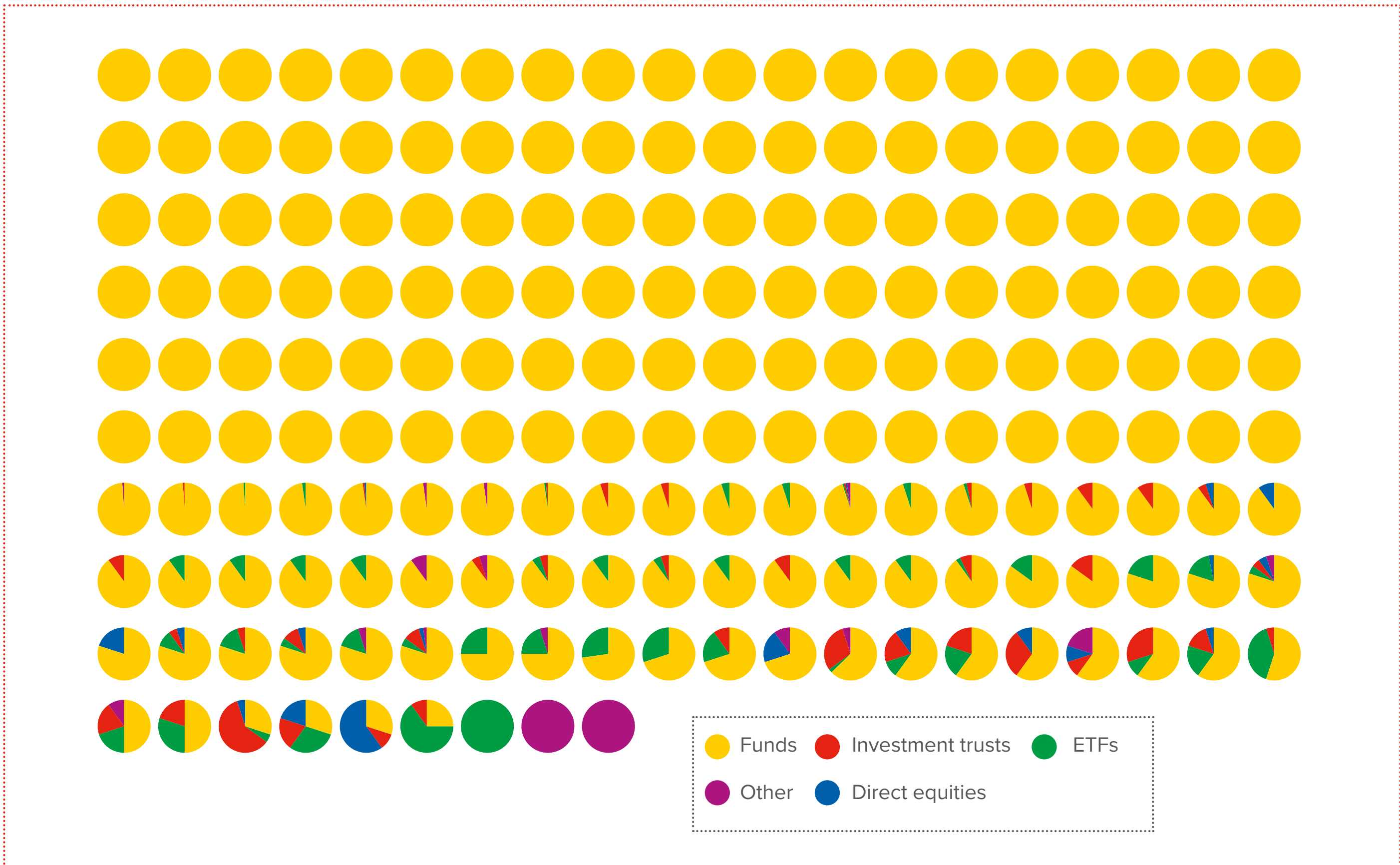
If the advice firm doesn't want to do everything in-house, either for some or all of their clients, there are plenty of ways they can outsource. 74% of firms will use multi-manager/multi-asset funds for some of their clients, typically those with less complex needs. These not only mean you are utilising the experience of the fund manager, but it also removes the need for regular client instructions for rebalancing and trading, as the trades are contained within the fund structure. 30% of new business flows go into these funds.

A number of product providers have created their own packaged range of model portfolios. These tend to be offered by "vertically integrated" providers, who have both platform and asset management capabilities in-house. The portfolios will often be built using in-house funds, however are normally priced at a very competitive level. Just over 10% of new business flows go in this direction.

Finally, most platforms now offer the ability to access model portfolios built and maintained by a number of third-party discretionary managers. These allow the adviser to invest their clients into a portfolio structure, as opposed to a single fund, with the ongoing management of the portfolio taking place under a discretionary mandate. All of the investment decisions are taken by the discretionary manager, meaning the advice firm can make a clear distinction to the client between the financial planning services they are providing and the investment management element being carried out by the DFM. Over half of advice firms will use these solutions for at least some of their clients, and 18% of new business flows go into these portfolios.

INSIDE A MODEL PORTFOLIO

Funds dominate the model portfolio world. Based on our State of the Adviser Nation (SOTAN) research, the total mean average use of funds as opposed to other asset types as the building blocks in models is 91%. Anything else is (currently) a minority sport. Our graphic below illustrates the asset types used by respondents of our SOTAN research who run their own model portfolio range. Each 'mini-pie' represents an individual respondents asset mix for their models.



The true picture is less absolute than that figure suggests, with around a third of respondents including other asset types for some asset classes, but it remains the case that the sector is culturally and practically geared towards open-ended funds.

THE ROLE OF PLATFORMS

Platforms play a critical role for model portfolios. They not only provide the necessary wrappers and custody for each individual client, but also have the functionality enabling portfolios to be managed in bulk. The portfolio manager, whether that is the adviser or the third-party investment manager, can make changes to the portfolio, with the changes then applied to every client who is linked to the portfolio. This functionality has enabled the model portfolio market to scale up to previously unimaginable levels – a discretionary fund manager can create a range of model portfolios which are made available by a number of platforms. These are then used by potentially hundreds of financial advice firms with potentially thousands of clients invested into the same portfolio. The DFM manages the portfolio via each individual platform and won't have any line of sight to the end client.

In terms of functionality, platforms are well suited to this role, however almost inevitably it can create a very inconsistent experience for everyone involved. Depending on which platform you are using, the level of information provided to the adviser and the reporting to the end client can differ not only in quality but also availability. Some platforms will communicate directly to the client on behalf of the investment manager, others leave this up to the adviser. Any advice firm using these model portfolio services should ensure they are clear on who is responsible for what, and that their agreements with both the DFM and end client are updated accordingly.

THIS IS A PAPER ABOUT INVESTMENT TRUSTS THOUGH, RIGHT?

Quite. And it's at this stage we should highlight that it's the differences in investment universe and trading functionality that can have the greatest impact on the end portfolio. Let's look specifically at trading costs and availability on the mainstream adviser platforms, collectively responsible for around £450bn of existing assets and net new flows of tens of billions each year.

	INVESTMENT TRUST TRADING	MARKET SHARE OF AUA
AJ Bell	Either completely or close to cost neutral due to in-house stockbroking	16%
Ascentric		
Raymond James		
Seven IM		
Hubwise	Minimise trading costs	19%
Praemium		
Standard Life Wrap		
Transact		
Advance from Embark	Trading costs arguably act as barrier for regular rebalancing	38%
Aviva Platform		
Elevate		
FundsNetwork		
James Hay MiPlan		
Novia		
Nucleus		
True Potential		
Wealthtime		
Aegon Retirement Choices (ARC)	Either not available to hold within models or not available on the platform at all	26%
Parmenion		
The Aegon Platform		
Quilter		

At a very base level of market analysis, our segmentation is striking. Of the 20+ mainstream platform providers in the UK, those who are truly asset neutral from a cost perspective make up around a sixth of total assets.

The next segment, where costs are minimised in the context of regular trading, typically via aggregation in the case of Praemium and Transact, makes up a further fifth or so of sector assets.

Which leaves us with the bulk, around 64 pence for every pound, where fundamental availability or pure trading costs acts as a real tangible barrier to using investment trusts in any form of mechanised CIP to begin with. We're walking down a path from previous projects with the AIC, but it's worth laying down this marker before we move on to the next layer of analysis.

We are going to explore these issues in more detail over the coming pages, focusing on the self-build and DFM models and looking in-depth at how investment trusts can fit within these processes.

MODEL BEHAVIOUR: RUNNING YOUR CIP WITH INVESTMENT COMPANIES

Now that we've established what the sector looks like in terms of current practice, it's time to get a bit more practical. There are as many CIPs as there are adviser firms (actually there are probably many more) but the principles of ensuring suitability and consistency should remain constant. In terms of including investment trusts, there are naturally some additional considerations to bear in mind, but as we'll see these shouldn't be too onerous, and we've definitely seen some green shoots of adoption in the last year or two.

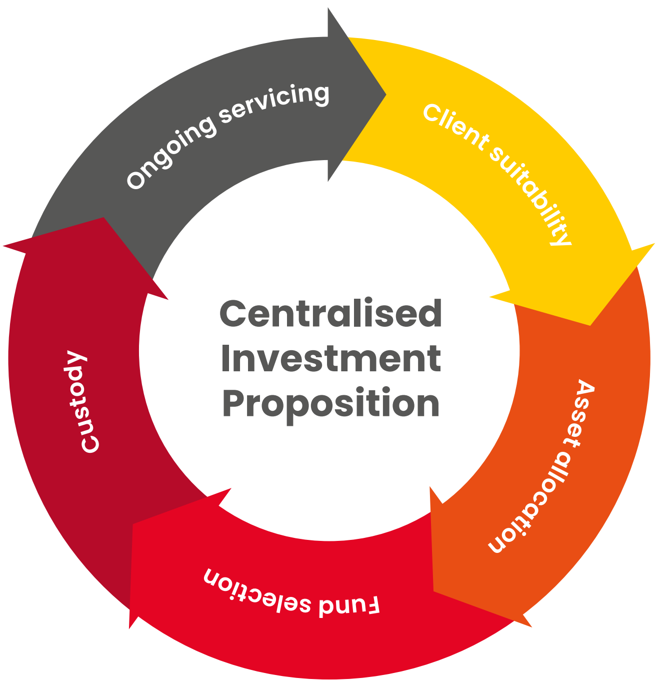
Let's first cover the basics and think about how firms go about covering these.

Ongoing servicing

- Trades/rebalancing
- Regular reporting
- Ongoing assessment of suitability

Client suitability

- Always the adviser's responsibility
- Factfind, risk profiling, cashflow modelling
- External tools used to support



Custody

- Investing the client's assets
- Via a platform...
- ..or direct custody with DFM

Asset allocation

- Matching the client's needs to an appropriate asset allocation
- Asset allocation models can be constructed in-house, using external tools, or sourced from third party

Fund selection

- Populating the asset allocation with funds
- In-house (using research tools or outsourced

We start at the top right of the wheel and – as is the way with wheels – we keep returning to the same, most important place, which is client suitability. Deciding on how you are going to assess a client's risk tolerance, capacity for loss and risk requirement is a fundamental driver of the eventual building blocks you use at the business end of your CIP – but for our purposes in this paper it's not something we'll dwell on. No matter how you go through the risk conversation and how (or whether) you use cashflow modelling, you still have an open field in front of you about the fulfilment of your CIP.

Leaving that aside, we'll move round the wheel step by step and consider each in turn.

ASSET ALLOCATION

The question of liquidity

The suspension of many property funds, especially those investing into commercial property, has raised questions about how suitable these products are for model portfolios. The increased adoption of model portfolios means that it is no longer one single client's assets being invested into the portfolio, it could potentially be hundreds of clients. Even a simple trade or rebalance could move £millions, making the challenge for the fund manager of managing liquidity within the product even harder.

The FCA is currently consulting on measures to address these issues. The consultation is open until 3rd November 2020, with a policy statement expected in early 2021. One proposed remedy would require investors to give notice, between 90 and 180 days for any withdrawal from these products. If this proposal becomes a rule, it will have significant impact on platforms and model portfolio providers who want to have exposure to commercial property.

Of course, REITs offer an alternative to this, providing a different structure to access property as an asset class. And with the majority of advisers agreeing that WOM firms should consider all asset classes, it would be remiss of us to not highlight that traditional property funds aren't the only show in town.

Ultimately, this is certainly one of many issues to keep an eye on.

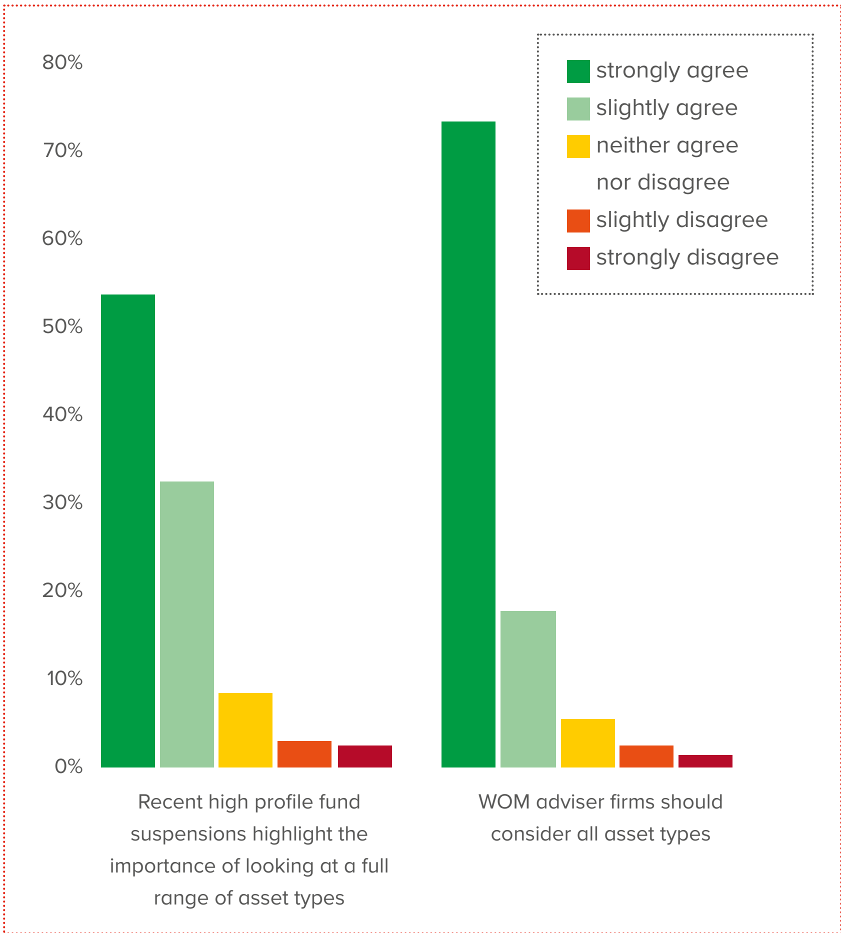
However we feel about Markowitz and Modern Portfolio Theory – 68 years old this year so not all that modern any more – the move to systemised, repeatable CIPs has meant that fund-picking for the sake of it is now a minority sport, and a bottom-up approach starting with asset allocation is now overwhelmingly favoured.

Who provides that asset allocation is a different matter. Our SOTAN research from late 2019 shows that 29% of firms who run their own models claim to have their own asset allocation model, with 38% saying they outsource that element.

Where you get the expertise from is important. As we know, algorithms which form a building block of coming up with answers are subject to all sorts of human bias in their design. For example, the AIC lists 58 different sectors in seven categories on its website. Some have only one or two companies (the Royalties sector, for example, relies fully on Hipgnosis); others a long list. In contrast, the Investment Association (IA) lists 39 sectors in ten categories.

Most asset allocation models don't allow for that level of granularity, although some do – Dynamic Planner, for example, lists 49 asset classes in its model. Most adviser-devised models use relatively straightforward methods, often with fewer asset classes.

We'll leave aside the quant debate on the relative merits of the different approaches, and just observe that if, as our recent research suggests, over half of firms believe that recent issues in the OEIC market mean it's more important than ever for firms to research all asset types, and that nearly 75% of firms believe whole of market advisers must consider all asset types, then it's important to ensure there's a process in place to do so.



Given that the IA and AIC sector definitions differ, it's unreasonable to suggest that the asset allocation model should favour the smaller cousin. But once the model has been run, it may be useful to have worked out in advance how the AIC definitions map to the sectors in your own model. This will then allow you to read across to relevant companies and consider them alongside appropriate mutual funds. The idea is to remove systemic tilts which limit the universe of investment vehicles which may be suitable for your clients.

We've seen some progress in adviser tools including ICs in their output as well. Recently Dynamic Planner included its first investment company – Seneca's Global Income & Growth Trust – in its risk profiling service and plans to add more.

FUND SELECTION

Here's where the rubber really hits the road. For firms who are looking to incorporate investment companies, the easiest way to start is to, well, start.

29% of firms in our SOTAN survey stated that they outsource fund selection to a third party. 39% keep it in-house and everyone else mixes it up. Whatever the approach, if investment companies are going to be a part of the potential universe for a CIP, it's important to start with a mandate for the investment committee, whether internal or external.

When we asked our survey respondents about reasons for using and not using investment companies, we found a real polarisation in responses.

"I choose not to use investment trusts due to the increase in risk."

"Our investment committee don't look at investment trusts, only collective funds (multi and single asset for different versions of the models)."

..."as part of a CIP, the more you use a specific IT, the more you are in danger of altering its price either by demand or by large selling"

Some firms point to issues with specific trusts and extrapolate those out to the market – but with 393 companies managing £208bn at 31 August 2020 (source: AIC homepage), there will always be a wide variation of situations and outcomes. Some find that they don't work well with their existing process, or that they add an additional layer of complexity. Others simply have a rejectionist approach, which sits uncomfortably with the whole-of-market point above.

These are issues of due diligence; for example, a small investment company may struggle to cope with very high levels of purchases and repurchases from a very large firm's CIP. This is also true of small mutual funds of course.

It is entirely reasonable for a mandate that includes investment companies to place strictures on what types are appropriate. This could include minimum size, longevity, history of discount management and more. Most firms are experienced in filtering mutual funds already; that skillset can be constructively applied to investment companies too.

Some firms are already navigating this successfully and making ICs part of their offering; about 17% of firms from our sample have at least 5% of their model portfolios in investment companies. DFMs and other third party MPS providers have a part to play here too; we'll cover that in the next section.

"If the DIM selects an investment trust we're ok with that provided the IT is deemed suitable for a retail investor."

"In favour of investment trusts being used within income portfolios."

"Investment trusts are an important asset class and should be considered by Financial Planner firms, although for many this will be within a packaged product (i.e. MPS)."

Custody

If you're going to use an investment company – or anything else – you'll need somewhere to keep it, and that's where the capabilities of the custodial options open to firms start to matter.

One of the most common objections we heard in our research for this paper was that the investment platforms most commonly used by adviser firms either didn't offer ICs, charged too much for trading them, or were a bit rubbish at including them in model portfolio structures. 22% of our respondents agreed with the statement "I'd use investment companies more if my platform(s) made it easier."

For sure a platform which doesn't offer access to the ICs you've identified as suitable in the steps above, will struggle to make it through your platform due diligence process – or it should. There is always a tail-wags-the-dog issue to contend with; a firm doesn't use ICs because the platform doesn't offer them; it then constructs its CIP without ICs; and so it goes. This is what the FCA called 'status quo bias' in its Thematic Review on assessing suitability in 2016, and it's problematic.

However, we think platforms have come a long way in allowing exchange-traded assets of all types, including ICs, to form part of model portfolios. Our respondents who hold ICs in models mentioned a number of platforms in despatches, including AJ Bell Investcentre, Ascentric, Fundment, FundsNetwork, Nucleus and Transact.

There are some platforms who simply don't have the wherewithal to offer this kind of functionality and that's fine. For the rest, it is worth seeing what the practical implications are of starting to include investment companies in your portfolios.

"...has serious problems to contend with when using rebalancing."

"...I use Ascentric and FundsNetwork. Both are very good at it."

Ongoing servicing

Part of running a CIP is ensuring its ongoing suitability. To do this you'll need to understand how your portfolios have behaved over the assessment period, both at a constituent part level and overall. Your platform or custody service will help with the latter; the former is something you can get from your normal investment data provider.

This is one of those areas where there is a level playing field between OEICs and ICs – and a key area for mitigating some of the risks mentioned by a number of our respondents. Dividend policy, discount management, cost control and more are all important elements of how ICs are managed and are available for analysis by portfolio allocators. There is more than enough information available to help firms assess ongoing suitability.

PRACTICALLY SPEAKING:

LET'S RECAP

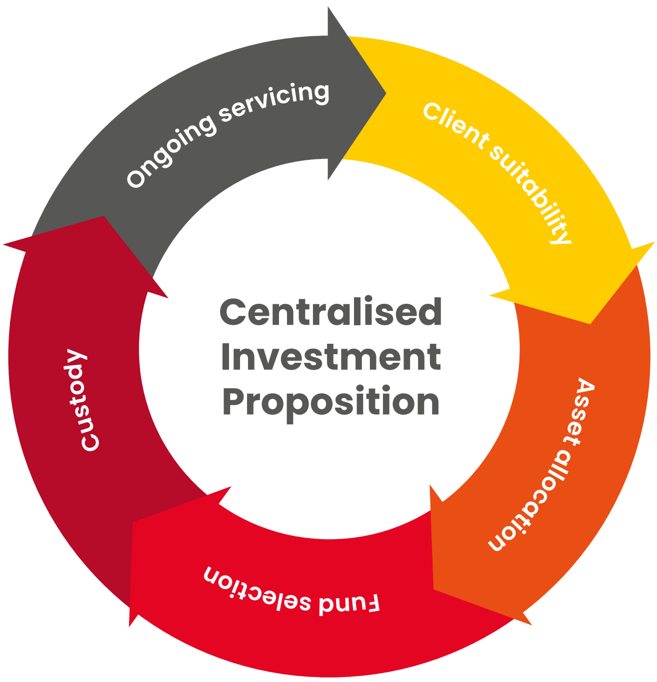
To close this section, let's look at the diagram once again and think about what's involved in adapting model behaviour to include investment companies.

Ongoing servicing

- Available corporate documentation
- Available direct or from data providers

Client suitability

- Happens independently of portfolio construction



Custody

- Clear requirement at due diligence stage
- Many platforms have improved their model capacities

Asset allocation

- Care to avoid designing in tilt to particular asset types
- Some progress with adviser support tools

Fund selection

- Clear mandate required to drive assessments
- New elements of due diligence to consider

USING ~~YOUR~~ THEIR DISCRETION

We've looked at what's happening and what needs to happen for more adviser-managed CIPs to include investment companies – not all plain sailing, but equally not beyond the wit of humanity. However, 43% of CIPs according to our sample aren't managed by the adviser firm at all; they're outsourced to a DFM Model Portfolio Service (DFM MPS).

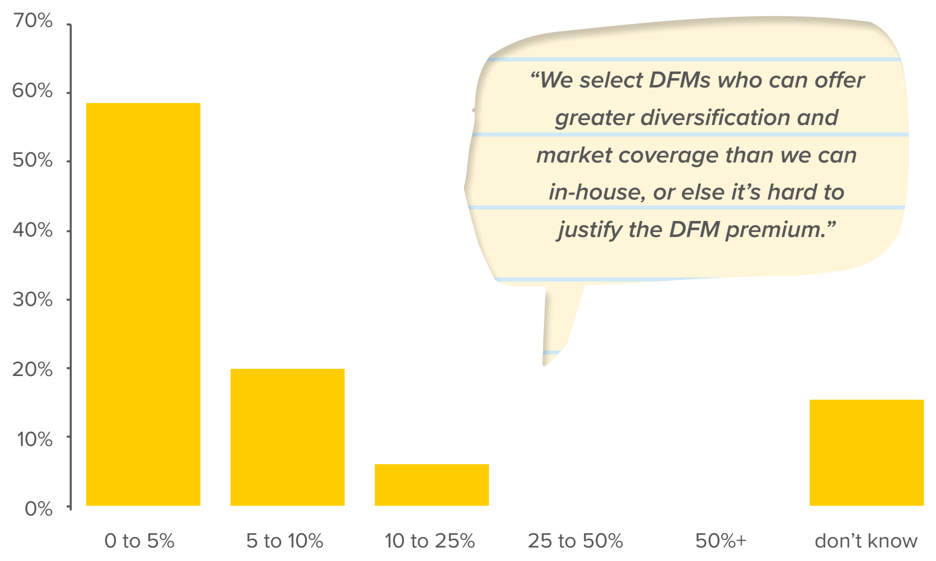
(We'll assume you're familiar with how a DFM MPS works; if not then we would take the liberty of directing you to this free lang cat publication which discusses the construction of different forms of CIP.)

The issues for DFMs running MPS propositions have some similarities with those for advisers running their own models, but there are some extra things to think about layered on top. For a start, most DFMs run their models on multiple platforms; it's not unusual to see a popular DFM listing their portfolios on a dozen or more. Given that we've already established different platforms have different strengths and weaknesses when it comes to model management functionality, it follows that there is a world of variation and complexity for the poor souls tasked with making it all happen on rebalance day.

In terms of adviser feedback, the chart below is interesting.

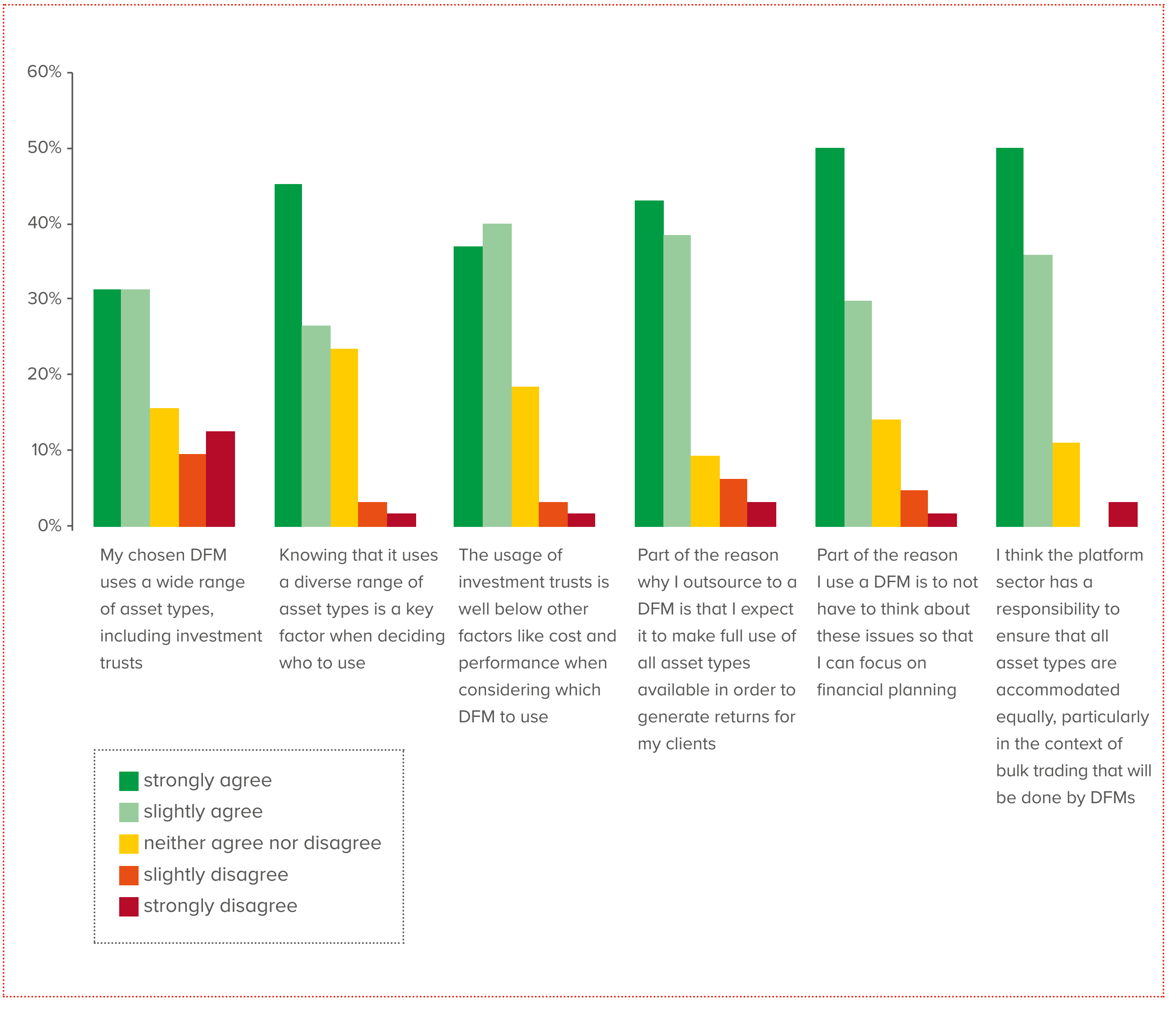
WHERE WE ARE NOW

For a typical client that you outsource to a DFM, roughly what % of their underlying holdings is in investment companies?



Overwhelmingly the response is obviously low or minimal allocation to ICs. However, it's far from the case that there is no usage, with 25% of respondents suggesting 5% to 25% of portfolios can be allocated to ICs. The 15% or so who don't know what's in the MPS they have appointed a DFM to run on their behalf, have some important questions to ask themselves, but we won't dwell on that.

We also asked firms to agree or disagree with a range of statements about DFMs holding a wide selection of asset types. Here's how we got on:



Picking out just a couple of these, we can see that firms are unlikely to use a DFM because they include ICs in their portfolios (over 75% agree or strongly agree that "the usage of ICs is well below other factors like cost and performance when considering which DFM to use"), but by and large they do expect DFMs to take an unconstrained view (over 80% agree or strongly agree that "part of the reason why I outsource to a DFM is that I expect it to make full use of all asset types available in order to generate returns for my clients.")

With all that, you'd expect DFMs to be well placed in having the expertise to go the extra mile – but only 60% of our respondent firms agree or strongly agree that "my chosen DFM uses a wide range of asset types, including investment trusts."

HOW THE DFMs SEE IT

As well as advisers, we spoke to a number of leading DFMs in preparing to write this paper. We asked if they use investment companies in their platform-based MPS offerings, and whether they do so in portfolios (model or otherwise) in their own custody. Here's what we found out from five larger firms, who collectively run close to £100bn of client money:

DFM	PLATFORM MODELS	OWN CUSTODY PORTFOLIOS	COMMENTS
1	No	Yes	"Not all platforms allow this and many still have transaction charges for listed assets."
2	No	Yes	"In the past it has been difficult to trade fractional shares of trusts on platforms… rebalances need to be precise."
3	No	Yes	"Some platforms have very high trading charges…OEICs all trade at the same time and the same price…we would struggle to get this as platforms have different processing points…if we were to sell a whole position it would place a lot of pressure on the IT."
4	No	n/a	"Structural issues."
5	No	n/a	"Can't invest in them due to structural issues…most platforms can't facilitate fractional dealing…this can be worked around in some cases…[but] the MPS business relies on scale which means we try and run the same model on every platform."

These comments have been edited down, but we can summarise the issues DFMs identify with trading ICs on platforms as follows:

1. **Trading charges**
2. **Fractional dealing**
3. **Consistency across Platfoms**
4. **Instrumental availability**
5. **Timely dealing**

Of these, point five is the hardest to work around. It is possible to find platforms with great functionality and great asset availability and who don't charge the earth for dealing. But if that isn't replicated across the market then the game changes. Instead of running one set of models on lots of different platforms, the DFM is forced to create different models depending on which platform it's using. For many, that just isn't worth the candle.

85% of our adviser respondents agreed or strongly agreed that "I think the platform sector has a responsibility to ensure that all asset types are accommodated equally, particularly in the context of bulk trading that will be done by DFMs." It's clear that there is still a way to go here.

WHERE SUITABILITY LIVES

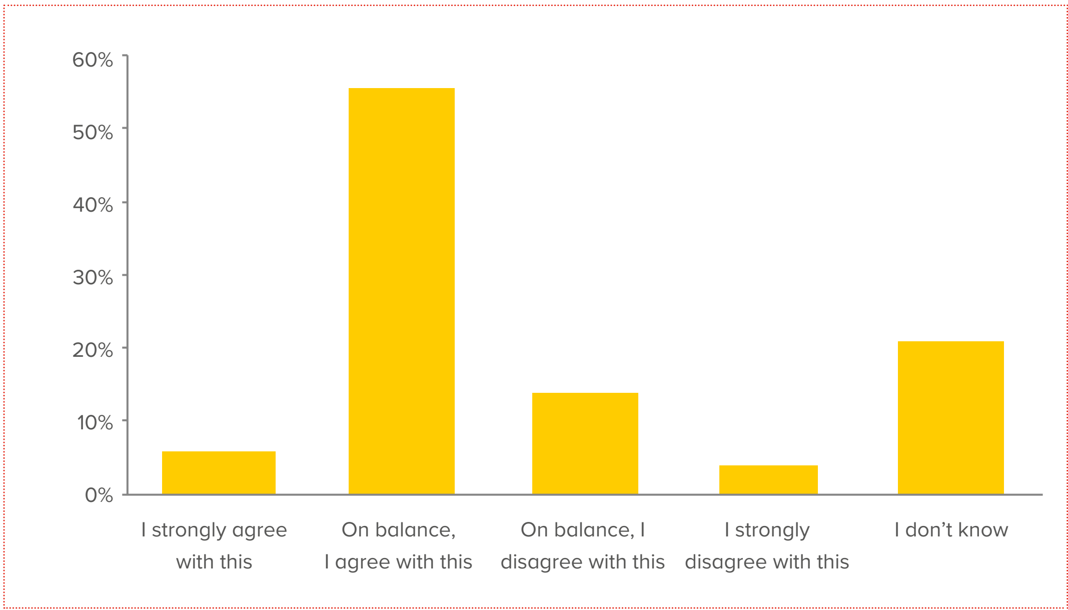
Perhaps the most interesting element of all this is that all the DFMs we spoke to who have an own-custody service include investment trusts in their portfolios. It's the structural issues on platforms which cause the concentration we've already identified into OEICs.

It's not a stretch to say that DFMs start with their preferred approach for portfolios in the venue closest to home. It follows, then, that their version of a 'most suitable' portfolio does include access to these wider asset types; even if they're not used in every circumstance. And the only possible logical conclusion from all that is that these DFMs view what they create on-platform as less suitable than what they offer in their own custody.

The difference may be marginal, and they may well still be satisfied that their portfolios are suitable for their given mandate (since they don't know the underlying client), but still: less suitable.

This is thrown into sharper relief when we think about income generation; one area where some of our panel respondents felt investment companies had a real role to play. We asked our respondents to agree or disagree with the statement "One might argue that investment trusts offer tangible benefits over other asset types in the context of income, such as the ability to smooth dividends by reserving some income."

The bar chart shows that well over half of our panel agree with the statement, though they wouldn't die in a ditch over it.



If there is a strong argument that certain CIPs – such as those which are aimed at clients needing income – are well served or better served by including investment companies in their asset allocation, then we are left with the realisation that either firms need to ask DFMs to manage that money in their own custody rather than on platform, or move away from model portfolio structures and into packaged multi-asset products which can offer more flexibility in underlying assets.

What doesn't feel tenable is, where those conditions are met and the firm does hold those beliefs, that they put them aside in order to be able to keep business streamlined and on the platforms they prefer to use. As mentioned earlier, there is a tail-wagging-the-dog issue inside all of this; that's not surprising when you are talking about varying something quite fundamental such as asset selection and overturning an accepted orthodoxy. But just because it's not surprising doesn't mean it's unimportant.

PRACTICALLY SPEAKING:

We'll leave you, then, with two open questions to consider.

1. **Does the constrained nature of many DFM MPS propositions on platform mean that they are less suitable than less constrained versions of those portfolios in the DFM's own custody?**
2. **If so, should the firm move away from using a DFM, or move away from using a platform?**

These are tough questions and the answer will play out over time – but given that suitability and its explicit demonstration is one of the biggest requirements of regulated advice and the focus of so much recent regulation, we think they'll be questions that will need answered.

CONCLUDING THOUGHTS: AT A CROSSROADS?

We leave our analysis with a sense that this is a section of the sector that is at a fork in the road. The development and now establishment of CIPs has achieved many positive things for the sector; consistent outcomes for clients and the mechanics of being able to offer a one-to-many service, freeing up time and resources to spend on financial planning being the two strikingly obvious ones.

But what of the firms who seek to step outside of the mainstream to use anything outside of mutual fund structures? Surely it's not too much to ask that platforms, the supposed nirvana state for open architecture investment choice, should be more accommodating? That's not just us hypothesising, the majority of firms we surveyed for this exercise agree.

THE DISCRETIONARY PARADOX

Most telling of all were our anonymised conversations with some of the mainstream discretionary fund managers, with the majority stating that they use investment trusts as part of their own custody solutions, compared to virtually no usage across their semi-commoditised MPS solutions across different platforms.

This results in a full discretionary versus discretionary-lite contradiction to us. The overwhelming majority (82%) of firms we surveyed agreed that part of the reason they outsource to a DFM is that they expect it to consider the full range of assets available. But what if fundamental structural barriers are in the way?

GREEN SHOOTS

So, if this is a part of the sector ripe for disruption, as the prevailing opinion suggests to us, where will it come from? It would be remiss of us not to talk about some of the early signs.

In the discretionary space, we're starting to see some investment trust flavoured green shoots among a couple of the lesser-known providers, namely Crossing Point and Binary Capital, both having launched a range of model portfolios using exclusively investment trusts as the component parts for the equity exposure of their portfolios. Time will tell whether this approach will remain in the specialist camp or whether it will pave the way into the mainstream.

In traditional platform-land, Standard Life Wrap has spent much of its recent development agenda enhancing its portfolio construction capability, introducing substitution architecture into its investment hub. This kit allows firms to step inside their range of models and swap out their underlying holdings, without breaking the wider model templates and spiralling into potential version control hell. This has It's immediate deployments in CGT harvesting and suchlike but its not a stretch of the imagination to imagine it having its use cases where certain clients are recommended less mainstream assets over others.

Elsewhere in platforms we see exciting developments from the lesser-known and newer entrants to the sector, with the likes of Praemium, Fundment, Seccl, Adalpha and Multrees all developing genuinely exciting, technology-first processes in various guises.

We argued in our 2019 Guide to platforms that the sector was beginning to fracture between traditional providers, vertical integrators and smaller, more nimble players and it may well be this pattern that leads to traditional portfolio construction becoming unglued for assets like investment trusts.

PRACTICALLY SPEAKING:

TEN THINGS TO ASK YOUR PLATFORMS ABOUT PORTFOLIO CONSTRUCTION

1. Do the Big Shop
2. take the Bins out
3. Birthday card for uncle Nick
4. take the (LANG) cat to the vet

1. What are your processes and procedures for creating and maintaining model portfolios? Give me screenshots and a demo if possible and tell me specifically how investment trusts fit into your processes?
2. Do you offer a full suite of investment trusts? How much does it cost to trade them? What if we're bulk trading or rebalancing, will my clients benefit from aggregation?
3. Do you offer pre-programmed, tolerance-based rebalancing?
4. Does any part of your technology or processes help me with version control?
5. Do you offer any form of substitution architecture? i.e. can I swap out certain underlying holdings for certain clients and not break the overall process?
6. Can I run multiple model portfolios? i.e. can I run a simple funds-only model in one tax wrapper and include investment trusts in another?
7. Can I see a version of your model portfolio reporting? Show me how investment trusts interact. Show me what the client will see.
8. Does any part of your technology help me with client permission gathering and resulting execution of instructions?
9. What is your development schedule for portfolio management? What enhancements are you adding in the next year? Where are you on the subject of fractional trading?
10. Do you separate out the disciplines of investment management and general portfolio maintenance on your platform? Can you segregate access within my firm? i.e. have a user who logs on and accesses admin and another user who logs on and accesses investment construction?

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