UK INTERMEDIARIES TEAM

Launching a DFM: Five key questions.

How to decide if an in-house discretionary fund manager is right for your business.

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Overcoming challenges and capitalising on opportunities should drive your strategic agenda.

5 key questions: What to ask before implementing a DFM.

As conditions for growth become less favourable and the cost of delivering advice that meets the demands of clients and the regulator continues to rise, should you consider launching a discretionary fund management (DFM) business?

It's certainly a strategic initiative we've seen gain traction in recent years. Besides giving you greater control over the client experience and outcomes, launching a DFM provides commercial benefits, insofar as it allows you to capture an additional part of your value chain.

That said, launching a DFM won't be right for everyone.

In this paper—written in collaboration with two of our clients as well as compliance consultancy threesixty services LLP—we outline five key questions to consider when launching your own DFM business.

1. Why are you considering launching your own DFM?

In recent years, balancing client needs with business needs has become increasingly difficult. In each or both of these areas, overcoming challenges and capitalising on opportunities should drive your strategic agenda.

The challenges

Client needs

Clients increasingly expect high-quality, personalised advice at a low cost. In addition, clients today are more aware of the alternatives to advice.

Business needs

It's getting harder to win new clients and integrate new business at scale. Factors such as market volatility, the increasing costs associated with running an advisory business, and the increased regulatory burden also impact profitability.

The opportunity

Becoming a DFM allows you to better align your investment proposition with the needs of your client base, more efficiently implement change, and enhance the experience you deliver. You might also be able to drive down costs for clients through your newfound economies of scale.

If you're currently running advisory portfolios, then obtaining your discretionary permissions creates a further opportunity to improve client outcomes, insofar as you will be able to act more quickly without having to obtain client consent. A more consistent approach to implementation across your client base may also reduce the compliance burden you're facing.

Lastly, from a business perspective, launching a DFM offers the potential to add a new revenue stream, which could enhance your enterprise value, and creates arbitrage opportunities on the multiple you might pay to acquire other advisory businesses.

2. Who are your target clients, and what matters most to them?

Consider what matters most to your clients and build something for them, not for you.

Who are your DFM clients?

First, consider whether your DFM will initially be available to existing clients or also marketed externally. Will you be operating in a particular niche, or will you be offering your services to the mass market? Are your clients onshore or offshore? The proposition you design will clearly need to be different depending on who your target clients are.

What do your target clients need from a DFM?

Next, think about the needs of your target client base. You will likely have already segmented your client bank, which should give you an indication of your target market and whether launching your own DFM is viable. You might also consider interviewing your financial planners and clients, as this will give you a sense of what's most important and what they're not currently receiving. Whilst you may find your clients are after something relatively straightforward—an investment proposition that maximises risk-adjusted returns at the lowest possible cost—you may have different types of clients with a variety of needs to satisfy.

It's worth expanding on this last point. At the very least, your clients will have different goals. For example, not everyone will be looking to accumulate wealth. Some clients will be investing for income or capital preservation. For others, ethical considerations will be important.

More specific objectives could also come to the fore. Think, here, about the way people use their savings in the real world. The investment requirements of a person saving for a comfortable retirement are not the same as someone saving to fund their children's university studies.

Understanding these nuances is essential. It will help you determine the breadth and depth of your proposition, including how many portfolios to offer, the pricing, how said portfolios should be structured, and the different risk profiles you'll need to cater to.

What are the expectations with respect to additional services?

You have the opportunity to tailor your marketing and service collateral to your clientele. You should therefore look to understand their service expectations. Would your clients welcome in-person or virtual events—to meet your investment team, for example? Are they investment savvy with an appetite for market updates and commentaries, or would they value really simple content covering investment basics?

Getting to grips with what's expected will help you allocate your resources later down the line and will mean you're adhering to the FCA's Consumer Duty principles of consumer support and consumer understanding.

TOP TIP

Differentiation is key!

One of the frustrations for existing adviser-as-DFM businesses is low adoption rates. Designing a proposition that's different to what's already available, yet in a way that better suits your clients, could improve adoption.

3. What do you need to think about from a regulatory perspective?

When launching a DFM there are, of course, a number of regulatory considerations.

Ensuring 'appropriate' resources, and demonstrating you are 'ready, willing and organised.'[1]

First, the FCA application process is a significant undertaking, and can take up to a year to complete. The FCA will assess whether you are 'ready, willing and organised', with 'appropriate' resources—both financial and non-financial—to meet the regulatory requirements.[2]

Specifically, you will be required to:

- Demonstrate that you have appropriate financial resources in place to meet the FCA's regulatory requirements—initially and on an ongoing basis.

  Assess the level of additional financial resources required by completing an internal capital adequacy and risk assessment (ICARA). Note that this is needed as part of your application and should be reviewed at least annually going forwards.

To ensure you're 'ready, willing and organised', the FCA will then require additional firm documents, including the following:

- A draft DFM client agreement
- A copy of the firm's DFM compliance monitoring programme

Systems and controls framework

On the latter point, the FCA will expect you to have a robust systems and controls framework in place.

An experienced compliance officer, who is able to oversee your DFM activities, is required. Any new senior managers will also need FCA approval.

Submitting your business plan

A detailed business plan is another important element of the FCA application process.

Your business plan should document:

- Why you're launching a DFM
- How you have put clients at the forefront of your business, in line with the FCA's Consumer Duty regulation
- The key individuals, in terms of both senior managers and investment managers, with proof of their experience and expertise to support these activities
- Details of the proposed DFM service, its distribution channels, and all charges

TOP TIP

Be prepared for the FCA to ask questions

During the FCA application process, you will likely be asked detailed and wide-ranging questions. As such, you may wish to engage the services of a compliance consultancy familiar with the FCA application process. This firm can provide support during both the application process and on an ongoing basis thereafter.

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[1] 'How to apply for authorisation or registration', The Financial Conduct Authority (FCA), 24 May 2023 [accessed 20 May 2024].

[2] One of the FCA's threshold conditions for authorised firms concerns 'appropriate' resourcing, see COND2.4 of the FCA Handbook.

4. Do you have the necessary infrastructure and expertise?

It should by now be obvious that building and operating a DFM is resource-intensive.

Consider the following key areas:

Business structure

You might decide to vary your existing permissions and run your DFM as a unit within your existing advisory business. Alternatively, you might choose to launch a new stand-alone company or an additional business within your group of companies. From a resourcing perspective, each option has pros and cons, which are worth exploring.

Investment personnel

Launching a DFM means taking responsibility for investment decision-making and investment results. Consider whether you have the appropriate talent in-house or whether you need to hire or work with an outsourced partner. Experienced investment professionals come at a cost, particularly if these individuals are joining your business full time. That said, the success of your business rests, in part, on your clients being able to trust the person investing their wealth.

Marketing and distribution

If you're looking to attract new clients with your DFM, then you'll need to think about your brand. You may need a professional website, sales literature, and investment strategy fact sheets. Will your investment team double up and drive business development, or do you need dedicated resource in this area?

Administration

Don't forget to allocate resources to the less exciting tasks of discretionary investment management, such as portfolio implementation, rebalancing, and reporting.

Technology

When it comes to technology, there are two main considerations: your investment team will need access to investment research and monitoring tools—as well as a portfolio management system—and you'll need either an in-house or external platform to provide access to your portfolios and custody assets.

TOP TIP

Speak to your bank sooner rather than later

A number of newly launched DFMs have reported difficulties in opening a bank account. Before granting approval, the FCA will need to see that you have a bank account—but many banks will require that you have your discretionary permissions before they're able to open a bank account. To get ahead of this potential issue, engage with your bank early.

5. Should you acquire, build, or partner?

Clearly, launching a DFM is not for everyone. It's a decision that requires careful consideration and many more questions than we can duly answer in this paper.

If you do decide that launching a DFM is in the best interests of your business and clients, then broadly speaking, you have three options: acquire, build, or partner.

Acquiring an existing DFM

The most obvious benefits here are a day one revenue stream and the ability to go to market quicker than you would if you were to build or partner. The downside is that this option is expensive, and you risk destroying the value of the business you acquire if you make significant changes (e.g., changes to the investment process or team).

Building a DFM yourself

This option gives you the most scope to tailor your investment proposition to the needs of your client base. That said, some advisers will find the costs and risks associated with building a DFM from scratch prohibitive. Consider whether you have the assets necessary to see a healthy return on your investment.

Building with a partner

Through a partnership, you'll be able to leverage the resources and expertise of a strategic ally. The right partner offers more than just resources; they can lend credibility to both your FCA application and your startup business. You'll likely face a lower AUM threshold, be quicker to market than if you were to build from scratch and incur significantly lower setup and operating costs.

The downside is that finding the right partner can be time-consuming. If this option is going to work for you, then it's essential you partner with a manager who shares your values and investment philosophy as well as your willingness to collaborate.

> "What was really important was finding an investment partner that would allow us to flex our investment knowledge, whilst still being a very, very safe pair of hands. This would free up our time to focus on client engagement."
>
> – Managing Director, DFM business

How can SEI help?

The challenge for advisers today isn't a lack of opportunity. The next few decades look to be full of promise—it's how best to plan for and capitalise on this promise that remains the challenge.

We can help. A partnership with SEI encompasses more than investment management. We provide support in compliance, manufacturing, operations, distribution, and investment management to help clients both manage risk and save time and money in transforming their business. Our solutions are designed to help you meet your strategic business objectives whilst empowering your engagement with clients and creating better investment outcomes.

"Very few people understood what we were really trying to do—most people were trying to sell us a white-labelled version of what they did. SEI took the time to understand us and what we were looking to achieve."

– COO, Financial planning firm

Interested in finding out more?

Contact our team today.

Benjamin Cooper
Asset Management Partnerships, IFA & Wealth
sei_intermediaries@seic.com

1st Floor, Alphabeta
14-18 Finsbury Square
London EC2A 1BR
+44 (0)20 3810 8000

seic.com/uk

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