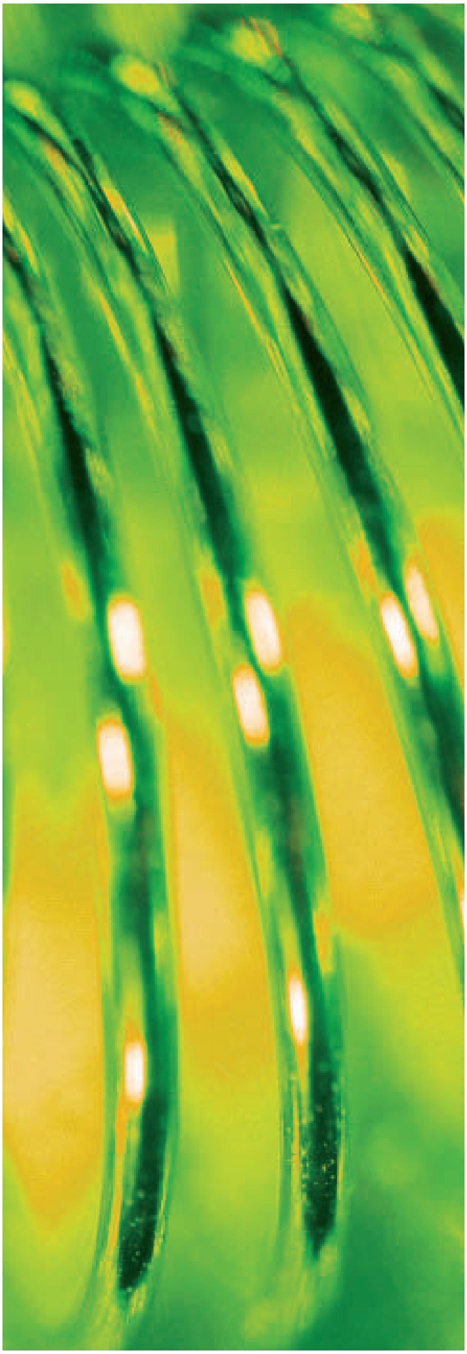

Bundled out the window

Australia is squaring up to commercial realities that may result in the end of bundled brokerage services.

Rachel Alembakis

Fund managers and asset owners continue to use bundled brokerage arrangements in Australia. However, as superannuation funds look harder at costs such as taxation and brokerage, this is leading some in the industry to believe that bundled services are coming to an end.

While a few superannuation funds and fund managers have unbundled trading and clearance from services such as research, access to IPOs and meetings with corporate boards, bundled services still dominate in Australia. Those relationships have persisted because of the size of the Australian market, the size of institutional investors such as superannuation funds, which manage A$1.3 trillion on behalf of beneficial members, and a reliance on historical relationships.

"There's a sense of if it isn't broken, don't fix it," says Seamus O'Concheanainn, managing director of niche management consultancy to the investment industry, Foxrock Consulting.

Phillip Weinberg, CEO at BestEx, a broker-neutral outsourced trading provider for equity fund managers, also notes that the persistence of bundled brokerage relationships can be partially attributed to a reliance on how business has previously been done.

Old school

"Firstly, some fund managers don't appreciate the way in which markets have changed, and that they are still used to old-school

Unbundling in Australia

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Seamus O'Concheanainn, managing director, Foxrock Consulting

methods where you placed your unfettered trust in a broker and that was it," says Weinberg. "Secondly, where unbundling comes in, they are held to ransom by brokers because of the need and perception that the only way they can obtain broker research is executing through that broker, and therefore they are prepared to accept sub-standard execution to get high quality research."

The relatively small size of the domestic listed market in Australia has also led to the persistence of existing relationships.

"When you put brokerage out to tender, you identify who you use and if the market knows who you use, they can reverse engineer to figure out when you're trading," notes O'Concheanainn. "The other thing is that if you're trading in small cap stocks, there are only a small number of brokers who have liquidity in those stocks."

What drives fund managers and asset owners to tender for brokerage services often centres around compliance and costs.

"The reason people tender for brokerage is a focus on transparency and cost effectiveness," says O'Concheanainn. "The compliance guys, the risk guys, are looking at the costs everywhere in a business and will look at the middle and front office. The investment manager has a focus on portfolio construction and stakeholder returns that are not always met by cost-focused initiatives."

This view of cost control and compliance around transparency and reporting is being thrust further front-of-mind as a result of domestic reforms through the previous government's 'Stronger Super' legislative package. Superannuation funds are now required to report to beneficial members on return net of fees and taxation and there are new regulations around risk management and reporting, all of which has put control and process further up the industry agenda.

"We have seen in the last two years a number of funds looking at the execution costs both in equity execution and foreign exchange," says Bryan Gray, head of sales and client management, J.P. Morgan Investor Services, Australia and New Zealand. "Super funds have traditionally handed over responsibility to the fund manager and said that they will measure the fund manager based on how good a job they do. As long as they get the return, that's fine."

He believes that this has changed and that the Super funds are saying, when they add up all the brokerage and the foreign exchange the broker executes on their behalf, there's a lot of cost, and they think that they could get a better deal by taking responsibility for that execution. They want the fund manager to continue bringing his intellect and strategies, but let them do the execution.

He pointed to J.P. Morgan's custodial arm, which has worked with superannuation fund clients that have directed foreign exchange trades through them rather than through a broker. He has also spotted that there is a rise in the broker panel approach by superannuation funds, which acts to reduce some of the broking fees.

Reducing fees

One superannuation fund that has taken that approach is Qantas Super, the corporate pension fund for employees at Qantas Airways. Qantas works with Parametric and has hired them as a tax-managed, centralised portfolio management manager (CPM Manager) whereby fund managers develop the investment strategy and inform the CPM Manager when they need to trade, and the CPM Manager implements the trades.

"We are sending quite large volumes of trades at execution-only rates to our panel of brokers," says Chris Briant CEO, Australasia at Parametric. "We still get to develop a good, close relationship with brokers for IPOs and placements, the things that funds value. What you're trading off is that we're bringing higher volumes at lower margins than what managers would have sent to the brokers directly."

Qantas Super explained their approach in a presentation at the 2014 Conference of Major Superannuation Funds. According to a panel presentation by Qantas Super CIO Andrew Spence, Qantas Super began transitioning to a CPM model in 2010 and has moved to a single trade execution model in listed equities and foreign exchange. According to the presentation,

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from inception to 31 December 2013, Qantas Super has saved a net of AU$2.8 million in foreign exchange trades and seen a net increase in after-tax return of AU$30.5 million per year for all listed equities, which Qantas Super calculates as net benefits to members of 54.4 basis points at the growth option level.

As superannuation funds explore the ways in which they could reduce brokerage fees, there is still difficulty in finding a workable model to disaggregate research services from brokerage commission, O'Concheanainn says, which makes it harder to persuade fund managers to seek out unbundled services. Additionally, the investment style of the fund manager can impact the extent to which brokerage costs will impact – buy and hold strategies verses index replicators, for example.

Consumer pays

But Weinberg says fund managers should be paying fixed dollar fees for broker research based on how much they consume, without the amount being linked to how actively they manage their portfolio or how much in assets under management.

"It's not as though a client that wins a new mandate and doubles its assets under management now requires twice as much research," Weinberg says. "The amount you pay for research is should be unrelated to your trading volume. Research remains valuable, though increasingly fund managers are doing more of their own research."

Weinberg also observes that the emergence of on-market book-builds reduces another key selling point of bundled brokerage services – access to IPOs.

The way in which brokers direct trades to lit or dark trading venues is another issue that clients must explore when working with a broker, Weinberg says. In 2013, the Australian Securities and Investments Commission (ASIC), the regulator of market integrity, issued a landmark study into dark trading pools and high-frequency trading (HFT) in Australia.

The ASIC report noted that there are currently over 20 venues and most trade in the largest 200 securities and collectively account for around 7% of total equity market share. Buy-side participants should be aware of where and why their brokers are trading, Weinberg said.

"In Australia, whenever a client gives an order to a broker, it gets routed to the broker's dark pool," Weinberg says. "There are only three reasons why they route to the dark pool instead of the markets – one, to avoid exchange fees,

two, to artificially boost their market share, and three to make money, because several of them operate their own HFT algorithms that are large participants in their dark pools. If none of those reasons involve doing what's best for clients, why should brokers route to their own dark pool? All of this information is disclosed – that's not a secret. It's all publicly disclosed, so why do fund managers allow them to get away with it?"

Weinberg notes that information about who is in broker dark pools is freely available on ASIC's website.

For asset owners, taking a closer hand in brokerage may result in significant cost reductions in a context where low-cost outcomes are preferable. Asset owners are questioning fund managers' relationships and how they justify brokerage costs, Briant of Parametric explains.

"I think what we're hearing from superannuation funds is that they just want transparency with those relationships," he said. "If an execution-only rate is one-third the rate that managers have been paying in the past, is that two-thirds really all for the insights that the manager is receiving from the broker? Funds are saying, we're paying you a lot of money to be an investment manager, and are you getting specific insights from those brokers when they're also providing those insights to the rest of the world?"

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>
> *Phil Weinberg, CEO, BestEx*