McInroy & Wood

PERSONAL INVESTMENT MANAGERS

"Lorenzo, I commit into your hands
The husbandry and manage of my house"

The Merchant of Venice

"Outsourcing" gained currency as a management buzzword in the 1980s. It meant sub-contracting to others work that you were unwilling or unable to do yourself. The word was associated with Mrs Thatcher's laudable efforts to shrink waste in the public sector. Do yourself what you can do best, pay others to do the rest. Stated thus, one could hardly object to the idea, and few did.

Where once a mere buzzword, now a vast industry. Government has grown ever keener to solicit advice, to subcontract its work. The present government is estimated to have spent £10 billion on private consultants in its first seven years. Apparently £150 million has already been spent on consultants for the 2012 Olympics. That's £3 million a medal. Public companies such as Capita and Serco are now intimately involved in the planning and provision of a mass of essential public services. Outsourcing is big business.

In the private sector, financial firms have been no less keen than government to outsource their requirements, whether of administration and processing, or of functions once regarded as inseparable from the core service. We are not just talking Bangalore call centres here. Our biggest banks subcontracted risk assessment of billions of pounds of their core assets to outside credit agencies. Little surprise then that the trend has spread into our own field, and many investment firms serving private investors have followed it eagerly.

Some big financial institutions turned long ago, for understandable reasons, away from employing their own investment staff towards third-party management companies. Their "outsourcing" laid the foundations of the investment management business as we know it today. Naturally enough, alongside these services designed for institutional customers, the independent management companies wanted also to attract individual savers. To do so they developed a huge range of packaged investment "products", mostly unit trust funds, for sale to small private investors. Today you can buy from a range of 2,200 such funds in the UK.

Properly used, packaged financial products are a brilliant resource for private savers whether they access them directly or through a well informed financial adviser. But where an individual investor gives total control over his investments to a discretionary manager, the merits and limitations of packaged products need to be clearly understood.

Access to a virtually unlimited range of external investment products and services has made it possible for personal investment managers, like financial institutions, to subcontract large parts of their traditional investment function and many now do so. A global portfolio consisting solely of other managers' products and services can be constructed to reflect almost any investment preference. Instead of themselves managing investments directly, the "outsourcers", as one can describe them, have become simply managers of managers.

The rationale for subcontracting relies on the truism that one investment manager "can't be good at everything". One might as well claim that Henry Ford didn't know everything about making cars. Maybe not, but history suggests that he knew what mattered. He had what it took. The issue here is about what it takes to be an investment manager. Is it definable? Is there an essential core expertise at all? Or can you subcontract everything?

If the latter, one might hope to assemble the most acclaimed specialists, the finest economists, the best of all breeds and get an investment thoroughbred that really "performs". Lurking in the background, however, is the ghost of LTCM, a notorious American high-octane fund. Hiring a couple of Nobel–laureate advisers didn't prevent it from foundering. Intellectual horsepower alone won't rescue a flawed construct.

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Another strand in the argument contends that delegating investment responsibility to third party "managers" spreads management risk. Indeed it probably does, but only to the extent that the responsibility of any one hired hand is limited. If one of them messes up, a client avoids financial catastrophe. On the other hand, the wider the dispersal of responsibility, the bigger the exposure to adverse swings in market sentiment – since a broad range of fund managers is likely as a group to be affected by market fashion. And, the wider the spread, the higher the probability of at least one turning out to be an outright dud.

Inevitably, spreading responsibility around by outsourcing different bits of a customer's requirements compromises day-to-day control. An outsourcing manager can hardly be said to be controlling the individual investments made by independent subcontractors. Loss of control tends to blur the line of accountability for what has happened.

Investment outsourcing also raises the costs to customers. The specialist secondary managers charge, so does the primary manager. In some cases the extra charge may be worth paying but the outsourcing process itself guarantees nothing. The outcome is uncertain, the extra charges are not.

One could extend the theory behind picking the best of investment breeds to absurdity. There are a host of managers of managers today; if two tiers add value, why not three? What about managers of managers of managers tomorrow as the logic might suggest? Parts of the hedge fund industry already involve several tiers of management (and cost), each purporting to filter the expertise of the next manager below. Little from recent experience in that field, however, suggests that piling expense upon expense consistently buys extra value.

Maybe the complexities of today's investment marketplace, the widened range of choice available, justify employing a super conductor to guide one through the product maze. In truth the basic forces underlying market movements are simple and no more or less complex than they have ever been. As for choice, the range of investment opportunity has always been virtually limitless. All that has changed is that the investment arena has been compartmentalised and packaged up into discrete parcels ("financial products") in order to stock the shelves of financial supermarkets. For customers, what matters is not the package but the contents.

Look at the outsourcing precedents in a wider field where the antics of central government provide rich pickings for the sceptic. Every day brings news of a fresh embarrassment occasioned by the failure of a private contractor to meet a public obligation. The tally would supply material for a season of Ealing comedies. Lost tax files, botched IT projects, prisoners' personal details released, billions of pounds tipped down the sub-contractors' sink. Barely a minister has resigned.

With that example, no wonder that after the biggest losses in British banking history, and prior protestations that packaged bank investments had dispersed all the risks, every executive remains in post. The risks were never dispersed but accountability, it seems, was cast to the winds.

Politicians can no more know about every factor relevant to a decision than a banker or an investment manager. Each will sometimes need to solicit expert opinion, technical advice, specialist input. But at every stage the proper boundaries of responsibility need to be understood and protected. The government could subcontract defence of the realm to mercenaries. It doesn't because British people insist that this national interest must be fully shared by those charged with securing it. It may be possible, sometimes even desirable, for investment managers to outsource fundamental parts of their work. That can remain acceptable to customers only so long as the interests of the subcontractors and managers are precisely aligned with their own.

Failing that, the results of outsourcing may prove as costly for private investors as they have for millions of taxpayers. Heaven forbid.

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