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Boutique asset managers offer competitive advantages

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The rally that began in March 2009 has reinvigorated investors' appetite for investing, but few financial advisers expect that navigating the recovery will be easy. They will need to identify money management firms that have the qualities required to produce strong performance for clients — in any market circumstances. Also, financial professionals will need to conduct careful due diligence to avoid the more hidden pitfalls that were brought to light during the crisis, including exposure to companies that used excessive leverage, and to unscrupulous operators.

For many, this has focused the search on so-called boutique management firms. Among other benefits, a boutique may offer a performance advantage over larger asset management firms; align the interests of money managers and investors; have differentiated and disciplined investment processes; and make investment decisions based on independent, original research.

Asset management has always been a boutique business. Sometimes boutiques are housed within large firms; more often, they are small, independent operators.

Boutique investment firms are attractive because their managers, who often have left larger, more- traditional work environments, tend to have great passion for markets and investing. Moreover, they have conviction in the investment processes that they have developed and a fervent commitment to disciplined execution of those processes.

These qualities have the potential to produce attractive investment results for investors whose risk profiles match a firm's offerings.

Past studies of the performance of financial firms have found that larger asset management companies benefit from economies of scale in distribution, compliance and technology. However, the cost advantages that they gain often don't translate into performance advantages for investors.

In fact, research studies published in 1995 and in 2007, showed remarkably similar results: About 70% of managers in the top performance quartile had less than $20 billion in assets. The 2007 study showed that 60% of managers in the top performance quartile had less than $10 billion in assets under management.

Although selecting a boutique asset management firm doesn't guarantee better performance, research indicates that these firms offer the potential for superior performance.

One reason for the performance advantage of boutique firms may be related to their structure. Typically, boutiques are owned by their principals, who often are responsible for asset management.

Consequently, these managers have a vested interest in the success of the firms' offerings. In fact, many have a significant portion of their personal assets invested in the portfolios they manage.

Although it may seem like common sense for managers to have assets invested in the portfolios that they run, it isn't always the case. Morningstar Inc. found that in 2008, 46% of U.S.-stock-fund managers, 59% of international-stock-fund managers, 65% of taxable-bond-fund managers, 70% of balanced-fund managers, and 78% of municipal-bond-fund managers didn't invest in the portfolios that they managed.

The failure of a high percentage of managers to invest in their own portfolios would seem to indicate a general lack of conviction in their investment processes.

There are many reasons that investment processes may be less crisp and decisive at larger firms. Managers at larger firms may have greater liquidity issues if their funds are sizable. They may be forced to navigate bureaucratic work environments that don't support crisp decision making. They may be more complacent if they don't have a vested interest in performance, and be less able to respond nimbly to changing market environments.

Boutique management firms, on the other hand, are built on the passionate belief that they can deliver solid and consistent risk-adjusted performance over time by employing well-defined and repeatable investment processes.

High-net-worth investors' appetite for return on investment has returned, and now rivals, their desire for return of investment. However, selecting investment opportunities in this challenging financial environment will require careful research.

Although many analysts agree that the recession has ended and recovery is under way, the future of some industries and many companies remains unclear. Consequently, quality research will play a vital role in performance this year.

Firms that differentiate themselves through the originality of their perspective, the depth of their insight and their ability to uncover unrecognized industry trends have the potential to provide investors with attractive returns. The underpinning of investment decision making at boutique firms is high-quality, independent, fundamental research.

The best boutique investment portfolios reflect their managers' appreciation of financial markets and their passion for investing through a disciplined process that is grounded in quality research. These portfolios align the manager's interests with those of their investors so that performance success provides rewards to all.

As the industry's and investors' perceptions change, assets under management may become a less important measure of a firm's investment success. If it is replaced by the quality of a firm's investment offerings and the significance of those offerings in asset allocation strategies, then boutique management firms will lead the way.

As you search for investment managers who have the potential to deliver strong results, be sure to consider boutiques.

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