



Wealth Management Services White Paper

High Net Worth Needs Open Architected Overlay Management in the Separate Account World

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About This Document

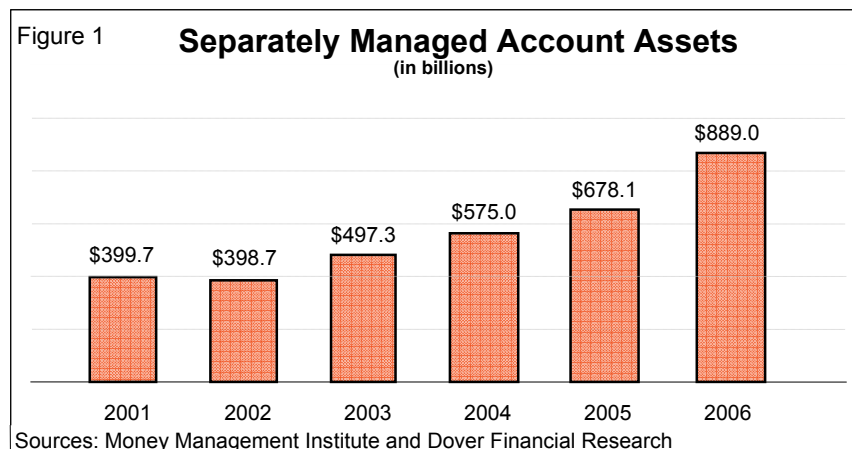
This document provides an overview of the separate account and the recent buzz about Overlay Management. This paper provides an in-depth view of the choices advisors have to add value and serve their clients.

For additional information on Overlay Management, please call (212) 799-5890

Separate Managed Accounts (SMAs) are the hot game in the money management industry. According to the Money Management Institute and Dover Financial Research, separately managed account assets have more than doubled since 2003, much of this can be attributed to the 31% growth rate experienced in 2006.

As the product type races toward the trillion dollar mark, and is adopted beyond Wall Street by banks and insurance companies, there is clearly more than marketing sizzle driving this growth. Cerulli Associates states that demographic trends, technology, changing intermediary landscape, and increasing demand for financial products and services, especially among the affluent and high-net-worth (HNW) customers are the key factors for this growth.

However, for separately managed accounts to deliver on their promise, the industry must continue to evolve from its current state and leverage technology advances that will ultimately deliver more personalized portfolios and better net returns to investors. (Refer to Figure 1)



1 Defining the Market

As defined by the Dictionary of Investment Financial Terms, Separately Managed Accounts (SMAs) are investment accounts that represent investment consulting relationships. In this arrangement, a client's funds are placed with various institutional-caliber Separate Account Managers (SAMs), who each manage a subset or "sleeve" of the portfolio. A key advantage to SMAs is the access they provide to top money managers previously inaccessible due to large minimums. In addition, all fees are wrapped into a comprehensive price.

Institutional portfolios have been managed utilizing separate account managers since the 1970s. As the product works its way from its institutional beginnings towards private wealth management, there needs to be significant changes in the way it is delivered (i.e., adapting institutional methods to meet the needs and demands of individual investors.) Technology continues to be one of the largest influences on the evolution of the industry and will force future product design towards efficient delivery of the best net return to the end client.

Today, Separate Account Platforms provide advisors with the opportunity to pick from the best managers available (Open Architecture) and deliver client ownership of the underlying securities. In theory, this approach should allow the advisor to manage to client-specific mandates and control many tax attributes. Even with the limitations that exist within this structure, which we will discuss below, value-added benefits can be delivered and are visible to the client, which results in a stronger bond between the advisor and the client. Extensive client profiling and strong tax management allow the advisor to clearly demonstrate the value of the fee they are receiving.

To date, the promise of Open Architecture and Separate Account Management has only been half realized. According to Financial Research Corporation, only a small portion of all SAM accounts have exercised their right to place restrictions on the management of their portfolios. The advisor can choose the best managers but, when it comes time to modify portfolios to reflect client constraints, mandates, and manage taxes, the “Separate Account Management with Open Architecture” promise can be difficult to fulfill. The “why” of this difficulty is worth exploring, as it will lay the foundation for the actions needed to remedy the current problems within Separate Account Management.

The two largest problems can be broadly classified as pre-trade compliance and taxes.

2 What is Pre-Trade Compliance?

Pre-trade compliance is the ability to implement client-specific restrictions. These restrictions consist of a broad array of constraints that create limits on what can be done with the client’s overall portfolio irrespective of the money manager’s target portfolio. Examples of these constraints include:

- mere whims of a client arising from nostalgia or other non economic factors;
- beliefs based on moral, religious, or ethical grounds;
- strong views on countries, markets, sectors, or securities; and/or
- legal restrictions on purchase, ownership, or disposition.

Pre-trade compliance also helps the client control the actions of the managers when there are outside assets, income, or other interests that form a risk position that should not be duplicated in the smaller sleeves of the portfolio, such as company stock, stock options, rental income, etc.

The true essence of pre-trade compliance should center itself around the creation of a mean variant optimal “portfolio” for that client (optimize the client’s specific constraints) and not a mean variant optimal “product” (optimize a set of generic constraints). The industry has struggled with recognizing this shortcoming given the limited resources with which to resolve the problem in portfolios that were less than institutional in size.

3 What Can Be Done About Pre-Trade Compliance in a Traditional Separate Account Manager Frame Work?

The industry would like to let us believe a lot can be done. In theory, we can tell each manager in our multi-manager portfolio to not buy or sell any security, to underweight certain sectors or market capitalizations, to not buy any security that has exposure to certain sin or social elements. The reality is that once we get beyond the simple “do not buy” or “sell” by ticker, manager acceptance of further restrictions is generally limited.

4 Why Do the Separate Account Managers Limit the Nature and Extent of Restrictions?

There are two very practical reasons that cause the interest of the Separate Account Manager and the client to diverge. First, numerous restrictions create compliance risk (i.e., the risk that the manager will violate a constraint). Ensuring all constraints are met requires sophisticated technology or enormous manual effort to adhere to the restrictions. Since most managers do not want the added manual effort, technology is needed to manage the portfolios. As of yet, most managers have not deployed the sophisticated technologies required to keep track of all these restrictions and order up the proper alternatives for the portfolio.

In the end, it is not in the manager’s best interest to accept accounts with restrictions unless they can deploy the technology that would allow them to efficiently provide greater customization and tighter fit to the client’s needs.

Second, numerous restrictions lead to problems with manager composites. Managers need to track the performance of their accounts in a composite that becomes the basis for their published track record. Consultants that evaluate managers will monitor not only this track record, but also more importantly the dispersion in the manager’s track record. The more the characteristics of a portfolio, such as sector weights or asset weights, differ from the stated benchmark, the more the portfolio’s performance will deviate from the benchmark. This deviation is then interpreted as the manager taking on greater risk or inconsistent application of their strategy when, in fact, it could be due to constraints imposed by a client. Managers with wider dispersion (the appearance of increased risk) may not win the same amount of assets as a more consistent manager. Consider for example two large cap core managers. Each manages 40 accounts.

<u>Manager</u>	<u>Composite Return</u>	<u>Total Assets</u>	<u>Highest</u>	<u>Lowest</u>	<u>Standard Deviation</u>
A	9.63%	\$233 Million	11.7%	7.30%	1.43%
B	9.53%	\$213 Million	9.99%	9.04%	0.30%

While Manager A has a higher composite return, the spread of returns between accounts is over four times that of Manager B. If a choice has to be made between the two managers, Manager B would be the obvious choice since the consultant would not want to run the risk that their client will be on the lower end of the range of returns.

Therefore, even if managers subscribed to the technology allowing them to implement client level customization, it is still not in the manager's best interest to accept customized accounts as long as consultants select managers on the basis of performance across accounts independent of any account level constraints.

5 Why Are Taxes a Problem?

Taxes are and have been a large thief on the net returns to a client. This problem is one of the most researched topics in Separate Account Management literature. It is widely held throughout the literature that taxes can certainly be minimized and returns enhanced with tax management. The more tax attributes a portfolio has, the more effective tax management becomes, in theory. Recall, the early Separate Account Management model, as designed for institutions. Many institutions are tax-exempt and therefore eliminate one of the largest constraints for Separate Account Managers. For the taxable investor, taxes act as a series of constraints that create the same problems as the pre-trade compliance problems outlined earlier, since security tax attributes are also client-specific issues. Depending on when the security was purchased or contributed to the portfolio, each client will face a unique event when trading occurs. At the extreme, a manager may be selling a highly-appreciated security, due to overvaluation, one day before a particular client's holding moves from a short-term to a long-term capital gain. The impact is a 25% tax penalty on that particular client.

Historically, turnover was criticized as the tax enemy. Loss harvesting, another important element to tax management, is less talked about but can be thought of as "good" turnover. In recent years, the literature has been making attempts to measure and quantify the impact of loss harvesting. The impact on taxes from loss harvesting goes beyond just the potential tax reduction in a given year from losses harvested in that year. Consider the tax loss carried forward. This aspect of loss harvesting can be considered an asset since a benefit can result. However, it cannot be assigned a value so it is not marketable and therefore difficult to measure. (Source: Torre & Rudd, 2004) Parametric Portfolio Associates has examined the loss harvesting issue quite extensively. They constructed a Monte Carlo Simulation, simulating different market environments and loss harvesting levels. The study attempted to demonstrate the excess return over the benchmark that could be added from loss harvesting. Their results showed excess returns of 0.6% and higher over a ten-year period. They also examined the analysis over a longer period of time and found the value to decline. However, it still was in excess of 0.3% over a 30-year time frame.

Separate Account Managers can take these issues into consideration, but will they? Or even should they? The Separate Account Manager must again either invest in sophisticated technology and/or engage in manual intervention. When they engage in these one-off activities, as previously discussed, Separate Account Managers increase the dispersion of returns in their client portfolios. Unless the industry hires and fires their managers based on pre-tax returns, we will not likely see managers addressing the tax issue appropriately.

6 More Complexity

Pre-trade compliance and taxes create a level of complexity that most managers do not want to address. If they did, would this be the end of the problem? While solving the pre-trade compliance and tax concerns would be helpful, there are other issues created by the current “sleeve” approach to Separate Account Management. These issues are inherent in the word “separate.” Each sleeve of the customer’s portfolio is managed independent of the others. Examples of these issues include:

- corporate actions
- index realignment
- wash sales
- redundant positions
- tracking error management

7 Corporate Actions and Tracking Error Management

Each day, there are numerous changes that can occur in a securities capital structure. Companies spin off subsidiaries, sell and buy other companies, recapitalize, and engage in numerous other activities. These actions can have an immediate impact on a manager’s decision to hold securities that are independent of the securities’ potential. The new security, or securities, may no longer be included in the current manager’s benchmark. This manager may decide to sell the securities to prevent tracking error problems. However, this newly-recapitalized security still may fit nicely in the “sleeve” of the client portfolio that another manager is managing. Unfortunately, one manager sold it, and another bought it back. All of this created, at the very least, transaction costs; or worse, taxes.

8 Index Realignment

The nature of multi-manager portfolios has been to reward managers that deliver exceptional performance relative to their benchmark. The reconstitution of the index that represents the benchmark leads to turnover as the manager trims holdings that are no longer representative of the index. Here again, the stock that is trimmed may have been a perfectly acceptable holding in the client’s total portfolio. Another manager that is actively managing to outperform the new index may add the security or add to an existing position. The result is multiple managers creating turnover that is irrelevant to the client’s profile.

9 Wash Sales and Redundant Positions

In reality, there must be some oversight of each sleeve’s manager to prevent wash sales. A sale that realizes a loss by any manager would require a restriction on the purchase of the same security in another portfolio. Likewise, transactions on redundant positions (the same security held in more than one sleeve of the portfolio) require restrictions on this security across the other sleeves. The consequences can be costly through the potential forfeit of a realized loss and tax reduction, the unnecessary transaction expense, and the

possible embarrassment in explaining the transactions to a client. Redundant positions can also cause an unintentional overweight in a security, which can be costly in total portfolio performance. At the very least, redundant positions can increase the overall volatility or risk of the client's total portfolio.

Arguably, every thing we have addressed to this point is minor in the traditional non-taxable world of pension and endowment management. Thus, the delivery of institutional quality managers to the High Net Worth individual has been a quantum leap over a single manager or a portfolio of mutual funds. The single manager suffers from the lack of expertise needed to properly fulfill the specific needs of the High Net Worth client. Mutual funds create more pre-trade compliance and tax problems than the Separate Account Manager solution. These platforms have brought us to a point where we can use what we have learned to evolve to a better solution for High Net Worth clients, Overlay Management.

10 The Role for the Overlay Manager

Active managers add alpha (i.e., value) through their investment models, which are *independent* of client constraints and apply to all the accounts managed. The Overlay Manager becomes the client-specific specialist. Each client has a risk tolerance, different cost basis for each security, gains and losses from outside assets, unmanaged securities such as company stock or stock options, and other factors that make each client unique in how the portfolio should be managed. This person or entity is given charge to view the client's situation from a holistic perspective. The Overlay Manager gives the client restrictions, mandates, and tax considerations probative value in making trading decisions. An Overlay Manager customizes the manager models to fit each client's specific constraints across all the sleeves of the portfolio.

In other research from Parametric Portfolio Associates, a simulation was completed comparing the approach of separate account management with and without an Overlay Manager. The simulation assumed a 10-year horizon and found that 0.3% to 0.6% and more excess return can be added with an Overlay Manager. These results represent only the value added through tax management. Additional value, which is more difficult to measure, comes from reduced transaction costs as transactions deemed unnecessary that would have occurred due to corporate action, index realignment, tracking error management, and elimination of redundant positions. An additional unquantifiable benefit is the intrinsic value the customer places on the advisor as a trusted advisor looking out for his/her best interests.

11 The Sleeveless Overlay Manager

Can overlay management be offered in a manner that effectively solves all the issues discussed previously? Taken to the extreme, a portfolio can become "sleeveless" and solve all of the conflicts of sleeve-based management. The current sleeve-based approach exists as a compromise between two extremes, a sleeveless approach at one end and a mutual fund wrap approach at the other. The sleeved approach is shown in figure 2 and the proposed sleeveless approach is demonstrated in figure 3. Although the figures suggest that

“sleeveless is a more simplified approach, a “sleeveless” approach also raises the most questions around implementation.

Sleeveless refers to the single portfolio within which multiple manager models are implemented. It is a single account from which all trades emanate and settle. The Sleeveless Overlay Manager can be considered a “full service” Overlay Manager providing Unified Overlay Management. To achieve a “full service” level, we must strip the trading function from the manager, and place it in the hands of the Overlay Manager. Additional functions performed by the Overlay Manager would include tax-lot management, coordinating account re-balancing and risk management.

The Sleeveless Overlay Manager can step away from the managers’ models and implement only those transactions best suited to the individual client’s constraints, risk profile, and tax information. To fully take advantage of all the potential excess return, there needs to be a method to pass the managers’ model and changes to that model to the Overlay Manager on a timely basis.

If we accept the above statements as true, we need to contrast the benefit received with what we may be potentially losing in eliminating the sleeve-based approach. The above requirements for a sleeveless approach will, and should, raise some questions in the minds of advisor’s and clients, such as:

1. Will high quality managers sell their model portfolios?
2. Can the Overlay Manager trade with the same skill as the Separate Account Manager?

Will high quality managers sell their model portfolios?

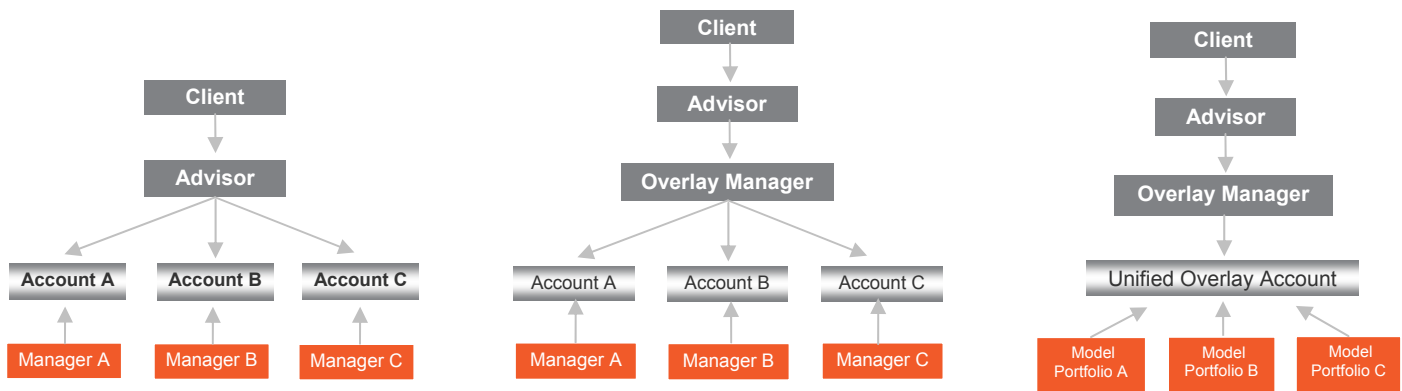
Playing devil’s advocate, an argument might be made that the best managers will not sell their model portfolios if they can fill their volumes through traditional means. We would agree that this is a possibility, though not necessarily true. There are two points to consider. Even if the best managers will not sell their models, can we still pick up a better net after tax and expense return by picking from those managers that will? The academic studies done on the value of tax management and the effect on after-tax returns, are manager non-specific. These studies clearly demonstrate that value can be added regardless of the manager. Remember manager performance ranks much differently on an after-tax basis. Second, many managers enjoy the alpha selection process and there are many that do not want to go through the process of linking to the appropriate systems that allow for them to communicate with the clearing broker and the custodian. The model portfolio process opens up a whole new and more efficient means of paying for their alpha generating processes and supporting their revenue needs.

Can the Overlay Manager trade with the same skill as the Separate Account Manager?

Trading skill varies from manager to manager and by style and capitalization. In most cases, trading skill is measured by the ability of the trader to purchase a recommended security at the then market price. Assuming, the manager is controlling the volume of trading, by both sleeve and sleeveless styles, there should not be a difference in market impact. Arguably, we may find that having multiple overlay managers helps remove the information component of a large trade by having those trades originate from multiple points of origination.

12 Conclusion

In the end, the advisor must decide if they can put more dollars in their client's pockets. The best manager with the best traders may not overcome the tax and compliance issues that are germane to that individual high net worth client. Consider the solution in three steps, each step solving a problem or set of problems. The first step towards putting more dollars in client's pockets is utilizing a sleeve based separate account management approach. An open architecture for manager selection provides additional alpha to the client through access to skilled managers. The second step is a sleeve based separate account management with overlay. This step adds value through solving many of the problems discussed by providing an Overlay Manager focusing on the specific needs of the client; however, limitations still exist on the restrictions Separate Account Managers will accept. The final step to solving all the issues discussed is a sleeveless approach with Overlay Management.



Regardless of which step is taken, the taxable investor and their advisors now have a choice and value can be added. In the end, this new evolution in the world of open architecture will only help us expand what we can provide and how well we can serve our clients.

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