MA Monitor: A Focus on Managed Accounts

This edition: A recap of the FRA's 8th Annual Managed Accounts Tech & Ops Summit in Miami, FL.

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ABOUT EZRA GROUP

Launched by Craig Iskowitz in 2005, Ezra Group is a technology and strategy consulting firm. Our focus is in financial services, with expertise in wealth management, retail brokerage and equity and fixed income trading.

MA Industry Fights Through the Financial Crisis

The Winds of Change

According to panelists at this year's Managed Accounts Technology & Operations Summit in Miami, wealth managers were swept up by the same destructive economic winds that hit the entire financial sector. With continued market turbulence, decisions made by managed-accounts (MA) professionals hold greater weight.

This newsletter contains tips and takeaways from the conference for finding and acting on MA opportunities: How are wirehouses altering product lines and fees, how can independents capitalize, are customers moving their money and, if so, to where?

Let us know if any of this information helps you navigate the crisis, or if you have any suggestions, by emailing us at craig@ezragroup.net.

Opening Remarks

Retirement Income Cycle is Expanding

Brett Ginter from Smart Consulting opened the summit in place of his colleague, David Gardner. Brett highlighted the potential impact on the managed account industry of the aging of the US population and the coming wave of boomer retirements. According to the US Census Bureau, the percentage of those 65 and older is estimated to be over 16% by 2020 (see chart), with other estimates as high as 20%. 4.3 million people will turn 60 every year for the next twenty years. It's also estimated that 5 million IRA rollovers will occur per year from 2009 - 2013. Longevity risk will become the new risk benchmark with the retirement income cycle stretching up to 40 years.

Retirement Income Solutions (RIS) will increase in popularity and be incorporated into UMAs that are multi-product with advisory and insurance, according to Brett.

Investors are focusing more on income preservation than accumulation.

State of the Industry

UMAs & SMAs in the Current Market

The speakers were Frank Campanale, CEO of the Wealth Management division of Advanced Equities Financial Corp. and Mark Brookman, SVP & Director of Program Management for Smith Barney Consulting Group.

What is the impact of the financial meltdown on the MA industry?

Mark stated his position that we [the MA industry] did nothing wrong regarding the crisis, it was "the markets that did us wrong." He also contended that nothing has changed in terms of the market's long-term cyclical nature.

Frank took a different approach in saying that we need to regain investor confidence and those responsible for the crisis should be confronted. In addition, he noted that unfunded pension funds, endowment spending plans and retirees outliving their savings are all crisis results.

The proliferation of CDO products and significant under-weighting of fixed income were both contributing factors in the market meltdown, Mark asserted.

Smith Barney is launching a guaranteed income program based on a UMA. They're also looking to automate the de-accumulation process with customizable depletion strategies that do not have guarantees. These new products will help the firm focus on client goals, needs and spending habits.

Managing client assets versus liabilities rather than managing versus a benchmark was proposed by Ron Ryan, founder of Ryan ALM and a friend of Frank. A specific liability index is required, assets must fully fund liabilities with any gaps closely monitored. All client assets must be included, no matter where they are custodied.

How are fees being impacted?

Mark noted that UMA fees have traditionally been around 3%, but the model has changed. Whereas fees have been bundled and hidden before, there must be greater transparency in the future. At Smith Barney, the average advisory fee is 1% with a 2% maximum. Model-based SMAs charge 25-30 bps. Creating a UMA by blending SMAs with ETFs lowers fees to 20-25 bps since it is blending active with passive. All these factors are driving down prices.

The real value added should be derived from the menu of services provided by the advisor., according to Frank. He theorized that fees could be maintained or even increased if the value of advisory services could be separated from the underlying investment vehicles.

Frank does see continued fee compression continuing in the near future, especially if the market returns only single digits or less.

What changes will there be to asset allocations?

We need to rethink "proper" asset allocation and diversification, Mark advised. Traditional asset allocation theory still works, as does modern portfolio theory.

Serious money is flying out of equities into money markets according to Smith Barney's monthly sales reports. This means that clients are giving away the upside since they will not be invested when the market turns.

Frank argued that tactical asset allocation and active management will be very important. Many clients just "chase the dot" on a scatter chart in the proposal system, and only want to invest in the sectors with the highest recent returns even if they've already run their course.

How many more advisors will leave wirehouses to become independent?

Advanced Equities Financial is made up of 80% employees and 20% W-2 temporary workers. Their average advisor production is in the $300-400K range. Many wirehouse are firing advisors in this same range because they're unprofitable. Maybe they're just better advisors than salespeople? He believes there are great opportunities in this market for independents and many higher producers that are leaving wirehouses.

Mark countered that he doesn't believe that advisors are abandoning wirehouses. Smith Barney's advisor average production is $700K and they have only lost six advisors that they wanted to keep. While it's true that independent advisors can get a 90% payout, their net is less than 60% and they have the headaches of managing their own business. The average advisor takes only 70% of their book with them when they leave, but this has been reduced due to market conditions.

Are customers really moving their money?

Frank tracks ACATs and sees money moving from brokerages into banks and T-bills, even though they have negative yields. "We're close to the bottom," Frank announced, but clients need to be convinced there is a bottom. The market can gain more than 30% if there is a turnaround and clients will miss this opportunity if they're on the sidelines.

Mark sees wirehouse money moving to retail and independent advisors as well as SMA money moving to UMAs.

Current Trends

Maximizing SMA/ UMA Operational Efficiencies

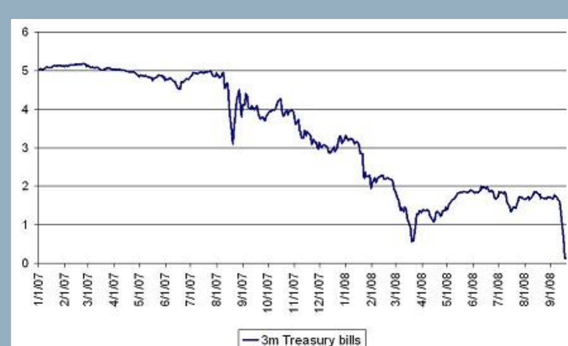
Panelists were Joseph Mrak, President & CEO of FolioDynamix, Gib Veconi, President of Peridrome and Kevin Arthur, Director, Fixed Income Markets, Omgeo.

Joe kicked things off by emphasizing that a singular solution, tax management with good tax logic and platform control all contribute to operational efficiency of SMAs/UMAs. He also noted that

Three-Month Treasury Yields

According to Frank Campanale, recent ACAT tracking data has shown that client money is moving into treasury bills from other products even though treasuries yields are effectively negative.

Last December, the Treasury sold three-month bills at a rate of 0.005 percent, the lowest since 1929. They have since recovered slightly and sold at a rate of 0.31 percent on Feb 9, although this is still significantly below the rate of just twelve months ago when the three-month sold for a whopping 2.2%.



breakaway brokers want a distribution platform that is not home office focused.

Some of the trends in outsourcing are towards models only programs, which increase downward fee pressure. Many IBD's don't understand the SMA market and outsource since they don't want to build from scratch. FolioDynamix does a brisk business in manager contracting, with more than 200 contracts executed.

According to Cerulli, only 30% of SMA accounts have special tax treatment. Tax management can be divided into three broad categories: Unmanaged, Rules-Based and Optimized. Joe believes accounts should be at least $200K for tax management.

Gib Veconi presented the results of a survey done by his company last October of 75 investment managers and sponsors.

Least Scalable in Managed Accounts: Client Request Servicing.

In the next three years, 34% of firms plan to implement message integration, 24% improved workflows and 14% document management.

A key problem inhibiting efficiency is that current messaging is architected around the batch processes of portfolio accounting systems instead of around critical business events. Peridrome's Dash product has a messaging API that can be used to convert batch processing to real-time and create customized workflows that define processing steps for specific request types, investment disciplines, or other criteria.

Kevin Arthur stressed the need for all trades to be locked down. 25-35% of all SMA trades are done away from the sponsor. This can get ugly due to the additional communications requirements between counterparties. A service provider such as Omgeo can streamline these communications since they act as a conduit for investment managers, broker/dealers and custodian banks to deal with each other more effectively.

Kevin doesn't recommend tax optimization for accounts < $1 mil.

Current Trends

Developments in Fee Billing

Panelists were Scott Fitzpatrick, VP Sales for Bonaire and Seth Johnson, CEO & Founder of Redi2.

Billing systems should reduce time to market for new products, Scott stressed. Bonaire's Revport does this by supporting fee calculations that are flexible and rules-based. It also provides STP for fee invoicing, accrual calculations, G/L postings and reversals.

Seth presented a case study from Newton Investment Management, which uses Redi2. 90% of their invoices are now approved via STP. 99% of accruals are created and posted automatically. Invoices that previously took 4-6 weeks to send out are now sent in 2-4 weeks.

The managed accounts industry spends approximately $42 mil annually to perform fee billing. 2009 MA AUM is projected to be $576 bil to $732 bil. Assuming fees of 150 bps, this equals gross revenues from $8.6 bil to $11 bil. Redi2 estimates 1.7% of billing is incorrect (either over or under billed) and that this can be reduced by 100 bps (down to 0.7% or total savings of $86 mil to $110 mil) by use of an automated fee billing system like Redi2.

Model-Only Programs

Concerns, Issues & Implications

Panelists were Kevin Lam, SVP at Macquarie Allegiance, Mark Thomas, EVP at Allianz Global Investors, and Dale Rottschafer, CIO at Metamorphosis Money Management (M3).

M3 specializes in tax transition strategies, according to Dale. Their biggest challenge is manager communication models, which differ between static vs active tax management. Using static tax management will stay closer to target portfolio returns.

Mark related how Allianz has created "Fish Products," which are 40-act funds with traditional model delivery in a hybrid model. They provide access to illiquid assets paired with a traditional agency portfolio.

What is the impact of handing off trading to an unaffiliated third party overlay manager?

When she was a due diligence analyst at Envestnet Asset Management, Dale recalled, they would review the composite performance of the overlay manager versus the underlying managers. Also, static models were avoided since they may cause unnecessary rebalancing.

Kevin said that transparency is required from the overlay manager.

Mark brought up that there are numerous contractual issues with hybrid overlay including trading responsibility. He also mentioned that it's important to maintain a balance between the needs of your traders, who want feedback on performance, against your lawyers, who want to maintain the strict advice-only model.

Portfolio managers often do not like giving up control or capacity required when participating in a models-only program, according to Mark. They also don't like losing the 10 bps or so required to be in a managed account.

Do you require sleeve-level performance measurement?

It depends on whether or not the client is seeing sleeve-level or overall account performance, Mark replied. Some sponsors don't show the managers the client's returns, only the performance for our sleeves.

If the end client sees our performance, then we would want to as well, Mark stated. It's critical to know how our services are being marketed. Are they selling our performance or just our advice? We want to ensure the client receives exactly what they were sold.

Kevin informed us that Macquarie Allegiance only measures performance at the composite level, so this is not an issue for them.

Dale warned that sleeve performance in SMA's does a disservice to clients since it can cause them to lose

TAX OPTIMIZATION:

DOES ACCOUNT SIZE MATTER?

There was a wide range of opinions among the speakers and panelists regarding the minimum account size required for tax optimization to be effective. Here's the rundown:

- $1,000,000* -- Dale Rottschafer, Metamorphosis Money Management (M3)
- $200,000 -- Joe Mrak, FolioDynamix
- No minimum -- John Bearce, Natixis

*$1 mil is also M3's account minimum.

sight of their goals by focusing individual manager results.

Mark advised that a contract addendum requiring quarterly performance reviews are helpful to increase the level of transparency.

A level of volatility is to be expected when reviewing quarter-to-quarter performance, Kevin cautioned. Although, he also noted, quarterly performance discrepancies usually work themselves out by end of year.

When an overlay manager is involved, who "owns" the performance?

In this scenario, Allianz only provides advice, replied Mark. The overlay manager owns the performance.

M3 acts as a discretionary overlay manager, Dale noted. They track model performance and compare against the composite, but do not compare client performance against a model. "We don't introduce tracking error, we reduce it," she stressed. All performance is presented as provided by M3.

Dale also noted that her firm's minimum account value is $1 mil. They provide highly customizable, highly tax efficient SMAs, which differs from the average SMA manager that has a standard tax model for all their clients.

Performance Measurement

GIPS 2010 Exposure Draft Open for Public Comment

The speaker was Karyn Vincent, Founder. Vincent Performance Services.

The GIPS Executive Committee is seeking comments on proposed changes to the investment industry performance standards, which include:

1. Compliance Statement – As part of the compliance statement, investment firms will be required to disclose whether their firm has been verified.

2. Fair Value – Firms are required to report portfolio performance based on fair value accounting.

3. Risk Disclosures – Firms will be required to disclose sufficient information to allow a prospective client to understand the relevant risks of the composite strategy.

4. Verification – The scope and purpose of verification has been clarified.

5. Non-fee-paying Portfolios – Investment firms will be required to include all discretionary non-fee paying portfolios in at least one composite.

6. Standard Deviation – Investment firms will be required to disclose the three-year annualized ex-post standard deviation of the composite & benchmark.

7. Proprietary Assets – Firms must disclose the percentage of composites composed of proprietary assets (e.g., "seed" capital or "house" money).

8. Real Estate External Valuation – Beginning January 1, 2012, real estate investments must be valued by an independent external valuer or appraiser at least once every 12 months.

Product & Service Innovations

Insurance, Tax Alpha & ETFs

The speakers for this session were Hutch Schafer, AVP, Smart Consulting LLC for DTCC, Jack Sharry, EVP, LifeYield LLC and Gary Gastineau, Managing Director, Managed ETFs.

Hutch Schafer, Smart Consulting

Hutch started off by explaining the process behind Lifetime Income Guarantees, which is an insurance product that provides a guaranteed income stream using the future benefit base of a managed account. The advantages of this product are that the client's assets remain in the MA and the annual benefit can increase as the account value rises, but never decrease.

Jack Sharry , LifeYield

LifeYield is a new company with a focus on the decumulation phase of the client's retirement cycle, according to Jack. He stated that their technology can maximize client's cash flow by selecting the best assets to sell across a client's entire portfolio. Jack also claimed that LifeYield can provide a tax alpha of up to 30%. Although they do not have any data available to verify this, they're currently working with an accounting firm to validate their results.

LifeYield was founded by Mark Hoffman, Paul Samuelson, and Michael Benedek, who previously founded Upstream Technologies. Upstream was acquired by Checkfree in 2007.

SunTrust Bank has agreed to make an equity investment in LifeYield and plans to deploy their Retirement Optimized Income (ROI) solution to advisors in May 2009.

Gary Gastineau, Managed ETFs

Gary discussed the advantages of ETFs over actively managed mutual funds. The cost of liquidity flows in mutual funds averages 75 bps, while ETFs have none. While funds have no trading costs, ETFs counter with indefinite deferral of capital gains taxes.

ETF trading volume is concentrated in the top 20 - 50 benchmark index funds, so there is less liquidity for all the rest. Gary contended that new ETFs can't compete with the tight intra-day spreads of the big funds, however some research would suggest otherwise (see "ETF Market Spreads" below).

While ETFs are generally better than their mutual fund counterparts, there are still problems with using ETFs, Gary said. Many investors are used to trading mutual funds at end of day for the net asset value (NAV). ETFs are not priced this way since they're traded on an exchange like a stock, even though their value is set like a fund. Gary has proposed a NAV-based trading method that would instead trade ETFs relative to a proxy value. At the end of day, when the ETF NAV is set, all trades would be translated into a final price relative to the new NAV.

ETF MARKET SPREADS ARE TIGHT ALL OVER

A study in the July 2008 issue of Journal of Indexes, examined the secondary market spreads in U.S. ETFs. It found that, according to NYSE data, over half of all U.S. ETFs had secondary market bid/offer spreads of less than 0.2%, while over 90% had spreads of less than 0.5%. Only 18 of 666 ETFs surveyed had spreads of over 1%.

In-Depth Analysis

Transitioning Trust Accounts to UMAs

Speakers were Michael Cifrese, Product Strategist, Investment Services Division of Checkfree and Andrew Muldoon III, EVP of Private Wealth Management at SunTrust Bank.

Michael Cifrese. Checkfree

Michael highlighted some of the issues with transitioning trust accounts into UMAs such as the different fee structures and use of models in trust accounts. Having a holistic view of a client's holdings is important, Michael noted, but inclusion of non-financial assets can be problematic, especially regarding rebalancing.

He also enumerated some generic UMA issues including coordinating trading across multiple managers, manager communications during model updates and discrepancies between a manager's sleeve versus non-sleeve performance.

Michael stated that in a UMA, each sleeve needs to have their own cash buckets. However, most UMAs do not work this way and instead manage cash at the account level, as Andy Muldoon argued in the next presentation.

Andy Muldoon III, SunTrust

SunTrust has $2.0 bil in UMA Trusts and 98% of all eligible trust assets are in UMAs, Andy announced. (The 2% of non-eligible assets include family businesses and other non-DTC items).

The bank has implemented a bifurcated portfolio management function - half are out dealing with customers and half are investing/trading at their Atlanta, GA office. Due to market conditions, the firm reduced their PM staff by 24% last December and also reduced expenses by 15%.

Andy stated that UMH products can benefit the decumulation phase since decisions are required as to where to generate cash at the tax lot level from across the client's entire portfolio.

The Fee Desk is critical when managing trust accounts since fees must be split based on trust interests. Co-trustees also complicate things when there is shared authority since the co-trustee must approve all trades. Even when the bank has full trading authority, they often perform courtesy calls to co-trustees before trading.

"DECUMULATION" DEFINED

Decumulation is the conversion of pension assets accumulated during an employee's working life into pension income to be spent during retired life. But in practical terms, decumulation embodies a significant new risk for the record number of future retirees moving from the accumulation phase of their lives to the distribution phase. The actuaries call it "longevity risk" while those of us in financial services simply call it "running out of money".
-- RetirementPlanBlog.com

Over 50% of SunTrust clients with $2 mil in assets or more hold annuities. Andy posed the question, "How should [alternate investments] be handled by the overlay portfolio manager (OPM)?"

When a trust is invested in a hedge fund, the OPM will have to deal with numerous restrictions, such as the fund's redemption period and gate (a percentage limit on the amount of withdrawals). For example, if the redemption period is three months, then the OPM must be able to track the sell order until it is finally executed by the fund.

UMAs can reduce costs in many ways, Andy asserted. For example, UMAs will reduce the number of

accounts that need to be processed in performance reporting systems.

At SunTrust, UMAs cash is managed at the account level with all managers expected to be fully invested.

SunTrust wants to focus on top line performance when meeting with clients, but they always show individual sleeve performance as well.

Innovation in UMAs

Positioning Overlay Technology

Panelists were Heather Garland, Director, Prudential Investments, David Small, Executive Director, UBS, Robert Klapprodt, President, Vestmark and John Bearce, SVP, Business Development, Natixis Global Associates. The moderator was Alois Pirker, Senior Analyst, Aite Group.

In your opinion, what is the most pressing issue facing firms implementing UMAs?

Customization. John mentioned that Natixis partners with Bonaire for billing and they facilitate addressing billing issues unique to each client. Also, which ADVs to send out to satisfy compliance is also important.

Dave responded that automation can improve scalability. If a UMA contains no models, only an SMA, Dave questioned how cash should be moved.

Integration with wealth management. Heather stated that there is a trend towards model-based UMAs. Prudential offers numerous models and their advisors can use their own asset allocation or use those provided by Pru.

Adoption. Rob emphasized the need to look at the entire process from end-to-end.

John compared managing exposure to different risk factors versus simple rebalancing. Overlay can differentiate a firm's UMA offering as more than just a statement solution. It can also be customized to the advisor base.

There are three levels of UMA: Passive, Active and Hybrid, said Dave. You can differentiate by providing better service. UBS reported net inflows into their UMAs throughout all of 2008, except for the last two weeks.

Vestmark also observed net inflows to their customer's UMA programs through all of 2008, stated Rob. UMA programs notched a smaller decline versus their corresponding benchmarks. Only single-style SMAs had significant withdrawals and closures.

How do UMAs differ from other accounts in tax management?

John noted some interesting statistics regarding the US economy. The current total national debt stands at just over $10.7 trillion. That works out to $17,000 for each tax payer reporting $75-100K of income and $90,000 for each of those reporting $200K and over.

Across accounts that Natixis manages there is a 50/50 split between taxable and non-taxable. They performed a 20-year backtest (ending five years ago) and determined that the value of tax management is approximately 2%. The value has been much higher recently.

Natixis provides higher-end tax optimization utilizing customized baskets of sector ETFs and all Natixis accounts have some level of tax awareness.

UBS looked into implementing a tax managed account, but their internal research felt that tax harvesting was good enough, Dave countered. He also took issue with Natixis's 2% tax alpha claim.

Rob agreed with John that tax awareness features should be available at all levels. One of Vestmark's clients, LPL Financial, implemented a feature to sell mutual funds before capital gains are distributed in December if the position had a loss for the year.

Vestmark's technology facilitates Versus Purchase (VP) selling instructions by automating the monitoring of individual tax lots.

Natixis worked with SoftPak Financial Systems to extract data from Vestmark for tax optimization. A rules-based system can introduce tracking error , but utilizing a risk model will reduce tracking error.

Outsourcing

What, When and How Much? Managing Growth the Smart Way

The speaker was Peter Quinn, CEO, Riverfront Investment Group.

Riverfront is a new SMA manager in the retail wrap space. Their core management was formerly the market strategy team at Wachovia Securities. They negotiated a lift-out last year.

The firm has $450 mm in AUM 1,300 accounts, trading on 11 platforms. They use strategic and tactical allocations to build portfolios as well as "tactical tilts" reflective of current market conditions.

Peter explained that Riverfront outsources all of their non-core functions:

- Attribution - FactSet
- Middle & Back Office - SEI
- Compliance - ACA
- IT Desktop Support - SyCom

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