

WM Monitor: Focus on Wealth Management

Inside: Excerpts from the FRA's 8th Annual Managed Accounts & Investment Solutions Summit



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ABOUT EZRA GROUP

Launched by Craig Iskowitz in 2005, Ezra Group is a consulting firm providing software development services, business and technology strategy and operational expertise. Our focus is in the financial services industry, adding value in wealth management, asset management, retail brokerage, private banking, equity research and hedge funds.

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Break Away from the Status Quo, Gardner Urges

"Doing more with less" is how R. Buckminster Fuller, in his 1973 book *Earth, Inc.*, proposed that the human race improve its overall standard of living.

In his opening remarks, Keynote Speaker David Gardner warned that the managed account industry needs to do the same. We must do it faster, with less risk and higher operating margins, even with 400,000 people laid off from Wall Street over the past two years.

David, a strategic consultant with DTCC/Smart Consulting LLC, also extolled his colleagues to embrace change. "Keep the status quo," has been our mantra for too long. No other industry has had as long a life cycle as Single Managed Accounts (38 years), he said. The industry has remained largely unchanged even as processing and operational risk has increased, David charged.

We've been fighting amongst ourselves for a sliver of this pie, one that has never exceeded more than \$1 trillion in its entire history. David pointed out that ETF's currently dwarf SMA assets by over \$300 billion. Even our fastest growing segment, UMA models, hardly registers with only \$80 billion in AUM, which is less than the expected growth of ETFs this year alone.

David gave three reasons why managed accounts maintained such anemic growth:

1. Not nearly as scalable or operationally efficient as ETFs, Mutual Funds, etc.
2. Sponsors have built proprietary infrastructures and haven't promoted industry standards or best practices.
3. Operations and processing are largely one-off and rely too heavily on manual intervention.

State of the Union for Managed Accounts & Investment Solutions

The Evolution of Products, Fees, Players, & Platforms

The moderator was Cheryl Nash, Senior VP, Strategic Marketing and Business Development Investment Services, Fiserv.

Next Generation: UMH

The next generation of wealth management products will be centered around Unified Managed Households (UMH), Cheryl argued. A UMH provides financial organizations with wider and deeper relationships with investors, she explained. The goal is a more holistic wealth management approach.

Fiserv's definition of UMH is "a platform for delivery of holistic wealth management advice," according to Cheryl. The platform must be able to inform management of discretionary assets based on a total view of the household versus looking at separate, individual accounts.

www.ezragroup.net

Holistic reporting is a critical component of the UMH platform, she explained.

Cheryl emphasized that advisors must provide custom solutions based on investor needs instead of proprietary products that appeal to mass markets. Understand each investor's goals and strategies and what each needs to retire.

Data aggregation technology needs to include both assets and liabilities to get the full picture of the investor's wallet, Cheryl stressed. It should support discretionary and non-discretionary assets and should include both non-managed assets and liabilities.

Move from solely holistic planning tools to a holistic planning cycle including implementation and monitoring. Review the client's financial plan quarterly to ensure that it's still focused on the client's goals. A lot of Fiserv clients are asking for reporting based on goals and strategies as opposed to benchmarks, she noted.

Cheryl believes that the industry should move away from selling products towards selling solutions. ♦

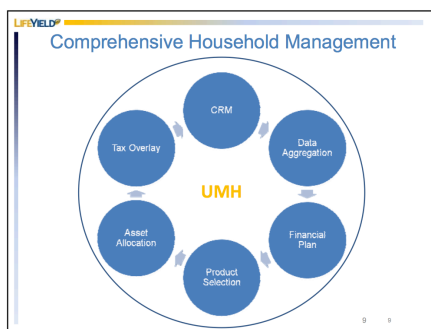
Retail Investing: Finding True Alpha

The speaker for this session was Jack Sharry, Executive VP, LifeYield, LLC.

Jack began his presentation with a quick review of changes in investor sentiments over the past thirty years. We're at a point now where the baby boomers are looking towards an uncertain retirement, he stated. After the market upheavals of the past few years, investors are looking for what Jack refers to as "true alpha" which is comfort, predictability and assurance. Investment alpha is elusive.

Jack agreed with Cheryl's previous comments that we're headed towards the UMH, which enables the advisor to look at the whole picture:

- Data Aggregation – combining household information from multiple custodians, allows advisors to provide more comprehensive advice.
- Financial Plan – how much income do you need? How best to get there?
- Product Selection – most investors have a "jumble of stuff" that they have purchased over time. How do you make sense of it? The tendency is to sell whatever didn't work. Jack expects to see more advances here.
- Asset Allocation – not just at the product or account level, but at the overall HH level.
- Tax overlay – we're seeing great strides here, how do I help my client get more from less with their retirement dollars? ♦



Source: LifeYield LLC

For more information on FRA events go to www.frallc.com

Asset Management: A Record Year for M&A

The speaker for this session was Darlene T. DeRemer, Managing Partner, Grail Partners.

Public money management firms have lost almost \$40 billion in market cap due to the financial crisis, Darlene reported. Financial services has gained \$52 billion in market cap back since then. While margins have gone from the mid 30's to the low 20's, annual earnings are still a robust 25-28%.

2009 was a record year for M&A in asset management with almost \$4.5 trillion in money management firms changing hands. As Darlene noted, "One person's crisis was another person's opportunity". Global banks were distressed and had to sell their money management businesses because they needed to raise cash. This year has been slightly slower in terms of M&A activity, which Darlene said is due to concerns of a double dip recession which is keeping cash on the sidelines. However, she then said, "We're aware of 3 or 4 multi-billion dollar transactions that should come to market within the next six months."

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-- Darlene T. DeRemer,
Managing Partner, Grail Partners

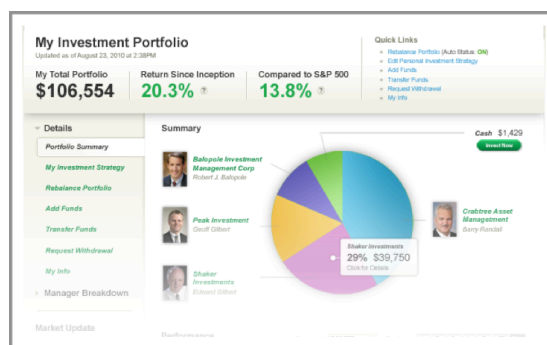
There's been an enormous consolidation of distribution in money management, Darlene observed. BlackRock's purchase of BGI created the world's first \$3 trillion money manager. The top three distributors control over 50% of the market.

If you look at publicly traded money managers, they'll trade between 10 and 12 times earnings. Today they're trading at about 10 and private transactions are at about 9. Money managers want to sell at pre-crash valuations, while buyers want bargains. This disparity between expectations is one of the reasons we're not seeing more M&A activity. ♦

Addressing the Fundamental Loss of Investor Trust

The speaker for this session was Chandresh Iyer, Managing Director and Head of Global Custody & Investment Services, Citigroup.

Chandresh began by stating that Citigroup is looking at social networking as a means of delivering advice, since you're more likely to do something if you see that your peers are doing it as well. A few months ago, Citi spun off a company called Bundle.com, which allows users to compare how people in various demographics are spending their money.



Source: wealthfront

Chandresh also recommended checking out a website called Wealthfront.com (formerly Kaching.com), which provides money manager screening and recommendations and facilitates direct investing by retail customers. Wealthfront provides transparency into your account(s), offers lower manager minimums, detailed manager data and drift alerts.

Could Wealthfront gather enough market share to make it a serious distribution channel? Since its inception one year ago it has attracted more than \$100 million to its investing platform. They have a way to go before they even register on the distribution scale, but it's definitely something to keep your eye on.

From a product perspective, Citi is also looking beyond traditional assets to alternative investments including private equity and commodities, Chandresh explained. Citi Private Bank also launched a new product platform called the Tailored Managed Investments Group, which will provide access to many alternative products, including hedge funds, for the HNW segment. ♦

Wirehouses vs Independent

How Mergers & Break-Away Brokers are Changing the SMA Playing Field

The moderator for this session was Kathleen Shkuda, President, Zigzag Consulting. The panelists were Eric M. Sutherland, Managing Director, Allianz Global Investors and Heather Gardner, Principal, CIMA, National Accounts Director, William Blair & Company.

According to Cerulli, separate account consulting has declined as a percentage of managed assets since 2007 while Rep as PM and Rep as Advisor have increased. This trend is projected to continue through 2011. One reason behind this is that RPM/RAA offer more control, Kathleen explained. With the onset of ETFs making it easier for advisors to manage portfolios, we've seen an increase in these two areas, she noted.

Kathleen reported that UMAs are growing, primarily at the big wirehouses. For example, Merrill Lynch is converting all of its separate accounts to UMAs and model portfolios. Even at some of the smaller firms, such as Bank of Hawaii (see below), MetLife & Citizen's Bank are all starting their own UMA programs.

Independents have improved their recruiting and back offices and they have benefited from technology provided by custodial firms, Kathleen noted.

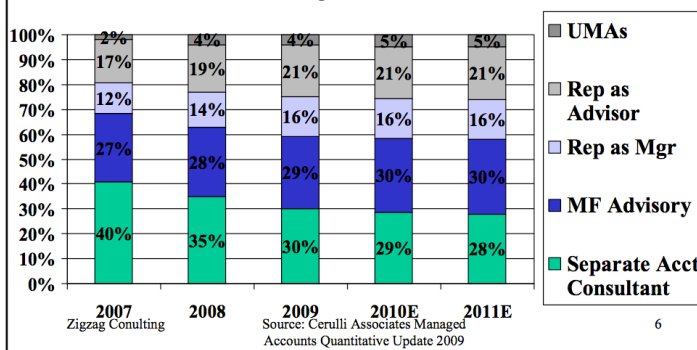
Wirehouses, on the other hand, have significant technology baggage. On the TAMP/Custodian/Independent side, they don't have the technology backlog since they use outsourced solutions and truly open architecture, which gives them more flexibility. This allows an independent advisor or RIA to use more than one back office and get the best of all worlds.

From a money management standpoint, is there a preference for doing business with a wirehouse versus an independent?

"There is no preference," Heather stated. "We want to be on both sides, because the advisors have been shifting both ways. In 2008/2009 the media was all over the big wirehouses losing advisors going independent." However, Investment News has a trend tracker of advisor movement which showed that a lot of the wirehouse guys just went to other wirehouses. "We have to follow them," Heather conceded. "You can't let

Separate Account Consultant Program Market Share Has been Declining

Distribution of Managed Account Assets



your advisor down if you have the assets there already." As a money manager, William Blair has had to look at the economics from an SMA perspective. The firm would walk away from business if an advisor moved to another platform, but only had a handful of accounts.

Eric agreed, but believes it has to be a different model and approach, which is why Allianz is decentralized in the field. With wirehouses, they seem to have more success when they start with the home office and they have the research and the scale and the platforms in place, Eric explained. The downside of wirehouses is the economics. The rates continue to come down. "When we first got in this business, we were getting 65-70 bps, but those days are long gone," Eric lamented.

How do you meet the needs of independents versus wirehouses?

On the independent side, Allianz has had better luck with newer strategies and carve-out strategies, Eric reported. Compared to wirehouse, the barriers aren't the same, he said. Traditionally, you needed a 3-5 year track record and X amount of dollars in AUM. But now, a lot of wirehouses are building "emerging manager" categories, which allows newer strategies to get on their platform.

The two mindsets are very different, Heather observed. The independent side is very disjointed. From an SMA perspective, they'll be used more by the larger teams for institutional or UHNW clients. "I think that UMAs will encompass a lot of the SMA business going forward as it becomes more adopted on the wire side," Heather predicted. ♦

Bank of Hawaii Launches \$2B UMA Program

By Tom Stabile, www.fundfire.com

The Bank of Hawaii is the latest to ride the UMA wave, unveiling a new program that opens the door to third-party SMA managers for the first time. The bank expects to shift more than \$2 billion of its \$6.6 billion in client assets over to the new UMA program, which will include SMAs, mutual funds and ETFs in its inaugural lineup.

The bank has gone down the path of many peer institutions in recent years, opting for an overlay management platform that it can operate in-house from Smartleaf of Cambridge, Mass., and getting manager research services separately from Denver's Prima Capital. The approach differs from another common UMA delivery model – tapping an outsourcer that runs both the platform technology and manager selection in one externally housed package.

The bank market is not monolithic, however, says Craig Iskovitz, principal at Ezra Group, a strategic consultant in East Brunswick, N.J. He cites the traction of Placemark, FolioDynamix and others in offering UMA platforms to banks.

"I see the integrated [UMA delivery] model being more successful than the standalone in the greater market," he adds. "But you will always have [wealth management sponsor] clients that don't need it."

Tax Management

Delivering Tax Efficient Investment Solutions

The speaker for this session was Randy Bullard, Executive VP, Institutional Business Development, Placemark Investments.

Randy began by listing the three main areas where tax efficiency can be achieved:

- Asset Placement – trust & estate planning, asset allocation and income management
- Tax Efficient Products – low turnover strategies, passive products, insurance products, tax-deferred accounts, utilizing products that are tuned to different registrations.
- Portfolio Customization – gain/loss matching, risk/tax trade-off management via portfolio optimization.

The goal of the tax management process is to match pre-tax returns and improve after-tax returns, Randy explained. Placemark does this with a quantitative, optimization-based overlay management process.

Since it's ultimately the client that must pay the taxes on their accounts, managers should assess the tax alpha that can be derived based on a client's circumstances to improve their after-tax return, Randy said.

However, Randy pointed out that it's impossible for an individual manager to meet a collective tax objective when managing their little slice of a client's portfolio. That's why a competent overlay portfolio manager is a critical component of a tax efficient solution.

We may be in a moderate return environment for a while and if the Bush Era tax cuts are allowed to expire, the gap between short- and long-term gains rates is going to increase. That means the value-add opportunity for a tax optimization process also increases, Randy noted. Every time that delta between capital gain rates and income rates grows the value add opportunity goes up quite a bit.

SMAs That Act Like Alternatives

The speaker for this session was David M. Spungen, Chief Executive Officer of Hillview Capital Advisors, LLC.

While many money managers have been switching client assets into alternatives in their search for better returns, David believes this is a bad idea. For a taxable individual, alternative investments, particularly hedge funds are extremely tax inefficient. They're also expensive in terms of fee structures versus separately managed accounts.

According to David, Hillside does their own research and locates managers that operate otherwise like alternative investments. They must be in separate accounts, with generally very workable minimums and reasonable flat fees.

For example, Winward Investments (which was recently purchased by Charles Schwab for \$150mm) has been successful in attracting assets from individuals, RIAs and large institutions, David revealed. When Hillside found them back in 2003 they were managing only \$200mm.

What Winward has done is similar to what most fund of hedge funds are pitching, David said. Good risk adjusted returns, with much less volatility, and less exposure to a significant decline in equity markets. They have daily liquidity, a fair amount of tax efficiency, flat fees and total transparency. Winward runs essentially a global, multi-asset class strategy. They were also one of the early adopters of ETFs, which, David suggested, is one of the reasons that Schwab bought them.

In 2008, Hillside started a closed-end fund strategy that invests in both fixed income and closed-end funds on a hedge basis. It's very tax-efficient since the fixed income side is invested munis.

David explained another reason for their tax-efficiency. If closed-end funds go to significant discounts to NAV, a lot of them overpay their dividends. They may go to a managed distribution policy and decide to pay 7% a year, for example. Hillside may earn 3% in dividends and another 2% in realized capital gains, which is basically just returned capital. So a lot of the return they get winds up being returned capital, which is very tax efficient, David explained. ♦

Outsourcing

Smart Outsourcing vs. Do- It -Yourself and Other Cost- Cutting Strategies

The moderator for this session was Seth Johnson, CEO & Co-Founder, Redi2 Technologies

Seth quoted a recent report by the Tower Group that predicted the use of "cloud services" will become mainstream by 2015. They will slowly evolve into public utilities that integrate traditional licensed software, augmented by vendor domain expertise. Cloud services currently represent just 1% (\$4 bil) of total IT spending, but are projected to grow to almost 5% (\$22 bil) by 2013.

What are you seeing by way of industry developments?

Carmine Remo, Managing Director, Head of SMA, SEI.

SEI has seen more RFPs for SMA outsourcing services in the past 6-8 months than in the previous four or five years, according to Carmine. Specifically, as it relates to the wrap business, he said that models only trends have really cut the number of accounts that investment managers have to take care in their back office. This hasn't done much to reduce manager's fixed costs, but has reduced their variable costs a bit, Carmine noted.

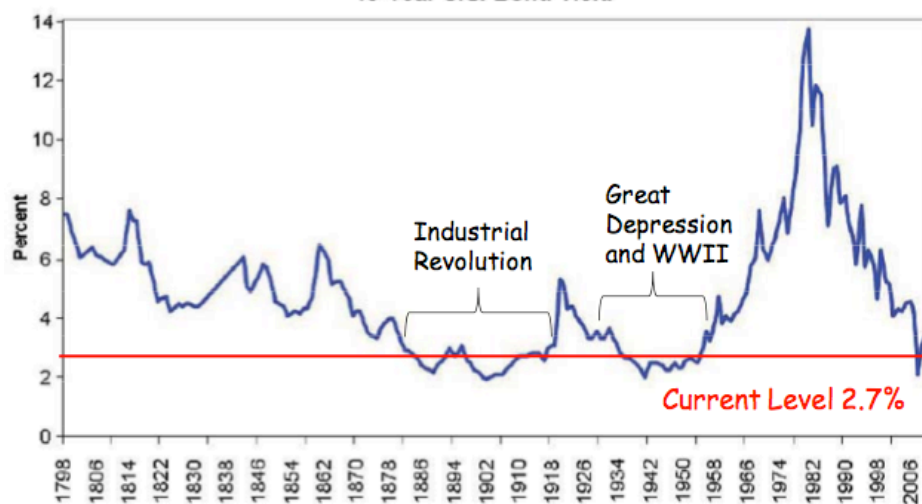
"Who'd have thought we'd be seeing a muni bond ladder strategy in an SMA WRAP space?"

-- Carmine Remo, Managing Director, Head of SMA, SEI.

Why Outsource?

Most firms use outsourcing to get access to an expertise that is hard or expensive to maintain on your own, Carmine observed. They're seeing some fixed income strategies get more shelf space. SEI is doing a muni bond ladder strategy for PIMCO. "Who'd have thought we'd be seeing a muni bond ladder strategy in an SMA WRAP space?" Carmine asked. ♦

Return-Free Risk 10-Year U.S. Bond Yield



Source: GMO LLC; Past Performance is no Guarantee of Future Results

Investment Theory

“The Efficient Frontier Isn’t”

The speaker for this session was Michael Jones, Founding Partner, Riverfront Investment Management.

There are three phases of life and three phases of investing based on a client’s income needs: Growth Only, Growth and Income and Income Only, according to Michael. For retirees in the Income Only phase, what they really need is a cash flow that grows.

Instead, what the industry has done is use systematic withdrawals and build a growth portfolio with a little lower volatility and then hope that everything will work out, according to Michael. The financial crisis showed a major flaw in this strategy. Suddenly a 6% annual withdrawal became a 9% annual withdrawal due to the drop in valuation. If you’re blowing a hole in your portfolio on year one, it’s really hard to bounce back, he observed.

And it’s almost impossible to recover if you’re invested in bonds, especially now with treasury yields at historic lows.

According to an article Michael recently published, if deflation is avoided, as he expects, “history suggests that bonds currently offer extremely low potential returns in exchange for a

substantial risk of loss. For example, if 10-year Treasury yields rise to 4%, a level seen as recently as April 2010, bond investors are likely to incur a principal loss of approximately 10%.”¹

In this environment, if we don’t get inflation, bond investors will be hit hard. As Michael explained, while treasuries were overvalued, corporates, mortgages and high yield were so cheap you could get away with buying bonds and make out reasonably well because spreads were so wide. But now, spreads have collapsed and yields on all those asset classes are at all-time lows.

Compared to the returns on a one-year treasury rolled over annually, the dividend yield on the S&P 500 beats it handily over the past 40+ years. In the past 10 years, there’s been a 40% increase in dividend income from the S&P500, even with the financial crisis, Michael reported.

You can potentially get a higher yield from the dividends paid by the stocks in the S&P 500 than from their 10-year bonds. All the growth potential and net dividends you can get for free. More current income, more future income higher short-term volatility, but lower long-term.

“When you look at the efficient frontier, where is the income?” he asked. ♦

THE TREASURY BOND BUBBLE

“DO YOU FEEL LUCKY?”

Michael Jones from Riverfront Investment Management presented this graph to show that treasuries haven’t been this low since WWII. According to Michael, rates can stay at these depressed levels only if the US undergoes an extended period of deflation.

If 10-year Treasury yields rise to 4%, a level seen as recently as April 2010, bond investors are likely to incur a principal loss of approximately 10%.

Sales, Marketing & Distribution

Working with Clients & Advisors

A lot of advisors are bucking the Rep as Portfolio Manager trend and taking back investment decision making, says Bob Kendall, National Retail Sales Manager, DWS. Advisors had been pushing assets onto platforms being offered by the home office and broker dealers. They want to take control back and create a different relationship with their clients. According to Bob, Sallie Krawchek said that her biggest competitor for talent now is LPL. Five years ago, no one would have thought that to be possible.

“Sallie Krawchek said that her biggest competitor for talent now is LPL.”

-- Robert Kendall, Director,
DWS Investments

We’re seeing an enormous trend of advisors who delegate an increasing amount of asset allocation decisions to asset managers with global, go-anywhere portfolios. It’s in some ways complimentary to Rep as PM, depending on how it is implemented, Bob added. ♦

1. “The Bond Bubble: Are Your Portfolio’s ‘Safe’ Assets Safe?”, Michael Jones, Riverfront Investment Group

Sales, Marketing & Distribution

Making Your Firm Shine in Sales

The speaker for this session was Walter Hartford, Business Development Officer - SMA, MFS Investment Management.

Walter started off by listing three areas where firms can shine: Distribution, Investments and Operations.

There are ways to differentiate yourself in distribution efforts in support of your wholesalers, Walter noted. You need to excel in platform components such as tax harvesting and tactical models. It's a Darwinian industry and if you're markedly worse than your competitors in any of these areas, you'll be in trouble.

Traditional wholesaling is an aspect of distribution that MFS focuses on. "You can never underestimate the value of a great wholesaler," Walter emphasized.

In the UMA context, you need to have higher-end conversations since you're communicating with the gatekeepers.

What's it going to cost? Walter explained that there are tangible costs that we all see in our P&Ls. Depending on the size of your organization, some of the intangible costs that are important include product specialists and marketing staffs.

MFS is spending a significant amount of money on its CRM system in order to improve client communications. Tracking both the number of times a client or prospect is contacted and when they are contacted is critical to the process, Walter asserted. He emphasized that you don't want to overload people with information. You want to be communicating the right information to the right people when they need it in order to be most effective. ♦

REDI[2]

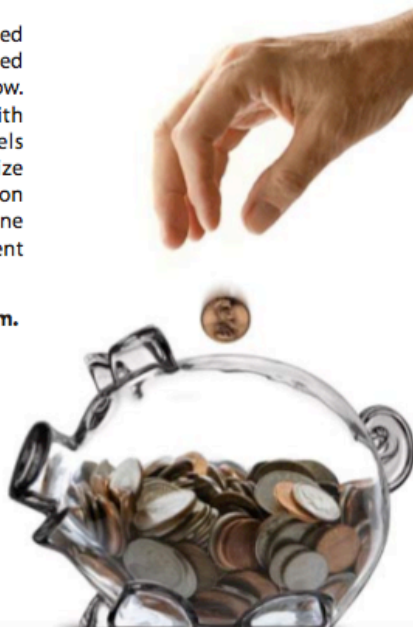
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