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The OPM Factor

Overlay portfolio management adds value your managed account clients can take to the bank.

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Plain and simple, the one great advantage of separate accounts is customization. They give advisers the ability to balance and tailor risk, return, and tax decisions to the individual investor.

Increasingly, technology is bringing these vehicles to investors who could not have afforded them in the past, making it possible for portfolio managers to manage large numbers of separate accounts and lowering the entry barriers. Many investors who in the past would have owned mutual funds can now own separate accounts.

But too often these investors own several separate accounts and fail to coordinate them, thus leaving the customization advantage on the table. A formal oversight program is essential to access the full power of the separate account.

The industry has reacted to this need with many flavors of multi-manager account (MMA) programs. MMAs, which combine the skills of multiple separate managers into a single account and are commonly sold by large investment companies, are increasing in popularity and availability. They offer benefits to investors, sponsors, managers, and planners.

Large institutional investors such as pension funds and big family offices have used MMAs for years because they can provide many advantages:

- A structural design with a clearly defined investment philosophy and risk control;
- Best-of-class managers, organized with little duplication of effort;
- Flexible manager diversification and re-allocation;
- Unified reporting;
- Disciplined re-balancing;
- Mandate customization;
- Tax customization; and
- Low trading and custodial costs.

To this, the sponsor adds value through strategic design, the discipline he or she imposes, and manager selection. Nevertheless, this system can -- and often does -- fail, thanks to poor coordination among managers. An IBM pension-fund executive is known to have complained often that while each manager beat his or her benchmark, the aggregation underperformed. Implementation slippage and inefficiencies creep into the management of MMAs.

In his book Integrating Wealth Management, Jean Brunel discusses many of these issues in depth. MMA sponsors need to centralize the customization and coordinate the trading and tax management that can occur across multiple strategies. And the solution to this coordination problem, especially in the smaller accounts a typical investment adviser is likely to handle, is the "overlay manager."

The logic behind this overlay manager is simple. In managing a set of highly customized portfolios, there are two types of decisions to be made -- model decisions and client-specific decisions.

Model decisions are applicable to all accounts, such as active stock selection. If managers want to replace IBM with Microsoft or increase exposure to technology, they normally want to do this across all accounts.

On the other hand, client-specific decisions are unique to individual accounts. If a particular investor will incur an unnecessarily expensive short-term capital gain when IBM is sold, or if he or she does not want to hold technology stocks, the decision needs to be customized for that account.

Start by separating model and client-specific decisions and assigning each to a specialist. The best active managers make active model decisions, but they are not always equipped to customize these down to client-specific requirements.

Overlay portfolio managers are the client-implementation specialists. They receive the managers' model portfolios and construct an aggregate target portfolio for each client account. They maintain this target over time and manage the client portfolio to track it closely. They honor individual investor restrictions. Full-service overlay managers customize active stock-selection decisions to the individual investor and enable tax management in the aggregate portfolio.

With a focus on tax-lot details, overlay managers can choose to step away from the target and obtain a tax benefit for the investor. They are in a position to make the trade-off between tax benefits and tracking differences from the target. It is also natural to centralize risk management with overlay managers and so reduce the cost of active management.

More specifically, overlay managers do the following:

- Coordinate trading. They trade the portfolio with an eye to reduce costs, exchange stocks between managers, and avoid small trades that do not affect overall performance.
- Manage tax lots. They maintain tax-lot information, choosing the best tax lot when a manager makes a sale, policing wash sales, harvesting tax losses when available, and deferring short-term gains until they become long-term gains.
- Re-balance the account. They allocate cash flows to the sub-portfolios, transition securities into or out of the portfolio, and rebalance manager and asset-class weights as they change.
- Control risks. They are the natural choice to centralize risk management strategies. They can balance risks against tax benefits and the cost of missing the target.

Focused overlay managers recognize the ongoing investment decisions, customizing them for each client and carrying them through to implementation. Tax management, risk management, and trading are centrally coordinated. This also simplifies administration and increases diversification at lower account minimums.

Advisers don't have to accept anecdotal evidence of the efficiency of the overlay portfolio management model. Even by examining just ongoing integrated tax management, it is clear the model has a true quantifiable advantage. In our research (D.M. Stein and G. McIntire, "Overlay Portfolio Management in a Multi-Manager Account," Journal of Wealth Management, Spring 2003), we explore the benefits and costs of an overlay manager using a simulation model. This simulation is an approximation of reality and uses a hypothetical return environment together with hypothetical managers to test the value of this tax-management strategy.

Through their portfolio management, active sub-managers seek to add value, that is, an excess return or alpha. But because the overlay manager may at times step away from the target, the portfolio may miss out on some of this alpha -- it may thus incur an alpha drag. The drag depends on the managers and the nature of their alphas. In our research, we've attempted to quantify the overlay's added value, focusing on the loss to alpha drag and the gain from tax management.

Let's consider two cases using a partitioned structure involving six managers, diversified by style and size (see chart below):

- Case 1: Without Overlay Manager. Each manager manages an account and has a target portfolio that evolves according to his or her stock selection; the manager re-balances each period perfectly to this target. The aggregate portfolio is the weighted combination of these portfolios.
- Case 2. With Overlay Manager. With the same aggregate target as in Case 1, we model a single portfolio that holds the stocks of the six managers. An overlay manager provides tax management and loss harvesting.

Upping the Alpha

An overlay manager can add 0.6% per year for 10 years in after-tax alpha after all expenses, including taxes, trading costs, and fees.

Partitioned Structure	Case 1: Without Overlay Manager	Case 2: With Overlay Manager
6 managers, diversified by style/size	After-Tax Alpha: -0.09% Before-Tax Alpha: 1.9% Tax Management Alpha: -1.65% Transaction costs and fees: -0.34% Alpha Drag: 0 (NA)	After-Tax Alpha: 0.51% Before-Tax Alpha: 1.9% Tax Management Alpha: -0.83% Transaction costs and fees: -0.30% Alpha Drag: -0.27%
	Index Tracking: 3.83% Turnover: 70% Stocks: 330	Index Tracking: 3.93% Turnover: 60% Stocks: 415
	Target Tracking: 0.03%	Target Tracking: 1.3%

The model is constructed so that the active managers are certain to achieve a before-tax alpha of 1.9% per year on all stocks they own. To force tight tracking to the target, we allow the overlay manager to step away from a manager's holding by only a small amount -- 0.3%. This forces the overlay manager to track the target quite tightly, in this case to within a tracking error of 1.5% per year. This 0.3% is a constraint imposed by the sponsor to force tight tracking; the 1.5% is the simulated result of the 0.3% deviation. Portfolios are modeled using a Monte Carlo analysis over a holding period of 10 years.

The chart shows the after-tax alpha measured relative to an after-tax benchmark index and attributes this to its sources. In the table, the overlay manager adds 0.6% per year for 10 years in after-tax alpha after all expenses, including taxes, trading costs, and fees. That is, if implemented well, it is possible both to add value and to coordinate taxable events without significantly compromising the active managers' alpha. If implemented poorly, the investor is better off in a mutual fund. The value added by the tax overlay depends on the nature of the active managers, their overlap, their concentration, and the manner in which the overlay is implemented.

This quantitative model makes numerous assumptions, but we did not tweak these assumptions or parameters with a goal in mind. With alternative assumptions it is possible for the value added by the overlay manager to be either higher or lower. As the car companies say, your own mileage may vary.

Our results are sensitive to assumptions about the simulation model; the market environment; the choice of the managers and the nature of their over-performance; the portfolio structure; and the implementation of the overlay manager. Our detailed research explores these aspects in more depth.

Of course, active portfolio managers differ widely with respect to the number of their holdings, trading, tax efficiency, and risk. If the managers' alpha is very high, then stepping away from it will be particularly costly, and it is harder for the tax management overlay to overcome this cost. For low alpha managers, the value added by the overlay increases. We have found that overlay managers can easily add value to stock selection managers with information ratios (alpha/tracking error) under 1.5. (Essentially, the information ratio is a quantification of the amount of skill a manager needs for overlay not to make sense.)

Certainly, the nature of the managers' alpha is also relevant. There are surely managers for whom the alpha drag model we have used is inappropriate. For example, a manager may have certain foreknowledge when his or her holdings will drop in value for an extended time. In this case, holding on to the securities to avoid a capital gain would be inadvisable, and our model of drag would be unsuitable. In addition, some managers are not suitable for inclusion in a MMA, such as those who add value by identifying trading inefficiencies and trading frequently during each day.

The design and implementation of the overlay require a balance among numerous considerations. In practice, a design is often attractive with fewer active managers, each taking a larger degree of risk and enough core so that the aggregation has the desired risk profile. The tax losses generated by the core are usually enough to offset gains realized by the managers. The balance between core and active, the choice of active managers, and the bounds on the tax-managed implementation is an art.

The example in the chart shows a 0.6% advantage in having an overlay portfolio manager. In fact, we have quantified the value added by overlay tax management to be anywhere from 0.3% to 0.6% or more, depending on the initial structure and the overall portfolio design. These estimates derive from ongoing tax management within the portfolio and include the alpha drag; they do not include sources for return enhancement such as operational efficiencies, trading efficiencies, or benefits that can be garnered from in-kind transitions, manager allocation changes, manager replacement, coordination of cash and security flows, and others. Indeed, total benefits can go well beyond the benefits we've quantified here.

Many financial planners already spend a great deal of time and energy acting as de facto overlay managers. They monitor client accounts, ask managers to take losses when available, police wash sales, and make sure customization features such as restrictions are honored across all accounts. With a dedicated overlay manager in place, the adviser is free to focus on larger client issues and relationship management.

It is not possible to be a top overlay manager from the sidelines or as an afterthought. It should be central. It takes focus, judgment, experience, and cutting-edge technology. It is true active portfolio management -- not through stock selection, but through customized implementation and tax management.

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