

# FUNDAMENTALS



OVERLAY PORTFOLIO MANAGEMENT

## A NEW PRODUCT AIMS TO IMPROVE THE TAX EFFICIENCY OF SEPARATE ACCOUNTS



David Stein

Taxable portfolios need special attention if Uncle Sam's share of the investment return is to be minimized. That's why the ability to do custom tax management has been a

major attraction of the increasingly popular separate-account programs. Yet, paradoxically, most accounts in these programs are not tax-managed or otherwise customized at all, meaning they're far from delivering their full potential value to investors.

That shortcoming could eventually be remedied if a new product known as overlay portfolio management gains acceptance in separate-account programs. Overlay management, developed to play a part in the new multidiscipline separate-account products being offered to investors with smaller account minimums, is intended to look out for the tax-management and portfolio-coordination needs of investors on a customized basis. A leader in this field is Parametric Portfolio Associates, an investment firm in Seattle. David Stein, the firm's chief investment officer, recently spoke with WEALTH MANAGER editors Robert Casey and Kieran Beer.

**One big factor behind the growth of separate-account programs is the tax issue. How do they really compare with collective vehicles like mutual funds in terms of tax efficiency?**

There are terrific differences. One is

that mutual funds must distribute capital gains every year, but they're not allowed to distribute losses. The second issue is that your tax experience is affected by what others do. If there are big withdrawals from the mutual fund, and it realizes capital gains to raise cash, the mutual fund and the investors will both have a taxable event.

A separate account doesn't suffer from either of those shortcomings. And losses in a separate account can have an immediate economic value to the investor. But more important, taxes need to be customized. That's the whole issue with managing taxes. They have to be customized with respect to your particular issues, your sequence of capital gain, your sequence of cash flows into or out of the portfolios. That's why separate accounts can be better.

**Yet research indicates that only a small number of accounts in these separate-account programs do get customized at all.**

Yes.

**Why is this?**

Products get sold for lots of reasons. One reason for the success of separate-account programs is the aura, or status, that surrounds them, as compared with commingled vehicles. Another reason is just the marketing game. Firms that offer separate accounts will claim they have the capability to customize, but in fact they're not always going to be doing that. Quite honestly, I think the investment community's been misleading its investors to some extent.

However, it's possible to do a separate

account well. Yes, it does take a fairly complex technology. But when it's done well it can provide huge benefits to the investor. That's my basic point.

**What is overlay portfolio management?**

Overlay management is in my mind an evolutionary step in the tax customization of separate accounts. Compare it with the traditional structure where the investor would hire some number of managers, say three or four, each running a separate portfolio. Overlay management allows all those portfolios to be integrated into one portfolio. A single overlay manager then does all the coordination and customization for that portfolio. I think of it as doing all the dirty work.

In essence, the individual managers provide the intellectual input through models, and the overlay manager then does what each one of them would normally do if they were managing the accounts separately. He centralizes the management process. Because he's centralizing it, there are opportunities to realize efficiencies between the managers. If one manager is selling something that another manager is buying, that trade doesn't actually have to happen, as an example.

**So you're talking about something broader than just looking at tax issues.**

Yes. The primary motivation from my point of view is the tax issues, but there are broader benefits. For example, you can keep the aggregate portfolio in alignment. Whatever your growth and value goals are, you can keep them balanced. If you include

fixed income, you can do automatic balancing of the asset classes.

**Overlay management is emerging as a mass-customization technique to help deliver the new multidiscipline separate-account products to investors with smaller account minimums. But there has always been a need for this function.**

Yes. The first benefit is that you get true tax management as opposed to what my partner has taken to calling mutual funds in drag, or cloned-type portfolios. Through overlay management you can get true tax value that can be quantified, for example, through the ongoing realization of capital losses.

to managing the migration of securities into and out of the account. You can often migrate securities in without selling them, without realizing a capital gain, compared with a mutual fund, for example. Similarly you can migrate securities out. If you're pulling out assets to spend on your vacation, you can pull out those that have appreciated least. Those tax benefits are a little harder to quantify because they depend on the particular set of circumstances you're dealing with. But they can be fairly substantial.

Another set of benefits is an operational one. Instead of dealing with some multiplicity of managers, you're dealing with one manager. There's one account, one custodian. You can have, say, six managers in a \$200,000 portfolio, and it will be managed as a single \$200,000 portfolio, not six \$30,000 or \$35,000 portfolios, which would be way too small to manage individually.

I truly believe there are efficiencies that come from individual managers' not having to do all the dirty work and detailed implementation of account opening, account closing, reconciling



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Yes. And for big investors they’ve had teams of people, for instance in family offices, who would do the integration and do the rebalancing, and work on the tax management. The change that’s happening now is a technological one. A lot of the management can be automated and done by a specialist.

**So overlay management offers more than one benefit?**

Compared with a tax-inefficient set of managers, I think the value is probably 100 to 150 basis points a year for 10 years. Compared with an already efficiently tax-managed portfolio where all you’re providing is the overlay and coordination, the added value is substantially less, probably between 35 and 100 basis points in after-tax return.

But then there are additional benefits

with the custodian, handling the strategic restrictions of the investor, and the like. That is an operational efficiency, and it should be cheaper in the long run. So although you’ve got to pay a little more to the overlay manager, you can reduce the fee or reduce the need to pay the typical active manager.

**There are hordes of inefficiencies in the back offices of the separate-account**

**world. Could those efficiencies you mentioned be quantified and recaptured from the fees now paid by investors?**

They should be recaptured in time. As we start with these new systems, the active managers are going to fight to keep their fees up and they're not going to be willing to reduce them too much. So it's going to be hard initially to capture all of the efficiencies. But as time goes on, with the incentives in the industry and with an increasing number of competitive money managers entering the business, it will clearly become more and more efficient. Investors should see the benefit of that.

**The functions that you ascribe to the overlay manager are highly customized, or granular, at the investor level. With that level of nitty-gritty detail, how can you automate and scale up this process to deal with thousands of different clients?**

Here's what makes me actually very confident about that: we've been managing customized portfolios of that type at Parametric for a number of years now. We customize each client, each individual tax lot, each individual cash flow, and we do it for thousands of accounts.

There are cases in which we can automate these functions now. For example, the client can come to us and say, "You must target tax losses of so many dollars a year out of this portfolio but no more than that." And we work with those kinds of restrictions. If the investor calls up at the end of the year and says, "Grab me capital losses. I just sold my business; I've got this huge capital gain and I need as many capital losses as I can get," sometimes we can work with that, and sometimes we can't. It depends.

**What about fees? Are they bundled in the wrap fee?**

The whole notion is really very new in the industry. So I don't think there's anything that you can really call typical. The overlay can be implemented in a lot of different ways depending on the risk characteristics of the portfolio, what the sponsor is trying to do, and the kinds of

managers he's hiring. We have this capability to do overlay management, and we implement it in different ways depending on the sponsor. The model we're furthest along with is our relationship with SEI Investments Co. in Oaks, Pa. We're being paid a subadvisory fee as a manager, and SEI then wraps that fee together with others into a bundled fee for the investor.

I think that's pretty much how it's going to evolve in the initial phase in the industry. But I can imagine cases where a big client may come to us and say, "Provide overlay management for me and for my account. Here are my managers. How much will you charge?" We'll charge him just a fee for our services, rather than a bundled fee.

**The role of the investment managers seems to be different in the presence of overlay management. As you say, there are fewer things involved. Their role is now keeper of a model portfolio rather than a full-fledged investment manager. Do you think that might be a problem for some of them?**

Yes. I think it could be a problem. But this happens to all industries as they evolve. Twenty years ago the investment manager was the firm. He hung out his shingle. He went marketing. He put together the portfolios. He did the research. He did the implementation. Maybe he even chose the custodian. Then as time elapsed, what we've seen in so much of the industry has been the rise of marketing, or distribution, organizations that give the client service but hire a subadviser as the investment manager. That has become the comfortable way to do business in the industry. Now the industry is just taking that to another level where we're saying, "All right, what we've called investment management should be separated into two functions for individual accounts: the choice of the securities and the implementation." And the implementation component has these huge efficiencies that could accrue if we could manage

the accounts in some way other than partitioning them to individual managers. You're bound to get many people who say, "Hey, I don't like that. I want to run my business as I did before." They're not going to want to participate. But we've seen many people who are willing to work in this new world.

**To some degree the overlay manager is managing the other managers.**

The way I think of it is that the sponsor is the one who's managing. The sponsor is the one who's in charge of the whole program. He might be the family-office executive or, in the case I mentioned earlier, SEI is the sponsor. The people at SEI choose the program. They define it as they want to. They're in charge, and they pull all the strings. And they choose the managers. They hire them; they fire them. Then they employ this overlay manager.

**What relationship does the client's adviser have with the overlay manager? How does that work?**

As the technology evolves, we'll be able to provide this kind of service to the adviser, the representative of the high-net-worth investor. Advisers will be able to say, "I want manager so-and-so and manager so-and-so, and I want you to combine them, and I want the risk of the whole thing to be a certain amount." I want to think that we'll be able to work with those advisers, much as we're working right now with the sponsors. I think certain simplified forms will evolve over time, which will make it much easier to have that communication with the adviser. But at this time we go through the sponsor, because the technology isn't quite equipped to be as flexible as it needs to be if every adviser is his own sponsor. In time we'll be able to sort of carve it apart and give individual advisers simplified flavors of it. But we can't do it right now.

*Robert Casey is editor and Kieran Beer is an executive editor at WEALTH MANAGER.*