



Parametric™

Leaders in Structured Portfolio Management

FULL DISCRETIONARY OVERLAY VS. PLATFORM TECHNOLOGY OVERLAY

The 'Buy' vs. 'Build' Decision

RESEARCH BRIEF

Spring 2009

Unified Managed Accounts (UMAs) are used extensively in the investment management industry as a way to integrate multiple investments within a single portfolio. To unlock the full potential of a UMA, overlay management is essential. A variety of overlay management options are available to help alleviate the complexities of implementation and day-to-day administration. Two popular solutions are full discretionary overlay and platform technology overlay. Although each offers significant benefits, firms that want to offer UMAs to their clients must determine which solution best meets their needs. ▶▶

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►► INTRODUCTION

The Unified Managed Account (UMA) evolved naturally out of the Separately Managed Account (SMA) industry. UMAs simplify the SMA experience through the integration of separate account managers, mutual funds and ETFs within a single portfolio. Although the industry is relatively new, growth has been rapid; UMAs are now used extensively by wirehouses, banks, broker/dealers and turnkey asset management providers as part of their fee-based investment and financial planning offerings. UMA solutions are also gaining traction in the registered investment advisory and multi-family office communities, particularly as advisors breakaway from larger investment firms.

Overlay portfolio management is central to UMA design and philosophy. As the account 'quarterback', the overlay manager is responsible for coordination and implementation. However, the role of the overlay manager, and therefore the levels of implementation and coordination, can vary greatly. Under a 'passive' approach, decisions made by the participating investment managers (research providers, in this case) are applied to client accounts with little consideration of investor-based customization. 'Active' overlay integrates the investment decisions of multiple research providers and effects those changes while maintaining client-specific customizations and tax management.

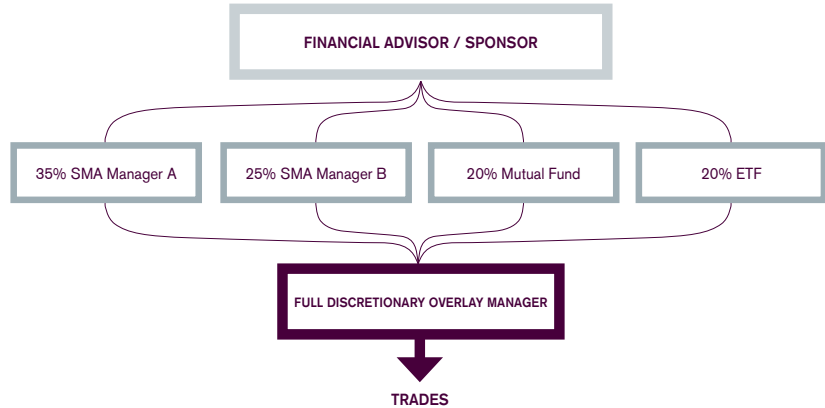
Two popular UMA overlay solutions available in the marketplace today are full discretionary overlay (hiring a third-party overlay manager directly) and platform technology overlay (purchasing and implementing a technology solution). A third option is to build an in-house overlay portfolio management system from scratch. However, depending on the size of the firm, the cost of building an in-house platform can reach tens of millions of dollars. In this paper, we will focus on a more common decision faced by firms with interest in sponsoring a UMA program: whether to 'buy' the services of an outsourced third-party overlay manager or 'build' an in-house platform utilizing a technology solution.

►► 'BUY' - FULL DISCRETIONARY OVERLAY

The full discretionary overlay manager aims to capture the pre-tax return of a combination of research provider models, funds, and ETFs while maintaining control over total portfolio risk and taxes. Tax concerns and the operational activities of opening, closing, trading and maintaining accounts are centralized between the overlay manager and the UMA sponsor.

Under the full discretionary model, the overlay manager assumes many of the operational and portfolio management functions that are typically not among the sponsoring firm's core competencies. A robust, active overlay strategy maintains the integrity of the investment process and delivers efficiencies to the UMA sponsor, research provider, financial advisor and end client.

EXHIBIT 1:



SOURCE: Parametric

UMA sponsors hire the overlay manager and research providers and provide access to advisors and clients. The outsourced structure of full discretionary overlay management is in place to minimize the operational and technological burdens on the sponsor, allowing the overlay manager to focus on day-to-day implementation and management. The overlay manager is able to provide account-level and program-level analytics to the sponsor, who may report this information to their advisors and clients. It is not necessary for sponsors to add compliance, trading, and software development personnel to their current staff in order to come to market with a robust UMA offering. In many cases, they may see a reduction in these costs.

Tax management is a key benefit of overlay management within taxable portfolios. Specific techniques (see Appendix A) include tax-efficient implementation of manager decisions, tax-loss harvesting, tax-efficient cash flow management, rebalancing, and wash sale coordination. As seen in Exhibit 2, in Parametric OverlayOne™ taxable portfolios there has been 1.37% of annualized after-tax outperformance since the inception of the program. In other words, because these clients invested in a program with an overlay manager instead of traditional separate accounts, they were 1.37% per year better off on an after-tax basis as an average. Parametric added this value while also maintaining tight tracking to the combination of underlying investments on a pre-tax basis, only deviating 0.01% per year on average. These numbers confirm the goals of full discretionary overlay portfolio management: **1.** Achieve the pre-tax return of the underlying investments; and **2.** Add after-tax value in taxable portfolios.

EXHIBIT 2:**PARAMETRIC'S LIVE EXPERIENCE**

As of December 31,2008

	*PRE-TAX COMPOSITE DIFFERENCE (%)	**AFTER-TAX COMPOSITE DIFFERENCE (%)
2003	-0.20	0.83
2004	-0.26	1.14
2005	0.19	1.06
2006	0.05	1.48
2007	0.23	1.60
2008	0.04	2.17
Annualized	0.01	1.38
After-Tax Alpha		1.37

*Pre-Tax Composite Difference = (Live Pre-Tax Return UMA Accounts - Pre-Tax Return of the Blend of Manager Models)

**After-Tax Composite Difference = (Live Pre-Tax Return UMA Accounts - After-Tax Return of the Blend of Manager Models)

►► 'BUILD' - PLATFORM TECHNOLOGY OVERLAY

In contrast to full discretionary overlay, platform technology overlay solutions are sold to sponsors, allowing them to access an application that provides functionality and connectivity to support managed accounts products. Depending on the technology provider, the solution may support both passive and active overlay management. In the passive environment, separate account managers access the technology provider's application to trade their account sleeves. This approach allows the investment manager to maintain trading control over their investment model. In the active setting, it is typically the sponsor that implements the account-level decisions, executes trades, and retains discretion of the accounts. Technology providers that offer active overlay management capabilities strive to achieve many of the same benefits that are realized with a full discretionary overlay provider, namely broad account oversight and benefits from tax management tools. While levels of tax management vary by provider, the primary divergence from full discretionary overlay is that the sponsor-firms themselves are responsible for the operational, trading, and portfolio management tasks of an overlay manager.

Smaller advisory firms may purchase a platform technology overlay solution or work through a turnkey asset management provider (TAMP) to access an overlay manager. These firms may not realize sufficient scale in their UMA program to be an attractive partner for a third-party overlay manager. TAMPs offer customized investment solutions and reporting services to advisors and their clients. Some technology providers charge a flat fee allowing sponsors to access their overlay portfolio management software. Others charge a fee per account. Firms with larger asset projections (typically at least \$100 million) that are not ready to assume additional operational, trading, and reporting responsibilities often elect to hire a third-party overlay manager directly. In this way, the sponsor, research provider and overlay manager each bring their specialized expertise together to provide the benefits of Unified Managed Accounts.

EXHIBIT 3:

BENEFIT	BUY FULL DISCRETIONARY OVERLAY	BUILD PLATFORM TECHNOLOGY OVERLAY
One account / one set of paperwork	Yes	Yes
Enhanced tax-efficiency	Yes	Maybe
Structured Rebalancing	Yes	Maybe
Total account after-tax reporting	Yes*	No
Direct ownership of positions	Yes	Yes
Customizable for restrictions	Yes	Yes
Less tax penalty when making manager changes	Yes	Maybe
Tax-aware withdrawals	Yes	Maybe
Investor control over taxable events	Yes	Maybe
Significantly lower operational costs to sponsor	Yes	No
Reduced paperwork and account service activities to sponsor	Yes	No

SOURCE: Parametric

* Parametric offers after-tax reporting to sponsors

An additional comparison should be addressed specifically from the investment advisory firm's perspective.

EXHIBIT 4:

CONSIDERATIONS ADVISORY FIRM'S PERSPECTIVE	BUY FULL DISCRETIONARY OVERLAY	BUILD PLATFORM TECHNOLOGY OVERLAY
Overlay management must be a core competency	No	Yes
Staffing	Reduce / Redeploy	Add
Time Commitment	Minimal	Varies - Significant
Trade Control	No	Yes
Trade Rotation	Imbedded in the process	Manual
Platform / Custodian	Open	Open
Sub Advisors negotiation required	Maybe	Yes
Added Compliance	No	Yes

SOURCE: Parametric

►► BENEFITS AND COSTS

There are benefits to both full discretionary and platform technology overlay portfolio management. Full discretionary overlay is generally lower risk to the firm considering UMAs. Program setup costs are greatly reduced relative to a technology solution where the application must be purchased and deployed. Employee time is the primary cost during the setup stage, as individuals work closely with the overlay manager to customize the program. The overlay manager, who is intimately knowledgeable about the tradeoffs between investment risk, costs and taxes, brings their expertise to the table, eliminating the need for firms to hire outside consultants to aid in program setup and decision-making. Once the program is live, the assets under management fee can be passed through to the client. Given the market environment and sales strategy, the program may take time to receive attention and attract assets. Under the full discretionary model, the sponsor-firm wouldn't have as much of an initial investment to recoup.

Importantly, with full discretionary overlay, the overlay manager has discretion over the accounts, and therefore takes on the day-to-day responsibilities of management and trading. This can reduce the sponsor's staffing needs and error obligations. If a trade error occurs, the overlay manager and sponsor work together to correct it.

At a certain breakpoint unique to each firm, 'building' a technology solution can be more beneficial to the UMA sponsor. After upfront costs have been recouped, if the program is successful attracting and retaining a significant level of assets, the potentially lower ongoing costs can lead to a higher level of profitability. However, building, implementing

and running a platform technology solution requires considerable expertise in addition to the monetary costs involved. Under the full discretionary model, the third-party overlay manager provides the expertise and assumes a significant portion of the setup costs. And while certain technology solutions provide after-tax management tools, full discretionary overlay offers the benefits of active tax management in addition to operational efficiencies realized through the integration of multiple investments into one account.

►► SUMMARY

As firms consider offering Unified Managed Accounts, they must determine which overlay solution fits within their existing business model. While each solution achieves certain efficiencies, only full discretionary overlay provides the full range of benefits. Hiring a third-party overlay manager directly or accessing a UMA program through a turnkey asset management provider can save time, limit costs, and take full advantage of each firm's expertise and core competencies. A full discretionary overlay manager carefully monitors and implements manager trading decisions in a customized manner for each individual client, realizes after-tax benefits and eases the administrative burden on the sponsor.

APPENDIX A: TAX-MANAGEMENT TECHNIQUES

- Wash Sale Coordination – Avoid wash sale violations that often occur in traditional separate account programs.
- Short-term Gain Deferral – Managers are driven to deliver pre-tax returns, often making changes irrespective of taxes. By taking into account (1) the amount of time until a security reaches long-term status, (2) the risk and size of the position, and (3) the size of the gain, Parametric can step in when a manager makes a change and hold off or trim the position until the security reaches long-term status.
- Active Manager Stock Decisions – Tax-efficient overlay managers have a small amount of flexibility around manager target weights; this gives them the ability to slightly overweight stocks at a gain and slightly underweight stocks at a loss, allowing for further loss realization or gain deferral.
- Manager & Asset Allocation Changes – When a research provider is replaced or the allocation changes, the overlay manager will transition securities where possible and make the change as efficiently as possible.
- Active Tax Loss Harvesting – The active overlay manager reviews each account daily and is able to actively realize small losses all year while managing the risk of the portfolio.
- Efficient Cash Flow Management – Portfolios are automatically rebalanced when there is a contribution and securities are transitioned in – just like a new account. Withdrawals are processed as tax efficiently as possible.
- Outside Considerations and Related Accounts – Parametric can associate related accounts for wash sale coordination and loss harvesting.
- Transition of Pre-Existing Securities – Pre-inception analysis identifies opportunities to keep securities with overlap to the active managers' models in order to defer capital gains realization.

IMPORTANT DISCLOSURES:

This information should not be considered investment advice or a recommendation to buy or sell any particular security. The information in this material and any specific securities mentioned are not intended to be representative of all securities purchased, sold or recommended for clients. It should not be assumed that any of the securities or recommendations made in the future will be profitable or will equal the performance of the listed securities. Past performance does not predict future results.

Parametric does not provide tax advice. Prospective investors should seek their own tax advice prior to entering into any investment strategy.