

SENIOR CONSULTANT

The Voice of the Investment Management Consultant

Overlay Management: The Whole Product Solution?

Stephen C. Winks

The question that persists during this particularly difficult period in the capital markets is whether the role and purpose of a brokerage firm is simply to execute securities trades or is there an associated responsibility to assist and/or empower the financial advisor to add tangible, quantifiable value through the exercise of their professional investment and administrative counsel. These two vastly different management philosophies in the financial services industry explain why top management at some firms seem to discount any need for change or innovation while other quarters of the industry deem it to be essential. The old school would suggest we are in the trade execution business, while the new school of thought would suggest we are in the business to add value. Ultimately, the financial services consumer will resolve which philosophy best serves their interests, and in recent months, the consumer has sent the industry a very clear message.

In today's terribly difficult investment environment the only constituency of financial advisors who continues to grow their business at a double-digit clip are the 12% of financial advisors who are addressing and managing a broad range of investment and administrative values through the engagement of their professional investment and administrative counsel for an on-going consulting fee. This is while 65% of financial advisors who are engaged in commission sales have experienced a 52% decline in earnings over the past year. The financial services consumer is telling us they want value to be added, so there is little question of where the marketplace is headed. Thus, if one is interested in the consumer, the challenge our industry faces is how do we go beyond a small number of early adopters who are adept at adding value to empowering all financial advisors to add value. This is no small challenge as a different culture, structure and technology is required in order to add value. The skill, passion and motivation of early

adopters simply does not extrapolate to an early majority of all financial advisors that need to quickly learn how to add value. Even if all financial advisors were to be provided access to the processes and technology necessary to add value, it does not mean that value would necessarily be added, as skill is required. Overlay management, an outgrowth of the multi-discipline account (MDA), may well be the answer. By extension, overlay management may be the vehicle that puts the advisor and the industry back on track for positive earnings and revenue growth.

Overlay management is a third level of asset management, complementing that of money managers and financial advisors, which addresses and manages portfolio detail at the client level, e.g., tax efficiency, risk and return, which are not possible to manage at the money manager level and are beyond the technological expertise of most financial advisors. This is accomplished by overlay managers, like Parametric and Placemark, taking all the buy-and-sell recommendations of an unlimited number of managed account managers in each client account and managing the aggregated recommendations to reduce undue concentration in a single holding, to optimize trading to facilitate tax efficiency and reduce portfolio turnover and trading cost using expert systems, and to optimize portfolio performance using proprietary

methodology, which can add 35-100 basis points in overall portfolio performance. Overlay managers like Parametric and Placemark empower financial advisors to add value in ways which would not otherwise be possible. Through expert systems, the overlay manager empowers the financial advisor to articulate and deliver the benefits of tax efficiency that go far beyond the advisor's personal skill and knowledge. The advisor doesn't have to understand trusts or sophisticated tax planning strategies, they just have to do what they do best: understand their clients' needs and deliver best-

**THE KEY TO
UNBUNDLING ASSET
MANAGEMENT PRICING,
TO MANAGING A
HIGHER LEVEL OF
CLIENT SPECIFIC
PORTFOLIO DETAIL, TO
DRIVING DOWN
ADMINISTRATIVE COST,
TO TAKING ADVICE INTO
THE MASS MARKET, TO
ENHANCING
PERFORMANCE BY
30-100 BASIS POINTS**



in-class solutions leveraging through the overlay manager's expertise. Most importantly, overlay management resolves many of the technological and innovation challenges the financial services industry faces. Because third party overlay managers have their own proprietary expert systems, there are no organizational constraints on the values to be addressed and managed, on investment products used or on the technology which can be brought to bear. This greatly mitigates the inefficiencies and the inherent technological constraints of outdated legacy systems tied to trade execution that stunt innovation and plague the financial services industry. Importantly, overlay management will facilitate the unbundling of research (buy and sell recommendations) and account administration from the asset management function. This will give firms that have scale in separate account administration, like Citigroup Asset Management (\$66 billion), an opportunity to use account administration cost, pricing and investment minimums as a means to grow and perhaps dominate the managed account industry. Citigroup Asset Management, already the largest separate account management firm, could easily become a top five asset management firm as managed accounts and overlay management disintermediate other forms of investment which are more widely used today. Overlay management would empower all financial advisors to add value which, in turn, places a heightened importance on managing accounts, greatly accelerating the growth of the managed accounts industry as a core mainstream investment vehicle.

Little did Peter Cieszko and Stuart Parker expect when Citigroup Asset Management introduced the multi-discipline account (MDA) that in it were the seeds of innovation, which would not only significantly change the asset management industry, but could possibly position Citigroup Asset Management as one of the dominant players in the fast-evolving asset management industry.

The MDA introduced two very important innovations: (1) composite performance reporting of multiple managed account managers as though they were one account and (2) the creation of a third level of professional

asset management – overlay management – which managed a level of client-specific detail not possible by the money manager, that goes beyond the technical capability of most advisors.

Initially, composite performance reporting made the big splash when MDAs were first introduced because it held the promise of saving advisors hundreds of manhours a year in using an Excel spreadsheet to incorporate all client account holdings into a performance monitor. But because the scope of the MDA reporting was limited just to managed accounts, its application was limited to those advisors working the institutional market or using MDAs as a core portfolio position.

**EXPANDING OVERLAY
MANAGEMENT BEYOND THE
MDA CHANGES THE FINANCIAL
SERVICES INDUSTRY IN
PROFOUND WAYS AS, FOR THE
FIRST TIME, IT FACILITATES ALL
FINANCIAL ADVISORS TO ADD
VALUE WITHOUT NECESSARILY
HAVING TO HAVE AN
EXTRAORDINARY SET OF SKILLS**

Ultimately, virtual income statements and balance sheets, and account aggregation (By All Accounts, Yodlee, eVare, Adhesion, Statement One) will resolve the challenge of reporting on all a client's holdings custodied at multiple institutions. But the innovation that changes the financial services world, as we know it, is overlay management expanded to incorporate all client assets, custodied at all sources, which addresses and manages all values, either cited by the investor (incorporated in the investment policy) or required under regulatory mandate. Expanding overlay management beyond the MDA changes the financial services industry in profound ways as, for the first time, it facilitates all financial advisors to add value without necessarily having to have an extraordinary set of skills.

Overlay management greatly elevates the role of the financial advisor in adding value.

The financial advisor simply has to be able to evaluate and articulate the needs, goals and objectives of each client to the overlay manager, typically taking the form of a statement of investment policy. The overlay manager not only directly assumes the responsibility to manage the aggregated buy-and-sell decisions of a large number of asset managers but, through expert systems, also manages values like risk, return, tax efficiency, liquidity and cost structure with a degree of technical competency and sophistication not possible by most financial advisors. This assures the full range of investment and administrative values are being addressed and managed as required under regulatory mandate (UPIA, ERISA, MPERS, Proposed Uniform Trust Code) and/or client instructions. Thus, through overlay management, the financial advisor is empowered to provide the highest level of professional investment and administrative counsel without being bogged down in the technical and administrative minutia of advice. With overlay management, the advisor is not put in the awkward situation of having to know how to build a clock, they simply have to know how to tell time. This is the long awaited innovation that will make it possible for all financial advisors to add value. In doing so, growth in the managed account industry is no longer constrained by the number of financial advisors adept at taking full advantage of the differentiating strengths of managed accounts in portfolio construction. With overlay management, the tax lot accounting available in a managed account is fully utilized and becomes central to managing tax efficiency. The style discipline of a managed account, which is so important to the overlay manager in managing risk and return, becomes central to portfolio construction. The low cost structure of a managed account, which is just one-third the cost of a mutual fund and is so important for a fee-based advisor and an overlay manager in having the latitude to price their services, becomes central to facilitating advice and central to portfolio construction. Thus, with overlay management, Citigroup Asset Management, the largest managed account manager, is poised for extraordinary growth because all investors prefer value to be



added, and many of those values are best addressed and managed through managed accounts. Since managed accounts incorporate tax lot accounting, which allows tax efficiency questions to be resolved, and style discipline, which allows risk and return to be managed in portfolio construction, and because neither of these disciplines are structurally present in a mutual fund, the overlay manager concept is that mechanism that will take the managed account industry from \$0.5 trillion in assets to \$5 trillion in assets over the next five years.

The overlay manager takes us beyond conventional wisdom to a new level of thinking. Consider the challenges that financial advisors and asset management firms face today in adding value at the client level. Mutual fund companies, under the 1940 Act, must manage money in accordance to the stated goals and objectives in the prospectus and cannot address the specific needs of each investor. Yet, the advisor who understands the needs of each investor, does not have access to the processes and technology necessary to be responsive to those client needs and/or does not have the personal interest and/or the skill set to address and manage a broad range of investment and administrative values required in order to add value. If the money manager cannot add value for each individual investor and the financial advisor does not have the skill or resources to add value, then the overlay manager does and can add value in a scale that investment management consulting has not been able to effect.

In principal, investment management consulting has been the answer in adding value at the client level. By building or gaining access to the process (asset study, investment policy, strategic asset allocation, manager search and selection, performance monitor, tactical asset allocation) and technology (account aggregation, Monte Carlo simulation, gating technology tied to investment policy, subaccounting, trade and order routing and reporting, real-time style attribution, investment methodology) necessary to add value, today, a small number of early adopters are adding value for their institutional and high net worth clients. But these 4,000 senior investment management consultants (our readers)

who advise 25% of all U.S.-based assets just account for one-half of 1% of all licensed financial advisors. There are simply not enough financial advisors adept at addressing and managing a broad range of investment and administrative values to serve all investors who wish value to be added. Overlay management is the solution in empowering the other 746,000 (or 246,000, depending on how you count) licensed financial services professionals to address and manage a broad range of investment and administrative values as required to fulfill our fiduciary obligation. Overlay management puts high level, comprehensive, expert advice in the reach of every financial advisor who wishes to add value for their clients.

OVERLAY MANAGEMENT IS THE SOLUTION IN EMPOWERING THE OTHER 746,000 ... LICENSED FINANCIAL SERVICES PROFESSIONALS TO ADDRESS AND MANAGE A BROAD RANGE OF INVESTMENT AND ADMINISTRATIVE VALUES AS REQUIRED TO FULFILL OUR FIDUCIARY OBLIGATION

When we speak of overlay management, we are speaking of it in its most advanced state, going beyond the services initially incorporated in the MDA. Technically, if you simply provide a composite performance report on more than one money manager, you are an overlay manager; but the value of the overlay manager is in managing a level of portfolio detail that is either too cumbersome or too technical for the advisor to handle. In its most powerful form, the overlay manager zeroes in on trade management, coordinates and improves of tax lot management, coordinates account rebalancing and risk management, while using proprietary systems that are typically not available to most financial services firms. The overlay manager avoids de minimus trades, exchanges stocks or tax lots among managers, when appropriate, and absorbs and

delivers stocks from a core position where appropriate. They maintain tax lot information, sell the best lot if held by more than one manager, harvest tax losses, police wash sales, defer gains from short-term to long-term and match losses and gains when required. They allocate cashflows, contributions and withdrawals, transition securities into and out of the portfolio, transition holdings on manager replacements and rebalance manager and asset class weights. They balance risk against tax benefits and the cost of missing targeted performance metrics, ensure the entire portfolio is within the guidelines of targeted metrics and ensure the entire portfolio is within the specified market metric.

Overlay management greatly elevates the level of counsel and the investment considerations advanced with the client as the financial advisor manages the process in which value is added, defining the rules, parameters, constraints and metrics in which the overlay manager works within. The advisor determines an acceptable range of tracking error, how to rebalance holdings, how to harvest tax losses, etc., all from a range of options. The financial advisor essentially is managing all the associated nuances of the values being addressed and managed, which is a very highly valued skill set. But, as much as the overlay manager elevates and enhances the role of the financial advisor, it has an even

larger impact in reducing the cost of asset management and reducing and streamlining the cost of account administration.

The administration cost of a separately managed account is notoriously expensive for both asset management firms and brokerage firms. Every brokerage firm has their own system and methodology to administer a managed account. This requires the asset management firm to create and staff custom administrative interfaces for each brokerage firm intermediary whose advisors wish to use/engage the asset management firm's services. There as many as four parties (the financial advisor, the advisor's broker/dealer, a third party managed account manager sponsoring platform and a custodian), which require the managed account manager to manage as many as four new account procedures, four trading



and trade reconciliation systems, four reporting systems and four client service functions for each account. At the client level, brokerage firms have a more complex problem because the average investor has 16 financial relationships that must be tracked and incorporated into reporting in order for it to be possible for the advisor to add value. Because of the complexity and expense of account administration, separate account managers are fortunate if they can net as much as 18 basis points from their 38-50 basis point asset management fee after deducting the cost of having one portfolio manager for every 500 accounts and the cost of providing often duplicate new account, trading, trade reconciliation, reporting and client service functions. Given that the industry has been slow to embrace total enterprise technological solutions which would entail new web-based technology (Market Street Advisors) which can cut 15 to 20 basis points out of separate account management administrative cost, overlay management interjects a new model in which extraordinary administrative efficiencies can be more readily achieved. This does not mitigate the need for more advanced technology, but overlay management accelerates the development of more efficient technology by creating very powerful economic incentives for leading brokerage firms and managers to innovate.

Rather than having to contend with so many disparate systems and requiring so many portfolio managers (one per 500 accounts) for tens of thousands of accounts, most asset management firms would be perfectly happy to sell their research, i.e., their real-time buy-and-sell recommendations, for 18 basis points, to an overlay manager who would, in turn, interface with brokerage firm intermediaries. Brokerage firms would engage the overlay manager (Parametric, Placemark), for 15-18 basis points, to assume fiduciary responsibility, construct and manage custom investment portfolios in accordance to regulatory mandate and the specific values and instructions cited in investment policy for each client, working with *all* the client's assets and liabilities. The brokerage firm would act as custodian and provide all account administration and support for 15-18 basis points. This

would result in truly customized portfolio management, where the full range of values (risk, return, tax efficiency, etc.) would be addressed and managed using auditable, expert systems, for a total of 50-55 basis points. The value proposition to the client and the financial advisor would be extraordinary. The advisor would not have to understand all the nuances of tax efficiency, UPIA or portfolio construction in order to add value. The client would not pay any more than normal for a traditional managed account at 50 basis points, and brokerage firms with scale such as Citigroup Asset Management (\$66 billion in separate account assets) would become a magnet for assets. Citigroup Asset Management could use its

**OVERLAY MANAGEMENT IS A
BREAKTHROUGH THAT
EMPOWERS ALL FINANCIAL
ADVISORS TO ADD VALUE AND
WILL ULTIMATELY LEAD ALL
FINANCIAL ADVISORS TO USE
ELECTRONIC VERSIONS OF THE
SIX FINANCIAL SERVICES
INVESTMENT PROCESS
NECESSARY TO ADD VALUE AND
AS IS REQUIRED BY
REGULATORY MANDATE**

economies of scale in account administration to drive down both managed account investment minimums to below \$50,000 and pricing, which would drive all but the most efficient organizations out of the managed account business. This would not only be good for the consumer and Citigroup Asset Management, but it would force the industry to embrace new web-based technology which will lead to even more efficiencies. *Senior Consultant* estimates Citigroup Asset Management managed account administration cost at significantly less than five basis points. So, firms whose actual costs are running 15-20 basis points would be well advised either to outsource their managed account business to Citigroup or to adopt far more efficient web-based technology. In

outsourcing, firms would gain access to a superior value proposition, would not incur onerous technical and administrative responsibilities and, as a smaller firm, would not have to worry about achieving scale or competing with pricing that comes with scale.

With the unbundling of research (the manager's real-time buy-and-sell recommendations) and account administration from separate account management, many of the operating inefficiencies of the managed account business will be resolved, cost will be driven down and the associated technology will eventually be commoditized. Thus, the role of the overlay manager who is actually managing the values important to each investor becomes the focal point in the industry's ability to add value. Dr. David Stein, chief investment officer of Parametric, has quantified the value added by overlay management on overall portfolio performance to be 35 to 100 basis points. (See "[Overlay Portfolio Management in a Multi-Manager Account](#)," *Senior Consultant*, November/December 2002.) In an era where it has been difficult to beat the index, enhancing performance by 35-100 basis points is truly extraordinary by any measure. The overlay manager is the whole product solution necessary to empower all financial advisors to add value but takes a totally different form than those of us in early involvement with investment management consulting would have imagined. The consulting community would like to

see electronic asset studies, electronic policy statements, electronic manager search and selection, and electronic performance reporting become universally accessible so it is possible for all advisors to add value. But all financial advisors do not have the skills to execute; instead, the overlay manager will add value for the advisor. Rather than cheapening consulting, it elevates the dialogue and points of discussion of all financial advisors. However, ultimately, in order to differentiate their work and enhance their value proposition, all advisors will gravitate toward an electronic asset study, an electronic policy statement, an electronic manager search and selection engine and an electronic performance monitor, as we would have anticipated, because it integrates the investor into the

investment process, which maximizes the value added.

Overlay management is a breakthrough that empowers all financial advisors to add value and will ultimately lead all financial advisors to use electronic versions of the six financial services investment process (asset study, investment policy, strategic asset allocation, manager search and selection, performance reporting, tactical asset allocation) necessary to add value and as is required by regulatory mandate

because it deepens the client relationship, fosters the client perception that value is being added, and in fact, maximizes the value of the financial advisor's counsel. Overlay management is an important intermediate step in the financial services industry at-large, empowering all financial advisors to compete on the tangible, quantifiable investment and administrative basis of the values they address and manage. ■

Notes

SENIOR CONSULTANT

**THE VOICE OF THE INVESTMENT
MANAGEMENT CONSULTANT**

James P. Owen
Co-Founder

Stephen C. Winks
Co-Founder, Publisher & Editor-in-Chief

Sydney LeBlanc
Consulting Editor

Mamie Woo McNeal
Production Editor

Eddie Bryant
Marketing Consultant



Advisory Board

Jerry Bott
Merrill Lynch

John Brock
Brock-Hazard/First Union Securities

Dick Charlton
New England Pension Consultants

Bob Cluck
Canterbury Capital

Harold Evensky
Evensky Brown & Katz

Jeff Frum
Wells Fargo

Rich Gleason
Salomon Smith Barney

Kathleen E. Hegenbart
Salomon Smith Barney

Brian Hunter
Prudential Securities

Greg Hunter
Alex Brown

Bill Johnson
CapTrust

John Kelsey
Salomon Smith Barney

Keith Phillips
Morgan Stanley Dean Witter

Bob Rowe
Morgan Stanley Dean Witter

Dick Smith
Capstone Investment Group

Jim Yanni
Yanni Partners

SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231

Ph 804-643-1035 ■ Fax 804-643-1544

www.SRCONSULTANT.COM