



**Parametric™**

Leaders in Structured Portfolio Management

## The Value of Overlay Portfolio Management Within a UMA

---

### CASE STUDY

Summer 2009

2003<sup>1</sup> marked the beginning of one of Parametric's innovative offerings: OverlayOne™. Since its inception, OverlayOne has outperformed expectations, proving itself as one of the most exciting overlay management options in the marketplace. ▶▶

### Steve Kauffman, CFA

Director – Overlay Portfolio Management

<sup>1</sup> Research, inception of first client assets, and seed-money for overlay management began at Parametric in the mid-90s.

### Parametric

1151 Fairview Avenue N.

Seattle, WA 98109

**T** 206 694 5575

**F** 206 694 5581

[www.parametricportfolio.com](http://www.parametricportfolio.com)

The managed account industry is currently undergoing a profound change in how it delivers separately managed accounts (SMAs), mutual funds and exchange traded funds (ETFs) to clients. Among these new innovations is the Unified Managed Account (UMA), an important upgrade in sponsor platforms with clear, repeatable benefits for sponsors, advisors, money managers, and—most of all—clients.

Sponsors (brokerage firms, banks, turnkey asset management providers (TAMPs), custodians, multi-family offices) offer UMAs as the pinnacle of client experience: a consolidated single account to hold and manage the client's various assets. A single set of paperwork to fill out, a single statement and report to receive, a single source to give social or stock restrictions, an ability to change managers with ease and give tax requests to a single location—all key benefits UMAs provide to the end user that have nothing to do with excess return.

However, not all UMAs are created equal—some merely glue managers together into a single custody account—convenient but one-dimensional. Others employ one of the most powerful tools in investment management: proactive overlay management. Parametric's long history in building and managing customized, tax-efficient individual portfolios has led to the creation of a multi-dimensional overlay management capability: OverlayOne. Since the beginning, OverlayOne has surpassed expectations of after-tax return. This demonstrates the benefit in balancing the artisan skill of stock selection with customization, risk-control and tax-efficiency.

## **BACKGROUND**

There are many reasons for the strong growth of SMAs across the industry, and the promise of customization and tax-efficiency—a truly 'superior' option for the high net worth marketplace—has been a major factor in driving growth.

Although still dwarfed by the mutual fund industry, SMAs continue to experience a high growth rate along side the billions that continue to pour into mutual funds every year. SMA programs have grown into the hundreds of billions as account minimums have fallen as low as fifty thousand dollars.

In SMA programs, managers often manage hundreds of accounts, sometimes thousands. In such an environment, most managers are forced to administer portfolios on systems designed to implement many accounts with as little effort as possible in order to be profitable on the SMA business. Unfortunately, any customization and tax-efficiency the managers provide becomes the rare exception. There is little ability to analyze the tax implications of a sell decision across each individual investor. In the end, clients suffer by having to pay a larger tax bill than they might have to otherwise.

## **THE PARAMETRIC ADVANTAGE**

The logistics of the traditional SMA business require a new account to be opened for each manager (large-cap-growth in account 1, large-cap-value in account 2, etc). In the traditional SMA world, managers would never—could never—reference the decisions of the other managers in the client's account to ensure their decisions made sense in the context of the client's overall portfolio.

**Exhibit 1:****PARAMETRIC'S LIVE EXPERIENCE VALIDATES OUR RESEARCH 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)

Parametric has taken our core capability of customized, tax-efficient individual portfolios and extended our expertise to the UMA. With our program, managers deliver their model portfolios to Parametric where portfolio managers review, optimize and deliver a customized, tax-efficient solution across the client's entire portfolio. This overlay management capability—which Parametric has named OverlayOne—has exciting implications for clients.

**GOALS**

There are two primary goals of OverlayOne. First, Parametric closely tracks the pre-tax returns of the underlying managers, delivering comparable pre-tax return as the clients would achieve in a traditional separate account program. Second, we customize at the client level and provide after-tax benefit where appropriate and reflect client social and risk parameters.

**LIVE EXPERIENCE**

When we started OverlayOne, we estimated that we would add approximately .60% (60 basis points) to after-tax return<sup>2</sup>. Over the last six years, we have tracked the active managers' returns within 1 basis point on a pre-tax basis and added 137 basis points of value on an after-tax basis. (See Exhibit 1)

**TAX MANAGEMENT**

Parametric has achieved this by employing the following tax management methods:

- 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 - Parametric has a small amount of flexibility around manager target weights; this gives us 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 manager is replaced or the allocation changes, Parametric will transition securities where possible and make the change as efficiently as possible;
- Active Tax Loss Harvesting - Parametric 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.

<sup>2</sup> See "Overlay Portfolio Management in a Multi-manager Account" by Stein, D.M and G. McIntire (The Journal of Wealth Management, Spring 2003).

Parametric has also been able to add significant tax savings through the transition of pre-existing securities and portfolios; also, our analysis identifies opportunities to keep securities with overlap to the active managers' models in order to defer capital gains realization.

## CONCLUSION

While OverlayOne represents a great step forward in integrated wealth management, our work and focus will not stop here. Integrating additional asset classes, generating more income from UMAs and giving the managers more trading control are a few of the projects currently underway at Parametric.

The value of a Parametric UMA in taxable accounts is substantial, and the benefits extend beyond just tax management. The client has the additional benefits of simplicity and convenience since all of their assets are in one account, offering them a unified view of the portfolio. They are able to implement security restrictions, set up systematic withdrawals, and have their portfolio rebalanced more efficiently and systematically than they would in separate accounts.

In other words, overlay management (Parametric's OverlayOne) and the UMA can finally deliver on the often-failed promises of separate accounts—evolution indeed.

---

### Disclosures

This information should not be considered investment advice or a recommendation to buy or sell any particular security. Actual portfolio holdings will vary for each client. 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 composite results.

Account Criteria: All accounts included in this composite are fully discretionary. There is no minimum balance requirement for an account to be included in this composite. Accounts are included in their first full quarter of management. Accounts are excluded after their last full quarter of management. Terminated accounts are included for all full periods prior to termination.

Composite Criteria: This composite includes taxable OverlayOne accounts that funded with cash, have no security restrictions, and do not have a Parametric separate account index allocation.

#### Calculation Methodology:

Account Level – Account performance is calculated using a time-weighted, daily-linked total return methodology. Dividend and interest income are accounted for on an accrual basis. All performance shown is net of transaction costs, gross of management fees, includes capital gains, and dividend reinvestment.

Composite Level – Composite returns are market-value weighted using beginning period values.

After-Tax Performance – After-tax performance calculations are based upon Parametric's best information concerning dividend and capital gain realization. Parametric's calculations incorporate the highest U.S. Federal marginal tax rates only – unless directed otherwise by a client or financial advisor. Individual investor after-tax experience will vary according to each investor's unique tax circumstances. As with all after-tax performance, the after-tax performance reported is an estimate. In particular, it has been assumed that the investor has, or will have sufficient capital gains from sources outside of this portfolio to fully offset any net capital losses realized, and any resulting tax benefit has been included in Parametric's computation of after-tax performance.

This information should not be considered investment advice or a recommendation to buy or sell any particular security. Parametric does not provide tax advice. Investors should seek advice from their own financial or tax advisor prior to entering into any investment strategy.