

FULL DISCRETIONARY OVERLAY VS. PLATFORM TECHNOLOGY OVERLAY: The 'Buy' vs. 'Build' Decision

RESEARCH BRIEF
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Unified Managed Accounts (UMAs) are used extensively in the investment management industry as a way to integrate multiple investments within a single portfolio. A variety of overlay portfolio management options are available to alleviate the complexity of implementation and day-to-day management at the program sponsor level. Two of the most popular are full discretionary overlay and platform technology overlay. Although each offers significant benefits, UMA program sponsors should consider which overlay solution fits with the existing business model. ►►

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The Unified Managed Account (UMA) is the natural evolution of the Separate Managed Account (SMA) industry. It simplifies the traditional SMA experience through the integration of separate account managers, mutual funds and ETFs all within a single portfolio. Growth within the industry has been stellar; 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 Advisor (RIA) and Multi-Family Office (MFO) communities, particularly as brokers 'breakaway' from larger investment management firms.

Overlay portfolio management is central to UMA design and philosophy. As the account 'quarterback', the overlay manager is responsible for coordination and implementation of the account. Trading activity occurs in a more efficient way than under a traditional separate account structure. As RIAs and MFOs consider Unified Managed Accounts, it is important to consider the benefits of different solutions available. The role of the overlay manager, and therefore the levels of implementation and coordination, can vary greatly.

We will discuss two common solutions available in the marketplace today: full discretionary overlay (i.e. hiring a third party overlay manager) and technology overlay solutions. The goal is to help investment advisory firms make an educated decision regarding the 'buy' vs. 'build' decision. That is, should the investment advisor 'buy' the services of an outsourced third-party overlay manager or attempt to 'build' an in-house platform using a technology solution?

►► **'BUY' - FULL DISCRETIONARY OVERLAY**

The full discretionary overlay manager aims to capture the pre-tax return of a combination of asset managers (research providers, in this sense) while maintaining control over total portfolio risk and taxes. This model minimizes the operational burden on the sponsors and research providers. Most investment management firms are comfortable delivering their intellectual capital to an overlay manager for implementation within client accounts since unified managed accounts are now common in the industry. Tax concerns and the operational activities of opening, closing, trading and maintaining accounts are centralized between the overlay manager and the program sponsor. The overlay manager tracks the pre-tax return, after-tax return, and several other account-level analytics.

With full discretionary overlay, the overlay manager assumes many of the functions of account management that are typically not among the core competencies of a sponsoring RIA or MFO. One primary goal of the full discretionary overlay manager within a taxable account is to offer after-tax benefits and portfolio customization. For tax-exempt accounts, the overlay manager is responsible for maintaining tight tracking to the targeted allocation while offering operational benefits and simplicity within one account. A robust, 'active' overlay strategy maintains the integrity of the investment process while delivering efficiencies to the UMA sponsor, research provider, financial advisor and end client.

Active tax management has been emphasized as a key benefit of overlay management

within taxable portfolios. Specific tax management techniques include tax-efficient implementation of manager decisions, active tax-loss harvesting, tax-efficient cash flow management, and wash sale coordination. In Parametric's taxable portfolios, from the beginning of OverlayOne™ in 2003 through 2008, there has been 1.37% per year of after-tax outperformance due to the use of these and other tax management techniques. In other words, because these clients invested their taxable portfolios in a program with an overlay manager instead of a traditional separate accounts structure, they were 1.37% per year better off on an after-tax basis as an average. Parametric added this after-tax value while also maintaining tight tracking to the manager models on a pre-tax basis, only deviating 0.01% from the manager models per year on average. These numbers emphasize the goals of overlay management: 1. Achieve the pre-tax return of the combination of manager models; and 2. Add after-tax value in taxable portfolios.

UMA sponsors are responsible for program set-up, including hiring an overlay manager, hiring research providers, and providing access to advisors and end clients. The overlay manager's role extends from initial trading to rebalancing, managing restrictions, managing cash flows, and the consideration of portfolio tax liabilities. This structure is in place to help minimize the operational and technological burdens on the sponsor, allowing the overlay manager to focus on day-to-day implementation and management. 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.

▶▶ **'BUILD' - PLATFORM TECHNOLOGY OVERLAY**

In contrast to full discretionary overlay, platform technology overlay solutions are sold to sponsors, allowing them to access an application, typically web-based, 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 update their models and trade their account sleeves. This approach allows the investment managers to maintain trading control over their investment models. Technology providers that offer active overlay management capabilities aim 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 are responsible for the operational, trading, and reporting tasks of an overlay manager. Under the active platform solution, it is typically the sponsor that implements the account-level decisions, executes trades, and retains discretion of the accounts.

Smaller firms may purchase a platform technology overlay solution or work through a turn-key asset management provider (TAMP) to access a third-party overlay manager. TAMPs offer customized investment solutions and reporting services to advisors and their clients. For these firms the economies of scale may not be sufficient to warrant hiring a third-party overlay manager directly. Many technology solutions will charge a fee per account for firms with less than 100 accounts, making a technology solution attractive and cost

effective. Firms with larger asset projections (typically at least \$200 million) and firms not ready to assume additional operational, trading, and reporting responsibilities often elect to hire a third-party overlay manager directly.

►► BENEFITS COMPARISON

Clearly, there are benefits to both full discretionary and platform technology overlay portfolio management. While certain technology solutions provide after-tax management tools, full discretionary overlay offers the benefits of active tax management in addition to operational efficiencies that are realized through the integration of multiple managers/funds/ETFs into one account.

EXHIBIT 1:

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 clients

An additional comparison should be addressed specifically from the RIA / MFO perspective.

EXHIBIT 2:

CONSIDERATIONS FROM RIA / MFO 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
Trade Control	No	Yes
Trade Rotation	Imbedded in the process	Manual
Platform / Custodian	Open	Open
Sub Advisors negotiation required	Yes	Yes
Added Compliance	No	Yes

SOURCE: Parametric

►► **SUMMARY**

As firms consider a UMA offering, it is important to carefully consider which overlay solution fits within the existing business model. While each solution achieves certain efficiencies, only full discretionary overlay realizes all of the benefits of overlay management. Hiring a third-party overlay manager directly or accessing a UMA program through a turn-key asset management provider should save time, limit costs, and take full advantage of each firm's expertise and core competencies. Parametric's full discretionary overlay management 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:

OverlayOne™ Live Performance (Compliance Approve version to be included in final version)

Parametric
OverlayOne™

Live Performance

PARAMETRIC'S LIVE EXPERIENCE VALIDATES OUR RESEARCH

As of December 31, 2008	PRE-TAX COMPOSITE DIFFERENCE %	AFTER TAX COMPOSITE DIFFERENCE %
Q1-2003	0.04	0.38
Q2-2003	-0.16	0.26
Q3-2003	0.00	-0.01
Q4-2003	-0.08	0.20
Q1-2004	-0.06	0.41
Q2-2004	-0.09	0.16
Q3-2004	0.03	0.42
Q4-2004	-0.14	0.15
Q1-2005	0.13	0.23
Q2-2005	-0.02	0.27
Q3-2005	0.09	0.29
Q4-2005	-0.01	0.27
Q1-2006	0.09	0.36
Q2-2006	0.05	0.59
Q3-2006	-0.11	0.16
Q4-2006	0.02	0.36
Q1-2007	-0.06	0.28
Q2-2007	-0.05	0.23
Q3-2007	0.11	0.38
Q4-2007	0.23	0.70
Q1-2008	0.01	0.31
Q2-2008	0.25	0.48
Q3-2008	-0.11	0.23
Q4-2008	-0.11	1.14
Annualized	0.01	1.38
After-Tax Alpha		1.37

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 is 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 highest U.S. Federal marginal tax rates only – unless directed otherwise by 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.

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