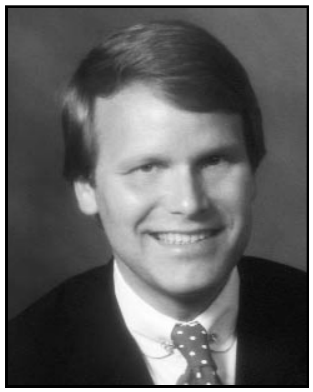
Industry Trends: The Next Generation of Asset Management

By Stephen C. Winks

Everyone knows and expects the internet revolution to change the asset management business, but the question is how. We know that today's asset management business and the financial services industry's product distribution organizational structure are not conducive to adding value. Mutual funds, the most prevalent asset management vehicle, manage money in the abstract with no understanding of the specific needs or the financial circumstances of its investors. Nor do financial advisors (brokers, et al.) have the comprehensive investment process technology necessary to manage the tens of thousands of investment options in terms specifically meaningful to each client's unique needs and circumstances. Thus, today's asset management conundrum: Money is being managed but not in terms specifically meaningful to the investor. There is, in effect, a disconnect between professional money management and the returns realized in the client's account. The money manager is not accountable for specifically addressing the needs of each investor, and the financial advisor who is accountable, does not have the comprehensive investment process technology that would make it possible. The answer is investment management consulting and its associated investment process through which it is possible for the financial consultant to add value in terms specifically meaningful for each client.



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The miracle of the investment process is that it allows the consultant to translate each client's unique needs and circumstances into a custom investment portfolio that will help the client achieve their long-term goals and objectives. The investment process allows the client, through the consultant, to manage tens of thousands of investment options in terms specifically meaningful to them.

Today, for most investors who do not have the financial resources to invest in multiples of $100,000 and avail themselves to separate account management, mutual funds are the primary investment vehicles used by consultants to construct custom investment portfolios. Yet, mutual funds are expensive with a cost structure of 150 basis points. By the time the consultant charges 75 basis points for their services and the firm charges 75 basis points for their services, the client is faced with a 3%+ charge for engaging the professional investment counsel of the consultant. Further, the mutual fund structure is not conducive to managing the tax efficiency of the client's assets nor does the retail-focused mutual fund offer the investment management style discipline of institutional quality separate accounts managers that is crucial in managing risk. As total consulting fees have come down from 3% to 2% or less, the consultant and their firms are getting squeezed as they have to work around the embedded 150 basis point cost of the mutual fund. Faced with absorbing much of this earnings squeeze, many retail consultants have found with as little as $20 million under advisement, it is less expensive for them to buy $70,000 of software, $20,000 of hardware and hire a $60,000 technical analyst to help build and run their own more sophisticated investment process than to use that offered by their firms ($20 million x .75% = $150,000 per year). In the second year, the hardware and software costs are paid for and the process cost drops to $60,000 or 30 basis points on $20 million in assets that continues to drop as assets grow. Because the process is funding vehicle neutral and is not limited to mutual fund or managed account assets in a wrap fee program format, it is far more sophisticated than the investment process offered by most firms, and the consultant by virtue of becoming the added value typically doubles his business in the first two years, eventually driving down process costs 10 basis points or less . Though this has cut the firm's 75 basis points charge to participate in their wrap fee programs to 10 basis points or less, it still has not resolved the issues of managing risk and tax efficiency in mutual fund portfolios and the high embedded cost of mutual funds which severely constrain the earnings of the consultant. The solution is creating a more imaginative way to offer separate account management with far lower investment minimums than the $100,000 minimum that can be secured at the major wirehouses. Mutual funds, by virtue of their management style, structure and pricing, are not well designed for the consultant to manage the risk, tax efficiency and cost structure of their clients' portfolios and to be adequately compensated. Thus, a new type of investment vehicle is needed that is more attuned to investment management consulting and custom portfolio construction. The consultant is doing all the work and adding all the value while the mutual fund is making all the money.

Separate account managers are engaged by institutional investors to manage money according to a specific investment mandate reflecting a specific investment management style for a specific portion of the institution's portfolio as outlined in investment policy. Until the mid-80s, the investment minimums for separately managed accounts typically were $10 million. With the advent of wrap fee programs, technology was created by Judy Rice at EF Hutton that made it easier for separate account managers to offer a $100,000 investment minimum and manage a large number of smaller accounts. EF Hutton agreed to custody the separate account assets and perform all the marketing, trading, account administration and reporting functions. The separate account manager would manage the money, for 50 basis points, or 100 basis points cheaper than a mutual fund. For every 300 accounts, or $50-100 million in assets, the separate account manager would hire a portfolio manager at $150,000 who was responsible for managing each of those accounts as a separately managed account. The portfolio manager would be a CFA or a CFA candidate and have some previous portfolio management experience typically at a bank trust department. Each portfolio manager works from their firm's buy-and-sell list and is compensated on the basis of how well their accounts performs. Sixty to eighty percent of the portfolio managers' assets reflect their firms buy-and-sell list. Yet the art form in separate account management is minimizing the dispersion in returns generated among its portfolio managers but having enough difference so the portfolios can not be characterized as a mutual fund. Thus, the separate account manager aggressively manages their portfolio managers to provide more consistency in the returns realized among all their accounts while assuring each account is different.

The challenge of dropping the investment minimums in separate account management from $100,000 to $25,000 or less, making separate account management available to a larger number of clients, is two-fold. First, it is very difficult for the portfolio manager to effectively manage the specific investment distinctions of more than 300 separately managed accounts. Second, it is very difficult for the portfolio manager to handle the direct client inquiries from more than 300 client accounts. Though the separate account manager is clearly at the outer limits of human capacity, there are other approaches to separate account management that would allow investment minimums to be dropped to $5,000 or less. This would make it possible for clients with as little as $25,000 to engage high level professional investment counsel.

Perhaps the most dynamic approach to dropping separate account management investment minimums is, rather than the separate account managers having to actually manage thousands of individually managed accounts and hire dozens of portfolio managers, the brokerage firm could buy the separate account manager's real-time buy-and-sell recommendations and run inhouse 80 to 100 distinct model portfolios built around the investment management styles of the 60 to 70 leading separate account managers in the country. The separate account manager would sell their investment research for 10 basis points, and the firm would charge 20 basis points for its investment process. The firm's objective, comprehensive investment process is funding vehicle-neutral, incorporating all investment vehicles to include individual securities, mutual funds and managed accounts, and is a form of ownership-neutral incorporating the full range of trust and insurance options. It is through this investment process technology that the firm manages its low-cost, low-minimum investment separate account model portfolios, and the consultant manages all the client's assets regardless of what form they take in terms specifically meaningful to the client. By virtue of the brokerage firm now managing the model portfolios in-house, there are extraordinary efficiencies that can be realized within the brokerage firm that could not be engineered by the separate account manager. The broker or consultant armed with user-friendly technology takes on the role of portfolio manager formerly engaged by the separate account manager. Unlike the portfolio managers or the separate account managers, the consultant has detailed knowledge of the client and **all their assets**. So, information can be managed in terms specifically meaningful to the client and is not limited to separate accounts. The cost of the managed account investment option is reduced to 30 basis points or one-fifth the cost of a mutual fund, and investment minimums drop from $100,000 to $5,000 or less. This new managed account model would make the all inclusive cost of engaging professional investment counsel that can manage financial information in terms specifically meaningful to each client's unique needs and circumstances cheaper than buying a mutual fund that cannot be investor-specific. This can be accomplished while increasing the consultant's compensation and increasing the brokerage firm's market value. It also integrates the firm's proprietary asset management arm into the consulting process that culturally brings consulting into the financial services mainstream, and makes consulting and its superior economics the primary product and service delivery methodology of the financial services industry. This eliminates the cultural bias toward product distribution, and importantly, gives 60-70 separate account managers the opportunity to cannibalize the $5 trillion mutual fund asset base with preemptive technology.

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The mechanics of how this works is partially technological and partly structural. In order to manage an unlimited number of custom client accounts, a technology is needed that would allow the client to be electronically defined in great detail. The thesis of consulting being: If we can define the investor in terms of risk, return, tax efficiency, liquidity, cost structure and investment time horizon, and if we can define investments in the same terms, we can create a mechanism that would allow portfolios to be constructed that would achieve the client's long-term goals and objectives. The convergence of Nobel Prize-winning investment theory and advanced systems technology makes this possible. Thus, if firms created an electronic gating technology that defined the investor in very intricate terms that is tied to trade and order routing it would be possible to generate an electronic policy statement and to create a management tool which would suppress trades which take the client's portfolio outside the constraints of investment policy. Accounts that are out of balance with the recommended investment strategy would be electronically rebalanced and managed by exception. Therefore, if the investor agrees with their investment policy statement and associated investment strategy that would achieve their long-term goals and objectives, then a virtually unlimited number of custom investment portfolios could be managed by the consultant.

This technology makes the compliance risk of a discretionary advisory account less than that of a commission brokerage. This gating technology, called Pegasus, was developed by Tom Roginski in 1994 as part of an intranet/internet-driven virtual real-time, comprehensive investment process technology created by Portfolio Construction Technologies. It essentially makes custom portfolio management possible for a consultant to execute across a large number of client accounts and is best executed at the consultant level so that all clients assets to include separately managed accounts, individual securities, mutual funds, checking and savings accounts, etc. can be cohesively managed, not just the client's separately managed accounts.

The gating and associated electronic policy statement is just part of a virtual real-time comprehensive investment process technology. The consultant can communicate via the internet in real-time to the investor using a series of sophisticated reports designed to each client's specifications which establishes in terms the client understands how well they are doing relative to their long-term goals and objectives and any other values they wish to monitor. As a result, there is a different sort of client dialogue stimulated which illustrates the value the consultants add. Some of this dialogue may have to do with the performance of the specific model separate account portfolios used to construct the client's portfolio. But most of the questions will be directed to aggregated portfolio performance: the big picture of the economy, market sector, cap size and style rotation, and its implications to the portfolio; progress relative to long-term goals and objectives; isolation of the key investment values of risk, return, tax efficiency, liquidity and cost structure which must be managed in order to achieve long-term goals and objectives; and normal administrative detail. Because everything can be communicated with the client in realtime, responsiveness to client inquiries between formal quarterly meetings is where much value is added and client satisfaction largely determined. Thus, in order to free the consultants' time to cultivate and win new business, to assure a high level of responsiveness to the client and to secure the highest client service ratings, the consultant will engage the services of an associate. This colleague is compensated by the consultant to help manage all aspects of the client relationship (to include constructing portfolios) and to eventually serve as a partner of and a successor to the practice. In doing so, and by utilizing a highly sophisticated centralized investment process technology, the consultant builds a mechanism that assures and quantifies the transferable value of their practice.

Value of the firm changes with this new investment management consulting business model.

The role, pricing, economics and value of the firm changes with this new investment management consulting business model. This is the track that commission brokerage firms can run on to make a successful transition to advisory services. By virtue of firms repricing and bringing separate account management in-house; creating a funding vehicle-neutral, virtual real-time comprehensive investment process technology through which brokers add value; and running the vast majority of their asset base through this investment process; the firm expands its earnings multiple to three times that a commission brokerage firm can command and greatly streamlines its cost structure, increasing its earnings and margins.

Pricing changes as well to reflect where the value is being added. The investment research to drive separate account model portfolios is 10 basis points, the investment process costs 20 basis points, the firm charges 30 basis points for its support and the consultant charges 90 basis points, for a total all-inclusive fee of 150 basis points. This is high-level custom portfolio management in terms specifically meaningful to each client offered at 6 basis points cheaper than the 156 basis point cost of the average mutual fund, which must manage money in the abstract without any knowledge of its investors. This technology is both preemptive to the mutual fund industry and the commission brokerage delivery platform in terms of the value it adds. Its cost structure is much more reliant on technology than a support staff of thousands and streamlines a highly-structured product distribution bureaucracy that is focused on the vested interests of its exclusive product franchises within the organization structure rather than the interests of the client or the consultant. Its cost structure is half or less that of commission brokerage, which results in higher earnings and profit margins. The combination of higher earnings, margins and multiple, and the massive asset base the firm will garner under its management will result in a larger market capitalization for the firm based on its 30 basis points (50 basis points with its investment process) charge for its services than it could command as a traditional commission brokerage firm. The pricing structure also, in effect, creates a 75% pay-out environment for the consultant with the firm providing far more user-friendly and sophisticated technology and support.

This next generation of asset management where brokerage firms assume a more informal role in empowering the broker to compete on the basis of the value they add, aligns the interest of the client, the broker, the firm and the money manager. It creates a new cultural, structural, technological and economic model for the financial services industry. It makes high level professional investment counsel possible for clients with as little as $25,000. And, its success is measured by how well the client is served in managing their financial affairs, which includes managing the asset and liability side of the client's balance sheet.

This model is the most likely path along which the brokerage industry will evolve because it answers the question of what firms should do with their proprietary asset management which is in conflict with an objective investment process that can only choose from the best investment options. By firms buying investment research only from the best separate account managers, they can drive down the cost of separate account management creating a vehicle more conducive to portfolio construction that can reach clients with as little as $25,000. By firms creating a virtual real-time comprehensive investment process technology, they empower their brokers to deliver an unprecedented level of investment counsel and value. With lower cost and lower investment minimums for managed accounts there are no better investment options to construct custom investment portfolios unless you have tens of millions of dollars to invest, use individual securities to construct your own portfolios, or use index funds. Even if a separate account manager were to emerge with superior numbers, there has to be an intermediary who can translate how that manager should be integrated into the client's portfolio and establish what its implications are on the portfolio in terms the client understands. Though the firm and the consultant must be constantly vigilant for new, outstanding separate managers and must rigorously evaluate their existing managers to maintain the integrity of the investment process, the consultant and the investment process used becomes central to the value added proposition to the client.

From a practical standpoint, this next generation of asset management assures investment management consulting will be the primary product and service delivery platform of the financial services industry succeeding commission brokerage. Notwithstanding the troubling outlook for commission brokerage and the need for firms to move toward advisory services, the reality of the financial services industry is that the areas of the firm that contribute the highest earnings, margins and multiple wield the most influence. Jeff Peek, the president of Merrill Lynch Asset Management, one of the top five highest paid executives at Merrill and one of the leading candidates for the presidency, and ultimately the chairmanship, could use this model as his platform to ascend to the presidency of the firm. Morgan Stanley Dean Witter, which has always had a proprietary product distribution mindset, could easily segue into this next generation of asset management built around investment management consulting and finally align its interests with that of its clients and consultants. David Odenath, president of Prudential Investments and his colleague, Judy Rice, who is responsible for consulting and building outside distribution for its products, are perfectly positioned to create this next generation of process-driven asset management. Similarly Brian Storms and Steve Fisher of PaineWebber's asset management arm, Mitchell Hutchins, would find this next generation of asset management tied to an investment process as a perfect vehicle to building their asset management business by cannibalizing the firm's sizable mutual fund asset base, and taking it and its associated process outside the firm to garner even more assets. Charles Schwab would solve its $250,000 investment minimum problem with separate account managers by directly or indirectly offering this business model to its independent advisors in its managed account program and immediately cannibalize its mutual fund asset base, making it one of the largest asset management firms in the world. Importantly, Schwab, like E*Trade, is betting heavily on internet brokerage that presumes firms will be able to charge for trade execution which is no sure thing. This would be a complementary business built around advice which would hedge Schwab's bet on internet brokerage. Dennis Mooradian and Shelly Freeman at Wells Fargo could adopt this business model and take a quantum leap in market stature with preemptive technology to aggressively grow their business while playing to their strengths in asset management.

This model is the most likely path along which the brokerage industry will evolve.

There are many reasons and many motivations why firms, brokers, consultants and clients would be attracted to a business model that can translate financial information in terms specifically meaningful to each client's unique needs and circumstances, and establishes accountability for results. This is the future of the financial services industry, and it is only a matter of time before it becomes a reality. ■