Portfolio Management

New Challenges, New Solutions

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As we emerge unscathed from the over-hyped, non-event of Y2K, what are the real issues facing consultants as we move into this new millennium? Is the concept of active management likely to become our industry's catch phrase for the year 2000 and beyond?

My bet is yes. I foresee the concept of active management walking hand-in-hand with the value-added mantra of the late 1990s. Those who embrace these concepts will prosper as never before, while those who ignore them will quietly fade from the scene.

Looking to the immediate future, many of our industry's current trends will have taken a firm hold. Due to the commoditization of cheaper, more-efficient, on-line trading, the major firms will be forced to completely convert the way they charge customers for advice. As discussed in this publication over the past several months, these giants are now beginning the transition process.

Transition Presents New Challenges

The wirehouses find themselves in transition also, but it appears their foresight regarding potential stumbling blocks is no greater today than in the days when tax shelters and real estate deals emerged as the hot tickets. As most of us can recall, that period ushered in the era of incentive plans whereby consultants were motivated to sell such strategies based upon a "where's-my-trip?" mentality as opposed to "how-will-this-investment-serve-my-customer?" consideration. Today's market demand for value ensures any such modern day tactics will be met with marginal (at best) long-term success.

And while today's wirehouses understand the same life-threatening need to convert to fee-based business as the major firms, their current lack of any added value offerings prevents them from successfully competing with on-line discount trading firms. At the same time, they seem unaware that the revenue from their newly designed fee-based business model will not keep pace with the revenues from the historic transaction-based model. Still, they move forward in what amounts to a panic mode, placing both their credibility and the future of their reps at risk in their feverish attempt to halt the customer exodus to on-line trading.

The current panic signals yet more trouble for this group as they force their reps into holding themselves up to the public as qualified consultants for mutual funds or active equity management programs. In extreme cases, novice reps are being passed off as seasoned portfolio managers. These charades are being facilitated by offering in-house, guided programs which attempt to bridge the capability gap caused by lack of any real experience in asset management. This misguided attempt to secure the future will only further propel the wirehouses down an already bleak path. Their customer accounts will be plagued with high volatility and lack-luster performance due to the random nature of inexperienced equity management decisions.

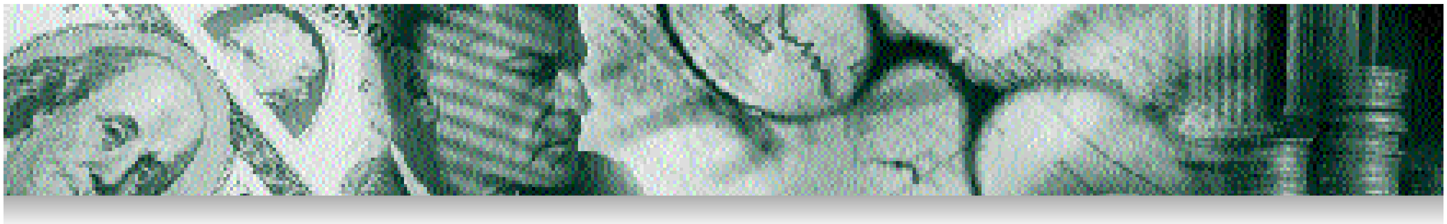
Bottom line: Today's wirehouses offer nothing more to the public than in the past. Their purported "value added" is simply a smoke-and-mirrors tactic for being able to charge for their services in a different fashion (i.e., fees versus transactions). In reality, their value remains stagnant (yet worthy) as professional transaction facilitators.

Technology Creates Real Value for Industry

So are these institutions finished as we know them today? Or is there an ethical and viable option for adding real value to this segment of our industry? Without a doubt, there is an answer – found in technology. Technology that will accord the wirehouses, as well as inexperienced equity management professionals, the tools to manage complete portfolio accounts easily and effectively, and with outcomes equivalent (and in many cases, superior) to today's most acclaimed money managers. The value represented by those employing this new technology will be both real and markedly beneficial to droves of new end-user customers.

We are all acutely aware of 20th century technological advances and what they have signified in terms of productivity across the global

continued on page 22



New Challenges, New Solutions

Continued from page 8

economy. I believe the investment industry stands on the verge of its own similar revolution as current technologies provide a virtual equity management environment void of the necessity for either innate skill or hands-on experience. Although only a handful of such technology-based products exist today, it is likely a waiting-and-wanting marketplace will eagerly embrace these new resources. Near-term demand is expected to flourish rapidly, and as with all goods and services, such demand will ultimately result in mounting supply, expanded capabilities and increased affordability, ensuring virtual management products will become as commonplace as today's desktop PC in the years ahead.

It is interesting to note that such technology will allow for all aspects of the equity management process to be automated, including ancillary services such as order execution and performance reporting. This complete package capability will not only lower costs for individual managers as well as larger consulting groups, but it will also provide unprecedented feedback (both in timing and scope) on all account activity. This bodes well for our industry as a whole. Tomorrow's virtual managers will enjoy complete and continual feedback regarding every conceivable aspect of each customer account. The "knowledge is power" maxim will grip this industry as the enhanced ability to quantitatively track (and react to) “what's working and what's not” becomes the standard for managed accounts.

It is certain that tomorrow's customers will demand nothing less. Market savvy, high net worth clients who once monitored individual stocks for simple gain/loss stats will soon become familiar with more advanced, portfolio assessment techniques. As the unquestionable value of such detailed tracking becomes more widely understood, the equity management professionals supporting their trading philosophies and actions with such information will see their businesses flourish. Credibility and trust will surge to all-time highs as customers feel more in tune and in touch than ever before. Finally, and perhaps most importantly, the objective nature of employing a quantitative modeling process (versus often rash emotional market reactions) will ensure the type of overall success found only through careful adherence to a disciplined approach.

Technology Aids Capacity Dilemma

In addition to enhancing and strengthening nearly every aspect of the manager/customer relationship, technology will also prove the answer to many other inevitable challenges facing our changing industry. From my vantage point, the most imminent of these concerns is the fast-approaching capacity dilemma. As our industry continues its slow but inevitable conversion from transaction- to fee-based compensation, two distinct capacity challenges appear on the horizon:

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- The capacity dilemma associated with the limited number of both qualified and quality managers to handle the influx of new business generating from America's vast new wealth.

More and more RIA customer dollars will be chasing the same few market gurus whose capacity will quickly reach its limit. As these reputed managers reach their maximum capacity, consultants will be forced to look further and further down the quality ladder to continue to place assets. And the further down the ladder one must go, the less customer value one can add. Technology capable of producing superior outcomes while managing limitless assets will become the definitive lifeboat for this group of industry professionals.

- The capacity challenge created by the swarm of newly licensed RIAs soon flooding the market.

Long-time registered representatives, once well compensated by simple transaction business, are being forced to prepare for the actuality of a do-or-die transition to a fee-based model. This situation leaves over half a million active RRs with two choices: (1) become an RIA or (2) find a new career. Although a portion of this group will undoubtedly opt for the latter, the majority, and certainly the most successful among them, are likely to hold the course and jump on the RIA bandwagon. Who will they turn to for quality equity management – the already overtaxed gurus previously mentioned? Again, the answer lies in new technology capable of delivering the tools necessary for even the newest rookie player to become a quality equity manager . . . literally overnight.

In addition to these dual capacity challenges, there is yet another formidable contender for the available pool of outside money management resources. In an attempt to respond to today's changing environment, Mother Merrill and other industry giants are rapidly converting their RRs to RIAs with the intention of referring customers to in-house programs and approved outside managers. Couple their new focus with virtually limitless resources, it becomes obvious that the small independents will have little outside access to the industry's best advice in the future. Unless, of course, that advice emanates from a virtual process which knows no limits or bounds. If such technology sounds more like hype than reality, perhaps a brief overview of present day processes managing millions in assets is in order.

Complete Portfolio Management

To begin, imagine a computer-generated, quantitative market-tracking process that serves as an ultimate black box for complete portfolio management. This box is fed an individual stock list along with a selected risk tolerance. A methodical interrogation and analysis of each individual stock as well as its ability to meet predetermined portfolio performance goals then commences. The result? Weekly statistical output presenting literally thousands of critical portfolio assessment figures, along with specific buy-and-sell orders for Monday execution.

Naturally, this is a simplified view of a highly technical process. The skill that today's technology lends to the process is both staggering and unparalleled in the human arena. In a typical 60-stock portfolio, an astronomical number of calculations are performed. For example, when a new portfolio is submitted, more than 600 tests are performed on each individual stock. The initial set-up of a 60-stock portfolio includes a 9-year, walk-forward analysis using more than 95.4 million calculations. And on a weekly basis, an average of 1.4 million new calculations are performed as the black box tests each stock for its likely continued contribution to the overall portfolio goal.

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Based upon combining the latest week's information with all past trending data, the box then issues an order to either maintain current holdings or to re-allocate certain equity positions (or portions thereof) to other portfolio assets. This includes heavy cash positions during market downtrends and a full (or nearly full) investment posture during periods of market expansion. It is important to note that the pre-selected risk tolerance has a significant impact upon future asset exposure. But the generalities included here remain consistent throughout the wide range of portfolios (including conservative, moderate and aggressive) currently employing virtual management technology.

No equity management skill required. No capacity challenge in sight. And when the inevitable question of returns and comparative market performance arises, such virtual management technology emerges as an even greater asset. A quantitatively modeled approach to the trading process consistently outperforms most market indexes under most market conditions, producing outcomes on par with the industry's top managers.

It is interesting to note that beyond performance considerations (which undoubtedly rank at the top of every professional's list), current technology users report "relief from stress" as important to their overall satisfaction with the virtual process as superior returns. The highly rated benefit of stress reduction heads the list of other naturally emerging advantages enjoyed by those utilizing technology in the management of their consulting businesses.

Consultants Gain Freedom

Other benefits include:

Increased time for business-expanding activities. Through the employment of technology, time formerly spent monitoring day-to-day market conditions becomes available for gathering new assets. Managers report that prior to converting to virtual equity management, more than six hours of their typical day was spent studying the markets and overseeing customer portfolio activities. Once these users become comfortable with letting the process do the work, hands-on management time becomes limited to placing new computer-issued trades on Monday mornings and routine researching of the market for new stock acquisitions.

The marketing advantage of having a real added-value ticket in place. Many of today's customers heading for the on-line trading shores have simply decided that they can do as good a job managing their own money as their former consultants. Newly gained insights regarding the superior performance capabilities of the virtual management process quickly (and justly) erode such confidence. The inclusion of state-of-the-art technology in one's consulting arsenal will retain many customers demanding this specialized technology unavailable to the retail market. And even as virtual management technologies inevitably arrive on the retail scene, end-user clients are likely to maintain their accounts with equity managers whose past market strategies and stock-selection expertise has proven itself over time.

The enhanced marketability of customized portfolios. It goes without saying that the greatest revenue producers for consultants are high net worth clients and institutional accounts. The classic profile of high net worth individuals is one of traveling first-class and receiving special treatment relative to the average Joe. Customized portfolios offer an efficient and affordable means for appealing to this desire for exclusivity. Reaching far beyond the expectation of special treatment for the wealthy, institutional accounts are typically accompanied by very real and specific performance criteria. The customization process ensures that any given set of considerations can be wholly accommodated through specific portfolio design.

The strategic advantage of offering customized portfolio services. Having previously discussed the uses and benefits of customized portfolios, the business-building applications for today's consultant become obvious. I am convinced that the ability to cater to individual client needs through virtual customization will be the ticket for setting one's practice apart in the coming years. Practices based upon allocating assets to mutual funds to accomplish similar goals will quickly become at risk as fee-mark-up for this service will become less and less acceptable in the future.

The exceptional financial advantage of retaining all but a small portion of management fees. Typically, outside managers receive half (and in some cases, even more) of the total fees paid to a consultant in exchange for their equity management expertise. Compare this number (often reaching thousands or even tens of thousands in monthly charges) to virtual portfolio fees starting at around $500 per month. The financial benefits gained through the employment of technology are noteworthy by anyone's standards.

Unprecedented consistency of both process and outcome. The ever objective, goal-targeting discipline infused into today's technology ensures consistent client outcomes. The current effort by consulting groups to match customers with suitable managers (in both style and strategy) is

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overwhelming and falls short in most cases. It is impossible to be all things to all people at all times. As technology designed to match managers with customers is more widely utilized, the real problem will emerge as the dynamic nature of the manager being selected through the search. Key employee and management personnel turnover ensures that even the best-fit matches will be subject to change, notwithstanding that what you see or hear from a manager is not always what you ultimately receive. All managers are human . . . and most active managers are artists rendering unique images based upon newly emerging market trends. Often they are similar to the last, but the myriad of dynamics unfolding during certain market conditions make conjecture of consistency unreliable at best.

New Control for Consultants, Managers and Clients

As a 20-year market veteran and current technology entrepreneur, I foresee the above list as only the tip of the iceberg relative to the ultimate benefits technology will provide to the money management industry. For instance, in addition to the in-place processes discussed in this article, new applications currently in production include "The Virtual Portfolio Builder" and "The Virtual Analyst." Both projects have been undertaken as a result of customer request for assistance in the initial stock selection process. We estimate testing of these products to be completed by year's end and available to the general market by March of 2001. Meanwhile, we continue to explore the endless possibilities of ideas designed to further our industry in terms of overall growth and profitability through technology.

Conclusion

In closing, keep in mind that as these and other new technologies are brought to market, both managers and end-user clients will enjoy unprecedented control over how their money is being managed. This enhanced ability to monitor current assets will naturally include the capability to better judge relative performance, and as relative performance is more easily ascertained, the tolerance for under-performance will dwindle at an exceedingly rapid pace. The "what-have-you-done-for-me-lately" battle cry will ring loudly and continually as never before. And those who cannot produce satisfactory answers to this question will find their customers aligning themselves with consultants who can. ■

Senate Banking Committee Studies Centralization Of All Stock Quotes While NYSE And NASDAQ Talk Merger

Continued from page 2

and-sell orders can be electronically matched and crossed off the exchange floors, and the buyers and sellers can split the spread of the 1/8 of a point or more (12.5¢ per share or more) between them, thus getting a better price. In fact, assuming a 6¢ per share retail commission, the investor almost gets the trade for free. The cost of the crossed trade is just 1¢ a share, and if the shares are actively traded, the trade is almost immediate in real time. This is, in fact, faster, better and cheaper than the trading floor of the exchanges.

It is with this background that Levitt has been pushing for a resolution which led to Senate Banking Committee hearings in New York last month. The SEC laid out its plan for restructuring the market. The plan proposed a range of six solutions. At the conservative end of the solution spectrum, the SEC could simply require greater disclosure of trade execution and order routing by market centers and brokers. This would require market orders to be exposed to price competition in other markets to assure customers get the best price available. At the aggressive end of the spectrum, all markets would be centralized into one system under one regulatory body.

The specialists, market makers and traders of the NYSE do not like the prospect of matching ECN pricing. Rather than the market maker keeping the spread between the bid-and-asked price as their compensation, ECNs split the spread with the buyer and seller, giving them a better price but eliminating the job of the market maker, specialist and floor trader. The challenge the regulators and legislators face is the exchange's specialists, market makers and traders own the majority seats on the NYSE which governs the exchange, and they are not about to put themselves out of business. Of the six solutions posed by the SEC, at the aggressive end of the scale is the centralization idea. Charles Schwab and the major brokerage firms were opposed to centralization on the basis of it being anti-competitive as it would impede, if not eliminate, the prospect of innovation. Senator Phil Gramm, chairman of the Senate Banking Committee, said, "Total centralization would stifle competition, precluding small or start-up firms from markets that should be freely accessible. The tenor of the meeting centered on not limiting competition. Schwab's general counsel, Hardy Callcott, made a particularly well-reasoned plea for the SEC to make real-time stock quotes free to the public. Exchange fees of $1.8 billion exceed the SEC budget by more than five times, and like genome research, real-time price quotes should be in the public domain.

THE CHALLENGE THE REGULATORS AND LEGISLATORS FACE IS THE EXCHANGE'S SPECIALISTS, MARKET MAKERS AND TRADERS OWN THE MAJORITY SEATS ON THE NYSE WHICH GOVERNS THE EXCHANGE, AND THEY'RE NOT ABOUT TO PUT THEMSELVES OUT OF BUSINESS

Arthur Levitt expressed fears that markets are being fragmented by orders being directed to other exchanges and