January-February 2002, Vol. 5, No. 1

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

[G r a p h i c o m i t t e d]

Why MDAs Will Reshape The Course Of The Financial Services Industry

Stephen C. Winks

If only in adversity do we find clarity, then what do we do when we can no longer sell the promise of extraordinary returns? We are only now just beginning to appreciate Warren Buffett's observation in late 1999 just before the market turned downward when he suggested the private capital markets were valuing companies in the same industry at one-third of the price that their publicly traded counterparts were trading. Buffett noted, "Why would one pay three times more for a company in the public trading markets when superior performing companies in the same industry in the private capital markets can be acquired for one-third the price?"

Essentially the pricing of securities in public trading markets had become disconnected from the fundamental economic value its earnings would command as a private enterprise. Even today, after a significant downturn, we are still trading at a 30 P/E which is twice the historical P/E of 16, because earnings have fallen faster than price. Thus, if the public trading markets are to remain healthy, the market correction is far from being complete, and it may well take a while for the market to recover. Yet, in this first sustained market downturn in 20 years, if the commission broker is going to continue to get paid, he is in the awkward position of not only having to continue to make investment recommendations without the promise of the extraordinary returns of the immediate past. These recommendations have to be made without the benefit of a rising market which may negate the soundest look. In the adversity of a sustained market downturn, the clarity of getting paid not to make investment recommendations makes imminent sense. The engagement of one's professional investment and administrative counsel to address and manage a broad range of investment and managing values for an on-going advisory fee becomes an overwhelmingly preferable business model to commission brokerage. It is good for the investor, it is good for the financial advisor, and it is good for the industry. Commission brokerage only works well when there is performance to sell. Thus, only in the adversity of a sustained market downturn is there clarity. It becomes clear to the investor, the advisor and their firm that a highly disciplined, long-term, fee-based approach to adding value, proven in the institutional markets, is essential for their continued success.

> "WHY WOULD ONE PAY THREE TIMES MORE FOR A COMPANY IN THE PUBLIC TRADING MARKETS WHEN SUPERIOR PERFORMING COMPANIES IN THE SAME INDUSTRY IN THE PRIVATE CAPITAL MARKETS CAN BE ACQUIRED FOR ONE-THIRD THE PRICE?" – WARREN BUFFETT

Let's all hope the market downturn is short-lived, and the markets will bounce back with the almost immediate economic recovery now underway. But the signs are clear that the extraordinary returns of the past 20 years cannot be sustained and keep our equity markets healthy. A sustained downward correction is in order. This is a moment of truth for the larger financial services industry which ultimately represents significant industry-redefining challenges on every front. If we hope for the best and plan for the worst, it would be difficult to argue that adding value through addressing and managing a broad range of investment and administrative values as required by regulatory mandate under UPIA, ERISA and MPERS would not be in the investor's, the advisor's, the firm's and the industry's best interests. This is particularly true with the transparency of the internet. It would be self-defeating not to add value. Yet, only 4% of the financial advisors at the major wirehouses that have built their entire practices around high level, expert advice (and account for 70% of on-going consulting revenues) and only one-half of 1% of all financial advisors in the larger financial services industry, are capable of providing high level, comprehensive, expert advice. How will the financial services industry make this important transition from commission sales to adding value through fee-based advice?

[G r a p h i c o m i t t e d]

In this difficult market environment, the multiple discipline account (MDA) where there are multiple managed accounts in one account, is an important key for a large number of financial advisors to adapt their business around adding value through multiple manager portfolio construction. Working within a commission brokerage culture, the financial advisor learns how to construct highly customizable multi-manager investment portfolios which is not only the skill set necessary to add value but intellectually takes the commission broker deep into the investment process through which value is added. Because MDAs have originated as a product from the proprietary asset management division of a major U.S. brokerage firm, it is totally consistent with today's product management organizational structure and culture, yet to succeed it requires the financial advisor to directly or indirectly to add value through multiple manager portfolio construction. The MDA does not require significant cultural, structural or technological changes on the part of the commission brokerage firm in order for a large number of brokers to develop the fundamental services necessary to add value. The MDA is the manifestation of how asset management firms must evolve to assure the highest level of value they add can be actually achieved and realized by each investor through financial advisors. When the MDA achieves broad market acceptance, then more sophisticated forms of portfolio construction and advice become more readily deliverable, and the depth and breadth of investment and administrative values being addressed and managed become key points of differentiation for the financial advisor. Thus, through MDAs, the financial services industry will have the means to quietly evolved to a much higher level of counsel. For those who believe high level advice is implausible to deliver en masse in a commission brokerage environment, you just have to look at CitiGroup Asset Management, the originator of MDAs and owners of the MDA name. We are at the early beginnings of this transformation. CitiGroup Asset Management has just had a $15 billion net inflow of assets in its MDAs through Salomon Smith Barney over the past 12 months, which rank it first among all U.S. asset management firms in net asset inflows. By virtue of MDAs becoming the hottest investment vehicle within the U.S. asset management industry hungry for a way to grow assets in a down market, we have found a means to develop the skill set of the financial advisor necessary to add value through multiple portfolio construction.

With the MDA, for the first time, the extraordinary asset management capability of institutional asset managers to add value is harnessed and translated through the financial advisor in terms specifically meaningful to each investor in one client account. Today, if a financial advisor wanted to construct an institutional quality multiple managers investment portfolio with separately managed accounts, it would be a daunting task. Consider the complexity. First, assuming a $100,000 investment minimum for each managed account and assuming five managers as a minimum for creating an investment strategy well-suited to the client's objectives (as outlined by the client's statement of investment policy), the advisor would only be able to work with investors with $500,000 or more to invest. This limits the application of institutional quality money managers to more discerning, high-end clients with the most assets. Second, in a multi-manager portfolio, the advisor assumes onerous reporting responsibility by having to personally create a composite performance report on all five managers because each manager only reports on the portion of the investment mandate they are responsible for. Most brokerage firms do not offer composite quarterly reports that incorporate multiple managers and multiple investment vehicles. Third, the advisor also assumes responsibility for coordinating, directing and managing the five separate account managers in executing a cohesive investment strategy as outlined in the investment policy statement created by the advisor. They must make sure one widely held stock holding among the five managers does not make up 25% of the total portfolio. They must execute a sophisticated tax planning strategy for each client harvesting tax losses and maximizing capital gains. They must make sure each MDA complements the core holdings of each client and reflects each client's specific instructions. They must monitor trade execution cost to assure best execution and to aggressively manage the overall cost structure of the investment portfolio. Managing this level of detail is why only 4% of the financial advisors at the major wirehouses generate 70% of the managed account revenues. They have had to build and structure their entire practices around multiple manager portfolio construction which drives their investment management consulting practice. The MDA resolves all these issues, and in doing so, opens the flood gates for high level, comprehensive, expert advice.

IN THIS DIFFICULT MARKET ENVIRONMENT, THE MULTIPLE DISCIPLINE ACCOUNT (MDA) WHERE THERE ARE MULTIPLE MANAGED ACCOUNTS IN ONE ACCOUNT, IS AN IMPORTANT KEY FOR A LARGE NUMBER OF FINANCIAL ADVISORS TO ADAPT THEIR BUSINESS AROUND ADDING VALUE THROUGH MULTIPLE MANAGER PORTFOLIO CONSTRUCTION

First, by the MDA reducing the account minimums to as low as $25,000 at Merrill Lynch and $50,000 at Salomon Smith Barney, the market for high level advice is expanded five or six times. There are only two million households in the U.S. that have $500,000 or more in liquid investable assets, but there are 15 million U.S. households with more than $100,000 in liquid investable assets where fee-based advice becomes economically viable for the financial advisor. By incorporating five or more managed account managers in a MDA, the market for high level, comprehensive, expert advice is grown by a factor of five or six times. One could argue whether mutual funds would be a better option for heretofore retail

© 2001 PCT Publishing
Ph 804-795-1642 ■ Fax 804-795-7703

[Graphic omitted]

investors, but it would be rendered moot by the finding that it is rare in an objective manager search that a retail mutual fund has the style discipline, performance and cost structure which would make it a competitive option within its investment management style peer group of leading managed account managers.

Second, by having 4-6 managers in one MDA account, a composite performance report can be electronically generated each quarter, each week, each day for that matter – materially reducing the labor-intensity of the advisor personally having to create each quarter a composite performance monitor incorporating all of the managed account managers within the MDA for each client. To the chagrin of the financial advisor, the Excel spreadsheet has become the most prevalent performance reporting technology within the industry because the industry has yet to figure out a way to generate performance reports incorporating multiple managed accounts, must less all the client's assets necessary in order to add value. Thus, in the MDA reporting technology are the seeds of more comprehensive reporting. An even more elegant web-based reporting solution will eventually evolve by popular demand which will incorporate all the client's assets and liabilities, going far beyond managed accounts. But until it does, the MDA makes it far easier for the financial advisor to report on multiple managed account mangers that comprise a multiple discipline account. By extension, the MDA is creating demand for a more comprehensive reporting technology. The MDAs reduction in the labor-intensity of constructing and reporting on multiple manager investment portfolios removes a huge barrier to entry for the vast majority of the advisors who want to add value for their clients. These advisors do not have people resources on staff within their practices or the interest in diverting valuable time from working with clients to performing less rewarding administrative tasks like creating their own composite performance monitors for every client each quarter. No one wants to have to use an Excel spreadsheet to create their own composite performance monitor using their own methodology which is fraught with great opportunity for mistakes. Only the most passionate and adept advisors in adding value go to those lengths; these are the senior consultants who constitute just one-half of 1% of all financial advisors but who advise 25% of all U.S. assets.

Third, the MDA interjects a third level of portfolio management to complement the managed account managers and the financial advisor, that allows a far higher degree detail to be professionally managed within the MDA than is presently possible for the vast majority of financial advisors to achieve on their own. This third level of portfolio management that the MDA brings through the financial advisor to the client level makes sure that:

THE STRATEGIC IMPLICATIONS OF THE MDA ARE PROFOUND AS IT INFLUENCES HOW THE FINANCIAL SERVICES INDUSTRY SUPPORT STRUCTURE NATURALLY EVOLVES AROUND THE THESIS OF ADDING VALUE

- The portfolio has no undue concentration of a widely held holdings among the multiple managers in the MDA, that would constitute an undue concentration in a stock. This provides an uncommon degree of oversight in constructing a multiple manager portfolio. The MDA provides for a better balanced investment strategy than mutual funds can provide and that advisors can typically provide on their own initiative.
- The third level of portfolio management structured in a MDA provides a far more disciplined approach to harvesting tax losses and maximizing capital gains among multiple managers within the MDA than is possible with most financial advisors. This introduces a well-conceived, professional discipline to manage tax efficiency.
- The third level of asset management in the MDA allows the MDA to be managed as a complementary investment strategy around a client's core holding which may be tied to an options strategy or restricted stock, which morphs the financial advisor into providing far more sophistication with an MDA than they possibly could on their own.
- The third level of asset management introduced by the MDA also aggressively manages trading cost by routing and crossing buy-and-sell orders and by routing orders into blocks.

The MDA shifts the focus of the financial advisor and the client to investment strategy designed to achieve the client's goals and objectives in the context of a larger investment process which provides a discipline through which value is added. Rather than discussing the specific stock positions of each manager within the MDA, the financial advisor will focus on managing investment values like risk, return, tax efficiency and liquidity as required under UPIA, ERISA and MPERS. In moving toward multi-manager portfolio construction, it becomes clear that it is what you do with the investment products – or process – that adds the value, not the investment products themselves. Thus, the six financial service (asset study, investment policy, strategic asset allocation, manager search and selection, performance monitor, and tactical asset allocation) investment process used to create investment strategy becomes the primary means through which advisors add value.

The strategic implications of the MDA are profound as it influences how the financial services industry support structure naturally evolves around the thesis of adding value. The capital markets value recurring fee revenues derived from investment management consulting three times more than commission revenues. The slow evolution from a product management organizational structure to a process management organizational structure will cut firm's operating cost in half or more, increase earnings and margins, and expand their earning multiple by a factor of three – all while empowering the financial advisor to deliver an unprecedented level of professional investment counsel. All this is particularly welcome in a difficult market and operating environment.

© 2001 PCT Publishing

The MDA is an important transitional product because it puts into play much of the machinery necessary for the financial advisor to add value. From the composite managed account reporting of the MDA will evolve aggregated account information on all the client's assets and liabilities, which will beget a virtual, real-time balance sheet and income statement, and total account transparency, which ultimately demands value to be added. But the MDA is more than that because it interjects another level of asset management that empowers financial advisors to, in effect, manage a level of detail they do not wish to involve themselves, yet is essential to adding material value. But most importantly, the MDA simplifies many of the technical aspects of adding value, allows the advisor to spend more time with the client to evolve investment policy and strategy. The MDA is not an all-end solution; it doesn't incorporate all the client's assets and liabilities necessary in order to add value. Thus, it is not a complete client reporting system nor does it incorporate investment policy. So, it has neither the front end or the back end of the investment process. But as an investment vehicle, the MDA is in the middle of the investment process, entailing multiple manager portfolio construction. As such, it becomes an important catalyst that will facilitate the industry and its financial advisors to fully leverage through process and technology.

Even when the industry introduces far more sophisticated forms of investment policy and performance reporting tied to portfolio management technology, the MDA will still be the core holding of most investor portfolios with more than $100,000 on assets because it represents the most flexible and customizable element of the portfolio. A financial advisor cannot influence how a mutual fund portfolio is managed nor can an investor. Because a mutual fund is a 1940 act company governed by a prospectus, it, by definition, cannot be investor-specific in how it manages money. Thus, the core of a client's account will always be a MDA because it gives the advisor and the client ultimate control of portfolio holdings.

Those who would suggest that a mutual fund or managed account wrap fee program is an MDA do not fully understand how important the third level of asset management introduced by the MDA is to the financial advisor in managing a level of detail essential to adding value. As a consequence, they do not understand how much more sophisticated a MDA is relative to a wrap fee program or the technological superiority of a MDA relative to a wrap fee program. Nor do they understand how the MDA takes the financial advisor far deeper into the investment process than a wrap fee program and facilitates a far higher level of value added than a wrap fee program.

The MDA puts the natural competitive forces of a free enterprise system into play as the industry makes the transition from product distribution through commission sales to adding value through the fee-based advice. Many of the industry's most difficult cultural, structural and technological challenges associated with adding value will reconcile themselves with the advent of MDAs. MDAs trigger a course of events that will forever change the culture, structure and technology of the industry. In greatly elevating the level of professional investment and administrative counsel provided, the MDA is one of the most important product breakthroughs of recent years. The MDA redefines and reshapes the course of the financial services industry around adding value through multiple manager portfolio construction. This is the fundamental skill set required for a large number of brokers to successfully engage their professional investment and administrative counsel for an ongoing industry fee. ■

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-Hazzard/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 804-795-1642 ■ Fax 804-795-7703
WWW.SRCONSULTANT.COM