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Some Thoughts On Multi-Discipline Accounts (MDAs) And Other Managed Money Programs

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Multi-Discipline Accounts (MDAs) are becoming the rage for small investors. Broker sponsors package families of separate account managers, with various investment styles, into diversified investment programs. These packages compete directly with those offered by funds-of-funds of mutual funds. The stated benefit is that the investor gets the skill, diversification and tax awareness that the big guys get, and he gets it at reduced fees through separate accounts, rather than expensive mutual funds. MDAs are certainly better for the small investor than leaving him to his own devices, since decisions are likely to be based on cocktail conversations rather than expert advice. And the investor is arguably better off than comparable approaches that use expensive mutual funds. However, the investor might be best served by something quite simple, like a tax-efficient index fund, e.g., an index Exchange Traded Fund (ETF). Also, the pre-packaged solutions offered by MDAs turn much of the traditional consultant's role into a commodity, reducing the need for a consultant. In other words MDAs are not all they're cracked up to be, but with some major improvements, all managed money products (including MDAs) could be worth the price of admission. In fact, all managed money accounts would benefit from the lessons presented in the following.

In light of recent discoveries about the importance of investment style, there is substantial room for improvement in MDAs, as well as other multi-manager programs. This article examines how these improvements can be achieved in each of the three areas of purported benefit: (1) skill, (2) diversification and (3) tax awareness. Multi-manager programs routinely confuse style with skill, making it very difficult to deliver on the promised benefits. **Styles go in and out of favor, but skill persists.** If these programs are going to actually deliver superior performance, after taxes and fees, they're going to have to make the important distinction between style and skill.

MULTI-MANAGER PROGRAMS ROUTINELY CONFUSE STYLE WITH SKILL, MAKING IT VERY DIFFICULT TO DELIVER ON THE PROMISED BENEFITS

1. Skill

Skill is important to the client because it adds value beyond the additional fees the client pays for active management. In a managed money program, this skill should be evidenced as return above an index fund or, for taxable investors, return above an index Exchange Traded Fund (ETF). Since managed money programs employ active managers rather than index funds, sponsors of these programs are telling their clients, explicitly or implicitly, that they are expert in identifying managers with skill. But do these sponsors really find skillful managers?

Clients should be skeptical of this claim for a couple of reasons. First, the list of managers under consideration is predominantly retail-oriented, which doesn't make it good or bad, but it does make the list very short. If the client is really going to get best-of-breed, the search for talent ought to extend to institutional managers. Who knows? Maybe some institutional managers are more talented than their retail counterparts. Second, most sponsors search for manager talent with tools that were developed in the 1980s, before we understood the importance of style and recognized the serious problem of confusing style with skill. There is new 21st century technology that can distinguish between style and skill, but it is grossly underutilized, probably because it is so new. As long as the confusion between style and skill persists, the promise of delivering skill to the client shouldn't be relied upon.

The future will dictate the real story, but since the sponsor is the evaluator, it will be interesting to hear how the story is told.

2. Diversification

Diversification is like motherhood and apple pie. It's a must-have because it's expected to give the client the best return for the risk being taken. Index funds provide diversification by holding the entire market. In managed money programs, diversification is achieved by allocating to managers with different styles. In MDA programs, the maintenance of good diversification becomes very complex because the sponsor has day-to-day responsibility for controlling an ever-changing mix of allocations to model portfolios of the participating managers, across an array of accounts with different profiles. The client should understand the mechanics of these allocation decisions. For example, if a growth manager and a value manager are used, do each receive half the assets? Are any adjustments made if the growth manager has meaningful holdings in value stocks? How does the sponsor monitor style purity and control overall portfolio diversification? In practice, the sponsor sees the model portfolios of all of the managers in the program and has the opportunity to decide how close to come to each model for each client.

The sponsor has trading technology to help him make these decisions, but this technology generally does not incorporate style. If the sponsor is monitoring style at all, there's a good chance that it's being monitored with returns-based style analysis (RBSA). RBSA cannot determine the style composition of a portfolio at a point in time. Rather, it can only estimate the mix of styles based on past portfolio returns, which is not very helpful to making allocation decisions at a particular point in time.

The trading technology can control sector diversification, since sectors are something we've understood for a long time, whereas the importance of style is a relatively new revelation. Again, there is 21st century technology available that identifies stocks by style, in a similar fashion to sector classifications, but this technology is grossly underutilized. Accordingly, style diversification, and therefore overall diversification, will not be achieved until this problem is corrected.

3. Tax Awareness

Tax awareness is the third stated benefit of managed money programs. Does anyone know if this awareness is actually delivering superior after-tax returns? We could be measuring and evaluating this, but we're not. Some claim that we're not measuring after-tax performance because there are no accepted procedures, but this is simply not true. The Association for Investment Management and Research (AIMR) has standards for after-tax performance measurement as well as recommendations on how these returns should be evaluated.

The real problems seem to be complexity and fear. Investments and taxes are both very complex. Put them together and you've got a mess. Tell your client you're tax-aware when you've never measured tax awareness and you're afraid to measure it. Tax awareness is neat to say but not very practical, especially in an MDA, where each account has its own unique tax situation. Don't be surprised if someday we are obligated to measure after-tax performance, and then we'll know.

Conclusion

So here's the point. The client can choose among mutual funds, index funds and managed money programs. In order for the managed money client to win against the alternatives, we need to use the best tools currently available, which today means technology that succeeds at identifying skill - technology that does not confuse skill with style. Also, as a special type of managed money program, MDAs require additional tools if they are to maintain style diversification, so they can achieve overall diversification. MDAs need to know the style of the holdings in the portfolio, not just the history of returns. As always, there are no guarantees that these improvements will result in success, but they will certainly help. ■

About the Author

Ronald J. Surz, CIMA, is president of PPCA, Inc. As a specialist in attribution analysis, Ron and his company is responsible for the development of StokTrib, software that tracks style allocations and the effects of style, using portfolio holdings. This point-in-time, style-based attribution analysis applies to both U.S. and non-U.S. portfolios. Ron holds an MBA in Finance, an MS in Applied Mathematics and a Certified Investment Management Analyst (CIMA) designation. In addition to being member of AIMR's Investment Performance Council (IPC) which develops and maintains investment performance presentation standards, Ron is also a member of the Board of Directors of the Investment Management Consultants Association, a professional organization held in highest esteem by senior consultants within the financial services industry. For more information about point-in-time, style-based attribution analysis, visit PPCA, Inc.'s web site (www.PPCA-Inc.com) or e-mail Ron direct at Ron@PPCA-Inc.com.

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