Volume 5, No. 6

SENIOR CONSULTANT
The Voice of the Investment Management Consultant

[ Graphic omitted ]

# Managed Account Wrap Managers Can't Meet New AIMR Reporting Guidelines, MMI Poses Resolution

*Stephen C. Winks*

The Association for Investment Management and Research (AIMR), the financial services industry's leading advocate for uniformity in performance reporting and grantor of the highly regarded Chartered Financial Analyst (CFA) designation, has raised an industry redefining question: Is there really any difference between institutional and individual investors? They both want to know the risk, return, tax efficiency, liquidity and cost structure of their investment portfolio and their progress relative to their goals and objectives. In fact, with the exception of tax efficiency, all investors, both individuals and institutions, are interested in the same investment values and even weigh those investment considerations in the same order of importance. This convergence of individual and institutional investment values raises many questions which must be resolved within a retail financial services industry that is primarily focused on serving individual investors. Principle among these questions is accountability. Are we not equally accountable for our recommendations to individual investors as we are to institutions?

In recent years, wrap fee programs have provided individual investors access to institutional quality, separately managed accounts that have made it possible for advisors to address and manage investment values like risk, return, tax efficiency, liquidity and cost structure in ways not possible with mutual funds and individual securities. Managed accounts offered through these programs have greatly elevated the level of professional investment and administrative counsel provided to high net worth individuals and middle market institutions (less than $100 million). Noting this very positive trend, AIMR has established performance reporting guidelines for managed account managers who are participating in wrap fee programs. AIMR has asked that by July 1, 2003, separate account managers participating in wrap fee programs be able to fulfill their fiduciary responsibility to independently verify the accuracy of all reporting data so that managers in wrap fee programs can become AIMR compliant in their reporting. Though there is no difference in the fundamental values reported between individuals and institutions, many managed account managers participating in wrap fee programs are not AIMR-compliant in their performance reporting because they do not have ready electronic access to the data controlled by the sponsoring wrap fee program that would facilitate compliance.

AIMR HAS ASKED THAT BY JULY 1, 2003, SEPARATE ACCOUNT MANAGERS PARTICIPATING IN WRAP FEE PROGRAMS BE ABLE TO FULFILL THEIR FIDUCIARY RESPONSIBILITY TO INDEPENDENTLY VERIFY THE ACCURACY OF ALL REPORTING DATA ...

The resolution or non-resolution of this issue provides great insight into how important traditional retail brokerage firms view fee-based advisors, adding value and the new advice business model. Though there are powerful market forces moving financial advisors in the direction of fee-based advice, financial services firms and their resources remain primarily focused on commission sales and trade execution. AIMR is the reality check that tells us whether retail financial services firms are really viewing “adding value” as a strategic imperative. There is no question as to whether clients prefer value to be added. We know that without the necessary processes, technology and support infrastructure, it is not possible to add value in conventional commission brokerage accounts, and thus, AIMR's question: "Shouldn't retail brokerage firms be accountable for their investment recommendations?" Essentially, are retail brokerage firms willing to commit the resources to support the financial advisor in adding value? AIMR is a very important litmus test for financial services firms. For financial advisors, the market downturn has provided clarity. The only advisors who continue to grow their businesses at a double-digit clip are advisors who are capable of addressing and managing a broad range of investment and administrative values for an

[Graphic omitted]

on-going advisory fee. AIMR compliance tells us which retail brokerage firms are serious about the advice business model and adding value.

The problem with managed account managers being AIMR-compliant lies in the electronic transmission of data from wrap fee program sponsors. Unlike institutional relationships, where the money manager managing separately managed accounts has a direct contractural relationship with an institutional investor, in wrap fee programs the managed account manager does not have a direct contractual relationship with the investor. The managed account manager is a subadvisor to the firm sponsoring the wrap fee program, so the investor has a direct relationship with the wrap fee program sponsoring firm, not the managed account manager. This structure allows the cost-effective bundling of due diligence, trading, custodial and reporting services, and incorporates a process to diagnostically establish and evaluate each client's goals and objectives, risk and tax sensitivities, and a process to determine an appropriate investment strategy citing specific asset classes, management styles and investments. Financial advisors using a managed account wrap fee program platform can offer a very high level of professional investment and administrative counsel. Managed account managers love wrap fee programs because the collective distribution that a program represents could mean billions of dollars in net new assets each year. Administratively, the firm sponsoring the wrap fee program platform usually executes all trades (through an affiliated firm) and records all trades as required for quarterly reporting to the investor. Indeed, the sponsor's records constitute the client's "official records" and are analogous to those kept by a client's custodian for institutional accounts. Accordingly, managers participating in wrap fee programs are often obliged to use or rely on the sponsoring firm's technological platform for client-related data. Though program sponsors are responsible for performance reporting, most sponsors do not have the ability to provide participating managers with an electronic feed of all information relevant to regulatory recordkeeping and AIMR reporting. In this day and age of virtual web-based information, the managed account industry is still driven by programming language and technology used 20 years ago. This not only prevents participating managers in wrap fee programs from being AIMR-compliant in their reporting but also establishes the notoriously primitive nature of the technology supporting fee-based advisors and all who are a party to the process of adding value. In the absence of an industry standard for the electronic transmission of data, money managers are either forced, at great expense, to create duplicate records necessary for AIMR reporting or to rely on the sponsor to keep the relevant data. Web-based technology exists which can efficiently foster this level of information transfer (Market Street Advisors), which can streamline managed account administration and can cut as much as 20 basis points in managed account administration cost, but unless there is an agreement on a standard for the electronic transfer of data, the information pipelines to the industry's most important wrap fee program-sponsoring firms will remain closed.

**MMI SERVES AN INVALUABLE ROLE OF GETTING ALL PARTIES TO CONSTRUCTIVELY WORK TOGETHER TO ASSURE THE ULTIMATE OBJECTIVE OF UNIFORM REPORTING**

From the sponsoring firm's perspective, there is no economic incentive to spend any capital so that participating wrap fee program managers can become AIMR-compliant in reporting performance. If firms acknowledge their accountability for investment recommendations, it could be quite expensive to become totally web-based in their performance reporting as, in becoming accountable, they must be accountable for all investments, not just managed accounts. At the wrap fee program-sponsoring firm level, typically the institutional performance composite used to initiate the manager relationship was AIMR-compliant and the due diligence process rigorously established the managers' credentials. So, the sponsoring firm, which is comfortable with their own books, records and reporting, has high confidence in the manager with or without the manager being AIMR-compliant in their reporting on wrap assets. At the manager level, the manager has no leverage with sponsoring firms, because they are the beneficiaries of receiving billions of dollars in assets, and no manager wants to cut off the capital inflows, particularly in a down market.

In resolution of this technological impasse, the Money Management Institute (MMI) is working with program sponsors and participating managed account managers to prepare a 13-page letter to AIMR which asks forbearance in requiring managed account managers participating in wrap fee programs to have AIMR-compliant performance reporting by July of next year. AIMR is correct in seeing no difference in reporting to individuals and institutions, and wrap fee program sponsors and participating money managers take no exception to the principle of uniform performance reporting. MMI serves an invaluable role of getting all parties to constructively work together to assure the ultimate objective of uniform reporting. Yet, it is the pressure brought to bear by AIMR that facilitates this discussion, which likely would not have occurred otherwise. Thus, though AIMR is certain to be somewhat sympathetic to the plight of the managed account manager, because AIMR is capable of moving all parties to action, AIMR should extend the deadline past July of next year but should nevertheless require a date-certain resolution.

AIMR compliant performance reporting is a particularly complex issue for retail brokerage firms at several levels. The firm would acknowledge fiduciary responsibility for investment recommendations which, in some cases, has been long denied. There is also the concern of whether all brokers, planners, advisors are capable of adding value if the firm should choose to become accountable for their financial advisors recommendations. This would require both training and structural constraints to advice to facilitate a large number of advisors to add value. Assuming the financial advisor can add value, the commitment to support the financial advisor in adding value goes beyond managed accounts to incorporate all client assets. Thus, ultimately, the firm is committing to a web-based reporting system incorporating all of a client's assets and

[Graphic omitted]

liabilities, whether custodied within or outside the firm. The firm would then have to agree to, or accept, a standardized protocol for data transmission. (The DTCC has already established universally accepted standards for affirmation and confirmation of trades that govern virtually all trades and data transmissions as we know them today, which should suffice for managed accounts as well unless there is an esoteric twist to how MMI/AIMR define a managed account. Essentially, "standards for data transmission" is a coded phrase for major firms agreeing to transmit data.) These actions, if executed, would represent a significant cultural, structural and technological departure from the conventional commission brokerage business. Thus, in a terribly difficult operating environment for commission brokerage, where firms are looking for ways to cut cost and increase earnings, margins and their earnings multiple, there will not likely be the financial latitude, the vision or the will to respond to AIMR-compliant reporting guidelines. The irony is by embracing AIMR and leveraging the advisor through the processes and technology necessary to add value, the firm can significantly cut operating costs and achieve higher earnings, margins and earnings multiple while empowering their financial advisors to deliver an unprecedented level of professional investment counsel. Importantly, commission sales can still be fostered through the new advice business model, but adding value is not possible in a commission brokerage model. Thus, AIMR makes it clear whether a commission brokerage environment is sympathetic to adding value. By firms not responding to AIMR, they would be acting counter to the investor's and the financial advisor's best interests, as both are well served by adding value. But it would not be unexpected if firms should not respond to AIMR, as it reflects the fact that the execution of commissioned securities trades still accounts for 75+% of retail brokerage firm revenues, and many firms are not ready for a significant shift in the cultural, structural and technological focus of their organization.

MMI and AIMR may be facing an immovable object in seeking retail firm compliance to AIMR reporting standards as it changes retail firms in fundamental ways. Retail firms may simply choose not to be accountable for their investment recommendations as the vast majority of advisors are engaged in commission sales, where it is not possible to add value. How a firm invests its capital and manages its resources makes it clear what is important. Thus, by managed account managers not being AIMR-compliant in retail firms, it becomes clear whether there is interest in adding value. This is a massively important realization for the thousands of senior consultants serious about adding value at retail commission brokerage firms that account for 75% of the managed account asset base at those firms and who are at the heart and soul of the emergence of the new advice business model. It leaves the door wide open to other options for financial advisors who are professionally compelled to be of value to their clients. By retail financial services firms not being responsive to AIMR reporting standards, they are, in effect, taking an all-or-nothing bet with a very low probability of success. They are putting all their eggs in the commission sales basket precisely when it is becoming clear the only venue for advisors to grow their business at a double-digit clip is through fee-based advice. Ultimately, the value proposition to the consumer is simply whether they want a broad range of investment and administrative values to be addressed and managed and value to be added. Because it is not possible to add value in conventional commission brokerage, brokerage firms will not be able to compete favorably for client accounts, and thus the very health of the retail brokerage industry swings in the balance on the simple issue of assuming accountability for investment recommendations and becoming AIMR-compliant in performance reporting. By doing nothing, retail financial services firms do not have to manage the cultural, structural and technological issues associated with adding value. But in not adding value, the commission trade execution franchise of firms will eventually be preempted by fee-based competitors who can add value and can execute trades at either lower cost or at no cost for the investor. In any event, trade execution becomes a commodity, which is why adding value and fee-based advice is so important.

**THE IRONY IS BY EMBRACING AIMR AND LEVERAGING THE ADVISOR THROUGH THE PROCESSES AND TECHNOLOGY NECESSARY TO ADD VALUE, THE FIRM CAN SIGNIFICANTLY CUT OPERATING COSTS AND ACHIEVE HIGHER EARNINGS, ... WHILE EMPOWERING THEIR FINANCIAL ADVISORS TO DELIVER AN UNPRECEDENTED LEVEL OF PROFESSIONAL INVESTMENT COUNSEL**

But, there are other ways to resolve AIMR compliance which does not require a retail brokerage firm to make an all-or-nothing bet. The industry could restructure the managed account so that the separate account manager actually keeps the books and records of the account, which is the same difference as their keeping duplicate books and records, putting them in compliance with regulatory and AIMR reporting requirements. In fact, Merrill Lynch today requires their participating managed account managers to assume this administrative responsibility of keeping books and records that would keep them in compliance with regulatory and AIMR guidelines. Therefore, today, all Merrill Lynch managed account managers are AIMR-compliant. This puts much of the core technology of the industry in the hands of the money managers with real economic incentives to innovate and develop more efficient administrative systems and technologies. For assuming this administrative burden, the managed account managers would earn higher compensation, at least five basis points, which would have been retained by the brokerage firm. The downside is that the brokerage firm loses control of their technology, but with there being no license for the managed account product area to create the processes and tech-

[Graphic omitted]

nology necessary to add value because adding value transcends managed accounts and should incorporate all product areas, and with the firm shunning industry redefining innovation and defining its role as simply facilitating trade execution, the firm actually loses nothing that it views as being important. This translates into a huge upside for the financial advisor, who has long suffered from inertia and outdated legacy systems. Though money managers would be more vigilant in driving down and streamlining cost in ways brokerage firms have not been, money managers would not likely have interest in creating the electronic processes that would reduce the labor intensity of the financial advisor adding value. Even though the creation of electronic asset studies, electronic policy statements, electronic manager search and selection, and reporting would be a catalyst for exponentially growing the managed account business, it would take the money manager beyond their core competency. Therefore, the creation of empowering processes and technology necessary to add value ideally should be housed within the advisor's supporting financial services firm, or directly housed in the financial advisor's practice via the web, or both. Ultimately, this will require the financial services firm to have the courage, the vision, the will and the know-how to add value and to define itself in that context.

A particularly interesting resolution to the AIMR reporting issue, which also resolves the bigger issue of enabling electronic process technology that would exponentially grow the advice and managed account businesses, is the emergence of a third party overlay manager. (See "Overlay Management: The Whole Product Solution?," *Senior Consultant,* November/Dececember 2002.) The overlay manager interjects a third level of asset management that allows a higher level of portfolio detail (tax efficiency, liquidity, cost structure, risk and return) to be managed that is beyond the interest and/or technical capability of most financial advisors. This level of detail is not possible with individual money managers because they do not have access to or responsibility for all the investor's holdings as would the advisor. For example, the overlay manager takes all the buy-and-sell recommendations of managed account managers (mutual fund, hedge fund, ETF, folio, etc.) and, using expert systems, manages a level of tax efficiency not possible with most advisors. They manage overlapping investment positions to assure no undue concentration in any one holding. They cross, route and execute trades, thereby reducing trading cost and activity and, through various methodologies and strategies, can add 35-100 basis points in portfolio performance, which is huge in the real world where beating the index has been problematic. But most importantly, the overlay manager not only represents far more advanced systems and technology than that in place in managed account wrap fee programs, but the overlay manager can today provide AIMR-compliant reporting to the investor and can electronically transmit the data necessary to keep participating managed account managers AIMR-compliant. If one were to go a step further and the participating managed account manager were just to directly sell their research (real-time buy-and-sell lists) to the overlay manager or indirectly sell their research through the wrap fee program-sponsoring firm to the overlay manager, the overlay manager would generate AIMR-compliant reporting, resolving the issue without requiring participating managed account managers to perform client-specific reporting. Because this would ultimately lead to lower cost and lower investment minimums for managed accounts, their market application is greatly increased. Using an overlay manager in this fashion could reap huge rewards for all parties involved.

**HOW RESPONSIVE FIRMS ARE TO AIMR REPORTING GUIDELINES WILL HAVE PROFOUND LONG-TERM STRATEGIC IMPLICATIONS AS IT WILL DETERMINE A FIRM'S COMPETITIVE MARKET POSITION AND THEIR STRATEGIC FOCUS FOR YEARS TO COME**

AIMR-compliant performance reporting may not be important to those involved in commission sales because there is no accountability for investment recommendations, but for consultants who are accountable for their investment recommendations, particularly those active in the high net worth market and the middle market institutional market, it is a strategic imperative that their reporting be AIMR compliant. In a highly competitive marketplace, if a firm or a consultant is not AIMR-compliant in their reporting, they are discounted as not being credible or serious in cultivating the most sophisticated segments of the market that account for most of the investable assets. Thus, it is very easy for those focused on the lower end of retail financial service market (investors with $100,000 or less in investable assets) not to see the importance of AIMR reporting. But in doing so they disconnect and alienate themselves from the very financial advisors that are slowly evolving (pulling) their firm to a more dynamic fee-based advice business model. If firms want to cripple their natural evolution to fee-based advice and higher earnings, margins and earnings multiple, they will not want to help managed account managers find a way to respond to AIMR reporting guidelines. If firms want to be accountable for their investment recommendations and encourage their advisors to add value, they will seek immediate AIMR compliance. For those of us driven by consulting, it will be very interesting to see how firms, by their actions or inactions, will declare themselves and how the competitive landscape will evolve. Either firms are accountable or they are not. How responsive firms are to AIMR reporting guidelines will have profound long-term strategic implications as it will determine a firm's competitive market position and their strategic focus for years to come.

The good work for AIMR in creating uniform reporting standards reflects more than a decade of work of investment professionals who seek to elevate professional investment counsel around the world by assuring the reliability of accuracy of information. We are very fortunate to have the MMI to resolve this important issue. ■




Ph 804-643-1075 ■ Fax 804-643-1544