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Building for the Future: Implementing Today's MSPs To Meet Tomorrow's Needs

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Separate account program sponsors are dedicating significant product development and information technology resources to the creation and distribution of new multi-style portfolio products (MSPs). While product developers focus on the needs of their advisors, they are often constrained by limited budgets, available resources and infrastructure of legacy systems. The implementation decisions they make today will either enable or preclude the next generation of products and features that their advisors will require.

Some approaches to implementing multi-style portfolio products can impair a firm's ability to develop future products. This paper serves to document the evolution of multi-style portfolios and the issues and trade-offs that program sponsors are facing in implementing these products with an eye towards enabling next generation MSPs and unified managed account (UMA) products.

The Birth of Multi-Style Portfolios

Much has been written about MSPs which are separate account products that integrate the input of multiple investment managers and deliver a complete asset allocation in a single custodial account. MSPs address many of the shortcomings and complexities of traditional separately managed accounts.

- **Reduced/Simplified Paperwork.** Rather than setting up a separate custodial account and agreement for each investment manager and style, MSPs require only a single set of paperwork to deliver multiple investment styles.
- **Focus on Asset Allocation.** Separate accounts have traditionally focused heavily on the "stories" of individual money managers, often to the exclusion of good asset allocation. MSPs focus on the consulting process and appropriate asset allocation, an important focus for firms hoping to build their fee-based businesses.
- **Superior Product Features.** Once multiple managers, and even multiple products are implemented in a single account, many product features such as automated rebalancing and integrated tax management become easier and more efficient to implement.

The industry has come to recognize these benefits, and MSPs are quickly becoming the focus of most fee-based practices that are looking to grow their assets and increase the number of advisors utilizing fee-based products.

> THE BASIC DEFINING CHARACTERISTICS OF MSPS ARE THAT THEY INTEGRATE MULTIPLE INVESTMENT MANAGERS OR INVESTMENT STYLES INTO A SINGLE CUSTODIAL ACCOUNT, AS COMPARED TO TRADITIONAL SEPARATE ACCOUNT PRODUCTS THAT IMPLEMENT EACH MANAGER/STYLE IN A SEPARATE AND DISTINCT CUSTODIAL ACCOUNT

Not All MSPs Are Created Equal

MSPs aren't an investment "product" with a generally accepted definition analogous to mutual funds. The basic defining characteristics of MSPs are that they integrate multiple investment managers or investment styles into a single custodial account, as compared to traditional separate account products that implement each manager/style in a separate and distinct custodial account. Numerous industry consultants have attempted to further define the various MSP implementations currently in the market. The following definitions[1] are now commonly used:

- **1st Generation.** Integrates multiple investment disciplines from the "house" investment manager into a single account. The original Citigroup Multi-Disciplined Account™ defined this first generation of MSPs. Since then, UBS PaineWebber and Merrill Lynch, among other firms, have implemented their own first generation MSPs, with all investment styles (e.g. large cap growth, international) being delivered by the internal investment management group.

- **2nd Generation.** Integrates multiple investment disciplines from a single investment firm or complex for distribution in other sponsor's separate account programs. These products can only be delivered by the larger investment management firms or complexes that are capable of delivering a full set of investment management disciplines required for complete asset allocation. Current offerings include those from the wirehouses, as well as Affiliated Managers Group, CDC IXIS and others.
- **3rd Generation.** Integrates multiple unaffiliated investment managers, usually assembled in a model portfolio, sometimes employing an overlay manager of some form to coordinate the trading activities of the various managers. Examples include Wachovia's MSP product offering.
- **4th Generation.** Integrates the input of multiple, unaffiliated investment managers in a free form or dynamic allocation, and adds value through some level of risk and/or tax management by actively coordinating trades across the managers or "sleeves" in the product. Examples include Placemark's Select products, McDonald's PrimeConnect portfolios and SEI's ISAM offering.
- **Unified Managed Account (UMA).** Predicted to be the final stage in MSP development by Cerulli Associates, a 5th generation product that incorporates separate account managers, alternative investment products and sophisticated wealth management features generally only offered today through family offices and high-end wealth management firms.[2]

The separate account industry was built on the premise that program sponsors and individual advisors add value through the selection of investment managers, matching managers with their clients' goals and other complementing investment managers. 1st and 2nd generation products undermine this fundamental value proposition and for this reason, are increasingly seen as transition products. In fact, many firms that have not yet introduced a product are choosing to pass on 1st and 2nd generation products, and instead are opting to go straight to 3rd generation products.

But 3rd/4th generation products introduce a new set of operational and systems complexities for separate account program sponsors. These issues can require the development of new competencies and investments in new systems and technologies. However, the infrastructure that must be developed to support MSPs won't simply address a short-term requirement. This same infrastructure will be called upon to enable future products. Just as 3rd generation products may be the focus today, full-featured UMAs will be the focus of these same firms tomorrow. The technology and business model decisions they make now in implementing MSPs will greatly impact their ability to implement next-generation products in the future.

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The Defining Role for Next Generation Products: Overlay Portfolio Management

Firms today are facing a number of very difficult design decisions as they respond to market demand for MSPs and must weigh those demands against their limited resources. Should they implement "easy" 2nd generation products as a stop gap or is that their long-term MSP strategy? (Many mutual fund and large investment management firms, having developed 2nd generation products, would like to see distributors adopt such a strategy.) Or should they instead tackle the operational and systems complexities involved in offering 3rd generation products now, in spite of tight budgets and IT resource constraints?

At the heart of this issue is a core requirement of 3rd/4th generation MSPs and UMAs: Overlay Portfolio Management (OPM). OPM is the function of taking the stock selections (often expressed as a model portfolio) of the various investment managers in an MSP and then implementing those stock selections, buying and selling the securities for an individual client account. An overlay portfolio manager typically takes over the trading/discretionary control and implements the stock selections of the various managers, taking into consideration client-specific customizations, and the trading activities of the other managers. For 2nd generation products, all the investment styles are provided by a single investment management firm, allowing it to serve as the OPM. This keeps the decisions involved in running the product within one investment management firm. Operationally to the program sponsor, this looks just like a traditional separate account manager, requiring virtually no incremental investments by program sponsors in systems or personnel. Thus, one can understand the allure of 2nd generation products: operational simplicity for the sponsor.

But to offer 3rd/4th generation MSPs and UMAs that integrate multiple unaffiliated managers requires that the OPM function be separated from the component investment managers. There is no way that the various unaffiliated investment managers can coordinate their trading activity with each other, while independently trading client accounts. Imagine a scenario where each investment manager clears their trades with all the other managers in a client's portfolio to check for wash sale violations, or to try and minimize the tax impact of a sell decision. The only way these products can be run effectively is for there to be an active OPM function that is separate from the investment managers who are providing the stock selections within the product.

Designing Today's Products for Tomorrow's Requirements

The defining features of next generation MSPs and UMAs are integrated tax management, risk management, automated and

intelligent rebalancing, automated cash management, integration of investment decisions with outside holdings and other advanced wealth management features. But implementing these features requires a different set of trade-offs and investment management disciplines than have traditionally been applied in separate accounts:

- **Integrated Tax Management.** Tax management has traditionally meant end-of-year tax-loss harvesting in separate accounts. Clearly this is an insufficient solution when taxable trades are made all year long. In next generation MSPs, tax management will mean analyzing and factoring in the tax impact of all trade decisions, along with the alpha a manager is seeking via stock selection. Tax impact is a function of the trades in all of the sleeves in a client account, as well as external tax events, and can only be calculated by an active OPM who has visibility to assets at a client level.[3]
- **Integrated Risk Management.** Like integrated tax management, risk management in next generation products will require that decisions be made looking across a client's entire managed portfolio, as well as assets held away. A client's true risk is a function of his overall portfolio, his industry exposure and/or profession, life stage, evolving investment goals, etc. Trade-offs and true "risk" within an MSP can only be measured and considered when looking holistically at a client's portfolio via active OPM capability.
- **Automated and Intelligent Rebalancing.** Rebalancing, whether for asset class changes or day-to-day cash flows, is required to deliver good risk management and is greatly simplified by having all of a client's assets in a single account. But rebalancing in next generation products will weigh the risk reduction achieved in rebalancing, against the tax and transaction costs for performing the rebalancing. As with tax and risk management, this analysis can only be performed when looking across the sleeves of a client's account, and when considering assets held away, requiring active OPM capability.
- **Intelligent Cash Management.** New cash coming into an account can be applied across the various sleeves and products within an MSP to achieve various goals, including risk management, and minimize dispersion or tracking error to managers' models. Likewise, cash coming out of an account can be extracted in a way to balance and minimize the impact from risk, tax and transaction-cost perspectives. This analysis can only be performed when looking across all of the sleeves of a client's account via active OPM capability.
- **Client-Level Portfolio Management.** A client's managed account is usually only a portion of their total assets. Next generation products will take into account the activities and dynamic risk and tax profiles of a client's "other" assets and change the investment decisions within the managed portfolio to improve the client's overall investment returns. This will require both the processes for collecting and feeding the necessary data into the investment process, and active OPM capability to make better decisions based on that data.

Implementing any of these features in next generation MSPs requires an active OPM role

in which investment decisions factor-in multiple client-level criteria that are simply not known by the underlying investment managers. So what does this mean for designing today's MSP products? Firms are faced with difficult choices in a difficult market – the need to provide the products capable of generating growth, while dealing with limited resources and tight budgets. Some firms are taking the easy choice: implementing the 2nd generation products being offered by their preferred investment management firms, understanding that this isn't a suitable long-term solution; but these products are proving to be weak asset gatherers, particularly given the early success of new 3rd/4th generation products. While launching and supporting 2nd generation MSPs is operationally simple, it diverts precious product development and marketing resources from the eventual task of implementing a 3rd generation product offering that is extensible for the future. Firms that are supporting roll-outs of 2nd generation products are inevitably delaying the ultimate roll-out of the 3rd/4th generation products that will be required to be competitive in the future.

Operating Models for 3rd Generation MSPs

There are multiple ways that 3rd generation products can be implemented, some of which will enable the next generation of products and some of which will make such extension more difficult and costly. Some firms and technologies are implementing a "passive OPM" role for their 3rd generation MSPs. In this model, trading/discretion continues to reside with the individual investment managers, and systems are used to integrate the various sleeves into a single account for presentation and reporting. In this model, OPM is less of a value-adding investment service and more of a pure systems capability. The other prevailing operating model for running 3rd generation products is to utilize an "active OPM" in which all investment managers send their model portfolios to the OPM to be implemented in client accounts. On the surface, these approaches would appear to equally support the basic requirements of 3rd generation products, but when one looks at extending these products to support 4th generation or UMA product requirements, the differences become quite clear (see Figure 1).

3rd generation MSPs simply must implement an active OPM function if they are going to be extensible and integrate next generation features without massive re-papering of accounts, subsequent changes of legal relationship between investment managers and clients, and technology and operational infrastructures. Firms that implement passive OPM 3rd generation products are building an operating infrastructure that will have to be torn down and re-engineered as next generation product features become a requirement.

Using an active OPM in delivering 3rd generation products has immediate term benefits beyond enabling next-generation features. As with "traditional" separately managed accounts, passive OPM MSPs are reliant on the varying abilities of the underlying investment management firms to deliver any form of client customization. Some investment management firms have the scale of operations and proven

Figure 1.

Product Feature	"Passive" OPM Support	"Active" OPM Support
Tax Management	With multiple managers independently trading, there is no capability to integrate active tax decisions as part of the investment decision-making process.	The OPM has the ability to integrate tax logic in decision-making, specific to each client, when looking across all of the sleves in the client's portfolio.
Risk Management	There is no ability to make decisions across the multiple managers to apply any risk control mandates that might impact the trading activity of the various sleeves in a product.	The OPM is able to implement any number of risk management mandates considering both the various sleeves of the portfolio, as well as considering the risk profiles and activities in assets held away.
Automated and Intelligent Rebalancing	Even "simple" absolute rebalancing rquires complex communications and coordination of trading activity. It's not possible to also then integrate other trade-offs (i.e., transaction or tax costs) into the rebalancing decision logic.	The OPM can implement any rebalancing logical automatically, considering any combination of trade-offs, including risk, tax, transaction costs and other client-specific issues.
Intelligent Cash Management	With multiple independent managers, cash withdrawals can result in excessive transactions and rely on the varying abilities of each manager to consider trade-offs.	The OPM is able to apply consistent logic to minimize tax impact and improve the overall client-level risk position when either pulling cash out or investing new cash in client accounts.
Client-Level Portfolio Management	Multiple independent managers have no ability to see and consider trading activity of other slices within a client's MSP, much less collect and act on information regarding assets held away.	The OPM is well positioned to work with advisors and sponsors to aggregate information on outside assets pertinent to the client's portfolio, and factor that information into the decision-making process for the client's managed account.

processes to support tax-loss harvesting requests, rebalancing, systematic contributions and withdrawals, and consistent restrictions handling, while others do not. Relying on the collective capabilities of multiple unaffiliated firms to implement decisions that require their active coordination increases the risk that errors will occur, and increases the cost and complexity of processing even the simplest customization request. An active OPM is positioned to deliver operational efficiency, consistency and quality in processing regular rebalancing, restrictions handing, tax-loss harvesting requests and wash sale avoidance as well as performing other client-specific customization that would otherwise require multiple complex communications between clients, advisors, sponsors and multiple investment managers. Furthermore, in a passive OPM model, investment managers continue to view each client account separately, and as such, are acutely sensitive to low account minimums. Whereas an active OPM can look holistically at a client account and manage a $25,000 sleeve efficiently and cost-effectively, individual managers operating in a passive OPM model are ill-equipped to deal directly with thousands of small sleeves. Active OPM becomes a means to significantly reduce overall account minimums, without burdening the operations of the participating investment management firms with a large number of small accounts.

The primary question firms should contemplate today is whether they, themselves, should take on the operational burden of being an active OPM or work with an outside OPM in offering next generation MSPs. As should be apparent, active OPM is not a simple set of decisions that are made by systems but a new form of quantitative and highly skilled investment management discipline. The decision on whether or not a firm should work with an external firm is largely a function of each firm's investment management abilities and available resources.

Conclusion

1st and 2nd generation products proved the potential of MSPs as evidenced by the early success of Salomon Smith Barney's Multi-Disciplined Account™ offering. While the current crop of 2nd generation products are easy for program sponsors to implement (requiring virtually no investments), they belie one of the most important foundations on which the managed account industry has been built – the ability for advisors to choose the manager most appropriate for each asset class and for each client. On the contrary, these 2nd generation products create distraction and take away the precious resources necessary to develop the operational infrastructure required to offer next generation products.

If they are to be extensible to the next generation product requirements, 3rd generation products must be implemented with an active OPM function that consolidates and coordinates discretion/trading from the investment managers. It's analogous to many other businesses: designing today's products to support anticipated future enhancements is a sure way to decrease future product development expenditures and reduce time-to-market for developing next generation products. Firms that aggressively implement open architecture 3rd generation MSPs using an active OPM are poised to extend those products with a minimum of incremental systems, resources or delays. Making the right implementation decisions on 3rd generation products today will allow program sponsors to be more responsive to the demands of the marketplace in the future. ■

Notes

1. Reference Kevin Keef's article, "Rise of Multiple Disciplined Product in the SMA Market: Bringing Separately Managed Accounts to Main Street," available on http://www.smaforum.com.
2. For more information, see "Unified Managed Accounts" in 4th quarter 2002, *The Cerulli Edge Managed Accounts Edition* by Cerulli Associates.
3. See *A Comprehensive View of the After-Tax Investing and Tax Efficiency* by Ron Pruitt for a more thorough discussion on approaches and methodologies for integrated tax management in multi-style portfolios.

About the Author

Randy Bullard is President of Placemark Investments and leads the firm's corporate and strategic development initiatives in the Dallas office. Randy is an industry leader and often speaks and publishes on issues related to developing and operating next-generation wealth management products, including unified managed accounts, multi-style portfolios and highly tax-customized investment portfolios.

In 1999, Randy helped found Placemark Investments, Inc., a registered investment advisor and investment management technology firm dedicated to delivering highly customized and tax optimized separate account solutions to trusted advisors and their clients. Placemark serves as an overlay portfolio manager for separate account program sponsors, offering unified managed accounts and multiple-style portfolios to their advisors and clients. For more information, please visit the company's website at www.placemark.com.

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