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Not A Crisis But A Crossroad, Part I: Defining the Challenge in Processing Separate Accounts

Bevin Crodian

Editors Note: Technological innovation in systems and operations continues to be a point of frustration with financial advisors, the firms that support them and with money managers as well. In this day and age of internet transparency, the financial services industry seems stuck in the past. Innovation and processing efficiencies are defined by the limits of the available technology. At this late date, the industry still does not have a common operating platform or a standard set of operating protocols. This is because very few people have the perspective to understand process from the eyes of the advisor, the eyes of the advisor's supporting firm and/or the eyes of the money manager. To foster productive dialogue among all interested constituencies that would lead to much sought after innovation, I have asked Bevin Crodian to describe the problem, describe the ever-elusive efficient processing platform and discuss the common fallacies that inhibit productive dialogue on this technological challenge. Bevin's unique vantage point gives him uncommon insight in which he has so graceously agreed to share. As a successful financial consultant, money management executive, director of administration of a very large wirehouse's consulting services division, director of their wrap business and now as CEO of Market Street Advisors, which has developed highly innovative breakthrough technological solutions for this space, Bevin Crodian is one of only 3-4 definitive authorities in the industry on the processes and technologies that foster high level counsel. In this, the first of three articles, Bevin will describe the problem we face. After reading all three articles, you will be in for a rare treat: the initiation of public dialogue that everyone will understand about our industry's challenge in technological innovation.

We often hear that operations in the separately managed accounts (SMA) industry are in crisis. This is an exaggeration. A crisis is when your house catches fire. You have a very short period of time to decide to fight the fire or escape. If you don't act, events will overtake you one way or another. However, it is fair to say that operations in the industry are at a crossroad. When presented with a crossroad, you have a longer period of time to make decisions before events overtake you. Furthermore, if you stop at the side of the road, you can wait to decide indefinitely. There is a significant risk that others will pass you by, but if there isn't much "traffic," this is not necessarily a problem. However, the parallel to Newton's Laws of Motion here is telling. A body, or an organization, at rest (or at the side of the road) has lost all momentum and is overcome by inertia.

Admittedly, when we are accounting for our individual behavior, it is surely always more comforting to say that we are at a crossroad as opposed to a crisis. Yet, it would be ridiculous to assume that any of us would look forward to telling our clients, our partners or our shareholders that we have lost momentum and have given in to inertia. However, a knowledgeable observer might be inclined to use the term "inertia" when describing the processing of separate accounts. But how can this be? Clearly, knowledgeable persons can also point to many industry professionals who are practically slaves to the goal of providing professional operations. How can they be working this hard and losing momentum at the same time? The answer is that when systems are overwhelmed, they are like the steam engines of yesteryear, pulling an overloaded train up a hill. The fireman could be shoveling the coal as fast as is humanly possible, but if the boiler is too small to produce the necessary amount of steam, the engine will lose momentum – possibly failing to pull the grade. When this happens, there is nothing to do but return to the bottom and wait for a bigger, stronger engine to come to the head. We can debate how far away the stronger engines are ad nauseum, but this only further contributes to inertia. What we can do, starting right now, is begin a constructive dialogue that will specify how powerful the engine

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must be to make the grade, but first, we must state the problem.

The Problem

The problem starts with a statement that can be heard at the beginning of virtually every recent operations and technology conference. The statement is something like, "Separate Accounts are Operations." On the surface, this may sound like a glib soundbite calculated to ingratiate the chairperson with his or her audience. Unfortunately, the statement, as it applies to the wrap business, is all too true. To add further confusion to the situation, this statement is also true in varying degrees, in other segments of the SMA industry. But before we go any further, we need to define some terms and develop an understanding of the overall operational context if we are going to have a coherent discourse about the problem in SMA operations.

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Channel

First, let's segment the market by distribution channel. SMAs can be sold to investors through the direct channel by Registered Investment Advisors (RIAs). An RIA can be, among other things, a one-person counseling business that provides investment advice as well as a very large money management firm advising tax-exempt pools of capital. SMAs, especially wrap accounts, can also be sold through the intermediary channel. This channel is supported by a sponsoring platform that is often, but not necessarily, embedded in a major brokerage firm. By accessing the intermediary sponsoring platform, financial consultants provide the link between the asset manager and the client.

The Process

The process is what is delivered through the different channels. Let's define it as the end-to-end investment service that successfully delivers asset management to a client, however defined. The process represents various components. In the intermediary channel, the sponsors all offer access to a list of managers. However, they very often add other services, such as client risk assessment, asset allocation advice, manager research and selection, advice and to varying degrees, consolidated reporting and monitoring. Some refer to these other services as the front office. The front office will be less of a concern here. Not that it is of any lesser importance to the process, but the greater problem in the industry right now begins after the manager is hired and the account needs to be opened.

For those who have lived in both worlds, the front office is a relatively simple place from a technological perspective. This is especially true when you consider that there are few common protocols and technologies to support the other parts of the process. Furthermore, the money manager, in both the direct and intermediary channels, as well as the sponsor, all need similar but not necessarily identical technologies for their operations. To understand the range of tasks, consider this. In addition to performing pre- and post-trade compliance, both money managers, and often sponsors, need to transmit, allocate and affirm block trades. This is often referred to as the middle office. Also, both the managers and the sponsors need to open and close accounts, provide tax-lot accounting, recognize corporate actions, reconcile accounts, measure performance, monitor asset flows and calculate bills. This is usually called the back office. Still further, for both business management and regulatory reasons, managers and sponsors need to warehouse both client and transactional data. This data must be readily available for a variety of reports, such as billing, client relationship management, sales management and regulatory filings. Not surprisingly, in the absence of a common, robust operating platform, the SMA industry has met the challenge of their operational requirements by assembling a varied set of often incompatible technologies. The lack of common protocols is no secret. Nor is it a secret that some wirehouse sponsors are reluctant to allow direct access to their proprietary operating systems, which adds an even greater level of difficulty to achieving industrywide operating efficiencies.

Earlier, we referred to shoveling a lot of coal and not pulling the grade. As this image applies to the competing technological needs within the process, here is an example. Assume an investment firm COO who must support different clients in different channels. Among others, she supports a fixed income manager who insists on acquiring a portfolio accounting system different from her firm's existing equity-oriented system. The PM is legitimately frustrated by the functionality provided by the current system, so let's assume that, for a variety of reasons, the COO agrees to the proposed installation. Besides the "firemen" who are responsible for "shoveling coal" in the middle and back offices, few at the COO's firm care about:

1. the new system being expensive and difficult to install;
2. it providing the functionality that the vendor represented;
3. it not being integrated with the rest of the firm's systems; and worse,
4. the added complexity greatly adding – possibly exponentially – to the costs of running and maintaining the firm's pre-existing platform.

All these issues are in place before the COO even tries to link-up with the various sponsoring platforms. However, the problems of this all too-real situation aside, we cannot fully explore the problem without a few more definitions.

Client

Not to back away from some of the issues surrounding the process, let's also segment the industry by client. The primary candidates for separate accounts are the mass affluent, tax-exempt and high net worth clients. Although the categories sometimes blur, you can say generally that the mass-affluent are served by the wrap* managers distributing through intermediary sponsors. The tax-exempt organizations are served by institutional money managers selling through the direct channel; and the high

net worth clients are served by private wealth managers who are often found in private banks (intermediary channel), but they could just as easily be an independent RIA (direct channel). Furthermore, if you superimpose the categories of client and channel, you can generate a dizzying list of permutations. For example, there is no governmental regulation or business principle that prevents a sponsoring platform, conceived to support the mass-affluent client, from distributing also to high net worth individuals or institutions of any size. The demarcations between the different client segments are more often driven by the sales culture and product evolution than by logic and function.

Functional Priority

Unfortunately, segmenting the industry by channel and client can be confusing. The reason has to do with the inherent "evaluative" nature of language. For better or worse, certain words in certain contexts carry meanings that point to a social hierarchy. For example, in the asset management industry, the term "institutional" implies better than "retail," "private" is better than "public," and selling "directly" is better than "mass" distribution. This is fine. This is how language helps organize a society. However, this situation can lead to a blurring of the meaning of these terms for marketing purposes. This is still a good thing. We can't manage it, if we can't sell it first. However, if you are a COO responsible for processing the business before you, it may be helpful to have a different conceptual framework at-hand, a framework that will allow you to make decisions about an investment service, regardless of what it is called or how it is sold. The requirements of this framework should be that it helps determine at least two things: (1) the profitability of an account and (2) the technology required to service it. Seemingly irresolvable situations can sometimes be illuminated by adopting a different perspective, going to a higher, or at least different, level of abstraction, if you will. So let's parse the industry by prioritizing the various features of the functionality required by differing channels and clients. For starters, let's introduce the terms "complexity," "customization," and "scale of the function." Here are some examples of what we mean.

For the sake of illustration, let's consider a firm that offers different services – institutional, wealth and wrap management. They have a large pension plan that requires them to run a fully hedged and balanced portfolio that settles both equity and fixed income ordinaries in Deutsche marks, using one dedicated domestic bank as a master custodian that will reconcile the account once a month. This is an example of complexity.

Now, let's also assume that the success of this strategy leads to the firm's high net worth department wanting it for their clients. Except that the private wealth managers need a few "minor" changes. They want to be able to offer the service in any currency with multiple custodians, reconciling over different cycles. Also, many of their clients must restrict the ownership of individual securities for various reasons. The designated securities must somehow be identified and blocked from the model portfolio. This is an example of customization.

Finally, the firm's national sales manager hears about the success of the new portfolio. He decides that he can sell it through a sponsoring platform. The only problem here is that he estimates that this service, which originally had minimums of $5 million, must now have account minimums of $100,000, and most importantly, the firm has to be able to process upward to 25,000 accounts, and the sooner the better. This is an example of scale.

Hopefully, we will now be able to eliminate some confusion. Often when you have a lot of smart people perplexed as how to describe a common experience, you have a situation where everyone is right and everyone is wrong at the same time. Here is how that can be. When we examine the process by channel, we are using a distribution-centric descriptive model. When we look at the industry by client, we are considering a product-centric model; and when we analyze the industry by functional priority, we are looking at a processing-centric model. The accuracy of your description is a matter of perspective.

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The processing-centric model describes the industry through the features of complexity, customization and scale. This model allows us to better evaluate our business from the perspective of processing requirements. All the features continue to be necessary for each segment, but they have different priorities. Here is how the different industry segments are described by this approach. The tax-exempt client serviced by the institutional manager tends to require that the middle and back office address the features in this order:

1. Complexity
2. Customization
3. Scale

The high net worth client serviced by the private wealth manager needs this order:

1. Customization
2. Complexity
3. Scale

And finally, the mass affluent client serviced by the wrap manager needs:

1. Scale
2. Customization
3. Complexity

Now we can state the problem more completely. Every segment of the investment management industry, whether segmented by channel, client or functional priority, tends to have differing processing requirements. These priorities may require different technologies for support. But this is merely to state the problem in the abstract. Here are a few examples. First case, a successful wrap manager's top priority is to process thousands of new accounts per year. This is more important than being able to provide performance attribution. In the second case, an institutional manager may need to account for asset-backed securities efficiently. They only have 100 accounts and no interest in the requirements needed to process thousands of accounts. These examples point to a situation that fosters a fragmentation of both function and technology. For example, here are some ramifications of the two situations. In the first case, the New Accounts department is quite large and might be desperate for Straight-Through Processing (STP) of new accounts. In the second case, portfolio managers open the accounts themselves and could care less about new account STP. However, their accounting department is overburdened, and they are desperate for accrual accounting to handle their asset-backed instruments. Though still problematic when considered in isolation, this problem expands geometrically when they run side by side in the same company. This is truer still, when there is not an adequate IT budget to equally support all business lines. This is not to say that an investment manager shouldn't choose to favor one business over another. However, it is to say that the firm's current IT infrastructure should not be the determining factor in this decision.

It shouldn't be a tremendous leap to assert that such conditions can quickly lead to poor client service, higher operating costs and lost opportunity for all concerned-clients, consultants, sponsors and money managers. This is not good business. Regardless of its origins, this situation surely presents the face of inertia. This is shoveling a lot of coal with little to show for it. It is no wonder that some investment management companies are reluctant to venture outside their current client base and channel. Business issues aside, the operational complexity of integrating the necessary technologies often makes the challenge of taking on another channel or client segment just too daunting.

By touching on the distribution channels, the products and the processes in the separate account industry, we have tried to state the problem in SMA operations by creating a framework for constructive dialogue. In the future, we will describe the platform necessary to support the functional needs of the industry (Part II). Finally, we will describe some of the fallacies that inhibit objective discussion of issues in the middle and back office (Part III). ■

Endnote

*We recognize that some in the industry consider the term "wrap" to be pejorative, much like referring to a marketing representative as a "wholesaler"; nonetheless, the term is descriptive and will be used here for its communicative value.

About the Author

Bevin Crodian is CEO of Market Street Advisors.

Notes

SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-643-1075 ■ Fax 804-643-1544
www.SrConsultant.com