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A Primer for Models-Based Sponsor Platforms: Manager Selection and Fee Considerations

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Money management has evolved in recent years wherein separate account clients are increasingly served via model portfolios produced by managers, personalized and tax-optimized through technology and delivered by brokers or advisors. In differing from the traditional process, models-based management offers significant benefits for all parties. As a result, sponsors are increasingly moving to, or evaluating a move to, models-based methodology. This paper is intended to provide insights into the sponsor-manager relationship and fee structure in a models-based platform.

Because of the numerous advantages, the majority of new platforms built today employ a models-based process. This paper examines the trend to models-based management and offers a strategy for sponsors to identify and engage managers. It also explores the many benefits of models and answer frequently asked questions.

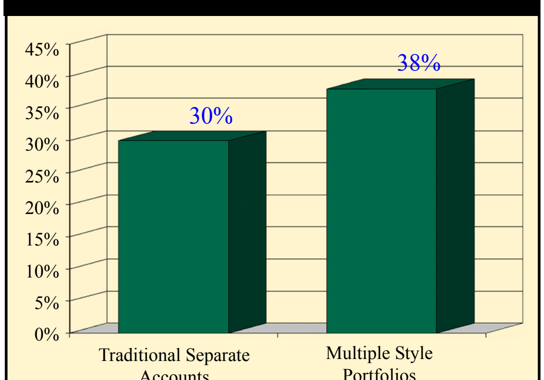
Why Models Are Becoming Popular

Separate account providers are increasingly turning to management-by-model for a variety of reasons. First, models allow managers to focus on their core competency of stock research, selection and portfolio construction. Second, the model management process enables program sponsors to blend multiple managers (including proprietary and non-proprietary managers, aka "open architecture"), add value through tax optimization, holistic personalization (e.g., total technology exposure < 10%) and proactive rebalancing and re-allocation. Third, models can provide substantial cost savings to both sponsors and managers. Fourth, the model management process enables more efficient and comprehensive compliance and brand control for the sponsor. The combination of better client service, lower costs and increased risk control is compelling. The result has been a very rapid acceleration in the use of models.

Throughout the 1990s, models-based management was a distant second to the more traditional method of managing separate accounts. The approach was all but forgotten until the advent of the multiple style portfolio (MSP), also known as a multi-discipline account (MDA) or multi-discipline portfolio (MDP), and their household-reporting cousin the Unified Managed Account (UMA). In order for MSPs to be effective, only one manager (the "overlay manager") deals with client customization, tax optimization and overall compliance and brand control, while all other manager participants provide model portfolios, typically focused on one style that is the manager's area of specialization. This approach offers numerous benefits to clients (reduction in the number of custodian accounts and other simplifications, cross-manager personalization and after-tax alpha) accounting for rapidly growing popularity as shown in Figure 1.

Multiple style portfolios increased from $17 billion to over $23.5 billion in 2003 alone, with further gains seen in early 2004. According to a straw poll by CheckFree Investment Services, already a quarter of sponsors offer or plan to offer some form of MSP in the near future. Another 50% are considering offering them, and only a quarter doesn't offer them and doesn't want to do so. Major players are among the leaders in adopting MSPs, with Smith Barney alone accounting for a half billion of the recent growth – more than 80% estimated as new money. According to the Money Management Institute, total new money added to separate accounts as a whole for the industry was $30 billion in 2003. Considering the time lag between the introduction of a new product (MSP) and full-fledged distribution, and considering that the relatively new MSP attracted $6.5 billion of the 2003 growth suggest that MSPs will experience high growth long into the future.

Figure 1.
2003 Growth in Managed Assets



Source: Cerulli Associates

The number of sponsors requiring a models-based approach in one or more of their offerings has grown rapidly in just the past couple of years. American Express, Bank of America, Curian, Envestnet PMC, FolioFn, Global Bridge, Lockwood, MyVest, Oberon and SEI, as well as the major wirehouses (such as Smith Barney, Merrill Lynch and Morgan Stanley) and overlay managers (such as Parametric and Placemark) all utilize models to serve clients.

Strategy: Identifying the Mix of Managers You Want

The first step is for the sponsor to determine the managers that the sponsor wants to offer on its platform. For proprietary platforms, the sponsor determines the target list of managers with input from the sponsor firm's advisors and brokers. For third-party platforms (often referred to as "turnkey asset management providers" or TAMPs), the sponsor determines the target list of managers with input from the distribution channels that the sponsor serves. Generally, there are five (non-exclusive) categories of managers to consider recruiting:

1. Managers who are currently managing significant assets on the sponsor's non-model platform. These are the first and most obvious managers to include on the new platform. These managers will not want to lose assets, and the sponsor will not want to lose the managers. As a result, the stage is set for a win-win negotiation.
2. Managers who have demonstrated solid long-term, net-of-fees performance. It is advisable that the sponsor engage at least three consistently performing managers in each style. On a model platform, changing or re-weighting managers for one client or for hundreds of clients is far easier and quicker than in a traditional platform; plus, managers need only a web browser to input their models, making participation in platforms practical for well-established (defined benefit, mutual fund) and boutique (specialist, client-preferred) managers who heretofore have avoided traditional managed account platforms because of the prohibitive technology and operations overhead required. This creates much more of a "free market" than exists today, which keeps manager fees competitive and performance incentives high. Clients, sponsors and well-performing managers will benefit in ways that are not practically feasible in non-model platforms.
3. Managers with "household name" brands. The vast majority of managers are not household names. Including one or more in a client proposal can help win clients.
4. Managers on competitive platforms. This can help a sponsor win advisors that want a switch to the sponsor's platform to be as easy as possible. (There is a concentration of separate account assets in 20-25 managers, each of which is available on most of the larger proprietary platforms).
5. Managers not on competitive platforms. As mentioned above, model-based platforms make it cost-effective for managers who have avoided separate account platforms to engage with a sponsor. For example, this makes defined benefit managers with excellent records, managing institutional portfolios available for the first time. In addition, excellent boutique managers are often discovered by the sponsor's advisors or clients, and need only a web browser to participate on the platform. To differentiate themselves from others, sponsors are advised to include managers from this category.

Interestingly, among the managers whom the sponsor may decide to "trim" are "tax-efficient" managers. With models-based platforms the sponsor performs tax-management and personalization as an overlay manager, thereby freeing style managers to concentrate purely on the pre-tax return of their model.

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Identifying Candidate Managers

An ideal manager would have consistent top-quartile performance, a household brand name, a productive working relationship with the sponsor and a competitive fee. In addition to these managers, it is likely the sponsor will need to identify other managers to achieve complete coverage. The sponsor's goal is to structure a program with a mix of managers that serves all clients' needs, having a lower cost structure. Achieving this goal is considerably easier with a models-based platform than with a traditional platform. In addition to managers with whom the sponsor is already working, managers who have already adopted the models-based approach can be found in the manager lists of models-based programs such as American Express, MyVest, Curian, Oberon or Global Bridge. They may also be found in the MSPs offered by or through such firms as SEI and Lockwood as well as overlay managers such as Parametric and Placemark. The next best place to locate prospective models-based managers is among prospective new entrants to the retail separate accounts arena, such as managers currently focused on large institutions and ultra-high net worth clients (typically with very high minimums). These managers would find managing money via a models-based platform similar in several respects to managing money for its traditional institutional client base. Fee schedules for equity managers are in the 25 to 40 basis point range (and potentially lower with volume breakpoints). In addition, operations, client servicing and marketing costs are lower relative to managing separate accounts on a non-model platform. Pension and defined-benefit managers in particular should be interested in providing models, because their traditional client base is shrinking.

Recruiting Strategy

Recruiting approaches differ based on each manager-sponsor relationship and needs. For existing models-based managers, the attraction must be the ability to leverage a current model and maximize distribution. The sponsor offers the manager an increasing asset base for essen-

tially zero marginal effort by the manager. For potential new entrants, the focus should be on those managers who desire access to the emerging affluent but who are unwilling to build and maintain the necessary operational infrastructure required by non models-based platforms. A models-based approach is very appealing to this group because of the ease of entry.

For separate account managers who have yet to adopt models, the appeal must be built around cost savings, scalability, asset retention and the potential to provide high contribution margin returns on the manager's research. A sponsor that shifts from a traditional approach to a models-based approach should find its existing managers more than willing to make the transition too. This is particularly true if the sponsor provides a significant asset base to the manager. Of course, sponsors can expect to pay higher fees for household name managers, assuming performance is not materially lower than other choices within a style. Overall, we are witnessing a sea change in the industry as more sponsors and ultimately most managers seek out the many benefits of using a models-based approach.

Selling Managers on Lower Fee Structures

If the sponsor has substantial existing assets, the process of lowering manager fees is primarily one of negotiation, based on a lower expected cost structure for the managers using a models-based approach. In this case, the sponsors should offer a lower initial fee structure to reflect a portion of the cost savings, making the proposition "win/win." Over time, however, the sponsor will be well positioned to further lower fees. As an example, the sponsor might propose a 5-10 basis point initial reduction and later lower fees an additional 5-10 basis points, gradually approaching 25 basis points, a typical fee for institutional managers.

New sponsors may find the need to start with rates closer to those of traditional programs but with aggressive breakpoints. Whether managers will agree to work with new sponsors (no available existing assets) will depend on their evaluation of future potential. Once the sponsor has gathered substantial assets, the sponsor will be in a position to negotiate lower fees. A breakpoint schedule can be established from the start.

New managers will appreciate the fact that there is little, if any, operational overhead and that the sponsor performs the majority, if not all, of the marketing. This group will be the most willing to accept lower fees at the start of the process, especially if given the opportunity to access assets of an established sponsor. It is a good strategy for existing sponsors who are moving to a models-based structure to engage at least some new managers to provide additional leverage for better pricing from existing managers.

Understanding Fee Structures

The existing fee structure of traditional money management is built around the concept of a manager's asset-based fee plus brokerage commissions based on the trading activity and a fee for custodial services. Retail separate

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accounts have evolved to a single asset-based fee or "wrap fee" that includes management, custody and trading. The sponsoring firm charges the wrap fee to the client and then pays the manager and covers the cost of trading and custody. In this structure, managers were once paid as much as 1% from an overall 3% fee. Price compression has forced management fees to a range of 36 basis points on the low end to an most 50 basis points for equity managers (fixed income managers are paid less) from an overall average 2% fee.

Price compression has become a serious issue for separate account managers on traditional platforms. In fact, a recent drop in fees to 36 basis points by a major wire house sponsor met with serious resistance. (Smaller sponsors with less pricing power tend to pay higher fees to managers.) Managers have fought the fee reductions, and many are concerned that fees are approaching unprofitable levels. Given that a manager's operations, technology and marketing on a traditional platform can total 30 basis points, only 6 basis points is available to cover research and stock selection. An answer lies in reducing the manager's operations, technology and marketing costs. A models-based platform does all three.

The models-based process removes a significant portion of a manager's cost structure. As a result, even though the manager's fee is typically less than in traditional programs, the manager's profit margin is considerably higher. Assuming that research and stock selection are considered to be core competencies (as they should be), this makes the models-based structure process quite attractive to managers.

At present, models-based managers are typically paid between 25 and 35 basis points from the first dollar managed, depending on style and the nature of the program. It should be noted that brand-name managers may seek higher fees and that brand-name sponsors may propose lower fees. Models-based fees are typically subject to volume breakpoints based on the asset level at each manager. This is a mechanism for lesser-known sponsors to match the lower fees paid by better-known programs.

Understanding The Benefits of a Models-Based Approach

Benefits can be substantial for all parties. For managers, these include:

- the ability to focus on their core competency,
- reduced operating costs,
- reduced marketing costs,
- reduced client servicing requirements,
- due-diligence savings and
- ease of entry.

Perhaps the most important benefit to managers is the ability to focus on their core strengths, which are typically research and stock selection within a style. This is the work that is most likely considered to be value-added by clients, advisors and sponsors. This is also the expertise that managers tend to tout when marketing to clients, advisors and sponsors.

By focusing on research and stock selection, models-based managers are in a position to reduce or eliminate several expensive areas,

including both variable and fixed costs. The greatest cost savings comes from the virtual elimination of back-office operations. Most managers estimate that this expense represents up to 15 basis points in aggregate (although a portion of these costs are fixed overhead). These costs can drop to near zero for those assets managed by a model.

While most operations costs can be virtually eliminated, marketing costs can be substantially reduced through the use of models. First, the sponsor does most of the marketing, especially for a MSP product or other forms of overlay management. Secondly, managers can simplify their marketing to a single marketing message based entirely on the model and its performance. Finally, there is no need for a manager to customize or personalize a proposal for a specific client; the sponsor will do that. All this adds up to significant savings relative to the traditional separate account approach where sophisticated wholesaling and individual client meetings or calls are required of the manager. As a result, the manager requires fewer wholesalers, and the pay-out can be reduced to align with compensation typical of mutual fund wholesalers. Based on an estimated 15 basis point fee for marketing traditional separate accounts, marketing costs for models may be reduced by as much as one-half. Overall, we project that the average marketing cost reductions might be 5 to 7.5 basis points.

The third area for savings is in client service. In most cases, a models-based manager will have no contact with the end client. As a result, the manager's client servicing costs can be virtually eliminated, as can the manager's fiduciary responsibility issues related to "know your client." Of course, managers will still need to service the sponsor (and in some cases the sponsor's advisors). In addition, the advisors might on occasion request assistance from the manager in handling difficult client cases.

Savings in due-diligence also come from a simplified and single relationship. Managers have substantially less responsibility in the due-diligence process. For example, they do not have to demonstrate proficiency of systems, client servicing or trading — three major factors for consideration in traditional programs. They also do not have to address issues of dispersion. Instead, managers simply must demonstrate the capacity to research and identify securities with strong prospects for good future performance within their discipline, style or asset class. This can simplify both the time and expense associated with due diligence.

Ease of entry is another key benefit. There are a number of high quality, institutional-class money managers who manage tens or even hundreds of billions of dollars for a relatively small number of clients. While these managers have tremendous track records, they may be reluctant to create the kind of operation necessary to manage tens of thousands of smaller accounts. By managing models, however, these managers have a simplified entry path to the fast-growing retail separate account space serving high net worth and emerging affluent investors.

Managers can also benefit in that they can be judged and paid based on the performance of their model apart from the impact of client restrictions. This may be a double-edged sword however, as they can no longer use client restrictions as a source for blame.

In addition to the benefits afforded managers, a models-based approach also offers substantial benefits for the clients. The first and most obvious of these is that per-client minimums can be reduced without burdening the managers. Clients can benefit in other ways as sponsors/brokers/advisors are positioned to take a more holistic view of client holdings. The firewalls between managers can be broken down at the sponsor (or overlay manager) level to prevent holding redundancies, allow for tax optimization, support greater personalization and to eliminate unnecessary trading.

The broker/advisor benefits, particularly since the models-based technology supports a holistic approach in serving clients. For years brokers and advisors have promised customization and optimization but often lacked the tools to deliver them. Now, with the advent of a models-based approach, brokers and advisors will be positioned to deliver what clients desire, and in many cases, what the clients have been sold.

From a sponsors' perspective, the use of models provides benefits and efficiencies in multiple areas. First, sponsors benefit from reduced manager fees, which can significantly add to the sponsors' bottomline. Second, any diminishing of control experienced by the managers is in actuality a shift of control to sponsors, which the sponsor needs in an increasingly scrutinizing regulatory and brand-protection environment. Also, depending on the way in which the models are handled, sponsors may make client accounts less transportable by brokers or advisors seeking to move from one firm to another. Based on these tremendous advantages, the industry is steadily shifting to a models-based approach with all key parties (manager, client, advisor and sponsor) enjoying significant benefits.

BASED ON THESE TREMENDOUS ADVANTAGES, THE INDUSTRY IS STEADILY SHIFTING TO A MODELS-BASED APPROACH WITH ALL KEY PARTIES (MANAGER, CLIENT, ADVISOR AND SPONSOR) ENJOYING SIGNIFICANT BENEFITS

Considerations

Sponsors will want to consider whether to offer a flat or tiered fee structure. The right choice will inevitably be influenced by each sponsor's position in the marketplace. If a tiered structure is selected, pricing can be adjusted in several ways, including by asset class and reputation. With regard to asset class, equity managers are typically paid more than fixed-income managers. Within the equity class, small cap and international (particularly emerging markets) tend to receive higher fees. Managers can also be paid somewhat based on marketshare. This is particularly true when sponsors recruit advisors who have existing books of business. In this case, the advisors may insist that a sponsor carry a certain manager, thus strengthening the manager's leverage.

Bonuses are another area to consider. Although not widely used at this point, sponsors could consider a bonus pool in conjunction with a later fee reduction. That way, the best performing managers in each asset class would actually receive a fee increase at the expense of the poorer performers.

A final issue to consider is how best to deal with alternative asset classes. These can include real estate, hedge funds, private equity and venture capital. In most cases, a models-based sponsor will report on such assets but not integrate them into the main program. Alternatively, however, creative managers may be identified that can effectively work within the models format.

Summary

For managers, the move to models is somewhat inevitable, even if not fully obvious today. Managers tend to seek assets in growth areas. This meant defined-benefit plans and mutual funds in the 1970s and 1980s, defined contribution plans and separate accounts in the 1990s, and rollover IRAs and MSPs in the 2000s. Interestingly, while there are often objections during the transition, managers ultimately adopt the new style to garner assets. For example, many managers philosophically objected to separate accounts for a host of reasons in the early 1990s. Not long afterward, however, those same managers built substantial separate account offerings. Similarly, while a few managers may list objections to a models-based approach, it is likely that nearly all will eventually adopt the practice due to the significant advantages.

For sponsors, the move to models is more obvious. In addition to significant cost savings through lower management fees, sponsors gain the ability to better serve their clients in ways previously limited to high-minimum private banks and family offices. The "Holy Grail" is a sophisticated portfolio management offering that enables a firm to manage the assets of households of all sizes as thoroughly as they manage the assets of their wealthiest clients. This includes asset management on a "holistic" basis, whereby the sum of the assets in any number of a client's or a family's accounts continuously track to a target total portfolio, rather than traded account-by-account in isolation from the whole. This holistic approach is only possible in a models-based platform and provides personalization, tax management, optimization, compliance and brand control that are simply undeliverable across a large client base using the traditional non-model approach. MyVest Corporation has pioneered work in this area with their introduction of the Strategic Portfolio System. Overall, the adoption of a models-based approach significantly improves wealth management for managers, sponsors, and clients alike. ■

About the Author

Kevin D. Freeman has more than two decades of experience in serving high net worth investors, both as a separate account money manager and as a platform sponsor. He spent nearly a decade at Franklin Templeton, helping to build their $2.5 billion separate account Private Client Group, after drafting an original business plan for Sir John Templeton in 1990. In 2000, he left Templeton as Senior Managing Director to co-found Separate Account Solutions, Inc., a customized provider of wealth management offerings focused on private client groups. Kevin, a CFA charterholder, actively works to improve wealth management offerings for sponsors, managers, advisors and clients. He is co-author (along with Erik Davidson) of the book *Investing in Separate Accounts* and currently consults to MyVest Corporation, whose input was valuable in the preparation of this paper. Kevin's e-mail address is kfreeman@separateaccounts.com.

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