



# Model-Based Multimanager Accounts

*Why These Accounts Are Sweeping the Industry*

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**T**he wealth explosion in the United States has generated investor demand for more sophisticated investment products and services. According to the annual World Wealth Report released by Merrill Lynch and Cap Gemini on June 9, 2005, the number of investors with more than \$1 million in liquid investment assets grew 10 percent to 2.7 million in the United States in 2004. Approximately 9 percent of these high-net-worth investors are described as mid-tier millionaires with assets between \$5 million and \$30 million whose primary service challenge is to “manage the managers” of their wealth.

Coupled with changing market conditions, an uncertain economy, and complicated tax laws, these wealthy investors need integrated advice and demand quality investment products. Today’s high-net-worth investors are requiring more sophisticated investment products and services from the traditional consultant or financial adviser. These investors are technologically savvy, Web-friendly consumers who can easily access financial calculators, investment information, and Monte Carlo simulators online. Importantly, they also know and care about taxes, costs of service, investment performance, and risk management. With the availability of passive index

mutual funds and exchange traded funds that generate low-cost benchmark-like returns, there will be less tolerance for substandard or inferior actively managed investment products. The traditional advice model must evolve quickly to one that features open and rational architecture, a selection of suitable, quality investment products, depth of information content, flexible and personalized functionality and advisory toolsets, and above all else, a capacity to add true, measurable value to the wealthy, taxable client.

The challenge for many investment professionals is to elevate their methodologies to new levels to address the asset management needs of their clientele and to integrate their tax minimization procedures into a cohesive, client-focused strategy. It is incumbent on all consultants and advisers to select investment products that are most appropriate based upon the clients’ needs rather than the associated commission, load, or other proprietary trading or brokerage considerations.

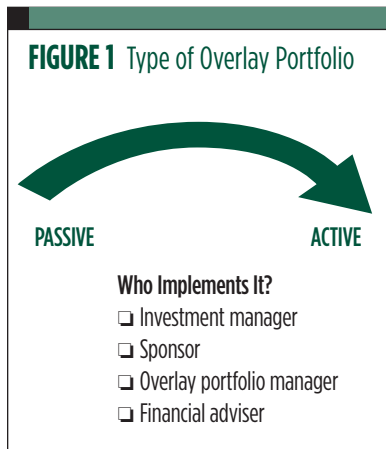
Separately managed accounts have emerged as a popular product of choice for the investment management consultant and financial adviser who specializes in serving the needs of affluent and high-net-worth individuals and families. In fact, the Money Management Institute forecasts that demand for separately managed accounts will grow from \$576 billion at year-end 2004 to more than \$1.3 trillion by 2008.

Advancements in technology and back-office operations also have fueled the growth in multidisciplinary accounts (MDAs), multiple strategy portfolios (MSPs), and overlay portfolio management (OPM). These derivations of traditional separately managed account product platforms allow the individual separate account managers to submit their portfolio models to a sponsor who then aggregates and trades accounts for the benefit of the client. OPM refers to the set of activities that integrates the investment management across managers. OPM rearranges the investment activities performed within individual separately managed accounts to embrace a more holistic view of the client’s overall portfolio by facilitating investing activities across separately managed accounts. As a result, a well-designed and executed OPM program offers the client the opportunity to realize an improved total portfolio management. That said, we should note that after-tax performance measurement is rare and there are few metrics in place to quantify the value of rebalancing for the client.

## The Key is OPM

To understand how a particular multimanager account program works, we focus on the two key aspects of the OPM effort: the type of overlay management being conducted and who is implementing it.

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These factors will determine how the activities in a traditional separately managed account are to be arranged within the multi-account program.

Keep in mind that all OPM efforts seek to preserve the alpha of the individual underlying managers. That is, the purpose of overlay management is not to interfere with the important investment decisions of the underlying managers. However, an active overlay approach puts a premium on integration activities such as avoiding security concentration that arises from overlap of securities in manager sleeves or reducing the likely tax liability by delaying a trade until the gain becomes long-term. Conversely, a passive overlay eschews these activities and seeks only to administer the manager's model to client-initiated cash flows or to facilitate rebalancing.

There are four primary candidates for the overlay manager:

1. An investment manager who directly manages a portion of the account and coordinates the investments of other managers
2. The sponsor of the investment program, typically the broker-dealer or a third-party platform provider
3. An overlay portfolio manager (who may or may not act as an investment manager for a portion of the account)
4. The financial adviser for the account

Table 1 shows the core services provided to clients in a traditional separately managed account and how those responsibilities change among three overlay examples: a sponsor-implemented passive overlay, an active overlay implemented by a portfolio manager, and an active overlay administered by the investment officer at a private bank.

### Implications for Financial Advisers

OPM provides the investor with benefits that include asset class diversification, the engagement of multiple managers who exhibit proven expertise in their respective styles and disciplines, ownership of the individual securities, improved tax management through interasset class portfolio integration, effective portfolio rebalancing, and streamlined operations, reporting, and administration. The realization of these benefits is a function of the sponsor, OPM manager, and/or structure of the overlay program. Therefore, the financial adviser is better able to efficiently integrate tax minimization and diversified private asset management strategies to add real, measurable value to each client's personal financial situation.

The OPM model can be tailored to match the business model of the sponsor organization and the related financial adviser. The traditional brokerage firm model centralizes research, analysis, portfolio management, and operations through one or more resource groups devoted to the business functions associated with all approved managed investment product lines: exchange traded funds, mutual funds, mutual fund wraps, variable annuities, traditional individual separately managed accounts, and OPM. Headquarters thus is better able to control operations, distribution, and sales of related investment products in the field and the rendering of advice to the firm's clientele by thousands of brokers and financial advisers throughout the country. This level of control signifi-

cantly improves compliance with applicable securities and investment advisory regulations, thereby reducing the business risk to the organization. By centralizing the OPM functions, the brokerage firm is able to scale its business and provide uniform, consistent resources to financial advisers in the field while controlling the delivery of investment services and products.

This centralization liberates the financial adviser to focus on growing business and client retention through greater levels of personalized customer service. Importantly, the financial adviser is empowered to customize each account based upon the client's particular set of circumstances and objectives. That is, through the OPM system, the financial adviser is able to select a suitable asset mix based upon the client's goals, resources, risk tolerances, tax situation, and personal preferences; match the right set of managers; set certain securities or sector restrictions to further tailor the portfolio design; address the tax characteristics of the portfolio; and automatically rebalance the portfolio according to prescribed asset-class and manager-structuring guidelines. Operationally, account-opening paperwork is reduced and simplified, and reporting is consolidated with the OPM single account structure.

Financial advisers from different distribution channels have seen the opportunity in the wealth management market and are all competing for the high-net-worth investor and family. These channels include traditional brokerages, insurance companies, independent investment advisers, accounting firms, family offices, and banks and trusts. Each firm emphasizes its own core competencies and particular set of value-added services, but the shift to fee-based, client-focused, consultative business models is clear and will be growing in the future.

Traditionally, the financial adviser from the bank or trust company has operated as a local portfolio manager for the affluent client. In many cases,

**TABLE 1** Typical Responsibilities Using Different OPM Approaches

OVERLAY TYPE	TRADITIONAL SMA		MULTIMANAGER ACCOUNTS	
	None	Passive	Active	Active
WHO IMPLEMENTS	Not Applicable	Sponsor	Overlay Portfolio Manager	Financial Adviser
Financial Adviser	<ul style="list-style-type: none"> <li>• Construct portfolio to match client objectives</li> <li>• Administrative instructions to rebalance</li> <li>• Communicate tax-related transaction needs to managers</li> </ul>	<ul style="list-style-type: none"> <li>• Match client objectives with packaged portfolios and customize as available</li> <li>• Communicate tax-related transaction needs to managers</li> </ul>	<ul style="list-style-type: none"> <li>• Match client objectives with packaged portfolios and customize as available</li> <li>• Communicate tax related transaction needs to managers</li> </ul>	<ul style="list-style-type: none"> <li>• Construct portfolio to match client objectives</li> <li>• Implement routine administrative trades to invest account at inception, handle cash flows, rebalance account, and respond to tax requests</li> </ul>
Sponsor	<ul style="list-style-type: none"> <li>• Provide advice to support portfolio construction:                             <ul style="list-style-type: none"> <li>– asset allocation</li> <li>– manager selection</li> </ul> </li> <li>• Performance reporting</li> </ul>	<ul style="list-style-type: none"> <li>• Construct portfolio mixes to meet common client objectives</li> <li>• Implement routine administrative trades to invest account at inception, handle cash flows, and rebalance account</li> <li>• Performance reporting</li> </ul>	<ul style="list-style-type: none"> <li>• Construct portfolio mixes to meet common client objectives</li> <li>• Performance reporting</li> </ul>	<ul style="list-style-type: none"> <li>• Provide advice to support portfolio construction:                             <ul style="list-style-type: none"> <li>– asset allocation</li> <li>– manager selection</li> </ul> </li> <li>• Performance reporting</li> </ul>
Investment Manager	<ul style="list-style-type: none"> <li>• Evaluate client suitability</li> <li>• Determine buy and sell decisions to invest accounts, implement position changes, handle cash flows, and respond to tax requests</li> <li>• Implement associated trades</li> <li>• Monitor individual accounts for consistency with desired positions, dispersion among accounts, compliance with investment policy</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluate client suitability</li> <li>• Supply model portfolio for sponsor to use in routine trades</li> <li>• Implement investment position changes across account base</li> </ul>	<ul style="list-style-type: none"> <li>• Supply model portfolio indicating buy and sell decisions</li> </ul>	<ul style="list-style-type: none"> <li>• Supply model portfolio indicating buy and sell decisions</li> </ul>
Overlay Manager	<ul style="list-style-type: none"> <li>• Not applicable</li> </ul>	<ul style="list-style-type: none"> <li>• See Sponsor role</li> </ul>	<ul style="list-style-type: none"> <li>• Evaluate client suitability</li> <li>• Apply model to invest accounts, implement position changes, respond to cash flow requests, tax requests, etc.</li> <li>• Implement all associated trades</li> <li>• Monitor individual accounts for consistency with desired positions, dispersion among accounts, compliance with investment policy</li> </ul>	<ul style="list-style-type: none"> <li>• See Financial Adviser role</li> </ul>

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>> “MULTIMANAGER ACCOUNTS” FROM P. 5

in addition to the range of trust and banking services available, the bank's trust investment department will manage a proprietary U.S. large-cap core equity portfolio. The positions within that portfolio then are communicated from a central research group to local portfolio managers who may tailor the sector and/or security selections to meet the needs of individual clients. Additionally, investments in taxable or tax-exempt fixed-income securities may round out the client portfolios for a more balanced approach. The trust company is able to effectively meet the multigenerational needs of many trust clients, given its intimate knowledge of a client's financial situation, its ability to provide mortgages and other private debt instruments, and its ability to value and manage nontraditional direct investments in real estate and oil and gas.

Banks and trusts are seeking to expand the universe of traditional investment opportunities they provide to their clientele by introducing third-party individual separate account managers with styles from other asset classes to complement their proprietary strategies. This move to open architecture challenges the traditional trust company asset management business and revenue model, but enables portfolio managers and trust officers to improve their abilities to meet the fiduciary obligations of clientele. Bank trust portfolio managers may use a decentralized OPM model to help defend and grow their businesses, better diversify client portfolios with proven professional private asset management, and preserve the trust company culture and hands-on approach to portfolio implementation.

In this model, the controls to the OPM software sit on the desktop of the local portfolio manager. Most of the operational benefits of the centralized OPM model apply to the decentralized OPM model. Importantly, though, in the decentralized OPM

model, the portfolio manager retains the control and discretion to manage the proprietary trust company portfolio and to implement the models submitted by the third-party management firms subject to client-specific restrictions and customizations.

While this expanded management role helps position the portfolio manager with the client and preserves the trust company culture, the trade-off is in the time required to perform the OPM activities. Thus banks and trusts may add relationship management personnel for client servicing and business development purposes to round out the team.

### Implications for Sponsors

Both centralized and decentralized OPM models improve investment results for the client, and the model-based structure facilitates delivering separately managed accounts at smaller account sizes. The inclusion of exchange traded funds and mutual funds on the OPM platform also allows the financial adviser and the sponsor to address passive versus active management issues in particular asset classes, and to provide access to investment products in other asset classes where separately managed accounts are not operationally feasible.

If the sponsor elects to act as the OPM, the firm will assume more of the associated operational functions such as trading, settlement, reconciliation, portfolio accounting, performance measurement, reporting, account opening, and administration. Quality vendors with specialized advanced technologies are available to assist sponsors in these back-office activities for both centralized and decentralized OPM models, or these services are available as part of a turnkey asset management platform.

Additionally, the sponsor will be charged with the manager research, due diligence, evaluation, and monitoring responsibilities to select investment strategies and styles that work well in these types of OPM environments. From a pure research

perspective, studying historical absolute and risk-adjusted returns relative to the manager's appropriate benchmark is not enough to build a quality stable of third-party managers in the OPM program.

It also is essential to review manager performance based on the individual securities within the managed portfolio. Such holdings-based analytics should focus on style and sector allocations, tax efficiency, and performance attribution to determine whether a manager's alpha is attributable to security selection, sector allocation and rotation, trading expertise, or timing in the markets. As OPM integrates securities across asset classes, it is important for sponsors to understand portfolio overlap, redundancy, and vacancy at the security level before individual managers are engaged, in order to structure the overlay program with a clear eye on quality management and adding value for the taxable high-net-worth investor.

From a qualitative perspective, sponsors must ensure that a manager's investment process fits the managed model business and the capabilities of the overlay portfolio manager. Typically, management processes that have a smaller number of securities, low rates of turnover, small cash positions, and liquid security positions tend to be most easily implemented in model-based programs. Banks and trust sponsors, which may prefer a decentralized OPM model, should select third-party model managers who complement their proprietary strategies with respect to asset class and style.

Note that managers are not allowed to include model-based accounts or related performance in their AIMR-compliant performance composites and reporting because they relinquish ultimate control of the final investment result to the sponsor or overlay manager. Thus, model-based and OPM program sponsors should be certain to track dispersion between the manager's wrap and high-net-worth composites and the performance of the

models in their particular programs, then explain any performance variances. Certainly, some level of dispersion is to be expected due to client restrictions and portfolio customizations imposed by the overlay manager to reduce taxation and meet client objectives.

Sponsors should understand that the number of managers participating in managed-model programs has doubled from approximately ninety

at year-end 2003 to 180 at year-end 2004,<sup>1</sup> with participation varying by asset class. Due to market liquidity, operational and trading considerations, and a number of qualitative and business issues, the supply of separate account managers willing to participate in small-cap, fixed-income, and emerging market international equity asset classes on a given managed-model platform is limited, and sponsors may need to

fulfill these mandates with other managed investment products.

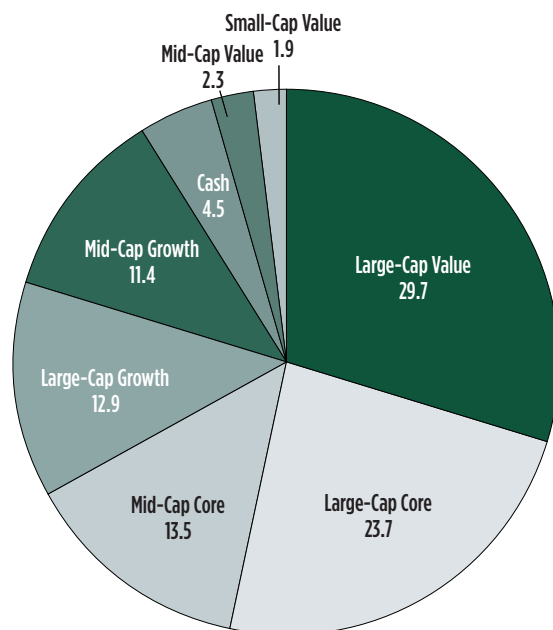
While the manager research, evaluation, selection, and monitoring task can be daunting and expensive, quality vendors are available to assist sponsors in either an unbundled, pure advisory capacity or as part of a turnkey asset management platform. In all cases, use of a third-party provider reduces the operational burden on the sponsor and in many cases can provide a more cost-effective solution than building the platform with internal resources.

From a product positioning perspective, sponsors should carefully position the OPM platform relative to traditional individual separate account managers. OPM offers clear portfolio management benefits for both financial advisers and investors alike for accounts up to several million dollars in size; however, for accounts in excess of that threshold, sponsors are able to deliver certain other asset classes and quality management via premium separately managed account strategies.

**TABLE 2** Historical Attribution Analysis Summary for U.S. Small-Cap Value Manager

	RETURN		RETURN ATTRIBUTABLE TO:				
	MGR	R2000V	ISSUE	SECTOR	TIMING	TRADING	TOTAL
Q1 2005	(1.98)	(3.98)	0.23	0.77	0.39	0.60	2.00
Q4 2004	14.69	13.20	0.70	(0.24)	(0.84)	1.87	1.49
Q3 2004	1.70	0.15	(0.12)	0.24	0.01	1.42	1.55
Q2 2004	3.93	0.85	1.79	0.67	(0.04)	0.65	3.08
Q1 2004	5.67	6.92	(3.03)	(0.02)	(0.41)	2.21	(1.25)
Q4 2003	14.32	16.37	(1.51)	0.40	(0.48)	(0.46)	(2.05)
Q3 2003	0.34	7.73	(8.72)	1.12	(0.37)	0.59	(7.39)
Q2 2003	19.24	22.72	(3.29)	0.87	(0.29)	(0.76)	(3.48)
Q1 2003	(10.88)	(5.08)	(4.33)	(1.16)	0.08	(0.38)	(5.80)
Q4 2002	5.00	4.92	1.03	0.55	(0.22)	(1.28)	0.08
Q3 2002	(11.77)	(21.29)	9.18	0.65	0.64	(0.96)	9.52

**FIGURE 2** Style Concentration for Combined Model Managers as of March 31, 2005



Source: Prima Capital

### Implications for Managers

Private asset management historically has been just what the name implies: a private, exclusive world of money management with a heavy emphasis on client service for both institutions and wealthy individuals and families. As institutional managers moved downstream to provide separately managed accounts to the retail investor market, and other high-net-worth managers seized the opportunity to grow assets under management through brokerage firm distribution, the managed-money paradigm began to change. In today's world of wealth management, advisers and brokers often serve as primary gatekeepers or consultants for clients, and portfolio managers tend to operate more as manufacturers of investment products. That is, brokers or advisers often serve as the manager of managers for their affluent clientele.

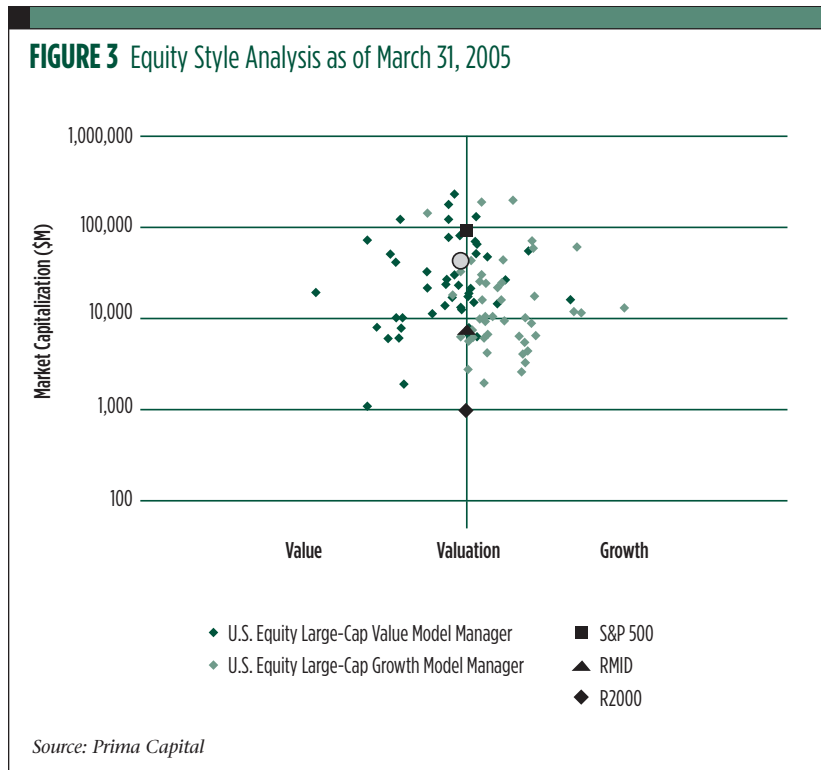
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As technology has improved, streamlining trading and operations and relieving a number of administrative and processing headaches, sponsors have been able to negotiate lower minimum account requirements and manager fees in exchange for product distribution through captive broker and adviser networks. Now, with advancements in OPM technology, managers are being asked to submit only their model portfolios to sponsors in order to participate on the respective platform.

Managers must determine how the managed model approach fits into their short- and long-term business strategies, and where their core competencies and opportunities truly lie. The very business of multimanager and model-based programs requires managers to separate themselves emotionally from controlling the entire portfolio management process and the client relationship, and their participation may change their reputations and brands in the investment marketplace. Model-based programs represent significant asset gathering potential for participating managers; however, they must accept that they only represent one sleeve in an overall portfolio mix. Sponsors will argue that with lower account-value requirements, improved operational efficiency, and by providing access to the mass affluent marketplace, a large portion of managed account and mutual fund assets likely will shift to this model-based platform. Not so coincidentally, as these model-based programs have mushroomed in the industry, the number of participating managers has mushroomed as well.

One important part of the business decision for any portfolio management firm to participate in a model-based program is to clearly understand the economics. The only operational responsibility the managers retain is to electronically submit their portfolio models on a regular and timely basis to the



sponsor for trading and execution. Therefore, the manager's focus shifts exclusively to research and portfolio management decisions, and he or she can export the significant operational and client servicing responsibilities and related expenses of the normal business model to the sponsor firms or approved vendors. These operational responsibilities include trading, execution, portfolio accounting, reconciliation, reporting, account opening and closing, client suitability verification, deposits and withdrawals, year-end tax trading requests, and implementing specific client restrictions. Consequently, managers can expect to receive lower fees (which range from 25 to 35 basis points in today's market) in exchange for the lower expenses associated with the model-based program. Initially, traditional managers tend to balk at this perceived reduction in their management fees; but when viewed in terms of net margin, the comparison with their fully loaded traditional net margin tends to be favorable. **M**

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### Endnotes

1. Money Management Institute Annual Conference, panel on the status of unified managed accounts, Philadelphia, Pa. (spring 2005).

2. The information and views contained in this article are current as of the date specified and are subject to change. The views expressed are of the writer specified and may not be representative of the opinions and views of other employees of Citigroup Asset Management or of the firm as a whole.