Overlay Management in the Separate Account World

BY MICHAEL WINKEL, J.D., CFA®

Separately managed accounts are the hot game in the money management industry. According to the Money Management Institute and Dover Financial Research (2007), separately managed account assets have more than doubled since 2003; much of this can be attributed to the 31-percent growth rate experienced in 2006 (see figure 1).

As the product type races toward the trillion-dollar mark and is adopted beyond Wall Street by banks and insurance companies, more than marketing sizzle is driving growth. Cerulli Associates (2001) states that demographic trends, technology, changing intermediary landscape, and increasing demand for financial products and services, especially among affluent and high-net-worth customers, are key factors influencing this growth.

For separately managed accounts to deliver on their promise, however, the industry must continue to evolve and leverage technological advances that ultimately will deliver more-personalized portfolios and better net returns to investors. Overlay manager programs are on the horizon as the next step in this evolution. What problems are they really solving?

FIGURE 1 Separately Managed Account Assets

<table>
<thead>
<tr>
<th>YEAR</th>
<th>BILLIONS</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>$399.7</td>
</tr>
<tr>
<td>2002</td>
<td>$398.7</td>
</tr>
<tr>
<td>2003</td>
<td>$497.3</td>
</tr>
<tr>
<td>2004</td>
<td>$575.0</td>
</tr>
<tr>
<td>2005</td>
<td>$678.1</td>
</tr>
<tr>
<td>2006</td>
<td>$889.0</td>
</tr>
</tbody>
</table>

Sources: Money Management Institute and Dover Financial Research, Spring 2007

Defining the Market

Separate account managers started moving from their pure institutional heritage and into the private wealth market in the 1970s. As the product evolves from its institutional beginnings toward private wealth management, significant changes are needed to adapt institutional methods to meet the demands of individual investors. Technology continues to be one of the largest influences on this evolution and will force future product design toward efficient delivery of the best net return.

Today, separate account platforms provide advisors with open architecture (the opportunity to pick from the best managers available) and deliver client ownership of the underlying securities. Value-added benefits are visible to the client, resulting in a stronger bond between advisor and client. Extensive client profiling and strong tax management allow the advisor to clearly demonstrate the value of the fee charged.

But the promise of open architecture and separate account management has been only half realized to date. According to Financial Research Corporation (2004), only a small portion of all separately managed accounts have exercised the right to place restrictions on the management of portfolios. The advisor can choose the best managers but, when it comes time to modify portfolios to reflect client constraints, mandates, and manage taxes, the “separate account management with open architecture” promise can be difficult to fulfill. The “why” of this difficulty is worth exploring, because it lays the foundation for actions needed to remedy
Pre-Trade Compliance

Pre-trade compliance is the ability to implement client-specific restrictions. These restrictions create limits on what can be done within the client’s overall portfolio irrespective of the money manager’s target portfolio. Examples of these constraints include the following:

- mere whims of a client that arise from nostalgia or other noneconomic factors
- beliefs based on moral, religious, or ethical grounds
- strong views on countries, markets, sectors, or securities
- legal restrictions on purchase, ownership, or disposition

Pre-trade compliance also helps the client control the actions of managers when outside assets, income, or other interests form a risk position that should not be duplicated in the portfolio, such as company stock, stock options, rental income, etc.

The true essence of pre-trade compliance should center on the creation of a mean-variant optimal portfolio for that client (optimize the client’s specific constraints) and not a mean-variant optimal product (optimize a set of generic constraints). The industry has struggled with recognizing this shortcoming given its limited resources for resolving the problem in portfolios that were less than institutional in size.

What Can Be Done About Pre-Trade Compliance in a Traditional Separate Account Manager Framework?

The industry would like us to believe that a lot can be done. In theory, we can tell each manager in our multimanager portfolio not to buy or sell any security, to underweight certain sectors or market capitalizations, to not buy any security that has exposure to certain sin or social elements. The reality is that once we get beyond the simple “do not buy” or “sell” by ticker, manager acceptance of further restrictions generally is limited.

Why Do Separate Account Managers Limit the Nature and Extent of Restrictions?

The interests of the separate account manager and the client diverge for two practical reasons. First, numerous restrictions create compliance risk (i.e., the risk that the manager will violate a constraint). Ensuring that all constraints are met requires sophisticated technology or enormous manual effort. Because most managers do not want the added manual effort, technology is needed to manage the portfolios. But most managers have not deployed sophisticated technologies that keep track of restrictions and order up proper alternatives.

Second, numerous restrictions lead to problems with manager composites. Managers need to track the performance of their accounts in a composite that becomes the basis for their published track records.

Consultants that evaluate managers will monitor not only this track record but also more importantly the dispersion in the manager’s track record. The more that characteristics of a portfolio, such as sector weights or asset weights, differ from the stated benchmark, the more the portfolio’s performance will deviate from the benchmark. This deviation is interpreted as the manager taking on greater risk or inconsistent application of strategy when, in fact, it could be due to constraints imposed by a client. Managers with wider dispersion (the appearance of increased risk) may not win the same amount of assets as a more consistent manager. Consider for example two large-cap core managers. Each manager has 40 accounts (see table 1).

While Manager A has a higher composite return, the spread of returns among accounts is more than four times that of Manager B. If a consultant had to choose between the two managers, Manager B would be the obvious choice to avoid the risk that a client would end up on the lower end of the range of returns.

Therefore, even if managers use technology to implement client-level customization, it still is not in their best interest to accept customized accounts as long as consultants select managers on the basis of performance across accounts independent of any account-level constraints.

Taxes

Taxes are and have been the great thief of net returns to a client. Taxes represent one of the most researched topics in separate account management literature. It is widely held that tax management minimizes taxes...

<table>
<thead>
<tr>
<th>MANAGER</th>
<th>COMPOSITE RETURN</th>
<th>TOTAL ASSETS</th>
<th>HIGHEST</th>
<th>LOWEST</th>
<th>STANDARD DEVIATION</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>9.63%</td>
<td>$233 Million</td>
<td>11.70%</td>
<td>7.30%</td>
<td>1.45%</td>
</tr>
<tr>
<td>B</td>
<td>9.55%</td>
<td>$213 Million</td>
<td>9.99%</td>
<td>9.04%</td>
<td>0.30%</td>
</tr>
</tbody>
</table>

The more that characteristics of a portfolio, such as sector weights or asset weights, differ from the stated benchmark, the more the portfolio’s performance will deviate from the benchmark.
and enhances returns. The more tax attributes in a portfolio, the more effective the tax management, in theory. For the taxable investor, taxes act as a series of constraints that create the same problems as pre-trade compliance constraints because tax attributes also are client-specific issues. Depending on when the security was purchased or contributed to the portfolio, each client faces a unique event when trading. At the extreme, a manager may be selling a highly appreciated security due to overvaluation one day before the client's holding moves from a short-term to a long-term capital gain. The impact is a 25-percent tax penalty on that particular client.

Historically, turnover has been criticized as the tax enemy. Loss harvesting, another important element of tax management, is talked about less but can be thought of as “good” turnover. In recent years, the literature has been making attempts to measure and quantify the impact of loss harvesting: it goes beyond just the potential tax reduction in the year the losses are harvested. Consider the tax loss carried forward. This aspect of loss harvesting can be considered an asset because a benefit can result. However, it cannot be assigned a value, so it is not marketable and therefore is difficult to measure (Torre and Rudd 2004). Parametric Portfolio Associates has examined loss harvesting extensively, reporting the results in Stein (2003). They constructed a Monte Carlo simulation, simulating different market environments and loss harvesting levels. The study attempted to demonstrate the excess return over the benchmark that could be added from loss harvesting. Results showed excess returns of 0.6 percent and more over a 10-year period. The study also examined a longer period of time and found the value to decline, but it still exceeded 0.3 percent over 30 years.

Separate account managers can take these issues into consideration, but will they? Should they? Separate account managers either must invest in sophisticated technology and/or engage in manual intervention. When they engage in the one-off activities, separate account managers increase the dispersion of returns in client portfolios. Unless the industry hires and fires managers based on pre-tax returns, we likely will not see managers addressing the tax issue appropriately.

More Complexity
Pre-trade compliance and taxes create a level of complexity that most managers do not want to address. While solving pre-trade compliance and tax concerns would be helpful, there are other issues created by the current approach to separate account management. These issues are inherent in the word “separate.” Each investment style in the customer’s portfolio is managed independently of the others. Examples of issues that arise include:

- corporate actions
- index realignment
- wash sales
- redundant positions
- tracking-error management

Corporate Actions and Tracking-Error Management
Each day numerous changes can occur in a security’s capital structure. Companies spin off subsidiaries, sell and buy other companies, recapitalize, and engage in numerous other activities. These actions can have an immediate impact on a manager’s decision to hold securities that are independent of the security’s potential. The new security, or securities, no longer may be included in the current manager’s benchmark. This manager may decide to sell the securities to prevent tracking-error problems. However, this newly recapitalized security still may fit nicely in another separate account in the client’s portfolio that another manager is managing. Unfortunately, one manager sold it, and another bought it back. All of this created, at the very least, transaction costs—or worse—taxes.

Index Realignment
The nature of multimanager portfolios has been to reward managers that deliver exceptional performance relative to their benchmarks. The reconstitution of the index that represents the benchmark leads to turnover as the manager trims holdings that no longer are representative of the index. Here again, the stock that is trimmed may have been a perfectly acceptable holding in the client’s total portfolio. Another manager that is actively managing to outperform the new index may add the security or add to an existing position. The result is multiple managers creating turnover that is irrelevant to the client’s profile.

Wash Sales and Redundant Positions
In reality, there must be some oversight of each separate account’s manager to prevent wash sales. A sale that realizes a loss by any manager would require a restriction on the purchase of the same security in another portfolio. Likewise, transactions on redundant positions (the same security held in more than one account of the portfolio) require restrictions on this security across the separate accounts. The consequences can be costly through the potential forfeit of a realized loss and tax reduction, the unnecessary transaction expense, and the possible embarrassment of explaining the transactions to a client. Redundant positions also can cause an unintentional overweight in a security, which can be costly in total portfolio performance. At the very least, redundant positions can increase the overall volatility or risk of the client’s total portfolio.

The Role for the Overlay Manager
An overlay manager is an individual who takes the responsibility for looking at a client’s entire portfolio and ensuring that what one separate account manager is doing in his portfolio is not counter to what
is happening in another separate account manager’s portfolio for the same client. Each of the managers is managing a “sleeve” of the client’s portfolio. They manage it independently of any of the managers in any other separate account or sleeve of the client’s portfolio. Active managers add alpha (i.e., value) through their investment models, which are independent of client constraints and apply to all the accounts managed. The overlay manager becomes the client-specific specialist. Each client has a risk tolerance, different cost basis for each security, gains and losses from outside assets, unmanaged securities such as company stock or stock options, and other factors that make each client unique in how the portfolio should be managed. This person or entity is given charge to view the client’s situation from a holistic perspective. The overlay manager gives the client restrictions, mandates, and tax considerations probative value in making trading decisions. An overlay manager customizes the manager models to fit each client’s specific constraints across all the sleeves of the portfolio. This person reviews the activity the individual managers are instituting and allows—or doesn’t allow—the activity into the portfolio.

In Stein and McIntire (2003), a simulation compared separate account management with and without an overlay manager. The simulation assumed a 10-year horizon and found that 0.3 percent to 0.6 percent and more excess return can be added with an overlay manager. These results represent only the value added through tax management. Additional value, which is more difficult to measure, comes from reduced transaction costs as transactions deemed unnecessary that would have occurred due to corporate action, index realignment, tracking-error management, and elimination of redundant holdings across multiple accounts. An additional unquantifiable benefit is the intrinsic value the customer places on the advisor as a trusted advisor looking out for his/her best interests.

The Sleeveless Overlay Manager
Can overlay management be offered in a manner that effectively solves all the issues previously discussed? Taken to the extreme, a portfolio can become “sleeveless” and solve all of the conflicts of sleeve-based management. The current sleeve-based approach exists as a compromise between two extremes, a sleeveless approach at one end and a mutual fund wrap approach at the other. The sleeved approach is shown in figures 2 and 3 and the proposed sleeveless approach is shown in figure 4. Although the figures suggest that sleeveless is a more simplified approach, a sleeveless approach also raises the most questions around implementation.

Sleeveless refers to the single portfolio within which multiple manager models are implemented (see figure 4). It is a single account from which all trades emanate and settle. The sleeveless overlay manager can be considered a “full-service” overlay manager providing unified

**FIGURE 2** Sleeved Separate Account Management

**FIGURE 3** Sleeved Separate Account Management with Overlay Management

**FIGURE 4** Sleeveless Separate Account Management with Overlay Management
overlay management. To achieve a “full-service” level, we must strip the trading function from the manager and place it in the hands of the overlay manager. Additional functions performed by the overlay manager would include tax-lot management, coordinated account rebalancing, and risk management.

The sleeveless overlay manager can step away from the managers’ models and implement only those transactions best suited to the individual client’s constraints, risk profile, and tax information. To fully take advantage of all the potential excess return, there needs to be a method to pass the manager’s model and changes to that model to the overlay manager on a timely basis.

If we accept the above statements as true, we need to contrast the benefit received with what we potentially may be losing in eliminating the sleeve-based approach. The above requirements for a sleeveless approach will, and should, raise some questions in the minds of advisor’s and clients, such as the following:
1. Will high-quality managers sell their model portfolios?
2. Can the overlay manager trade with the same skill as the separate account manager?

Will high-quality managers sell their model portfolios? Playing devil’s advocate, an argument might be made that the best managers will not sell their model portfolios if they can fill their volumes through traditional means. This is a possibility, though not necessarily true. First, even if the best managers will not sell their models, can we still pick up a better net after-tax-and-expense return by picking from those managers that will? Academic studies on the value of tax management and the effect on after-tax returns are manager nonspecific. These studies clearly demonstrate that value can be added regardless of the manager.

and many do not want to link to systems that allow for them to communicate with the clearing broker and the custodian. The model-portfolio process opens up a whole new and more efficient means of paying for their alpha-generating processes and supporting their revenue needs.

Can the overlay manager trade with the same skill as the separate account manager? Trading skill varies from manager to manager and by style and capitalization. In most cases, trading skill is measured by the ability of the trader to purchase a recommended security at the market price. Assuming the manager is controlling the volume of trading, by both sleeved and sleeveless styles, there should not be a difference in market impact. Arguably, we may find that having multiple overlay managers helps remove the information component of a large trade by having those trades originate from multiple points.

Conclusion
Advisors must decide whether they can put more dollars in clients’ pockets. The best manager with the best traders may not overcome the tax and compliance issues germane to an individual high-net-worth client. Consider the solution in three steps, each step solving a problem or set of problems. The first step toward putting more dollars in a client’s pocket is utilizing a sleeve-based separate account management approach. An open architec-