The Evolution of Unified Managed Accounts

From Multidisciplined Accounts to Unified Managed Households

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In the late 1990s, a quiet revolution started in the separate account industry. A large asset management firm developed a set of predefined asset allocations that combined multiple in-house separate account managers and automatically delivered basic services such as rebalancing. What used to be a relatively complex and difficult-to-sell investment product (the separately managed account or SMA), instantly became simple and more accessible to advisors and their clients. The firm's multistyle portfolio (MSP) resulted in an explosive growth in assets and the adoption of fee-based investment products with a new generation of advisors.

Since that time, other major advisory firms have been developing their own multistyle separate account programs. The result has been an alphabet soup of new investment solutions—multistyle portfolios (MSPs), multidisciplined portfolios (MDPs), and most recently unified managed accounts (UMAs). UMAs allow an advisor to create a diversified asset allocation that can include separate accounts, mutual funds, exchange-traded funds (ETFs), and even hedge funds in a single account to meet the investment needs of a wide variety of clients. The benefits to advisors and sponsors for these new investment solutions are numerous:

Better diversification at lower account minimums. Traditional separate account programs have a minimum account size of $100,000 per investment style. So a client with a 10-percent allocation to international equity needed $1 million to have a fully diversified separate account solution. Many UMA programs allow separate account portfolios to be implemented with as little as $25,000 and support the use of ETFs and mutual funds to fill in asset classes that don't meet this minimum. The result is better-diversified asset allocations for all clients, but particularly for those with accounts of less than $500,000.

Improved client services. Traditional separate account and mutual fund wrap programs often left rebalancing and cash management services (e.g., systematic withdrawals to support retired clients' income needs) up to the advisor. Most advisors view their primary source of value to be advice, not operationally implementing basic account services. UMA programs provide automated rebalancing, cash management, and other account services, allowing advisors to better serve their clients, significantly reducing the time spent delivering high-value services.

Improved features and functionality. Separate accounts often have been sold as more customized and tax-managed investment products compared to mutual funds. In truth, very few client accounts are customized (less than one-third according to research by Cerulli Associates[1]). Conversely, UMAs generally support much more sophisticated customization capabilities. By placing the majority of a client's assets in a single UMA portfolio rather than breaking those assets up across multiple managers and accounts (as is done with traditional separate accounts), the gains and losses realized in a client's account can be analyzed and customized to improve the client's after-tax returns. Account customization for risk and tax purposes allows advisors to deliver new value to their most demanding clients.

UMA programs now are capturing the lion's share of new flows at firms that have launched such programs. Mature UMA programs (those that have been available for at least one year) at most sponsors are capturing more than 50 percent of new flows. In our opinion, the unified managed account is the future of fee-based investment advice.

Changing the Fee-Based Business Model

Separately managed accounts are a relatively mature product with a well-established infrastructure and operating model. Program sponsors (e.g., wirehouses, regional brokerage firms, and large banks) establish relationships with a roster of third-party (and perhaps affiliated) investment managers to participate in their programs. Advisors are able to create solutions for clients by opening individual accounts to be directly managed by any of the managers in the program. For a client with a diversified asset allocation, multiple managers generally are selected and multiple custodial accounts opened, one for each manager/style.

Unified managed account programs (and MSP/MDP programs before them) represent a fundamental re-engineering of this traditional SMA business model. Instead of opening one account for each manager/style and giving each manager discretion over a portion of a client's assets, UMAs generally are integrated into a single account, and that account has a new centralized investment manager that oversees the trading and delivery of services. This new investment manager is called an overlay portfolio manager (or just overlay manager). The underlying style managers provide their investment advice to the overlay manager in the form of a model portfolio (individual security names and weights). The overlay manager then is responsible for implementing all of the trades for the chosen managers in a client's account, as well as implementing any customization mandates (e.g., excluding restricted securities) and client-specific features (e.g., rebalancing, cash contribution/withdrawal processing).

Overlay portfolio management services can be provided by a third-party investment manager specializing in such services, or by in-house resources using special software. Third-party investment managers that were the fully discretionary investment advisors to clients in separate account programs now serve as the nondiscretionary subadvisors to the overlay managers by providing their model portfolios to be implemented through the overlay management process. Like the financial advisors, money managers operating through an overlay management process no longer are hampered by the operational burden of providing services on individual client accounts. Money managers instead can focus on what they do best—researching and selecting securities, and managing a portfolio to best meet the stated investment objective.

Model Portfolios—Reinventing the Separate Account Industry

The advent of UMA programs and the overlay portfolio management business model is beginning to have a major impact on broader separate account programs. When UMA programs and overlay management models first were launched in 2001, they were seen as a limited offering—packaged investment solutions for the mass-affluent marketplace. But those early UMA programs now have grown to dominate the fee-based platforms of major sponsors, enabling more advisors to offer robust solutions and better serve their clients, while also delivering operational efficiencies, cost savings, improved compliance, and oversight to the sponsoring organization.

Sponsors are increasingly looking at their UMA programs as not just another product on the "product shelf" alongside mutual fund wrap, separate account, and other fee-based investment programs; but as the definitive future platform for delivering product-independent investment solutions for their more-affluent clients (i.e., those with $100,000 or more to invest). In support of this new broader vision for the UMA, sponsors are looking at ways to migrate advisors and clients from traditional single-manager SMA programs to their new UMA programs. Part of this migration effort involves enhancing the traditional SMA programs to support some of the client benefits and operational efficiencies being realized in more advanced UMA programs.

One recent development has been the announcement by Merrill Lynch that it will be changing the structure of its massive Consults separate account program in the future. Merrill proposes changing managers from being fully discretionary on each client account to providing model portfolios for implementation through some form of overlay management process. Merrill's efforts should result in significantly improved economics and operational efficiency in the Consults program, and could be a bellwether of changes that other leading sponsors might take in re-engineering their broader fee-based platforms to realize some of the operational efficiencies and client benefits being realized in newer UMA programs.

The Impact on Financial Advisors

The use of UMAs has quickly been adopted by financial advisors for a number of different reasons. The two most commonly cited reasons are practice management and client-specific investment customization, both of which are achieved through operational efficiencies.

Traditional SMAs were a great choice for financial advisors and their clients seeking control, customization, and transparency for their investments. Historically, however, SMAs have been labor intensive and cumbersome to administer during account set up and on a continuous basis. For example, if the asset allocation required five different asset classes, then it would require the advisor to complete five account-opening documents, one per money manager. In many cases, the same five money managers are available through a UMA, therefore requiring only one set of account-opening documents. Ultimately, less paperwork means more time for the financial advisor.

Clients in fee-based programs often need access to services and portfolio customization including stock restrictions, rebalancing, cash management, and tax customization/management. While traditional SMAs can implement restrictions at the account level, the process is cumbersome and difficult to monitor for compliance. With a UMA, the overlay manager is able to consistently apply the restriction (as well as any other customization mandates for tax or risk purposes) across all of the managers/products implemented in the client's account. Here are a few examples where advisors have effectively used these capabilities within UMA programs to improve their practice, and better serve their clients.

Example—Client Restrictions

A doctors group specializing in nephrology wanted a specific money manager for the large-cap value allocation of its pension plan. With practices focusing specifically on human kidneys, the doctors have seen the damage caused by alcohol and tobacco and wanted to restrict their pension investments from these two sectors. The financial advisor had a choice to make with the pension plan. She decided to compare several individual SMA money managers against using the same money managers within her company's UMA program. The stock restrictions were requested for the individual money manager but the request could not be fulfilled. However, through the use of risk-factor matching, the UMA was able to restrict the specific industry sectors.

The individual money manager could not honor the restriction request because one of its largest positions was a tobacco company. In this instance, the overlay manager was able to replicate the money manager's investment style while at the same time implement the client's restriction requirement. The advantage of the UMA was clear. Instead of navigating through several restrictions with multiple money managers (and their varying abilities or willingnesses to comply with the restriction request), the advisor was able to efficiently comply with the pension plan's investment policy statement.

Example—Rebalancing and Cash Management

Once an account is established with the correct asset allocation and stock restrictions, the financial advisor must maintain the client's risk profile by rebalancing the portfolio. While most clients agree with the concept of asset allocation, they often are unwilling to trim from their outperforming investments to reallocate to their underperforming investments. UMAs generally incorporate automatic rebalancing, helping clients and advisors do the right thing, even when psychology would have them do otherwise.

> Only a centralized overlay-management process that makes client-level (rather than manager/product-level) decisions is capable of making appropriate tax-management decisions for the client.

Automated rebalancing was of paramount importance to one particular regional broker-dealer sponsor. Many advisors with the sponsor had allowed a large quantity of client assets with one particular high-performing manager to build up over time without rebalancing, a violation of the firm's stated policy and intent to rebalance client accounts regularly. Advisors in general were reluctant to pull money out of such a hot manager/product. The manager's performance failed spectacularly when the technology bubble burst, resulting in unhappy and lost clients. Enforcing systematic rebalancing across the program would have allowed this particular sponsor organization to better manage and reduce the risk in its client accounts.

In a similar way, cash contributions and withdrawals are more efficiently processed in most UMA programs. With traditional SMAs, cash management can be a five- or six-step process, and most SMA programs don't support any form of regular or systematic contribution or withdrawal process. Specifically for IRA accounts that have required minimum distributions (RMD), it is easy to miss an account and therefore not make the correct RMD calculation for a client, resulting in a significant penalty and an unhappy client. If the assets are consolidated within a UMA, the process generally is automated and the advisor has only a single account (the UMA) and a single manager (the overlay manager) to coordinate with to ensure compliance.

Example—Tax Management

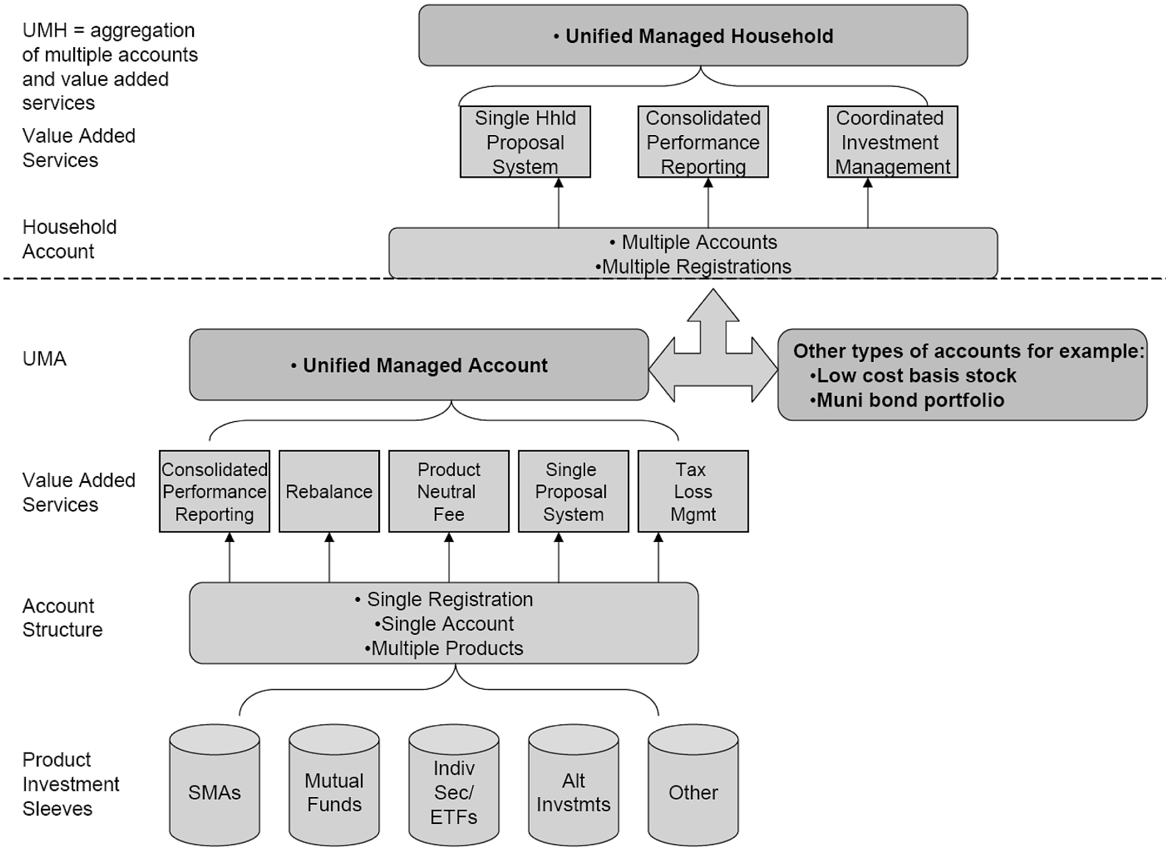
Tax management always has been a consideration for SMAs. Assume an asset allocation with two money managers, each manager attempting to minimize taxes within his portfolio. The money managers may work against each other because each is unaware of the other's investments decisions.

In the example shown in table 1, the individual managers were delivering a relatively tax-efficient solution. But since Manager A's long-term capital losses offset Manager B's long-term capital gains, the client is stuck with a nasty $100,000 short-term capital gain that couldn't be anticipated or avoided by either manager individually. Only a centralized overlay-management process that makes client-level (rather than

TABLE 1 Examples of UMA Tax-Management Capabilities (see text for details)

	MONEY MANAGER A	MONEY MANAGER B
Short-Term Capital Losses	-	-
Short-Term Capital Gains	$100,000	-
Long-Term Capital Losses	$100,000	-
Long-Term Capital Gains	-	$100,000

FIGURE 1 Unified Managed Household



Source: The Money Management Institute and Dover Financial Research

manager/product-level) decisions is capable of making appropriate tax-management decisions for the client.

Another example of the benefits of UMA tax-management capabilities is the case of a successful real estate developer. Now in his early sixties, the client wanted to start enjoying his life a little more by spending more time with his family. In order to do so, he and his financial advisor decided to liquidate a portion of his $100-million real estate holdings. He elected to invest a portion in the securities markets. He had many concerns from a tax standpoint: reducing short-term capital gains, coordinating outside taxable events with other strategic advisors (CPA and lawyer), and taking outside taxable events into consideration when investing.

Some UMA programs, through an integrated overlay-management system, can coordinate and consolidate a client's account allowing for coordinated tax considerations. In this case, each of these considerations was accounted for with the active tax management. Several conference calls with the client and his trusted business partners resulted in an initial $15-million investment. Quarterly conference calls are held to coordinate all of the client's taxable events.

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The Unified Managed Household—the New New Thing

Understanding that UMAs are an account-level investment solution, the Money Management Institute, in cooperation with Dover Financial Research,[2] in summer 2005 presented research on a conceptual new product architecture, "The Unified Managed Household." The unified managed household (UMH) is a framework for providing integrated investment solutions across the totality of a client's assets (figure 1).

The UMH has the potential to allow advisors to deliver superior value by providing integrated services in consideration of a client's complete

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portfolio. While advisors often cannot control or influence a client's external holdings (e.g., many clients will have 401(k) assets held in an employee-sponsored program), they can expand client relationships by tightly integrating the products and services they do provide with assets held away. UMH-type programs should provide the ability for advisors to deliver this enhanced level of service.

The fee-based investment platform in most sponsor organizations is continuing to undergo significant evolution. Traditional SMA programs generally are losing ground to new UMA programs, which will further evolve in time to support cross-registration and even cross-organization investment solutions. As these programs continue to evolve, advisors will see substantial benefit in the efficiency of their practices and their ability to deliver ever greater levels of service and value to their clients.

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Endnotes

1. Cerulli Associates. 2002. Considering Taxes. *Cerulli Edge Managed Accounts Edition* (third quarter).
2. Len Reinhart. 2005. Understanding the New Realities of Unified Managed Accounts. The Money Management Institute and Dover Financial Research, presented at the Money Management Institute Annual Separate Managed Account Conference (summer).