The high-net-worth (HNW) wealth management industry is constantly evolving, and it is worthwhile to examine some of the trends among HNW investors since the financial collapse of 2008. We believe that investors:

- want to be more involved in the decision-making;
- are more cost/value/tax sensitive;
- are more concerned about due diligence;
- are more interested in risk management, transparency, and liquidity;
- are less interested in traditional bond/equity portfolios; and
- are increasingly interested in/open to more nontraditional investment approaches and solutions.

How should advisors to HNW investors and families be building portfolios and running their businesses? How can they help clients achieve evolving goals and objectives, and/or take advantage of industry trends? Are there best practices among successful, profitable, and fast-growing advisors that can be identified, analyzed, and adopted?

Successful advisors and financial institutions are winning business in a competitive marketplace by building and managing differentiated investment portfolios and running their enterprises efficiently and profitably. We are in a position to observe them and see what they are doing to set themselves apart.

Based on our observations, here are six habits we see successful advisors using to address the demands of HNW investors.

**Actively Adopting and Employing Unified Managed Accounts**

A unified managed account (UMA) is a professionally managed, regularly rebalanced account that can accommodate many types of investments in a portfolio within a single account. UMAs offer advisors the ability to actively tax-manage portfolios as well as improve operational efficiency.

Contrast it with a portfolio of separately managed accounts (SMAs), where each account in the portfolio contains a specific type of investment that is separately established and managed.

SMAs originated as institutional offerings with high initial investment minimums (e.g., $5 million–$10 million), but over time these minimums were dropped in order to access the HNW and smaller institutional spaces, and now are generally $250,000–$500,000.

The promise behind SMAs is that they are customizable, they can be tax-managed at the individual account level, and investors actually own the underlying securities in the portfolios in their own accounts (versus a mutual fund, where investors simply own shares in the fund, not the underlying securities invested in by that fund). These features all appeal to taxable HNW investors. But from an advisor’s perspective, managing multiple portfolios of SMAs is not a scalable business and the promise of active tax management has, for the most part, gone unfulfilled.

In addition, the operational management (implementing, rebalancing, managing cash flows, etc.) of a portfolio of SMAs is inefficient and cumbersome, and something advisors really can only get wrong, because it is a function the client assumes will be handled correctly.

With a UMA, the same managers offering SMAs instead act as sleeve managers inside a multi-manager account, sending their buy and sell signals to a third-party overlay manager whose responsibility it is to execute those trades in the most cost- and tax-efficient manner possible (see figure 1).

The earliest generations of UMAs were decidedly retail-oriented and investor unfriendly, with significant negative
Table 1: Advantages of Today's UMA Programs

<table>
<thead>
<tr>
<th>Quality Managers, Tax Efficiency, Easy Implementation</th>
<th>Customizable Asset Allocation and Model Portfolios</th>
</tr>
</thead>
<tbody>
<tr>
<td>Proprietary or third-party research, due diligence, and portfolio monitoring</td>
<td>Flexible and open platform that allows for both proprietary or third-party sleeve management</td>
</tr>
<tr>
<td>Increasing manager acceptance and participation means ability to build and manage widely diversified portfolios</td>
<td>Full advisor discretion means easier rebalancing and tactical re-allocations</td>
</tr>
<tr>
<td>Negotiated access and management fees</td>
<td>Easier to implement customized investor portfolios—SRI, concentrated stock, etc.</td>
</tr>
<tr>
<td>Negotiated investment minimums combined with active tax management</td>
<td>Sleeve-level reporting allows easier comparison to manager SMA composite (i.e., the performance &quot;drift&quot; that may come with active tax management)</td>
</tr>
<tr>
<td>Rapidly evolving technology means inclusion in the UMA of more of the overall portfolio (e.g., credit, alternatives, option overlay, etc.)</td>
<td>Custodial-agnostic programs increase advisor flexibility</td>
</tr>
</tbody>
</table>

Taking Full Advantage of the Evolution of Alternative Investments

Since alternative investments first grew popular with high-net-worth investors in the early 1990s, opinions have fluctuated about how to use them. Today we are seeing wealthy investors take a more conservative approach to alternatives, opting to use more-liquid and -regulated investment vehicles as opposed to less-liquid limited partnerships or more-diversified but also more-expensive funds of funds. We expect this trend to continue as the distinction between alternative and traditional investments blurs.

In the past three years alternative investments have somewhat returned to normalcy. Despite generally negative media and relatively anemic performance, many investors understand that alternative investments may add value to well-diversified portfolios. So where is the industry heading?

Consider the interesting and rapid growth and acceptance of alternative investment (AI) retail products, including separately managed accounts, mutual funds, and regulated investment companies (which are hybrids of a mutual fund and a limited partnership). These investment vehicles have been adopted widely by advisors due to their more conservative approach to using leverage and managing liquidity and risk, and also by their more-regulated legal structures, especially among mutual funds.

Consider the portfolio illustrated in figure 2. Five years ago, an investor who wanted this portfolio would have been limited to a diversified fund of funds limited partnership, or would have needed to be large enough (i.e., have more than about $25 million) to build this portfolio with direct investments into the underlying hedge funds. Further, the advisor and/or investor would have had limited ability to directly allocate assets, influence manager decisions, or re-allocate to accommodate changing market conditions.

Today this portfolio can be built entirely with 40 Act mutual funds, if desired, and this fundamentally changes the conversation advisors can and should be having with clients. Even when dealing with qualified purchasers who have the ability to invest in hedge funds, the conversation can and should now revolve around the investor-specific trade-offs among return, risks, liquidity, and fees—a discussion that simply could not have taken place when the only structures, especially among mutual funds, were mutual funds and exchange-traded funds (which cannot be tax-managed as effectively because they are individual securities and not a portfolio of securities, as is the case with actively managed sleeves).

But the technology and the manager participation rate have evolved to the point where the optimal use of the UMA structure has moved from retail clients, where operational efficiency for the advisor was paramount, to taxable HNW investors, where customization and active tax management move to the forefront. Table 1 summarizes the potential advantages of today’s UMA programs.

The ability to employ premier managers in actively tax-managed sleeves within one overlay account delivers on the decades-old promise of a portfolio of SMAs—better managers, ease of implementation, customizable to investor-driven specifications (e.g., socially responsible investing or SRI), and cost- and tax-efficiency. These programs also drive efficiency and profitability for the advisor. We anticipate that asset managers will begin to once again increase the investment minimums of their SMAs in order to re-institutionalize them and make their strategies available to HNW investors only through model sleeve accounts.
place when we were only able to talk about hedge funds.

Investors should not expect the same risk and return characteristics from these strategies vs. their hedge fund cousins, given the investment and leverage constraints on mutual funds, which are more regulated. This is the case even if the strategies are managed in a manner similar to a limited partnership run by the same portfolio manager.

Despite this, and despite the relatively short track records of many AI mutual funds, many investors seem happy to exchange the potentially superior performance of a limited partnership for the liquidity and regulatory “bear hug” associated with AI mutual funds.

The availability of these products means that an aversion to limited partnerships is no longer a reason to avoid alternative strategies. Assuming the sophistication and investment objectives of an investor warrant the inclusion of alternative investments within a diversified portfolio, the conversation then needs to focus on the characteristics the investor expects and desires from that AI exposure.

As these conversations take place, one result may be the eventual acknowledgment that “alternative investment” is an unfortunate misnomer. Perhaps the discussion is really just about what level of investment constraint investors want to place on the construction and management of diversified—and ultimately pretty traditional—portfolios.

**Optimizing Active Management Fees**

An interesting behavioral aspect of the active vs. passive debate is that many advisors and HNW investors simply prefer active management, regardless of the evidence that it is very difficult to do well consistently in active management. Many advisors base their practices on a fundamental value proposition: “I can find better managers than your current advisor.” Many investors want to believe that they—or their advisors—can do better than the market.

Because both advisors and investors are likely to continue using active management, a natural question is (or should be), “How do we optimize active management fees?” A simple but powerful answer to that question is to spend active management fees where they have the highest probability of making the biggest difference. Rather than a bottom-up approach of populating a portfolio with specific active managers and then adding up the cost, many advisors take a top-down approach where a total amount of active management fee is specified and then the portfolio is built spending those active management dollars where they are likely to do the most good.

An active portfolio built primarily around long-only managers in efficient asset classes, especially if those managers employ a large number of positions, is much more likely to underperform a similar passive portfolio net of fees, and leads to the notion of “diworsification.” Interesting analysis done by the Yale endowment fund and others suggests that the dispersion of returns between top-quartile and third-quartile managers for most traditional, long-only asset classes is not wide enough to support the time and resources required to find those top-quartile managers, and that passive strategies are preferable for many of those asset classes.

Further analysis done by Standard & Poor’s via its semi-annual SPIVA report shows that the overwhelming majority of actively managed mutual funds underperform their respective S&P benchmarks, net of fees, over almost all time periods. (Note: One counterargument to this analysis is that this underperformance is based on poor construction and use of the respective S&P indexes, not actual manager performance.)

If a top-down approach to active management is taken, then four primary areas for exploration reveal themselves:

1. Traditional asset classes that historically have been less efficient and therefore offer an improved potential for active-management alpha. These might include micro-cap, international small- and mid-cap, emerging markets, all-cap, global equity, and so forth.
2. Managers investing in more-efficient asset classes (U.S. large- and small-cap, developed international, etc.) who run high conviction, concentrated portfolios and have proven historically that they can do so successfully.
3. Nontraditional but fairly liquid investment strategies that introduce a more diverse set of potential return drivers into the overall portfolio. These might include many of the AI illustrated in figure 2—long/short, global macro, relative value, market neutral, event-driven, and momentum-oriented trading strategies. These strategies cost more to access (even in mutual funds) in comparison to more-traditional strategies, but they tend to invest in less-efficient markets and they have the potential to improve the overall diversification of the portfolio.
4. Other nontraditional but more-illiquid strategies, such as private equity, venture capital, buyouts, and real estate; the Yale analysis referenced above indicates that it is worth the time and effort necessary to locate the dispersion between top-quartile and third-quartile managers in these areas.

In a volatile and potentially low-return market environment, fees matter and are a tangible source of potential advisor added-value. That does not mean that advisors need to give up active management and adopt a passive, low-fee approach. What it does mean, however, is that they should seek to enhance the value potential of those active management fees by focusing on those investment areas and strategies that offer the biggest portfolio bang for the active management buck.

**Building Thematic—or Why vs. What—Portfolios**

The most practical way to apply behavioral finance concepts to wealth management is to build and manage investment portfolios that are aligned with the way investors actually think about their money. Under modern portfolio theory, the objective of portfolio construction is to maximize the
portfolio Sharpe ratio, or risk-adjusted return. In thematic investing, on the other hand, the objective is to solve specific investor problems, take advantage of identifiable trends in the larger macroeconomic environment, or help investors understand why the portfolio is built as it is. Examples of thematic portfolios might include:

**Goals-based:** Portfolios are built and managed to address specific investor objectives rather than to optimize a statistical ratio that may or may not mean anything to the investor. Figure 3 illustrates this concept using an adaptation from Chhabra (2005).

**Multi-alpha:** Let’s define alpha simply as any action an advisor takes in managing a portfolio that potentially adds value and investors are willing to pay for. A multi-alpha portfolio focuses on the role that each particular investment plays within the portfolio (e.g., tax and fee alpha, active management alpha, low-correlation alpha, leverage and illiquidity alpha, etc.; see figure 4). These portfolios focus on why vs. what, which may have intuitive appeal to some investors.

**Yield/income-oriented:** Portfolios are built and managed explicitly to maximize the yield and/or income, and include several different asset classes in addition to fixed income in an attempt to improve diversification (see figure 5).

**Inflation-hedge:** Portfolios are constructed using asset classes and investment strategies that historically have shown inflation-protection tendencies or properties.

**Risk factor allocation vs. asset allocation:** Portfolios are built to allocate risk, which can be challenging because it requires accurate mapping of risk factors to investable assets. We see HNW investors expressing more interest in this approach. (Note that risk-parity strategies are a specialized case and the most widely commercialized example of a risk-factor approach.)

**Economic regime-based:** Portfolios are tactically tilted based on cyclical economic regimes, such as rising or falling inflation or rising or falling growth.

**Employing Third-Party Managed Model Portfolios**

Many advisors believe one of their primary value propositions is the construction and management of client investment portfolios. Nothing wrong with that, but many other advisors increasingly are seeking to outsource some or all of that function to qualified model managers—what the institutional world calls outsourced chief investment officers. Advisors who outsource are choosing to focus their activities on their core competencies—financial and estate planning, family...
governance, business development, and relationship management—and outsourcing at least some portion of the investment management function as a way of improving productivity, efficiency, or (potentially) performance. Often using UMA technology, the number and quality of potential outsourced model managers continues to grow, and advisors can find providers of actively managed exchange-traded fund, mutual fund, SMA, and even AI portfolios, depending on the requirements of their specific business models.

**Actively Using Performance Reporting for Business Development, Client Retention**

Comprehensive performance reports can be the most tangible illustration of advisors’ added value—why they are worth their fees. Investors may be drawn to an advisor based on performance, but investors remain clients and may advocate for an advisor because they are constantly reminded in a variety of ways that the advisor is adding value. In this way, a performance report is an indispensable tool.

Performance reports that allow advisors to use them as business-development and client-retention tools should include the characteristics shown in table 2.

For more information about performance reporting, see Welch and McIntyre (2012).

**Summary: Focusing on the Left Side of the Decimal Point**

In a volatile, potentially low-return market regime, advisors need to think differently about what adding value means in constructing and managing investor portfolios. We believe too many advisors spend too much time focusing on investment activities that potentially add value in basis points—they’re focusing on the right side of the decimal point.

Advisors who are most successful in growing their practices spend far more time focusing on the left side of the decimal point—i.e., on those activities that add the most value to investors’ financial lives. In terms of actual long-term value to a client portfolio, for example, we believe the hierarchy of added value might look like the following:

1. **Estate planning**
2. **Asset allocation**
3. **Cost and tax management**
4. **Beta management**
5. **Manager/security selection**
6. **Using third-party managed model portfolios.**
7. **Actively using performance reporting for business development and client retention.**

A few advisors may enjoy significant success without employing any of these habits or just one or two of them. In our experience, however, advisors who do use these best practices are enjoying faster growth, improved operational efficiency, enhanced client advocacy, and increased profitability.

Scott Welch, CIMA®, is executive vice president and chief investment officer at Fortigent, LLC. He earned the Investment Strategist and Alternative Investments certificates from IMCA. He earned a BS in mathematics from the University of California, Irvine, and an MBA in finance from the University of Massachusetts Amherst. Contact him at scott.welch@fortigent.com.

**References**

1. With respect and apologies to Steven R. Covey, author of the *7 Habits of Highly Effective People* (1990).

**Endnotes**

**Table 2: Examples of Performance Reporting “Must Haves”**

<table>
<thead>
<tr>
<th>Comprehensive</th>
<th>Consolidated</th>
<th>Customizable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timely and accurate</td>
<td>True data aggregation regardless of custodian and/or liquidity</td>
<td>Both time- and dollar-weighted performance, gross and net of fees</td>
</tr>
<tr>
<td>Benchmark, peer, and universe manager performance comparisons</td>
<td>Thematic or goals-based reporting capabilities</td>
<td>Aggregation and reporting on hedge funds and other illiquid assets</td>
</tr>
<tr>
<td>Scatter-plot features to show the value of portfolio construction</td>
<td>Tax lot accounting</td>
<td>Reconciliation and rebalancing capabilities</td>
</tr>
<tr>
<td>Benchmark customization</td>
<td>Risk-adjusted return analysis to show the advisor’s “added value”</td>
<td>Ad hoc reporting capabilities and online/mobile access</td>
</tr>
</tbody>
</table>

© 2014 Investment Management Consultants Association Inc. Reprinted with permission. All rights reserved.