

Not All Overlay Managers Are Created Equal

Considerations for firms contemplating overlay management
and money managers participating in these programs.



Executive Summary

As the Unified Managed Account continues to display an impressive growth trajectory on its march to relevancy, both sponsors and money managers are starting to focus on what had seemed to be subtle differences between overlay management approaches. This paper attempts to highlight some of those nuances so that money managers may ask the tough questions that directly impact the factors that matter the most to them.

Introduction

As the Unified Managed Account (UMA) continues to establish a foothold in the managed account segment, money managers that had previously ruled out participation in a model-based program are starting to reconsider their position due to a variety of forces which include: competitive pressures, market share erosion and the need to diversify revenue sources to supplement their traditional 'direct' managed account business. Similarly, managers who were early adopters of unified managed account programs, are beginning to reevaluate the appropriateness of their program participation. Emerging process formalization in the form of industry standardization, evolving best practices, and technological advances have begun to reshape some of the original assumptions defined during the nascent stages of the UMA.

To be certain though, the fundamental concept of a UMA offers tremendous upside to all participants in the value chain, without creating a zero-sum outcome. UMAs can be a powerful asset gathering tool that simultaneously creates new levels of scalability and efficiency for the advisor, without added expense. The client stands to benefit from improved diversification and product mix, greater flexibility, and enhanced return potential. Money managers participating in model-based programs often benefit from exposure to new market segments, in addition to a wider profit margin than their traditional directly managed programs.

For managers who wish to establish a policy around new platform participation or even evaluate the efficacy of their existing programs, it is important to closely examine to whom they are entrusting the implementation and integrity of their model portfolios. We believe that in the second generation of model-based distribution, managers should insist on a much more granular

level of process detail regarding the caretaking and implementation of their most important asset - their intellectual capital. This paper examines existing differences in implementation approach and processes, as well as the compliance, financial, operational and brand risks associated with them.

As a helpful framework to guide the evaluation process, there are two fundamental implementation approaches we'll highlight in this paper: (1) Centralized or Decentralized implementation, and (2) whether model portfolios are Partitioned or Consolidated. We'll offer definitions while examining the benefits and, more importantly, the risks of these two implementation approaches below.

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Model Implementation: Centralization vs. Decentralized

Options in program implementation range from fully **Centralized**, which typically refers to the use of an Overlay Manager, to fully **Decentralized**, where individual reps independently trade and administer model portfolios themselves.

With platforms operating in a decentralized mode, individual reps in the field are each generally tasked with implementing manager trades in their own accounts. For advisors who are also communicating with clients, generating new business, administering accounts, or even on vacation, model changes are unlikely to be effected in a timely fashion, or sometimes skipped altogether. It also means that because the trade is likely to be spread out over dozens if not hundreds of reps, portfolios will likely be exposed to a highly dispersed pattern of returns.

With platforms operating in a centralized environment, a model liaison desk should acknowledge the model delivery and immediately audit it against the previous version to ensure no updates have been inadvertently missed and the model contents are in good order. From there, the Model Trading desk should work up a trial hypothetical trade – across all accounts – to see the aggregate block size. The Model Trading Desk, given the size of the block, should then devise a trading strategy consistent with the market conditions at the time, incorporating any color that has been provided by the manager's own trading desk. Trading options should generally include use of basic limit orders, algorithms, dark pools, specialized third party trading desks, DMA or any of a variety of other appropriate options for that particular security, security type, market cap and sector. At that point, the hypothetical trade should be handed over to a team of portfolio managers to fine tune the results – incorporating pre-trade compliance restrictions, tax sensitivity considerations, trade preferences and

other variables – ensuring that the portfolios remain closely aligned with the manager's model while also adhering to the various client mandates. Once the trades have been worked up, the multiple trade blocks are forwarded back to the Model Desk trader specializing in the specific security class. The desk should then aggregate orders and into a 'super block' and begin to execute according to the trade strategy. This should all happen within a 15-20-minute trade rotation window, to ensure the minimization of execution dispersion from the manager's trades.

If any post-execution reporting is due back to the manager for trade rotation purposes, such as block completion status, average fill price or block size, the model support desk should immediately communicate those details back to the manager's desk. Post-trade analytics should be run regularly to ensure that the trading strategy did indeed minimize market disruption and, to the extent the manager provides 'fill guidance', the block execution quality should be compared to the manager's guidance.

Managers should ask the platform about audits and the mechanism employed to ensure that client portfolios are tracked in-line with the manager's model. Platforms should have stated policies around upper and lower quarterly return variances, which if violated should prompt a reconciliation call between platform and manager. The result of this call should be a side by side comparison of block trade execution prices to understand the nature of the problem along with a remediation plan.



Portfolio Discretion: Centralization vs. Decentralized

In a Decentralized environment – particularly Rep as PM programs – advisors are often permitted to make their own judgment calls on accepting model changes communicated from the money manager. In this mode, the manager operates in more of a research provider capacity making suggestions to the rep.

In some cases, reps can choose to deviate from the model as a result of an advisor's own personal bias about the attractiveness of the specific security and whether it is indeed worthy of buying or selling. Other times, advisors may establish 'gain budgets' which, when exceeded, compel the advisor not to generate any additional gains for the year resulting in portfolios being locked until sufficient losses are generated to proceed. And in some cases, an advisor may run the portfolio through tax optimization software which utilizes a rules-based trade-off engine that is designed to look at the similarities between positions being eliminated and positions being purchased. If certain analogous factors exist, the software may suggest that it's better to decline the trade rather than incur the tax penalty. If trades are not placed due to gain budgeting lockups, or model holdings were not traded due to tax optimization software, managers should ask platforms if they get credit for these assets and how it impacts their fees.

Additionally, new accounts pose a particularly tricky situation in a decentralized environment as reps may not have well vetted or consistent operational workflows, nor appropriate service-level policies in place. In these situations, accounts can sit in their legacy holdings and/or cash for significant time periods without being fully invested. Managers should ask decentralized platforms about their policy regarding the timely allocation of assets to model strategies. In addition to consistent implementation, these policies (or the lack thereof) can significantly affect the AUM-based fees paid to managers. If an account is only partially implemented to a manager's model is the manager eligible to receive a fee during this period? A partial fee? Who decides?

Clearly with many advisors controlling the timing and parameters governing implementation for each account, and their hands hovering over the trade button each time a model change comes in from the manager, client portfolios often look vastly different than the manager's model and each other. Highly dispersed return profiles are common, as are non-model holdings, which are difficult to justify or value.

In contrast to the above, UMA platforms employing a Centralized implementation team enlist an overlay portfolio manager, who effectively operates as an extension of the manager's trading desk. While there is latitude afforded for client-specific preferences like do-not-buy/sell/hold rules or incorporating client tax mandates and preferences, all variances are rules-based and centrally administered to work in unison with the manager's trade instructions.

Not surprising, managers providing their model portfolios to decentralized platforms are increasingly concerned with the potential reputational and compliance risks that naturally arise from the lack of strict policies and well-engineered processes for implementation and auditing.

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Portfolio Segmentation: Non-Partitioned vs. Partitioned

In a Non-Partitioned UMA platform, models from various managers are blended and reweighted for implementation in client accounts, creating a 'super-model'. If you held IBM at 5% in your model and were assigned a 10% allocation slot, IBM would be reflected at .5% in the 'super-model' (assuming no other manager holds IBM). Every morning, a new day's worth of portfolio holdings are indiscriminately sent into the system and compared against the super-model to evaluate what is over-or under weighted.

Contrast that with a Partitioned UMA platform: one of the more remarkable advancements in second-generation UMAs is the structural concept known as sleeves - synthetic partitions erected between managers inside of an account. Its design objective is to allow manager models to operate purely and independently of one another, as they would in individual SMAs, while maintaining the strategic benefits resulting from coordinated implementation within a single account. The result is, effectively, the elimination of the confusion and inefficiencies resulting from the 'super-model' approach.

The revolutionary impact of the sleeve construct is worth understanding; in fact it's arguably the single most important consideration as managers evaluate platform participation. Investment organizations that place a high priority on evaluating 'actual' manager returns – such as consultants, advisors, and institutions - should have this very high on their list of priorities as well.

That is not to suggest that sleeve-based systems are easy to operate. In fact, creating a sleeve-based UMA platform is an operationally daunting and expensive proposition as it requires highly refined processes and workflows, specialized staff (accounting, operations,

trading and portfolio managers), and state-of-the-art portfolio management and accounting technologies, specifically designed to persistently track transactions at the tax lot level. Each tax lot inside an account must be explicitly tagged and associated to a manager's sleeve. This means that if IBM is held by two managers, the method to assign them is based on the actual trade that was generated by the respective manager. The same applies for dividends, corporate actions, trade errors, fees, income and all other adjustment transactions. By keeping the transaction segmented and persistently tagged; appreciation (or depreciation) in those specific shares will always be credited to the manager who made the purchase or sale decision.

Contrast that with a non-partitioned environment, where the holding-to-model weight relationship is estimated daily by comparing the current portfolio holdings to the 'super model'. An industry veteran once made this astute assessment of sleeve vs non-sleeve based UMAs: "...think of one of those big popcorn canisters you get during the holidays with the three segments for different flavors. The segments are basically sleeves. You can easily see how much caramel corn is left and how much has been eaten relative to the cheese popcorn. Now take that divider out, shake the can and try to give your friend half of each flavor. Now that's what it's like to manage a portfolio without sleeve".

Clearly, the inability to segment holdings by managers has a massive cascading impact that managers need to consider.



Non-Partitioned Asset Tracking and Sales Reporting

In a non-partitioned environment, where lots are not explicitly assigned to managers, both current and historical weights allocated to a manager's strategy are based on that day's super-model. Consider an instance where two separate managers are allocated at an equal weight. Manager 1 purchased a 10% holding in IBM last quarter which has now appreciated to a 15% weight. Manager 2 comes along today and initiates a 10% stake. Suddenly the account has a 25% 'actual' holding in IBM, of which Manager 1 represents half based upon target weights in the super-model. In this scenario, Manager 1 should have had a 15% holding based on their well-timed decision. However, with a super-model, Manager 1 now 'penalized' down to an attributed holding of a 12.5%. Manager 1 just experienced one of the painful effects of non-partitioned overlay: earned gains (and earned fees) were cut in half simply because another manager inadvertently overlapped one of your holdings.

Next consider Manager 2's request to rebalance holdings back to the model's target weight. With a non-partitioned UMA, the only choice is to rebalance the entire account back to the weights in the super-model. However, Manager 1 had made the right bet to continue to ride the trending market with its IBM holding. That correct bet was knee-capped by Manager 2's request to rebalance, further eroding the actual performance of Manager 1 in the account. Multiplying these two simple examples across the many holdings and asset classes that comprise a multi-manager super-model and you can quickly understand why this issue must be addressed through sleeve partitioning. Conversely, in the sleeve-

based world, managers are able to issue a rebalance command to the overlay manager fully confident that they are only effecting their discrete positions at the cost basis, tax lot structure and gain/loss conditions they're anticipating.

In terms of sales reporting, managers should be permitted real-time access to AUM figures that are based on actual tax lot tracking rather than some crude estimation method of attributing assets in a non-partitioned environment. The latter methodology frequently causes distorted allocations and flows to your model and consequently may significantly impact fee billing. Compound that with decentralized platforms that distribute models to reps to implement at their convenience, and it's easy to see why standards and best-practices are rapidly materializing.

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Performance Reporting

Without sleeve-based UMAs, it is impossible to accurately report a manager's true performance. Manager returns presented from a non-partitioned system would have to be either be manager-provided, using the manager's stated SMA composite, or 'guesstimated' by means of model-change tracking, weighting or attribution. All are highly inaccurate and do not represent the manager's 'actual' performance within a client account.

On the other hand, in a partitioned sleeve-based program, a client's actual returns can be generated and reported. Money managers that participate in a sleeve-based program should also be provided with a portal to view the actual sleeve returns (without client details displayed), along with relevant composite portfolio metrics.

For managers who elect to remain on non-partitioned platforms, they are beginning to modify their model provider agreements to protect their brand's reputation, restricting or prohibiting explicit reference to the firm and product name in client proposals, presentations, statements and performance reports.

Conclusion

As a Unified Managed Account (UMA) platform provider, Adhesion Wealth has the unique vantage point of having administered both sleeve-based and non-sleeve based programs in centralized and decentralized environments over nearly two decades.

While we have evolved to only support sleeve-based centralized overlay management, we appreciate the nuances and challenges of the various approaches. The good news is that with growth comes focus and attention: industry discussions are now evolving to include best practices, communication protocols and standardization. But managers need to ask the right questions and carefully consider the tradeoffs between participating in early-phase UMA programs and the potential impact it may cause from a brand and compliance perspective.

The flexibility of providing models to a network of reps under a decentralized model may seem like a quick way to get broad distribution and instantaneous shelf-space, but it should be considered carefully as it does come with potential financial, brand, and compliance risk. Similarly, while sleeve-based platforms may appear to be an extension of your firm, there are some additional layers of operational burden.

Regardless of the camp you find yourself in, there may be some exciting news on the horizon: some believe that if there is a reasonable expectation that if the overlay manager is trading in a fashion consistent with the manager's own desk and can provide evidence of monitoring the trade process and best execution, that those accounts may be considered an extension of your trading process and thus claimed as discretionary assets. If this interpretation is upheld and embraced by compliance managers and CFOs, there is sure to be a landslide of attention from consumers and regulatory agencies on the proper handling of model distribution and implementation.



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