MONEY
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Class Notes
The Evolution of the Managed Investment Solutions Industry

I. Managed Investment Solutions
- A. Also referred to as "Managed Solutions"
- B. Managed investment solutions offerings have surpassed $3 trillion in assets

II. History
- A. Forty years ago, investment advisory was limited to only the very wealthy, pension plans, and large endowments and foundations

III. The 1970s
- Most people had little to no exposure to stocks
- Most had their equity in their homes with retirement money in a pension plan managed by their employer
- There were no IRAs or 401(k)s
  - IRA – a personal savings plan that allows an individual to set aside money for retirement, while offering tax advantages. An individual may be able to deduct some or all of their contributions to an IRA; may also be eligible for a tax credit equal to a percentage of their contribution. IRA earnings are not taxed until they are withdrawn.
  - 401(k) - defined contribution plan offered by a corporation that allows employees to set aside money for retirement. The employee makes pretax contributions from paycheck. The money grows tax free, until funds are withdrawn. The employer can make matching contributions. 401(k) is the IRS section describing the program
- Average American worked at the same company for decades, retired at 65, received Social Security, and a monthly check from their former employer (defined benefit plan)
- Defined Benefit Plan: pays a defined amount of money, typically monthly, based on a formula that factored in such things as length of service and salary level. Employer bore the investment risk of the accounts.

IV. ERISA Employee Retirement Income Security Act of 1974
- A. Had a significant effect on managed investment solutions
- B. Established fiduciary guidelines for plan trustees, including investment advisors
- C. Required trustees of private pension plans to:
  1. Document their investment process
  2. Prudently invest and monitor the assets
  3. Held the plan trustees to a fiduciary standard
- D. Resulted in many plans hiring investment advisory firms to manage the assets in a fiduciary capacity
- E. Applied this concept to the investment accounts of higher net worth individuals

V. The 1980s
- A. People were living longer
- B. Companies were finding it difficult to pay for longer-term-expenditure defined benefit retirement plans
- C. Companies began freezing their traditional defined benefit pension plans
- D. Moved to 401(k) plans:
  1. Less costly
  2. Transferred the investment risk to the employees
- E. As of 2010, only 17 Fortune 500 companies still offer defined benefit plans

F. Individuals became solely responsible for their financial security
G. 1970s: Separately managed accounts created at EF Hutton
H. Mid 80s: SMAs expanded to include independent money managers who at the time were managing large pension plans
I. The concept was: offering can be created for lower-minimum account sizes, with the same professional investment management and construction, the same consultative process as what was available to large pools of assets, now for investors with minimum investments of $100,000

VI. The 1990s

A. Separately managed solutions became a mainstream product of wirehouses
B. Participating money managers went from just under 30 in 1987 to several hundred by 1995
C. Boom market encouraged personal investment
D. Political and economic security boosted confidence
E. The consultative sale was modeled after ERISA
F. The popularity of the advisory solutions brought about significant advances in back office technologies
G. Allowed major firms to include mutual funds as investments in the advisory program portfolios, bringing minimum account sizes even lower

VII. 2000 to Present

A. Advances in technology
B. Broader range of available investment vehicles
C. Major banks bought up most of the wirehouses, entering into the managed investment solutions market
D. Exchange-traded funds arrived as an option within advisory programs
E. Rebalancing and drift reporting (the ability to monitor portfolios that become over- or under-weighted due to market conditions, and the ability to then rebalance an account with the push of a button)
F. Technology advances allow for multiple investment vehicles to sit inside one account (Unified Managed Account)
G. One money manager, called an "overlay manager", can oversee any combination of securities

VIII. Timeline

A. 1974: ERISA was passed
B. 1976: in response to ERISA, the first EF Hutton SMA program began
C. 1987: Merrill Lynch, Paine Webber, Prudential all entered the SMA market
D. 1989: the first Mutual Fund Wrap program (TRAK) introduced at Shearson
E. Early 1990s: most wire houses and regional firms were offering SMA and Mutual Fund Wrap Programs
F. 1997: The Money Management Institute (MMI) launched
G. 2002: Smith Barney Consulting Group launched the first Unified Managed Account (UMA)

IX. Types of Managed Solutions

A. Definition: an investment account that is owned by an individual investor or an institution and contains the following components:
   1. A professional money manager is hired to manage the assets in accordance with the investment objectives
   2. The investment objectives are clearly stated in an Investment Policy Statement (IPS)
   3. The account is typically sold under an all-inclusive (wrap fee) arrangement

B. There are many types of Managed Investment Solutions, including:
   1. Separately Managed Account
   2. Mutual Fund &/or ETF Wrap Account
   3. Rep as Portfolio Manager/Rep as Advisor Account
   4. Unified Managed Account

X. Advantages of Managed Investment Solutions

A. Financial advice most objective when a fee is charged periodically against the value of the account versus charging a fee every time a decision is made against the account (eliminates the notion that the financial advisor may be "churning" a portfolio)

B. Transparency
   1. The ability to look at each individual holding in an account,
      a. Easier to avoid securities overlap
   2. Ability to see all the fees that are paid
      a. Easier to monitor the value added
   3. Align the advisor and the investor so they both “sit on the same side of the table”

C. Fee-based financial advisor is held to a fiduciary standard
   1. Must manage portfolios as if it were their own money
   2. Must understand the investor’s entire financial picture, including, but not limited to:
      a. The purpose of the portfolio
      b. The time horizon for the investments
      c. The income needs of the investor
      d. The risk tolerance of the investor
   3. Fiduciary standard is one of the main reasons managed investments solutions are so popular

D. Customization
   1. Allows investor to define certain parameters at the security level
      a. Example: investor is buying employer’s company stock through a 401(k), may not want a portfolio manager to buy more of the stock to avoid becoming over weighted in that stock or in that industry
   2. Several managed investment solutions allow a restriction to be put on the money manager so as to not buy particular stocks, but allows them to continue to buy it for other clients

E. Tax management
   1. Allows the investor to minimize taxes in several managed investment solutions options with the ability to harvest gains or losses

F. Diversification
   1. Can be attained even if only one money manager is hired
   2. May hire more than one money manager, each with different styles of investing, attaining further diversification

G. Professional oversight.
   1. The money manager is responsible for their performance
   2. Sponsors are responsible for the performance of the money managers
   3. Advisors are responsible are responsible for performance in relation to the client’s investment objectives

XI. Sponsor

A. The legal administrator of a managed account program

B. Some of the services they provide are:

1. To develop and maintain an approved list of money managers
2. Do research on money managers
3. Hire and fire money managers
4. Determine client suitability and provide appropriate mailings to clients (statements, form ADVs, performance reports)
5. Perform periodic review of a client's financial position

XII. Types of Managed Investment Solutions

A. Separately Managed Account (SMA)

1. The oldest managed investment solution
2. A portfolio of individual holdings that is managed by a professional money manager
3. The individual investor directly owns the account holdings
4. The cost basis for tax purposes is tied to each stock
5. The lower account minimums (as low as $100,000) gave the investor access to money managers whose minimum account size was typically in the millions of dollars
6. This lower account minimum allowed investors to hire multiple money managers with differing styles of management to meet their goals and objectives
7. The money managers offer multiple disciplines (e.g., value, growth, and international)
8. Each investor's account is managed individually from other investors' accounts
9. Accounts can be "householded": accounts held at one custodian can be combined for billing, reporting
10. Types of SMAs:
    a. Sub-Advised Program
        - Traditional SMA
        - Firm typically acts as the sponsor with one contract
        - The sponsor is responsible for the manager roster, minimum account sizes and management fees
    b. Dual Contract Program
        - Typically two contracts, one with the investor and the asset management firm, and a contract with the investor and the sponsor
        - Typical program designs can have an unlimited number of managers
        - Fees and account minimums vary by manager and investor
    c. Proprietary Program
        - Asset manager is affiliated with the sponsor
        - Typically one contract but there may be varying minimum account sizes and fees

B. Mutual Fund Advisory Account

1. Financial advisor fills out an investor questionnaire and is presented a strategy of mutual funds to best suit the client
2. Assets are commingled with other investor's assets
3. Financial advisor oversees the account for the investor
4. Fee structure: investor pays a single, all-inclusive, asset-based fee that covers advice, investment management and trading/custody
5. Typical average minimum account size: $50,000

6. Accounts may be householded for purposes of billing and reporting

C. Exchange-Traded Fund Advisory Account

1. The financial advisor fills out an investor questionnaire and is presented a strategy of ETFs to best suit the client
2. Financial advisor oversees these accounts for the investor
3. Investor owns the underlying assets in the ETF
4. Fee structure: investor pays a single all-inclusive, asset-based fee that covers advice, investment management and trading/custody
5. Typical average account minimum size: $50,000
6. Accounts may be householded for purposes of billing and reporting

D. Rep as Portfolio Manager/Rep as Advisor Account

1. The fastest growing segment of the managed investment solutions offering
2. The financial advisor is the consultant and portfolio manager
3. Financial advisor is held accountable for performance of the account and will have a track record of the performance
4. Assets are not commingled with other investor's assets
5. Investor owns the securities in the account (unless the account contains mutual funds)
6. Fee structure: investor pays a single all-inclusive, asset-based fee that covers advice, investment management and trading/custody
7. Average minimum investment: typically $100,000
8. Rep as Portfolio Manager account: the advisor has *discretion:*
9. The advisor has preapproval from the client to buy and sell securities without the client's ongoing consent
10. Rep as Advisor account is *nondiscretionary:*
11. The advisor must obtain consent from the client each time a change is made to the investments

E. UMA

1. Multiple investment vehicles residing in one account registration
2. Uses an overlay manager:
    a. The "quarterback" of the UMA strategy
    b. Defines the universe of what should be bought and sold
    c. Decides the weighting of what should be bought and sold
    d. Decides who makes the specific security buys and sells
    e. Uses research advice to locate top stock picking and/or sector opportunities
    f. Provides efficient rebalancing of account when necessary
3. Model management:
    a. Investment managers sell their buy and sell lists to a sponsor for use by overlay managers of unified managed accounts
    b. Allows the overlay manager to gather the intellectual capital from other investment managers
4. UMA allows the manager to use technology to take advantage of the expertise of many and create "sleeves" of that expertise and effectively manage it in one account

XIII. What The Experts Are Saying

A. It is believed that each managed investment solutions offering will continue to grow
B. High net worth individuals typically own multiple managed investment solutions within one household

C. Additional investment vehicle options will continue to be developed, e.g., ETFs, alternative investments
D. Unified managed account technology will continue to advance and can be used across all managed investment solutions

XIV. Consultative Sales Process

A. Step 1: Interview and Gathering Information:
   1. The financial advisor interviews his clients and gathers information
   2. This may be the most important step
   3. The long-term purpose for the assets must be established as well as any interim needs
   4. It is imperative that the financial advisor understands the client's risk tolerance, income needs, and any future liabilities before proceeding to the next step
B. Step 2: Proposal of IPS and Written Plan:
   1. Financial advisor drafts the initial investment plan
   2. Initial Policy Statement (IPS) will serve as a roadmap for both the client and the financial advisor
C. Step 3: Implementation and Managing the Investments:
   1. Financial advisor purchases investments
   2. Portfolio design must take into account current market conditions and possible tax implications, especially if a client owns existing securities
   3. May decide to implement the portfolio slowly over time
D. Step 4: Ongoing Monitoring and Research:
   1. Financial advisor supervises the portfolio, making changes as necessary
   2. The policy in step two should be reviewed periodically because financial circumstances will change
   3. The financial advisor must continuously monitor the portfolio to ensure that it is serving the needs of the specific client

XV. All-Inclusive Fee

A. A fee based on a percentage of the assets is charged and covers:
   1. The financial advisor
   2. Investment manager
   3. Transaction and trading fees
   4. Sponsor fees
   5. Costs of portfolio monitoring
B. Fees are transparent
C. Client benefits to fee-based pricing:
   1. Aligns the advisor's interests with his or her clients: advisor and client both want the account to grow
   ~~2.~~ Advisor is unbiased in the use of investment products
   3. Fee-based pricing provides transparency
   4. Accounts held with one custodian can be "householded" together for purposes of billing
D. Advisor benefits of fee-based pricing:
   1. Aligns the advisor's interests with his or her clients
   2. Advisor is unbiased in the use of investment products
   3. Provides an ongoing revenue stream; typically provides the advisor with a more stable income
   4. Often leads to deeper client relationships, improved client satisfaction and higher client retention

5. Advisory relationships can translate into capturing more client wallet share through increased trust and broader services
6. Fee-based practices are more attractive to acquire, leading to a higher multiple for selling a practice and/or creating a succession plan

XVI. Growth of the managed investment solutions industry

A. The assets in managed investment solutions have exceeded $3 trillion
B. Survey done by the Money Management Institute and Dover Financial Research: Estimate growth of another $665 billion by 2014

XVII. Conclusion

A. This massive, over $3 trillion industry; will only continue to grow on a global level
B. All these solutions are sold through the same consultative process
C. Managed investment solutions allow financial advisors to better serve their investors
D. As the advisory business expands, new technologies and solution advancements will be continually created to fuel growth