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THE ADVANTAGES OF MULTI-ASSET MANAGED ACCOUNTS THAT INCORPORATE DIRECT SECURITIES

Glen Holder

The business efficiency benefits of multi-asset managed accounts for advice businesses are widely known. When these advantages are also on-shared with the end client, multi-asset managed accounts represent a compelling value proposition for any forward thinking planning practice. It is therefore no surprise that these structures have had a stellar rise in take up over the past few years.

Until recently however the proliferation of multi-asset managed Accounts has been largely focused on "fund of fund" solutions, particularly when it comes to Separately Managed Accounts (SMA's). "Fund of Fund" SMA's are managed account products that invest in a number of underlying active or passive funds, or a mix of both, with the managed account portfolio manager usually coming from an asset consulting background. Given the key role that asset consultants have traditionally played within the financial advice sector, and being so closely attuned to industry dynamics and the needs of advisers, it is perhaps natural for them to have filled this role.

In this white paper however we put the case forward for a different approach. Rather than a "fund of fund" structure, we discuss the advantages of multi-asset portfolios that incorporate direct securities into their core investment process. We highlight how changing regulation (such as RG97) and intensified scrutiny of best interest duties increases the appeal of this approach, and why new entrants into the managed account market, who have the proven expertise to incorporate and manage direct securities, can achieve improved overall portfolio outcomes. We also highlight the significant advantages provided by the incorporation of direct securities into SMA's, such as the ability to enhance the advisers own value proposition and how this can encourage greater client engagement.

When referencing multi-asset managed accounts that incorporate direct securities in this article we are referring specifically to multi-asset portfolios constructed using a mix of direct stocks, listed Exchange Traded Funds (ETF's) and only a very limited allocation to external active managers. Under this approach, external active managers are only used when it is believed that a significant alpha opportunity exists, and is usually limited to asset class exposures where

ETF's or direct securities are not appropriate, such as alternatives. We contrast this approach with a traditional "fund of fund" offering, solely implemented using active managed funds or ETF's. From an overall asset allocation standpoint, however, the two types of portfolios will not materially differ.

We also wish to distinguish the true incorporation of direct equities into the investment process from simply adding a direct equities SMA "sleeve" run by an external manager, which for the purpose of this paper will remain in the "fund of fund" category, given it is still a form of outsourced management, with associated costs.

A Portfolio for the times -benefits for advisers and their clients

With the retail advice industry currently subject to the greatest scrutiny in its history, it is important that any product an adviser recommends can be clearly demonstrated to serve the client's best interests. At the same time advisers are under increasing pressure to demonstrate their own value proposition. For a number of important reasons, multi-asset SMA's which incorporate direct securities can help meet these dual aims.

Client best interests

Since the royal commission into misconduct in the financial services industry there has been increased emphasis from the regulator that a client's best interests are paramount. This puts the onus on the adviser to demonstrate that any investment they recommend stacks up versus competing products. While there is much conjecture around what exactly constitutes "best interests" when it comes to investment solutions, it is clear that both cost competitiveness and after-tax returns are key factors. Failure to address these twin considerations risks winding up in the cross hairs of the regulator, particularly if there is a perceived benefit to the advice business of recommending the product.

Unsurprisingly this is causing consternation amongst advice groups. Not because they don't have their client's best interests at heart, but because often it's very difficult to show that a strategy is the right one until after the fact. This is especially the case when it comes to investing, which inherently involves an element of risk.

Understandably, many advisers are now choosing to narrow their focus in on costs. With a beefed up regulator determined to take more aggressive actions on enforcement, this is an obvious path of safety, as cost is the one component of investing which can be determined with certainty before advice is provided.

At the same time increasing regulation is demanding greater cost transparency within products themselves. The application of RG97 means that financial product providers, which includes SMA issuers, are now required to include the management fees of all the underlying funds held within the product in the Indicative Cost Ratio (ICR) of the managed account itself. This is exposing the high product costs of "fund of fund" SMA's. Whereas previously only the headline multi-manager fee may have been included in the product disclosure statement, now the ICR is an "all in" figure, which must be disclosed in client Statements of Advice.

On the other hand, multi-asset managed accounts constructed mostly of a mixture of ETF's and direct equities are not nearly as adversely impacted by RG97. This is because there are no underlying ICR's associated with direct equity holdings and ETF's are typically very low cost. Assuming the headline manager fee is competitive, the "all in" cost will be significantly cheaper than "fund of fund" solutions paying large fees to external managers. Despite the competitive fee structure however, the client is still benefiting from active management. Assuming the SMA manager incorporating direct equities can demonstrate alpha, then it could be argued this represents a "best of both worlds" approach. That is, active management at close to a passive price. See Figure 2: Projected costs of solution (indicative only).

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The quote

The increased granularity of a direct securities approach allows the SMA manager to more accurately measure and monitor overall portfolio risk

Figure 1. Example of a multi-asset managed account incorporating direct securities with a balanced risk profile, broken down by asset class and investment type.

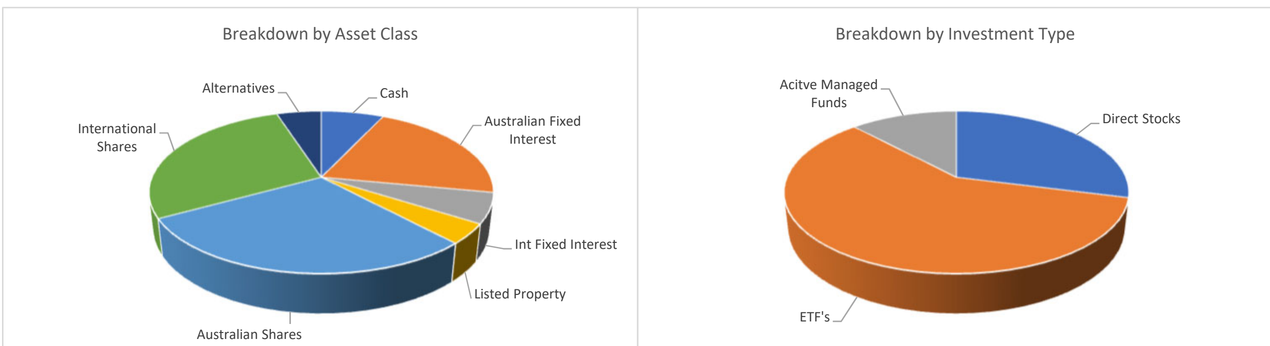
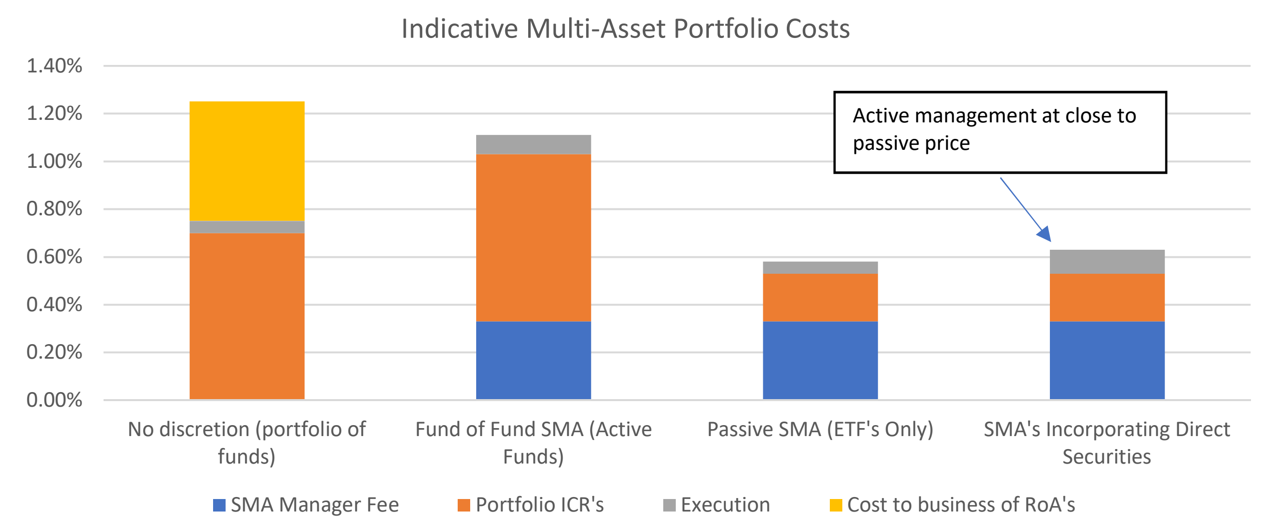


Figure 2. Projected costs of solution (indicative only)



Enhancing the adviser's value proposition

An important consideration for any advice business is the ability to demonstrate an ongoing value proposition. If an adviser cannot demonstrate the value they provide to his or her clients, then not only does it beg the question of whether they are acting in their client's best interests, but it also risks the future of their business as a going concern.

In the race to reduce costs, many advisers have begun to abandon active management altogether, instead opting for portfolios made up purely of passive ETF's. However there are risks for advice businesses adopting this strategy. If a client's portfolio simply mirrors that of a cheap online robo-adviser, how long before the client questions whether they need to continue to engage an adviser at all?

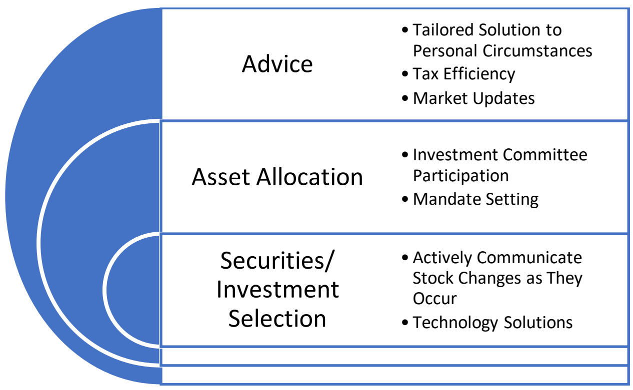
A key advantage of multi-asset managed accounts that incorporate direct securities is that they can help the adviser protect and amplify the adviser's own value proposition. This is because they allow the adviser to play an enhanced role in the ongoing investment communication and governance oversight of the portfolio, particularly in the case of private label offerings. Forward thinking SMA managers can ensure advisers are kept abreast of the investment rationale for all current holdings and any changes as they happen, allowing the adviser to become the conduit for this information. Technology can help make this process easy to the point of being seamless. For example, each time a trade is made in a direct security held within the portfolios, the adviser can be notified, and choose whether or not to communicate this with their clients depending on client preferences. There is also scope for the adviser to remain more informed regarding the composition of the portfolios, due to greater transparency and the fact that they will be dealing directly with fund manager, rather than an asset consultant. This then allows for a deeper discussion with clients.

In the case of a private label solution, the advice business may choose to play a role in setting the investment mandate. Representatives from the business can also sit on the investment committee, playing a governance role. While this is also possible with "fund of fund" structures, the level of granularity is far greater with an SMA that incorporates direct securities.

While the impact of more closely tying the adviser to the investment value proposition is considerable, the time commitment required of the adviser is little more than that of a "fund of fund" solution, enabling the adviser to focus on servicing their clients in other ways and on growing their business.

Figure 3 illustrates the three pillars of an adviser's value proposition when it comes to investments. A comprehensive multi-asset managed account solution that incorporates direct securities can help an adviser play a role and demonstrate value at all three tiers.

Figure 3. Three pillars of an advisor's ongoing investment value proposition



Increased client engagement

The proliferation of smart phones and devices, as well as improvements in online platform technology, has led consumers to expect greater engagement opportunities from their service providers. The enhanced transparency that comes with owning visible direct securities feeds into this theme. Tech savvy millennials can jump onto their smartphone and view exactly which holdings they own. Older clients also enjoy remaining more informed, for example it allows them the opportunity to discuss with their peers which stocks have been the best performing in their portfolio this year.

Furthermore the inclusion of direct securities in SMA's allows for greater expression of individual client preferences. This is especially timely given the growing social and ethical considerations of investors. Instead of having to defer to the standardised screen of an ethical fund manager, latest gen platforms allow for the specific exclusion of individual companies on a client by client basis, ensuring they line up directly with the investor's preferences and principles.

Investment advantages of greater transparency

The most obvious advantage of multi-asset portfolios that incorporate direct securities is greater transparency, however, the benefits of additional transparency go beyond the investor simply knowing which stocks they own. It also extends to two of the core aims of retail portfolio management, that is, the capacity for improved risk/return outcomes and higher after-tax returns.

Top to bottom risk analysis – a whole of portfolio approach

The increased granularity of a direct securities approach allows the SMA manager to more accurately measure and monitor overall portfolio risk, providing they have the expertise and right quantitative tools at their disposal. This is because portfolio risk is more than just how the different headline asset classes or funds behave relative to one another, but also how the individual underlying assets themselves behave, down to the security level. For example, a balanced portfolio with an Australian equities allocation that is overweight in a sector which is highly correlated to international equities will contain significantly more downside equity risk than a balanced portfolio tilted the opposite way. This is despite both portfolios potentially having the same headline asset allocation. In that regard the manager with greater transparency is arguably in a much better position to optimise the overall risk/return ratio of the multi-asset portfolio.

This increased ability to risk measure the portfolio from "top to bottom" and take a whole of portfolio approach is particularly useful during times of market stress. As direct securities managers are more acutely aware of the underlying exposures, they are in a position to more accurately monitor the cross-correlations imbedded within the portfolio, and how those correlations are changing through time.

Unfortunately this type of in-depth quantitative analysis is much more difficult under a "fund of fund" approach, due to the unitised structure of managed funds. Opaqueness is exacerbated by the fact that many active fund managers can be protective when it comes to disclosing details of their underlying holdings. Instead "fund of fund" managers are usually forced to rely on what the underlying active fund manager tells them, in terms of their risk exposures.

Investors must also be cognisant that third party active managers will be focussed primarily on their own benchmark, rather than the greater interests of the multi-asset portfolio. Indeed each underlying manager has no knowledge of any other holdings in the multi-asset portfolio outside of their own allocation. This includes managers of outsourced direct equity SMA "sleeves".

It is partly for the reasons outlined above that many large industry super funds have begun in-housing their asset management, rather than allocating out all of the different asset class exposures to third party managers. It is not solely a cost exercise.

It is important to point emphasize that the construction of a multi-asset SMA that incorporates direct securities into its core investment process demands the requisite skills; hence it is prudent to seek managers who come from a direct funds management or securities analysis background.

The ability to accurately identify strong performing external managers should not be disparaged however. Indeed it is a requisite skillset for any multi-asset manager, including those that internalise components of their active management. One example where this skillset is required is in alternatives, where typically Hedge Funds are employed, and selected based on process, transparency, management, cost and track record. A deep quantitative understanding of contrarian, trend following, and other common approaches is essential when selecting and combining appropriate strategies.

Improved after-tax returns

There are tax advantages to incorporating direct securities into multi-asset portfolios. Rather than merely owning units in a trust, the client maintains beneficial ownership of the assets held directly. This can provide material benefits in the form of capital gains tax minimisation. Latest generation platforms and accounting software packages usually allow for easy and automated tax optimisation when it comes to CGT parcel selection, improving after-tax returns. In addition, the ability to in-specie transfer existing holdings in or out of the managed account structure without requiring a sale can avoid unnecessary tax events.

Technology – the great enabler

Perhaps the main reason why this type of solution is only now coming to the fore is due to substantial advances in technology across the industry. This applies at the investment level, the platform level and at the business level more generally.

Firstly, advances in data extraction and quantitative investment techniques have significantly reduced some of the costs traditionally associated with direct securities investment management. Instead of requiring large teams of expensive analysts, an investment manager with the right skillset and tools can now extract and process large datasets of financial information to generate alpha-delivering portfolios at a much lower cost. When these costs savings are passed onto the end client, all members of the retail investment value chain can benefit.

Secondly, the ongoing platform arms race has meant that most retail platform providers can now accommodate fast and efficient processing of direct equities holdings and trades at cost effective prices. The removal of minimum trading fees in favour of fixed percentages within most SMA structures means that lack of diversification is no longer an issue. Relatively small parcels of shares can be held with no increase to portfolio cost. Further, CGT parcel optimisation and other useful tools provided by these platforms are perfectly suited to direct holdings, helping to enhance after tax returns.

Finally, innovations in business communication methods, such as automated emails and text messages, videoconferencing and portable devices can help SMA managers communicate same-day trading decisions and regular updates to advisers. Advisers can then use these same methods to keep their clients informed, requiring a minimal time investment. Not only does this enhance client engagement, but it also helps cement the adviser's ongoing role as the trusted adviser.

Future proofing your business

In a world where client best interests are paramount, multi-asset managed accounts that incorporate direct securities can provide unparalleled advantages to advisers and their clients. Reduced costs associated with internalising active management can place them at a price point close to passive solutions, whilst still providing alpha opportunities normally associated with active funds. Further, increased transparency allows for improved risk management, the potential for better after-tax outcomes and greater client engagement opportunities. **FS**