Practice Management

The UMA Office

***Synopsis*: A variety of practice management and client service trends are suddenly pointing in the direction of a unified management account back office provider.**

***Takeaways*: Hooking up with a UMA provider can be a time-consuming task on the front end, but it may offer dramatic improvements in office efficiency on the back end.**

For the past eight or ten years, we've been hearing about Unified Managed Accounts, which are kind of like separately-managed accounts on steroids. A UMA is an investment platform that can encompass virtually all investment vehicles--stocks, bonds, mutual funds, separately-managed accounts--all in the same account in a single registration across a variety of platforms. Of course, you can also put all those things into Schwab or TD Ameritrade accounts, which has made a lot of us scratch our heads about whether there's a business need for this fancy consolidation.

According to Steven Kaye, president of American Economic Planning Group (AEPG) in Watchung, NJ, a number of recent trends are converging on the UMA solution.

Such as? For one thing, in order to get access to investments with high minimums (such as timber land or venture capital funds), some advisors are creating their own LLCs and pooling client assets. This, of course, normally invalidates their E&O insurance, and it may give their clients fits when it comes time to do their taxes. "The primary drivers were that you could pool client investments for access to different assets, and also to drive down your expenses," says Kaye. "With a manager who might have real minimums of $5 million, instead of seeing 200 trades from an advisor, they would see one trade." But, he says, LLCs don't have daily liquidity and they are not transparent--indeed, they look to the client a bit like hedge funds.

The same aggregation can be handled inside a UMA. "You get all of the good things that those pooled platforms offer," says Kaye, "but without the lack of liquidity, the audits, the K-1s, the delayed reporting and so on. It is a better mousetrap to achieve the same types of efficiencies."

Other trends? What about diversifying among custodians, and actually searching for that "best execution" that may someday be enforced by the SEC? "With our UMA platform," says Kaye, "we can have a client have their IRA at Schwab, their joint account at Fidelity and their kids' UGMA at TD Ameritrade, and we can produce one performance report through the system."

Any more? As we saw in last month's newsletter, the all-in cost to clients--including your fee and the underlying expense ratios of the asset management services--could become a huge competitive issue in the coming years. Kaye is ready. His UMA provider, Adhesion Wealth Solutions in Charlotte, NC, costs ten to fifteen basis points, depending on the services he's accessing in any individual portfolio. For that, he gets not only back office services (more on that in a minute) but also access to portfolio managers who sell their buy and sell recommendations to him, through Adhesion, for a fraction of the cost if they had to manage the back office activities of the portfolio. "A separate account manager who might charge a 1% expense ratio retail might go as low as 25 basis points in a UMA environment, or even less," says Kaye. "They can do this, since they are not really doing the trades; they are just sending their intellectual property to the UMA vendor, who is executing the trades."

The result? "Typically our smaller clients, if you count our fees and the underlying expense ratios as well as Adhesion," says Kaye, "are paying an all-in cost of under 150 basis points. That," he adds, "is probably a worst-case scenario."

But this doesn't include the trading costs. Trades, however, are aggregated, so that a Schwab $9 buy or sell trade is allocated across all the clients who are moving into or out of that position. Since

Continued on page 8

The UMA Office

Continued from page 5

American Financial Planning uses model portfolios and the trades are almost all aggregated (including the trades proposed by the portfolio managers), the cost to any individual client is negligible.

Another trend is office efficiency. Most UMA providers--including Adhesion--will automatically rebalance portfolios based on a tolerance that you give them, using its automated systems rather than the "by hand" method or semi-automated using Tamarac or iRebal. "The computer systems check the allocations against the bands that we provide them--and they check daily," says Kaye.

Along the same trend, Kaye's UMA provider offers automated performance reporting, and posts the account data, including performance and current values and positions, into a client web site. "We have really outsourced all of that to them, but the clients don't know that," says Kaye.

The system also allows for customized tax management, which may not be a big trend now, but could become one if taxes go up as some are expecting. Kaye's firm sets different parameters on different individual client portfolios. If a client is holding a large position in low-basis stock, the rest of the portfolio could be given to a separate account manager who is holding individual stock positions, and the UMA provider could be instructed to look for opportunities to harvest losses to offset some of the gains. Losses could also be harvested to offset any gains taken during rebalancing or model changes. In all accounts, there is a protocol to flag any trading situations where the conflicting buy/sells presented by different managers might trigger the wash sale rules.

Finally, as advisors become more involved in actively managing client assets, the UMA platform might offer some advantages. "We can put a short position in client portfolios as just one of many assets," says Kaye. "We are not highly-active traders, but the platform is much more nimble, and allows us to be both more reactive and opportunistic."

So how, exactly, does all this work? AEPG vice president Peter Needham says that he started the conversion process when he sent out a formal request for proposal to a dozen different UMA providers, including Adhesion, Envestnet, Fundquest, Fortigent, Placemark, Folio Dynamix, Bellacore and two joint ventures that involved National Advisors Trust Company, where AEPG is a shareholder. The basic goal seems to have been a search for a lot more scale without adding a lot more staff.

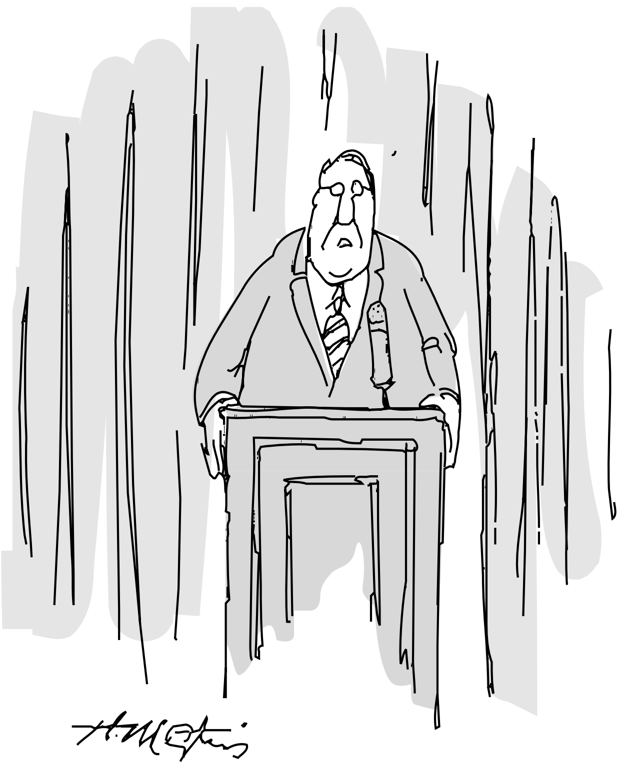
Needham says that a certain amount of due diligence is required up-front (which represents a cost to your firm), mainly because all the different providers have different cost structures and business models. Some, like Fortigent, perform due diligence on every manager they work with, and build that cost into the overall fee. Adhesion doesn't, which Needham was comfortable with, since his firm has CFAs on staff who do this analysis in-house.

Other providers may not be open to new managers, which would have been a deal-killer for Kaye, who needed an S&P 500 manager for AEPG's existing portfolio models, and recruited one for Adhesion's platform. "For the most part, UMA providers are willing, and sometimes eager, to get more separate account managers on their platform," he says. "But it can be an education process. The manager may say, what do you mean, you're only going to pay us a fraction of our regular fee? But when they learn that they're doing very little extra work, and getting distribution and additional assets for virtually zero cost, they start to get receptive."

Needham says that it required a full year of research before he felt comfortable with his choice, and then the real work begins: transferring hundreds of accounts into the new structure. But, he says, once you're up and running, you suddenly discover that you have virtually unlimited spare capacity on your platform.

In the early stages, you face a variety of decisions: creating the model portfolios, identifying the managers (Adhesion currently offers just short of 50 separately-managed investment strategies in flavors ranging from large to small cap, international, bond and a variety of sector strategies--in addition, of course, to all the available mutual funds and ETFs), specifying the tolerances for each asset class for rebalancing, determining how you want the tax management to work.

The portfolio might consist of individual stocks, ETFs, index or actively-managed funds. Of the



"And I'm here to reassure all of you that, with this emergency bail-out, all of my friends at my former place of employment will be well taken care-of."

separate account managers on the Adhesion platform, only a small handful charge as much as 50 basis points, and only one charges more than that. Kaye points out that his worst all-in cost, including all the various expense ratios and AEPG's annual fee, is equal to your average equity mutual fund. "For that," he says, "we give you asset management plus all the various financial planning services and tax management."

AEPG uses 32 different model portfolios for its clients, and the basic structure for each is a core-and-explore process. The core is an all-world index fund, which happens to be invested 55% outside the U.S., comparable to the ex-U.S. global market. The "explore" parts currently include gold, a value/restructuring actively-managed fund, some investment-grade corporate bonds and a junk bond position that is being unwound as the spreads tighten. Rebalancing covers both the broad allocations and the underlying investments within each allocation. A 20% relative band means that if the core is 50% of the overall portfolio, then the core portion would have to drop below 40% of the portfolio or rise above 60% before the rebalancing is triggered. An ETF which is 10% of the portfolio would have to stray above 12% or below 8%.

Since Adhesion uses Schwab PortfolioCenter in conjunction with its proprietary performance reporting software, an advisory office's users don't need the software; indeed, if the performance statements are posted on the web and can be sent via encrypted e-mail, it takes a huge chore off the planning firm.

With all this extra capacity, AEPG began to realize that it had other options--and that one of them would be to offer some of its newfound scale to other advisory firms, serving as private label asset manager using Adhesion's platform. "We're able to offer a smaller planning firm all of our models, the low cost, the web site, everything done through the back office, and they can even throw away PortfolioCenter," says Kaye. AEPG currently charges 25 basis points for the service.

The theme of this article is an impressive gain in productivity and capabilities all arising out of one decision. If you're like me, you've probably been sleeping on the UMA issue, waiting for some sign that other advisors are starting to dip their toes in the water. AEPG seems to be swimming in the deep end, and the combination of benefits--none of which would have been particularly significant five years ago--now seems interestingly compelling. The trends are pointing toward having a consolidated investment back office that combines automated rebalancing with portfolio position downloading, reconciliation, web performance reporting, tax management and dramatically lower all-in costs for the end client.

If any of this sounds like your expectation for the future, you might give the UMA providers a second look--or contact AEPG (www.aepg.com) and see if they can give you instant access to the future.■