Your Q&A

What Criteria Should Drive Overlay Decision?

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Your Q&A is your opportunity to get your questions answered by industry leaders.

Q: What criteria drives the decision whether to use overlay management? Is a centralized or decentralized implementation approach to unified managed accounts best?

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Answered By

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A: When evaluating whether to embrace overlay management, advisors and sponsors alike need to consider the portfolio's overall sophistication and the resources needed to manage it appropriately.

For example, a non-overlay approach may be sufficient for a portfolio with a limited number of strategies. The type of portfolio will often require less-robust processes, procedures and functional capabilities. Accordingly, the management technology would be less robust, less expensive, and require less experience and skill to properly execute.

In contrast, an overlay management approach is better suited for a more sophisticated portfolio, which utilizes a larger number of holdings and looks to leverage best-in-breed rebalancing and tax management strategies. The investment in technology, training and processes, combined with the required execution precision and expertise, would be difficult for managers to produce in an alternative structure.

The rise of unified managed accounts (UMAs) and model portfolio programs have increased the discussion on whether a centralized or decentralized overlay approach is the better fit for high-net-worth investors.

Centralized refers to a management regime in which portfolio administration is governed by a single, dedicated implementation structure that's typically run by an overlay manager. Decentralized refers to multiple uncoordinated implementation resources.

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

With platforms implementing in a centralized environment, a model liaison desk will monitor and accept the model portfolio delivery and immediately audit it against the previous version. This helps to ensure that no updates have been inadvertently missed and that 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 trading desk will 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, among other measures.

Advisors have strong feelings about whether an overlay management or non-overlay management is the right fit for them. Clearly, many advisors want to control the timing and parameters governing implementation for each account. They want to be able to hover over the trade button each time a model change arrives from the manager. However, with this approach, client portfolios often look vastly different than the manager's model, with highly dispersed return profiles and often with non-model holdings difficult to justify or value.

Contrast that situation with UMA platforms employing a centralized implementation team, where the overlay portfolio manager is effectively operating as an extension of the manager's trading desk. While there is latitude afforded for client-specific preferences – such as 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 surprisingly, managers providing their model portfolios to decentralized platforms are increasingly concerned about potential reputational and compliance risks that naturally arise from the lack of strict policies for implementation and auditing.