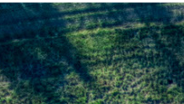
Vestmark

The False Choice in Portfolio Construction, Building Blocks and the Advisory Solution of the Future

Does an advisor's primary value proposition involve constructing and managing bespoke portfolios – or is it about financial planning and behavioral coaching? The answer has major implications for the entire advice supply chain from asset managers to home offices to advisor and investors.



Executive Summary

As we have seen the almost 11-year bull market turn into a pandemic-fueled, highly volatile bear market, an important philosophical question remains: what is the financial advisor's primary value proposition?

On one hand, many still believe it involves constructing and managing bespoke portfolios: performing research, selecting investment vehicles and hands-on portfolio management, rebalancing, and tax optimization. In fact, among all fee-based advisory programs, Rep as Portfolio Manager (or Rep as PM) still holds the largest pool of advisory assets (nearly $1.7 Trillion) and has grown at a 5-year CAGR of 15.9%.[1]

On the other hand, a growing number of advisors and home offices feel that financial planning and behavioral coaching adds the most value. Why waste time trying to add alpha or improve risk-adjusted performance when data tends to show that (1) the majority of advisors struggle to do it consistently[2] and (2) advisors in aggregate provide little quantifiable value to clients when building their own asset allocations using mutual funds or ETFs – but can generate meaningful alpha via behavioral coaching[3] and protecting clients from themselves?

Add in the proliferation of advisory programs (where client accounts need to be opened in product-centric silos), the unfulfilled promise of early-generation UMAs/UMHs, and the general difficulty of customizing third-party models, and it's easy to see why the 'models-or-not' choice feels like such a binary decision.

In this paper, we suggest that this debate has led to a false choice related to portfolio construction (with implications for advisory programs and underlying technology platforms needed to support them). In short, we believe the answer to the 'Rep as PM or outsource?' question is:

- 'Yes'. Each value proposition has merits and advisors should have the flexibility to employ both approaches in a single custodial account within home office-defined guardrails.
- Investment vehicles should be able to be used as interchangeable portfolio building blocks regardless of trading discretion, security- or product wrapper-type.
- A strategic approach to technology platform and longer-term advisory program consolidation can ultimately deliver the best outcomes for home offices, advisors, and investors alike.

[1] Cerulli Associates. "U.S. Managed Accounts 2019." 2019.
[2] Envestnet, Envestnet Report. "Digging Into Portfolio Performance Outliers." 2018.
[3] Vanguard's Research. "Putting a value on your value: Quantifying Vanguard Advisor's Alpha." 2019.

Introduction

“How can I add the most value to my clients?”

Many advisors and home offices have spent long hours pondering the answer. In turn, many are feeling pressure to choose between bespoke portfolio construction and financial planning/behavioral coaching as their go-to value proposition. But evidence suggests this binary perspective, or false choice, has led to sub-optimal results not only for advisors, but home offices and investors as well.

For advisors... choosing one approach or the other with nothing in between results in a cascading list of trade-offs that impact control, client service, resource allocation, and revenue generation; trade-offs that largely disappear if both approaches could easily be executed in a single custodial account.

For home offices... walking the tightrope of enterprise risk management and advisor autonomy can be difficult, costly, and inefficient. While models may be more HQ-friendly, many top-producers want the freedom they feel they’ve earned. The difficulties in allowing for multiple combinations and permutations of investment vehicles and discretion has resulted in a proliferation of advisory programs (many BDs now have six or more) -- along with the operational inefficiencies, inflated headcount, and technical debt required to support them.

For higher net worth (HNW) clients... the only way to currently benefit from the advantages of both models and bespoke portfolios is to have multiple accounts across multiple advisory platforms (typically featuring multiple inconsistencies in portfolio and reporting taxonomies). The result? A muddy, confusing macro view of portfolios and accounts that look meaningfully different as they migrate from being proposed to being managed to being reported on.

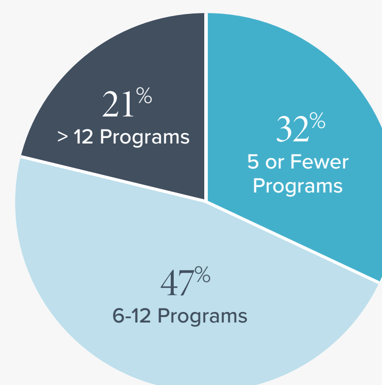
Before delving deeper into solving for these issues, it is helpful to remember the benefits each distinct flavor of portfolio management is designed to provide.

The Case for Models & Outsourced Portfolio Management

A good deal of research suggests that advisors struggle to add alpha or quantifiable value by acting as their own Portfolio Manager:

- The majority of an advisor’s alpha-generation comes from behavioral coaching (approximately 150 bps), followed by spending strategy/ withdrawal order (up to 110 bps) and asset location (up to 75 bps)[4]
  Reference Vanguard chart on page 3

Number of Advisory Programs Across Survey Participants



SOURCE: FUSE Research Network, LLC. “The Road to a Single Unified Platform: Why Aren’t We There Yet?” 2019.

- While advisor-managed portfolios do outperform models in any given year, these portfolios exhibit more occurrences of significant underperformance and twice the volatility of fund strategist models[5]

Most advisors don’t outsource asset allocation to outside models, but many more should, according to a new report by Cerulli Associates. Just 12% of advisors outsource all of their portfolio management to a third-party model provider, be it a broker-dealer home office, third-party turnkey provider or a product manufacturer providing preset portfolios. Another 22% of advisors use models as a baseline and then modify the allocations to suit their clients. The rest (66%) tend to build their own allocations. But Cerulli’s research suggests that only about 45% of advisors should be building portfolios on their own. And a full 29% of the advisor market — some $5.9 trillion in assets — should fully embrace third-party models.[6]

[4] Vanguard’s Research. “Putting a value on your value: Quantifying Vanguard Advisor’s Alpha.” 2019.
[5] Envestnet, Envestnet Report. “Digging Into Portfolio Performance Outliers.” 2018.
[6] Ignites. “Know It or Not, Advisors Need Managers’ Model-Making Help: Cerulli.” Jackie Noblett. April 22, 2019.

SOURCE: Vanguard's Research. "Putting a value on your value: Quantifying Vanguard Advisor's Alpha" 2019.

The value-add of best practices in wealth management

Vanguard Advisor's Alpha strategy	Module	Moving from the scenario described to Vanguard Advisor's Alpha methodology Typical value added for client (basis pts)
Suitable asset allocation using broadly diversified funds/ETFs	I	> 0 bps*
Cost-effective implementation (expense ratios)	II	40 bps
Rebalancing	III	35 bps
Behavioral coaching	IV	150 bps
Asset location	V	0 to 75 bps
Spending strategy (withdrawal order)	VI	0 to 110 bps
Total-return versus income investing	VII	> 0 bps*
Total potential value added		About 3% in net returns

* Value is deemed significant but too unique to each investor to quantify.
NOTES: We believe implementing the Vanguard Advisor's Alpha framework can add about 3% in net returns for your clients and also allow you to differentiate your skills and practice. The actual amount of value added may vary significantly, depending on clients' circumstances.

Beyond this hard data, there are a number of other qualitative benefits to which proponents of models point. Summarized in a recent Broadridge study[7], these include:

- Business scalability
- Ability to leverage investment manager expertise
- Greater focus on client acquisition and retention efforts
- Improved ability to address compliance regulations
- More stringent manager due diligence

One common thread across many of these benefits is found time (or specifically, having more of it to spend on activities more closely tied to building deeper client relationships, increasing satisfaction, and driving organic asset growth).

When looking at the hard data and softer qualitative benefits, the case for model usage and outsourced portfolio management seems clear. Or is it?

"It's not easy for advisors to balance business development with portfolio management. Rather than analyzing every position, a growing number of advisors rely on models to manage assets, so they can focus on client building and retention strategies."[8]

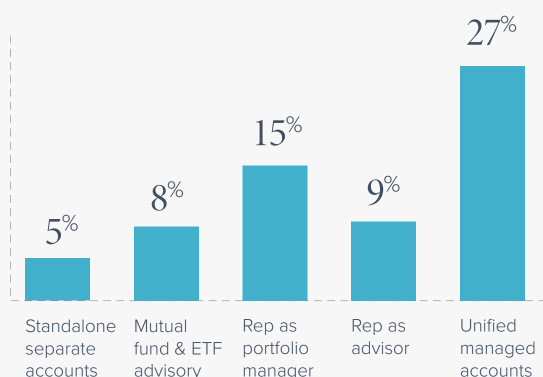
[7] Broadridge. "Distribution in a model-driven age" 2019.
[8] Ibid.

The case for Rep as PM

If the case for using models is clear, many home offices and advisors may have missed the memo. That's because assets in Rep as PM programs continue to grow – and other than UMAs and a much smaller pool of ETF advisory assets, Rep as PM is the fastest growing advisory program over the last five years, according to Cerulli. Why is this the case?

The most likely answer may be because that is how it has always been done. For decades, 'advice' has traditionally been product-centric, with advisors having freedom to construct bespoke portfolios and/or fill asset allocation buckets based upon the distinct and unique needs and objectives of each client. Many advisors firmly believe managing money is their primary value-add, and many HNW investors expect a truly customized solution for the 100 bps or more they're paying annually. In fact, at a recent INVEST Conference, it was revealed that 60% of HNW investors are NOT satisfied with the level of personalization from their wealth manager.[9]

Advisory Program 5-Year CAGR, 2019



SOURCE: Cerulli Associates. "U.S. Managed Accounts 2019." 2019.

As summarized in a recent Broadridge study, proponents of bespoke portfolio construction also believe:

- Use of model portfolios makes it harder for advisors to differentiate from self-serve and robo-advisory options
- Model portfolios are not as effective in down markets or highly volatile markets
- It's harder to assess risk with model portfolios compared to custom portfolios
- "I fear clients will think I am lazy for using model portfolios"[10]

Lastly, we see two other emerging benefits related to constructing custom portfolios for each HNW client:

- **Direct Indexing:** an index replication approach where assets are invested directly in some or all of the index's underlying securities. Doing so leverages the portfolio management skill of the advisor, differentiates from passive, low-fee index products, and allows for the generation of quantifiable tax alpha via built-in tax-loss harvesting methods.
- **AI:** While artificial intelligence related to portfolio construction is currently more 'artificial' than 'intelligence,' we do believe machine learning and other AI processes will emerge to help advisors actively and accurately predict when asset allocations or individual holdings will cause portfolio drag under certain sector, market, or macroeconomic conditions.

Why Not Do Both?

At Vestmark, we do not think advisors, home offices, or investors should be forced to deal with a models-or-no-models proposition. And while we are beginning to see advisor customization of models gain momentum, it is still within product-centric advisory program silos where the technology and operational burdens of executing at scale have proven difficult for advisors and home offices alike.

With that in mind, we would like to suggest a better way:

- start with a blank sheet of paper **or** a model (crafted by the advisor, home office or third-party manager/ strategist)
- choose from a wide array of investment vehicles including individual securities, MFs, ETFs, SMAs, models and cash – regardless of who has discretion
- put each allocation in flexible sleeves that can be managed independently of **and** together with the account's other holdings
- allow for granular trading and rebalancing rules across one, some, or all sleeves and accounts
- preserve portfolio accounting and reporting purity at the account, sleeve, and tax lot levels

Finally, do all this in a single custodial account driven by a single, consolidated technology platform that enables the process to be easily repeated and scaled across hundreds of thousands of households.

[9] Capgemini Financial Services Analysis. "Executive Interviews" 2019.
[10] Broadridge. "Distribution in a model-driven age" 2019.

Fulfilling the (largely unfulfilled) promise of Unified Managed Accounts

While this may look like a UMA at first glance, those who have built or used UMA advisory programs know current iterations are not nearly as seamless or easy to implement and use.

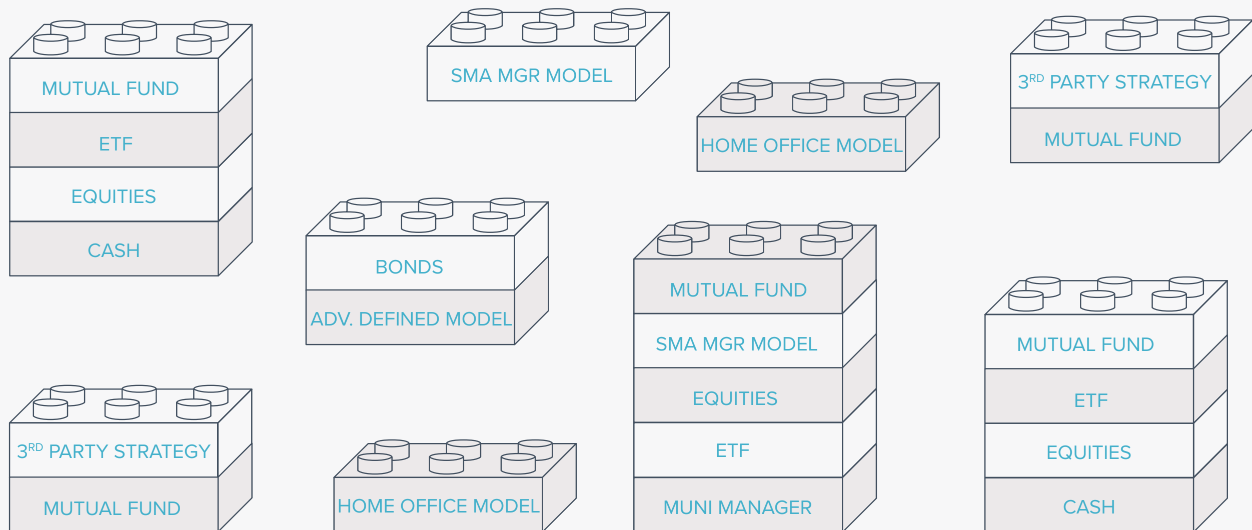
Vestmark's vision and technology platform align closely with a solution proposed by Cerulli Associates: the Unified Advisory Platform (or UAP). More than just a new acronym slapped on an old idea, Cerulli describes the UAP as follows:

"Platform consolidation presents a compelling strategy. Financial advisors can access all their firm's offerings in one place, with a single login. They can construct portfolios on a singular platform, without being constrained by the artificial product boundaries imposed when a firm's managed account programs are disaggregated into separate programs for mutual funds, exchange-traded funds, separate accounts, and advisor discretionary programs. UAPs also offer streamlined processes, such as a singular investment contract, block trading, consolidated billing, performance reporting, and uniform pricing."[11]

This moves well-beyond early iterations of UMAs and the ability to customize models. It's a highly robust advisory program solution enabling mass customization at scale. It offers meaningful benefits for advisors and investors alike – all while enabling improvement in home office efficiency across product, trading, overlay, operations, and compliance teams.

Shouldn't it be this easy?

Agnostic building blocks – regardless of security type, product wrapper, or trading discretion – available via a single advisory program and within a single custodial account.



> *Advisors can seamlessly create customized portfolio solutions blending investment content from multiple sources: advisor-driven and home office models, third-party strategists, SMA managers, mutual funds, and ETFs.*

[11] Cerulli Associates. "U.S. Managed Accounts: 1Q 2019 Edition, Issue #71, Consolidated Platforms Issue." 2019.

How Advisors Benefit

This type of advisory solution removes the false choice in portfolio construction and allows individual securities, mutual funds, ETFs, and SMAs (and models) to be used as they should be: wrapper- and discretion-agnostic portfolio building blocks that co-exist in a single custodial account. Regardless of where an advisor falls on the 'Rep as PM' vs. 'models' continuum, both portfolio construction approaches can be facilitated on a single platform (and in a single account) as dictated by the unique needs and objectives of each individual client.

How Investors Benefit

This type of unified advisory solution provides investors with greater access, consistency, and transparency:

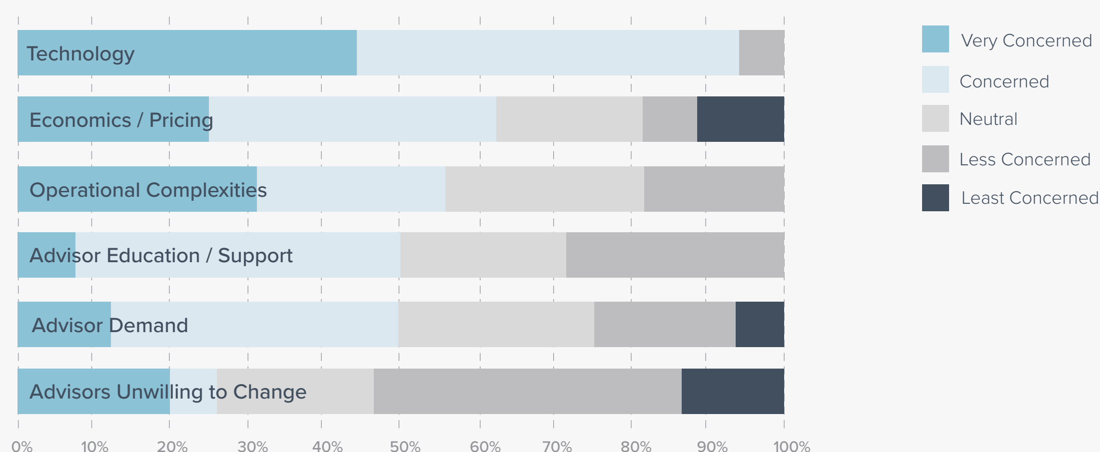
- **Access:** With access to the widest possible variety of investment options, investors can be assured that their advisor has the tools necessary to craft portfolios fully-aligned with their investment goals.
- **Consistency:** Anyone familiar with household-level performance reporting knows that the portfolio initially proposed tends to look different than the one that gets managed (which then tends to look different from what ultimately gets reported on). With this solution, investors enjoy consistency from a single, common asset allocation, product and reporting taxonomy – from initial client proposal to subsequent performance reports and everything in between.
- **Transparency & Suitability:** A unified advisory platform can decouple and level fees as products or investment vehicles proposed to the client would not offer the advisor or home office a meaningful economic advantage. As noted by Cerulli, "by creating a better pricing relationship with clients, managed account sponsors can generate enthusiasm among advisors to support the evolving consolidated platform and spur them to encourage clients to sign new investment agreements."[12]

How Home Offices Benefit

From a pure portfolio construction standpoint, home offices would help eliminate the false choice – and at the same time more effectively balance enterprise risk and advisor autonomy. That's because Product, Investment, Compliance and Risk Management teams can turn the dials as needed on an advisor-by-advisor basis – and granularly set permissions related to access, suitability, trading, rebalancing, and overlay management.

More broadly, by decommissioning the dozens of proprietary and siloed systems and workflows put in place to serve the specific operational needs of each advisory program, home offices can enjoy greater operational efficiency, reduced technical debt, lower back office support costs, and increased advisor satisfaction.

Top Concerns Regarding Moving to a Consolidated Platform – Overall



SOURCE: FUSE Research Network, LLC. "The Road to a Single Unified Platform: Why Aren't We There Yet?" 2019.

[12] Cerulli Associates. "U.S. Managed Accounts: 1Q 2019 Edition, Issue #71, Consolidated Platforms Issue." 2019.

Is It Really That Easy?

In short, no – it isn't. While the strategic imperative to eliminate technology platforms and advisory programs is clear, implementing that solution is much more complex. From overcoming inertia and choosing the right technology provider to potentially re-papering clients and changing advisor behavior, there's no shortage of tactical challenges.

Vestmark fully appreciates and understands these challenges (and has spent nearly two decades helping highly successful firms overcome them). In fact, migrating to a fully-consolidated solution has rarely been the first step. Most successful implementations tend to involve the migration of multiple advisory programs in their current state in parallel with a clear, longer-term consolidation path (and based on a timeline that makes the most sense for that particular firm). Ultimately, because Vestmark's technology allows for both current and future states, senior executives in every part of the organization can have confidence in the future-proof nature of their investment.

As Cerulli and the Money Management Institute (MMI) validate in their most recent Advisory Solutions Quarterly[13]:

- Most managed account sponsors spend considerable time developing a consolidated managed account platform because of the complicated and protracted technology efforts involved.
- Rather than wait for technology to be complete before launching a consolidated platform, managed account executives should consider rolling out the initiative in waves. Simplifying paperwork, streamlining client support, and creating rationalized pricing can be implemented in stages as a way to build advisor support for the evolving platform.

Managed Account Sponsors' Attitude Toward Platform Consolidation, 2019

Response	%
We are planning on integrating all of our managed account programs onto a single-account architecture but are not there yet	57%
We will continue to allow various programs to exist on different platforms	24%
We have migrated all of our programs onto a single account architecture	14%
We are anticipating our custodian or TAMP will make these changes	5%

Analyst Note: Sponsors were asked, "What best describes your opinion of platform consolidation (getting all managed account programs on a single chassis)?"

SOURCE: Cerulli Associates. "U.S. Managed Accounts 2019?" 2019.

[13] Money Management Institute-Cerulli Associates. "Advisory Solutions Quarterly – Q2 2019." 2019.

Conclusion

So, is the advisor’s primary value proposition financial planning and behavioral coaching? Is it bespoke portfolio construction? And if the answer is ‘both’ or ‘it depends’, then what should the advisory solution of the future look like?

We firmly believe that the answer is ‘both,’ as both approaches have merit and can add quantifiable alpha. Which approach is used should ultimately be dictated by the many nuances of each investor’s current situation, beliefs, and objectives.

We feel both approaches are best served by non-siloed advisory programs. A truly unified program in which both approaches can be executed within a single custodial account likely offers the broadest range of benefits to advisors, home offices, and investors.

More crucial, however, is leveraging a single technology platform that can serve ‘business as it is today’ **and** ‘business as it should be tomorrow’. This gives enterprises complete implementation flexibility and a high level of certainty in making a future-proof investment.

Finally, we believe Vestmark offers such a technology platform. The VestmarkONE® platform is arguably the only solution available today that gives advisors the autonomy to customize portfolios at scale against a backdrop of non-invasive home office guardrails designed to effectively mitigate enterprise risk.

Ultimately, this strategic approach to technology platform and long-term advisory program consolidation enables broker/dealers, bank wealth organizations, insurers, TAMPs, large RIAs, and digital advice providers to deliver the best possible outcomes for advisors, home offices, and investors alike.

Find out how Vestmark can enable you to offer the best of both worlds.

Call (781) 224-3640, **email** inquiry@vestmark.com, **or visit** www.vestmark.com.

Vestmark is a leading provider of wealth management solutions and services which enable financial advisors and institutions to efficiently manage and trade their clients' portfolios using an innovative SaaS platform. Founded in 2001 and headquartered outside of Boston, Vestmark's mission is to enable investors to strengthen their financial well-being.

Supporting over $1.4 trillion in assets and 4.5 million accounts, we are a trusted partner to some of the largest and most respected firms across the wealth management industry. For more information about Vestmark's solutions, call (781) 224-3640, email inquiry@vestmark.com, or visit www.vestmark.com.

Vestmark Inc.
Corporate Headquarters | 100 Quannapowitt Parkway, Suite 205 | Wakefield, MA 01880

1.781.224.3640
www.vestmark.com

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