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the best SMA
for your client



A Manager Apart

To tap the growth in separately managed accounts, advisers must master the basics of manager selection

BY HOWARD J. STOCK

SEPARATELY MANAGED ACCOUNTS ARE BIG business, and one that around 70% of advisers say they wish to tap, according to Financial Research Corp in Boston. By the end of March, total assets in managed accounts reached \$736.4 billion, an 8.6% increase over the previous quarter and 24.8% growth year over year. While this total is only roughly a tenth of the assets held in mutual funds, it shows an appetite among the wealthy—managed account minimums per manager are still mostly in the \$100,000 to \$250,000 range—for the type of account that lets them customize their investments to take into account their existing holdings and tax liabilities.

SMAAs work well for the wealthy, but they also help advisers build their fee-based businesses, which in turn helps banks eager for the recurring income these accounts provide. But managing these accounts requires much greater depth and sophistication.

While banks and their broker-dealers routinely limit the number of individual managers advisers can use, there is still enough difference between managers in a style category to warrant a concerted effort by the adviser to match the manager with the client's specific needs.

Steve Deutsch, who manages Morningstar's separate accounts business in Chicago, says the fundamentals hold true across all investment vehicles, but there are a few variables, including risk versus reward, whether the fee charged justifies the level of service the customer is promised and if that service actually materializes. Ultimately, he says, the money manager should be prepared to customize the portfolio and take the investor's needs into account in investment decisions.

The ultimate question is what does the client need an SMA to do? What problem does it need to solve? If a high-net-worth investor has a lot of money in large caps, some in small caps and very little in mid caps, is an SMA the best vehicle with which to solve the problem? If the investment is just to fill a gap in a portfolio, advisers should also look at mutual funds and exchange-traded funds, and include those options in a cost-benefit analysis.

"Advisers shouldn't think of any one investment vehicle as a magic bullet," Deutsch says. "The adviser's job is to think things through to the next level to find the best solution, whether that be an SMA, a mutual fund or an ETF. Advisers must think about the individual client and not confine themselves to one kind of offering."

But the expectation should be that separate account managers have the skill set to generate alpha, outperforming the benchmark in their market. From this perspective, advisers must choose which index they need to use to benchmark a manager's performance and whether that manager adds enough alpha to justify the cost.

THE FOUR Ps

"It's all about the four Ps: People, philosophy, process and performance," says Jay Kimple, head of marketing and client relations at Informa Investment Solutions in Chicago, which generates

data and reports on the roughly 2,000 firms providing individually managed accounts. "People" involves looking into who is actually managing the fund, how long they have been at the same firm, whether they have a stable support staff, and so on. "Philosophy" refers to how the manager approaches the investment decision. "Process" is the manager's focus on companies, not worrying about the overall market but looking at investments from the bottom up.

Kimple says performance is the last piece of the puzzle—if the other three components are in place, hypothetically it's a given. In addition, it's a mistake to take a manager's current performance into account without running models to see how that manager's strategy would have performed in different market periods. "A lot of people mistakenly believe that by keying in on performance, they can tell if a manager is doing a good job, but there are different ways to monitor a manager's performance—rates of return or how they've done in a particular calendar year, say, 2003, which was not a good time for the equity markets," he says.

There is also the risk side of the equation—perhaps using standard deviation as a volatility measure or a relative indicator like beta—to measure the manager's peer group result, which stacks up his or her results against similar managers. "If a manager has done a good job picking assets across an investment style and in the same capitalization range, performance between managers is often very similar," Kimple says. "If one has a much higher risk level, that probably means your selection process needs to be reviewed."

Of course, advisers who have done a thorough planning job shouldn't pull up managers with too high a risk profile. Plus, banks' program managers will usually pre-screen managers, so the actual universe advisers have to choose from is relatively small. Bill Stone, senior vice president and director of PNC Wealth Management in Pittsburgh, says his advisers' menu is selected by a dedicated research group within the wealth management department based on five factors—people, process, performance, business

structure and legal and compliance.

"We're looking at the individual responsible for management of the fund, his or her background, tenure, experience and whether the people responsible for past performance are still there," he says. "We look at the depth of the team and how stable that team has been."

Stone says the overriding theme is consistency, which goes hand in hand with performance and will cause the team at least to do more digging. "We'll look at their peers for outliers and question whether their process is logical," he says. "Then we look at historical valuations, whether they're overweight in a certain sector, and so on."

In terms of performance, PNC's researchers look at index benchmarks and for growth at a reasonable price, deep-value management and for a sub-style that might be out of favor but the research department thinks will come back around. "We also look at how the manager has added value in the past and what has been done to reduce risk," Stone says. "Some managers are not performers, but they offer a smoother ride, which is appropriate for some clients based on their risk tolerance. Lastly, we look for consistency to approach going forward."

When looking at risk and return, Stone knows that while a manager may perform well, that performance comes at too great a price to clients with a conservative bent. "When we look at risk and return, we're looking for up versus down capture, and whether that matches the client's goals," he says. "Some clients may tolerate a more aggressive manager; others can't take the gyrations. We also look at the degree to which the manager hugs the index—some don't even look at the index, but others use it as a safety blanket."

Business structure refers to ownership of the investment firm, manager tenure and whether the manager has a personal equity stake and is thus more likely to stay. Some firms have their managers under a 10-year contract, but it's also a good sign when they have a personal stake in the portfolio, i.e. they eat their own cooking.

Last, Stone wants to know how they firm deals with legal and compliance issues. "Maybe the firm has the type of



The Top 10 Managers by Sector

Morningstar data shows performance is just one piece of the puzzle

	Investment Firm	Gross Return Annld 5 Yr (%)	Max. Mgmt. Fee (%)	Min. Initial Purchase Retail	Flexibility Measure
Large-Cap Growth Separate Account Strategies					
Peter Eichler	Aletheia Growth Portfolio	17.43	N/A	\$1,000,000	N/A
Michael Schroer	Renaissance Large Cap Growth	13.11	0.75	\$200,000	High
Robert G. Hagstrom; Kyle Prechtl Legg	Legg Mason Capital Mgt Gr Eq	12.67	0.75	\$25,000,000	N/A
David Anthony Russo; Beth A Lang	Capital Mgt Lg-Cap Gr Eq	11.77	0.75	\$100,000	High
Stephen Paul Thorson	Emerald Capital Large Cap Growth	10.08	1.25	\$100,000	High
N/A	Johnston Asset Mgt Corp. Lrg Cp Equity	9.96	0.75	\$5,000,000	N/A
Robert Paul Groesbeck; Robert Dainesi	Groesbeck Inv Mgt Corp Gr of Inc	9.89	1	\$500,000	N/A
Arthur Moretti; Ingrid S. Dyott	Neuberger Berman Socially Resp Eq-SMA	9.42	N/A	\$100,000	Medium
Robert G. McVicker; Christopher J. Collins	Oak Ridge All-Cap Gr Comp	8.85	0.85	\$100,000	N/A
Bob Doll; Dan Hanson; Tasos Bouloutas; Brenda Sklar	MLIM Large Cap Growth	8.49	0.6	N/A	Medium
Large-Cap Blend Separate Account Strategies					
N/A	Rockwood Capital Strat Eq	12.40	0.7	\$500,000	N/A
Christopher Mullarkey; Roger M. Lob; Michael J. Mullarkey	Markston Intl All Cap	12.39	0.95	\$5,000,000	Medium
Gautam Dhingra	High Pointe Capital Mgt Select Val	11.67	0.85	\$10,000,000	N/A
Bob Doll; Dan Hanson; Tasos Bouloutas; Brenda Sklar	MLIM Large Cap Core	11.28	0.6	\$1,000	Medium
Gerald Kaminsky; Gary Kaminsky; Michael Kaminsky; Linda Shields; Richard Werman	Neuberger Berman All Cap Core Equity-SMA	11.04	N/A	\$100,000	Medium
Thomas G. Fox	Quantitative Advantage Global Equity	10.76	0.5	N/A	N/A
James F. Barksdale; William Andrew Bruner; Richard Terrence Irrgang	EIC All Cap Value Equity	10.42	0.75	\$500,000	N/A
Jeanie Wyatt	South Texas Money Mgt Core Eq Taxable	10.30	N/A	\$500,000	N/A
N/A	MLIM Core Equity (SMA)	10.23	N/A	N/A	N/A
Edward S. Loeb; Robert M. Levy; William C. Nygren; Clyde S. McGregor; Floyd Bellman; Andrew M. GLuck; Robert S. Burstine; Michael J. Mangan	Harris PC Eq	10.18	1	N/A	N/A
Large-Cap Value Separate Account Strategies					
Peter Eichler	Aletheia Value Portfolio	17.73	N/A	\$1,000,000	N/A
Mark Hillman	Hillman Capital Mgt Focused Advantage Eq	17.15	1	\$1,000,000	Medium
Stuart Lippe; Barbara Browning; Bruce Kaser	Freedom Capital Mgmt Conctrtd Value Eq	15.58	N/A	N/A	N/A
Jon D. Bosse	NWQ Inv Mgt Special Eq	15.41	0.85	\$100,000	Low
Douglas Cannon	Texas First Inv Mgt Large Cap Value	15.33	1.5	\$500,000	N/A
N/A	Horizon Asset Mgt Svcs Spcl Opp Invstng	15.10	1	\$500,000	N/A
N/A	MLIM Large Cap Value VI (SMA)	15.10	N/A	N/A	N/A
Bob Doll; Dan Hanson; Tasos Bouloutas; Brenda Sklar	MLIM Large Cap Value	14.14	0.6	N/A	Medium
Ric H. Dillon Jr.; Charles S. Bath; Thomas P. Schindler; Christopher M. Bingaman	Diamond Hill Capital Mgt Select Equity	13.86	0.9	\$1,000,000	High
Ric H. Dillon Jr.; Charles S. Bath; Thomas P. Schindler; Christopher M. Bingaman	Diamond Hill Capital Mgt Lg-Cap Eq	13.30	0.8	\$1,000,000	High
Mid-Cap Growth Separate Account Strategies					
Charles G. Mackall, Jr.; Peter C. Keefe; James H. Rooney	Avenir Value Core Equity	20.17	1	\$500,000	N/A
Randy Cloud	Cloud, Neff Mgt C-N Russ Midcap Gr SWI	16.12	0.15	N/A	N/A
Tony Y. Dong	Munder Capital Mgt Md-Cap Core Gr	15.86	0.75	N/A	Medium
N/A	Sovereign Mid Cap Equity PCG	15.54	N/A	N/A	N/A
Judith M. Vale; Robert W. D'Alelio	Neuberger Berman Sm-Cap Val Equity-SMA	15.53	N/A	\$100,000	Medium
Mark E. Scarlett; Matthew J.N. Roehr	Northwest Inv Counselors Sm Co	15.38	1	\$500,000	High
Khateeb A. Lateef	Lateef Mgt Non-Taxable All-Cap Gr Eq	15.23	N/A	\$1,000,000	Medium
Ronald Baron	Baron Small Cap Equity	14.56	1	\$5,000,000	High
James R. Margard; Daniel M. Brewer; Mark W. Broughton; Mark H. Dawson; Peter M. Musser	Rainier Inv Mgt Small/Mid Cap Eq	14.52	0.9	\$15,000,000	N/A
Thyra Zerhusen	Optimum Inv Md-Cap Core Eq	12.94	0.9	\$5,000,000	High

	Investment Firm	Gross Return Annldz 5 Yr (%)	Max. Mgmt. Fee (%)	Min. Initial Purchase Retail	Flexibility Measure
Mid-Cap Blend Separate Account Strategies					
James Langer; Kip Meyer; Brien O'Brien; David Heller N/A	Advisory Res Sm Md-Cap Val	23.61	1	\$5,000,000	N/A
	EARNEST Sm-Cap Val	22.14	1	N/A	N/A
James Langer; David Heller; Brien O'Brien	Advisory Res Sm-Cap Val Eq	21.20	1	\$5,000,000	N/A
Gautam Dhingra	High Pointe Capital Mgt Sm-Cap Eq	21.15	1	\$5,000,000	N/A
N/A	Horizon Asset Mgt Svcs Spin Off Invstng	21.14	1	\$500,000	N/A
Kris Anderson; Ethan Anderson	Rehmann Financial Anderson Portfolio	19.68	N/A	N/A	N/A
Charles W. Neuhauser; Donald Wang; Vincent Sellecchia; J. Dennis Delafield	Reich & Tang Cap Mgt Concentrated Eq	19.33	1.5	\$500,000	Low
N/A	C. M. Bidwell & Sm-Cap Eq	17.35	1	\$250,000	N/A
Charles W. Neuhauser; Donald Wang; Vincent Sellecchia; J. Dennis Delafield	Reich & Tang Cap Mgt Md-Cap Val Eq Prod	16.17	1	\$5,000,000	Medium
Yang Lie; Michael R. Lehmann	Third Avenue SMID Cap Value Equity	14.59	1	\$1,000,000	Medium
Mid-Cap Value Separate Account Strategies					
Randall Abramson; Herbert Abramson; Martin Braun	Trapeze Long Only Equity	39.32	1.5	\$500,000	High
Randall Abramson; Herbert Abramson; Martin Braun	Trapeze RRSP	31.50	1.5	\$500,000	High
David B. Iben	Tradewinds Mid-Cap Value	26.46	0.85	\$100,000	Low
William B. Moody; Amory A. Aldrich; Michael C. Pierre	Moody Aldrich Focused Val	21.07	1	\$250,000	Low
Edward A. Trumbour; Rastuslav Berlansky	Brandywine Sm Mid Cap Val Eq	18.57	0.9	\$10,000,000	N/A
Ron Mushock	Systematic Financial Mgt Mid-Cap Value	18.42	0.75	\$5,000,000	N/A
Timothy P. Beyer	Sterling Mid-Cap Value	18.14	0.85	\$10,000,000	Medium
Robert Costomiris	Wells Capital Disciplined Mid Value	18.11	N/A	N/A	N/A
Marilyn G. Fedak	AllianceBernstein MA Sm Md-Cap Val	18.10	0.95	\$100,000	Low
J. Dennis Delafield; Vincent Sellecchia	Reich & Tang Cap Mgt Delafield Norm Risk	17.28	1	\$250,000	High
Small-Cap Growth Separate Account Strategies					
Scott Michael Rich	MindShare Capital Mgt Sm-Cap Gr	23.15	1	N/A	N/A
James W. Oberweis; Martin L. Yokosawa; Ken Farsalas	Oberweis Asset Mgt Micro-Cap Gr	22.68	1.3	N/A	High
John P Richardson; Julie Hollinshead; Robert E. Crosby	Munder Capital Mgt Micro-Cap Eq	21.96	1.25	N/A	Medium
Thomas J. Ross; Louise M. Laufersweiler	RCM U.S. Micro Cap Eq	20.83	1	N/A	N/A
Lee Molendyk; Lance Swanson	Insight Capital Res & Mgt Sm-Cap Gr	20.18	2	\$100,000	N/A
Paul A. Radomski	Renaissance Small Cap Growth	18.02	1	\$200,000	High
Randy Cloud	Cloud, Neff Mgt C-N Russ 2000 Gr SWI	17.42	0.15	N/A	N/A
N/A	KPH/Kempen, Sm-Cap Val Eq	16.88	1	N/A	N/A
Andrew Scott Cupps	Cupps Capital Small Cap Growth	14.88	N/A	N/A	N/A
Dennis Lynch; Alexander Norton; David Cohen; Sandeep Chainani	Morgan Stanley Small Company Growth	14.82	1	\$25,000,000	N/A
Small-Cap Blend Separate Account Strategies					
Ricardo Bekin	Ativo Small Dynamic Portfolio	27.80	2	\$50,000	N/A
Eric James Miller; William J. Nasgovitz	Heartland Sm-Cap Val Strat	23.17	1	\$5,000	High
N/A	TS&W Small Cap Value	22.90	1	\$5,000,000	N/A
N/A	The London Co. Small Cap	22.39	1	N/A	N/A
David E. Kaplan	VMF Capital Small Cap Core	21.84	1	\$250,000	Medium
John P Richardson; Julie Hollinshead; Robert E. Crosby	Munder Capital Mgt Sm-Cap Val	21.23	1	N/A	Medium
Chris D. Wallis; Mark J. Roach; Scott J. Weber	Vaughan Nelson Inv Mgt Sm-Cap Val	20.57	1	\$1,000,000	Medium
N/A	Wells Capital Small Cap Value Equity	19.50	1	N/A	High
Robert P. Fetch; Steven M. Lipper	Lord Abbett & Co. Sm-Cap Val SMA	18.52	N/A	\$100,000	Medium
Kenneth Reid	AXA Rosenberg U.S. Mid/Small Cap Equity	17.47	0.85	\$50,000,000	N/A
Small-Cap Value Separate Account Strategies					
Frederick L. Astman; Scott William Hood	First Wilshire Securities Mgt Mgd Acct	33.61	1	N/A	High
Max Zavanelli	ZPR Fundamental Small Cap Value	30.69	2	\$100,000	High
N/A	Acadian Small Cap	29.12	0.75	N/A	Low
Charles W. Neuhauser; Donald Wang; Vincent Sellecchia; J. Dennis Delafield	Reich & Tang Cap Mgt Micro Cap Eq	24.33	1.5	\$500,000	Low
Francis E James, Jr.; Barry R James; Thomas L Mangan; Ann M Shaw; David W James	James Inv Res small cap	22.45	1.25	\$1,000,000	Medium
Matthew D. Reams; Sabrina Churchwell; David Stiles Griffin	Buckhead Capital Mgt Sm-Cap Val	22.30	1	\$250,000	Medium
Ric H. Dillon Jr.; Charles S. Bath; Thomas P. Schindler; Christopher M. Bingaman	Diamond Hill Capital Mgt Sm-Cap Eq	21.84	1	\$1,000,000	High
Phyllis G Thomas	NWQ Inv Mgt Sm-Cap Val Eq	21.52	1	\$100,000	Low
Douglas Cannon	Texas First Inv Mgt Small Cap Value	21.30	1.5	\$500,000	N/A
Edward A. Trumbour; Rastuslav Berlansky	Brandywine Sm-Cap Val Eq II	20.68	0.9	\$1,000,000	N/A

culture we don't want to be involved with," he says.

What about manager performance after you've bought in? Stone believes that so long as the manager is doing what he or she promised to do at the outset, patience on the client's side of the table is a virtue. However, woe to the manager who dips out of style to bolster his performance.

"Underperformance often comes down to the manager's underlying substyle. We bought them for that substyle, so we understand. If nothing has changed in the manager's investment style, we'll give it quite a bit of time," Stone says. "However, if a manager has outperformed the index but there has been some style drift, we'll pull the plug pretty quickly."

CUSTOM BUILT

A manager's willingness to customize the portfolio based on a client's wants and needs is also important; in fact, it's one of

the major selling points of SMAs. For example, wealthy clients often have held—or still hold—large amounts of company stock. To be properly diversified, the client's company should be excluded from the manager's roster. In some cases, it might even be best to omit a whole sector. Individual managers also must work with advisers when it comes to tax loss selling.

Stone recently worked with a client who is an executive at a public company. "I talked to him about what he was trying to accomplish," he says. "He has very large holdings in the stock of his previous and current employer, both basic materials companies. He wanted to retire on a certain income, most of which would be covered by his pension, so our conversation was largely about his estate and what he wanted to leave behind."

Since the client in question had a huge amount of assets in basic materials, Stone needed to build a large-cap stock portfolio

with a less cyclical linear correlation. He also used managers in small caps, mid caps, international and bonds, plus a hedge fund of funds and private equity exposure to round out the portfolio.

Stone says PNC wealth managers typically meet with clients a minimum of twice per year. "Some want to be completely hands-on. Others are so involved in their businesses and feel that they lack investing expertise. So they'd rather delegate the responsibility."

PNC Wealth Management uses a menu of around 25 to 30 managers at any one time. "We keep it relatively tight because we have such stringent guidelines. But we're constantly looking for new managers," Stone says.

Client minimums for SMA accounts are typically \$100,000 to \$250,000 per manager. "We'll look at what the client is trying to accomplish and build a portfolio around that," Stone says. PNC wealth managers have 100 relationships at most, and the average managed account size is \$1 million. Advisers can use any combination of managers for these accounts.

David Maynard, director of wealth management at Southern Community Bank in Winston-Salem, N.C., is still in the early stages of building a managed account business. So far, he has 20 relationships, half individual, half corporate, averaging \$1 million apiece. His operation manages a total \$120 million in brokerage assets, but it only began its focus on wealth management last year. Nevertheless, Maynard was able to bring in \$10 million in managed money last year, and he's on track to do the same this year.

Maynard has built his business solely on his relationships with the bank's commercial officers. When they talk to a potential corporate client about lending, Maynard is there in the meeting to talk about investment opportunities.

Most of what he does on the corporate side is fixed-income investing, for which he uses individual managers. "One company opened a \$1.7 million account recently that wanted all of its money with a fixed-income manager," Maynard says. "Sometimes, we use balanced managers, but this account is mostly in government, AA and AAA bonds.

We tend to have very conservative investors at this bank, and that's certainly the case with our corporate clients."

Maynard says closing this deal took around a month of joint meetings with commercial officers to pin down exactly what the client needed. By offering a managed account, he is able to provide better service and performance while at the same time enhancing the commercial relationship. For this particular case, Maynard chose a money manager at a \$2 billion firm that only does fixed income. Since the manager buys at institutional prices instead of retail, the client ends up with a portfolio better tailored to its goals while at the same time saving money.

"The client was looking for customization," Maynard explains. "We needed a manager who could make sure the cash is available when the client needs it."

Tax efficiency wasn't part of the equation for this client, which is a nonprofit, but it does come into play for individual clients with large mutual-fund portfolios because a personalized tax-efficient managed-money account can significantly lower their capital gains liability. Maynard says his corporate and individual clients often go hand-in-hand—commercial officers work with top-tier clients, often wealthy executives who end up opening personal accounts. He says the bank's niche is small-business owners.

"Individual clients are looking for performance and a level of service they're not getting from their current adviser," Maynard says. "The minimum for a managed money account at our broker-dealer is \$100,000, although I don't look at that option unless a client has at least \$250,000 because it's difficult to get the necessary diversification below that."

Southern Community Advisors has access to between 40 and 60 individual managers on its various platforms through broker-dealer Uvest. Maynard chooses the most appropriate manager for his clients by looking at performance, manager tenure and risk ratios. "I manage toward risk, so I look for ratios that are substantially below those of the market," he says. "I also look for manager accessibility; it's nice to use a manager a

client can actually talk to. For this reason I'll use managers in our region or at a firm with a rep nearby."

UP AND RUNNING

Given a hypothetical client with \$2 million in stocks, bonds and mutual funds, Maynard says he starts with a Morningstar analysis to determine how the client's portfolio is performing and then he meets with the client to review his analysis, talk about embedded fees in the mutual fund portfolio, gauge whether there's any overlap and compare its performance with a personalized portfolio of stocks and bonds. "We also discuss risk tolerance to see if anything needs to be changed," he says.

Maynard says that if a case goes beyond what his modeling software can achieve, he leans on Uvest's wealth management division for information and to pin down an appropriate allocation, including,

where necessary, the client's existing holdings. "It's an individualized process—if the client has a qualified account with no tax implication, it may be easier for the manager," he says. "But if there is a tax implication, I'll need to work with the manager to make sure it's a painless as possible for the client."

To build the best possible package, Maynard works whenever possible with a client's CPA to help determine the best strategy for liquidating unwanted assets. "We certainly try to meet with every client's CPA," he says.

Going the distance is what it's all about. Advisers who don't add all the bells and whistles for their managed account clients won't keep them very long, he says. Those that do, though, are winners—if he keeps up his current momentum, Maynard is well on his way to reaching his personal goal of \$100 million in managed assets in five years. [Bank](#)