

SMARTLEAF: THE MISSING LINK IN SUCESSFULLY PROVIDING FIDUCIARY COUNSEL

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How does the financial services industry manage its fiduciary obligations to the consumer? Effective January 31, 2006 brokers who cannot declare they are acting in a fiduciary capacity are required to use a disclosure statement (consumer warning) stating the broker is acting in a sales capacity and is not obligated to act in the consumer's best interests. Clearly every consumer would like to trust their advisor to act in their best interests so they can rely on their advisor's counsel. And certainly every advisor would like to comply. But this requires more than a simple declaration—the broker has to actually address and manage a broad range of investment and administrative values in order to fulfill their fiduciary obligations to the client. Thus the conundrum...

The industry must find a way to both:

- empower the advisor to address and manage a broad range of investment and administrative values required to fulfill one's fiduciary responsibilities
- reduce the complexities associated with managing an extraordinary level of portfolio detail for very large number of unique client portfolios

This requires the industry to take full advantage of technological advancements and expert systems that leverage the counsel of the advisor.

Smartleaf, Advisors, and Fiduciary Counsel

In a major technological breakthrough in overlay management pioneered by Smartleaf, there exists a solution for both the banking and the brokerage industries. Through Smartleaf, banks gain access to best in class outside managers without sacrificing their historically attractive profit margins ascribed to proprietary management. Brokerage firms gain an expert system for their brokers to professionally manage (against objective fiduciary criteria) the incredible amount of portfolio detail necessary to fulfill their fiduciary obligations even when elements of its counsel is beyond the broker's technical proficiency and interests.

By virtue of Smartleaf being able to resolve both industries' challenges, the convergence of high-level counsel in the banking and brokerage industries around common fiduciary principles is affirmed. For both banks and brokerages, Smartleaf provides the "missing link" necessary to successfully provide fiduciary counsel.

Smartleaf's sleeveless in-house overlay management technology gives the advisor more control over the investment process, so the operational complexity to fulfill fiduciary responsibility can be better managed. With Smartleaf, third-party investment methodologies that generate superior performance can be seamlessly integrated into the investment process. Smartleaf also allows for portfolio customization and client restrictions to be accommodated, is far less expensive, and far less complex to administer than conventional sleeved-based overlay management technology.

The Current Landscape for Client-facing Fiduciaries

How does the brokerage industry address the new fiduciary disclosure obligations provided it is a violation of the internal compliance protocol for a broker to acknowledge their fiduciary obligations? Today, for the vast majority of the industry's 658,000 registered advisors, there is no large-scale institutionalized support for fiduciary counsel. This is why the SEC is requiring a clarifying disclosure statement. Thus the imperative: the industry must find a way to support any and all of its advisors who wish to become true fiduciaries. In order to grow and thrive, the brokerage industry must go beyond a few thousand highly capable senior consultants and bring fiduciary counsel within the reach of all its advisors.

The competitive implications of January 31st for both bankers and brokers are profound. On January 31st, when the highly accomplished, top senior consultants in the brokerage industry declare for the first time they are acting in a fiduciary capacity, the traditional distinction between brokers and bankers in rendering investment advice will not longer exist. We are at an historic, industry redefining inflection point that requires the industry to reassess its role and responsibilities in acting in the consumer's best interest. If the investment advisor is rendering investment advice, they must declare they are acting in a fiduciary capacity, if not, the consumer is left to their own devices in determining investment merit, regardless of how limited the consumer's investment knowledge and experience may be.

Overlay Management's Link to Fiduciary Responsibility

Separate account portfolios have become a popular investment vehicle for fiduciaries because they allow for both *continuous* oversight of the account (real-time access to account holdings) in addition to *comprehensive control* over trading activity within each portfolio. Separate account portfolios are the only managed investment vehicle in which the client directly owns each individual security in the account. This makes it possible for an incredible amount of portfolio detail to be managed in real-time thus making continuous comprehensive counsel possible. But 'traditional' separate account portfolios, where the assets are sub-divided and farmed out to numerous outside managers, present a number of shortcomings, including:

- Operational inefficiencies due to the need to coordinate and reconcile the trading activities of numerous outside managers
- Excessive costs associated with the infrastructure needed to deal with the operational inefficiencies

Thus the evolution of overlay management—where model management (alpha generation) is separated from portfolio manufacturing and administration (trading, account customization). Overlay management is fast becoming the 'new standard' in the industry, particularly in light of the new fiduciary burden being placed on advisors in both the banking and brokerage world. By allowing the advisor to directly manage the stocks and bonds in the various model portfolios at the client level (as opposed managing sleeves of third-party managers at the money manager level), overlay management provides for extraordinary operating efficiencies and cost savings.

A sleeveless in-house overlay management technology, developed by Smartleaf, completely eliminates an entire layer of unnecessary complexity and expense in separate account administration. Because portfolio manufacturing is centralized, entire layers of operational infrastructure are eliminated. This simplifies many of the tasks associated with separate account

management. For example, when a manager is replaced, in the traditional separate account world the account with manager A would have to be closed and an account with manager B would have to be opened; oftentimes this would also require a complete liquidation of the securities as they are transferred from one manager to another. With overlay, the transition can be performed relatively effortlessly, since just the model is replaced; the assets stay in the same account, and just get managed against a new model. With overlay, unnecessarily complex and expensive tasks that are eliminated include: the opening and closing of accounts, routing of trades, shadowing of accounts for AIMR reporting, and reconciliation of accounts.

Another requirement of fiduciary counsel demands a high level of account customization and personalization to reflect the specific needs of each individual investor. Smartleaf allows more portfolio customization and client restrictions to be accommodated than conventional sleeved-based overlay management technology. A higher level of portfolio detail/account customization can be managed utilizing a sleeveless overlay management technology because it does not cause dispersion in the outside manager's performance composite. In sleeveless overlay management, the advisor/overlay manager is responsible for customizing and executing the individual trades in each client's separate account, leaving the third-party manager's performance composite unaffected by the performance of the individual accounts. Alternatively, in a 'traditional' separate account program, customization of client accounts causes dispersion in the third party manager's performance composite. This dispersion may negatively impact the manager's overall composite performance and risk profile. This may lead to an understandable reticence on the part of third party managers to customize individual client accounts, thereby running counter to the advisor's interests in providing fiduciary counsel. Sleeveless overlay management completely eliminates this issue, thus aligning the advisor with the client in providing whatever degree of customization necessary to address the client's specific needs.

Overlay management in general aligns the interests of all parties: the sponsoring overlay management program (bank, brokerage firm, RIA), the financial advisor, and the money manager. This is because each expert is focused on their core competency: the overlay manager and the financial advisor are responsible for knowing the client and creating the custom parameters (asset allocation and account restrictions) for the individual investor; the money manager is responsible ONLY for creating and maintaining alpha-generating investment portfolios, not for trading individual portfolios for customers it does not know. Smartleaf enhances that value proposition by eliminating unnecessary complexity, facilitating more portfolio detail to be managed, being far less expensive and providing far more control.

Though Smartleaf can act as a traditional outsourced overlay manager, it can also serve as a web-based expert system allowing the firm to bring overlay management in-house. Smartleaf empowers the advisor to automatically, continuously and comprehensively monitor each of their unique client portfolios against a custom performance benchmark and set of portfolio restrictions. Each day, Smartleaf sends actionable trade recommendations with documentation explaining the rationale of each trade to the advisor. These recorded recommendations automatically keep each of hundreds of unique client portfolios in compliance with the agreed upon investment policy and strategy. Smartleaf empowers both brokers and bankers to provide continuous comprehensive counsel and brings fiduciary counsel within the reach of all. Smartleaf is the epitome of the faster, better, cheaper mantra that drives innovation and productivity gains. Smartleaf can be deployed on a centralized or decentralized basis, providing flexibility to match operational preferences, culture and investment processes of the sponsoring firm and their advisors.

Today's environment demands unprecedented innovation for the continued success of banks and brokerage firms. In periods of rapid change, convention and status quo can often inhibit

successful execution. Certainly both the banking and brokerage industries have blind spots that require them to go beyond their conventional operating model to assure their competitive market position. Decisive action is required on the part of both banks and brokerages if they are to control their own destiny.

Implications for Banks and Broker/Dealers

Banks insist on total control of their investment process (including asset management) and believe it is an abrogation of their fiduciary responsibility to outsource any element of their investment process to a third party. Yet over the past decade, banks have seen the assets of households with a million dollars or more under advisement double from \$5 trillion to over \$10 trillion while their market share of professionally managed assets has declined from 89% in 1995 to 38% today and an estimated 29% by 2010.

Conversely, the brokerage industry's market share has grown exponentially over the past decade. By utilizing best in class, objectively selected, institutional quality money managers (separately managed accounts, ETFs, hedge funds, private equities), the brokerage industry has responded to the needs of today's sophisticated, demanding investor. If the banking industry wants to stem the flow of high net worth assets being won by the brokerage industry, it needs to find a way to incorporate best in class outside money managers within their investment process without killing their attractive margins, historically attributable to their proprietary asset management.

Brokers face a different challenge. Brokerage firms must find a way to effectively empower a large number of brokers, not just their top senior consultants, to fulfill their fiduciary obligations in acting in their client's best interests. In the weeks to come, any advisor who is not able to declare their fiduciary obligation to act in the consumer's best interests will have an uphill battle in winning new clients. Not having 'fiduciary status' will be a distinct competitive disadvantage, and would open up a broker to the risk of a) losing current clients to other bankers/brokers who can convey the trust associated with fiduciary status and b) put them at a competitive disadvantage in gaining new clients. A declaration of fiduciary status is required if the broker is to even state they are rendering investment advice. If the brokerage industry wants to continue to build its high net worth market share it must find a way to empower its brokers to fulfill their fiduciary obligations in portfolio construction.

The control issue for banks that prevents them from using best in class outside money managers and the control issue of brokerage firms in acknowledging the fiduciary obligations of their brokers both work against their own best interests. Both the banking and brokerage industries must go outside of their conventional operating model to resolve these competitive issues. The institutions which are most expeditious in addressing these issues, either banks or brokerages, will gain a significant competitive advantage and opportunity to gain market share. Ultimately all market segments of the financial services industry will, by necessity, be unified by common fiduciary principles. In the seeds of the evolution of the banking industry we will find a solution for the brokerage industry; conversely, in the seeds of the evolution of the brokerage industry we will find a solution for the banking industry. The evolution of overlay, which removes unnecessary layers of complexity and cost in delivering customized investment portfolios to clients, offers an elegant solution which addresses the issues faced by both the banking and brokerage industry. This is why the prudent investment process for banks and brokerage firms look remarkably similar—even though they were independently developed—since they have been established around the core principal of fiduciary responsibility.

Through Smartleaf, banks gain access to best in class outside managers without sacrificing their historically attractive profit margins ascribed to proprietary management. Brokerage firms gain an expert system for their brokers to professionally manage (against objective fiduciary criteria) the incredible amount of portfolio detail necessary to fulfill their fiduciary obligations even when elements of its counsel is beyond the broker's technical proficiency and interests. By virtue of Smartleaf being able to resolve both industries' challenges, the convergence of high-level counsel in the banking and brokerage industries around common fiduciary principles is affirmed. For both banks and brokerages, Smartleaf provides the "missing link" necessary to successfully provide fiduciary counsel.

Smartleaf has created a technology which is an expert system that empowers the advisor, not just an outsourced third party overlay manager, to automatically manage on a daily basis a large number of investment and administrative values required by regulatory mandate, client directive or investment policy. For example, if the advisor is interested in constructing and managing tax efficient portfolios for their taxable clients, Smartleaf offers three layers of tax efficiency (tax efficiency trade-off between alpha and dispersion on a sliding scale, optimization of tax loss harvesting, tax budgeting) that are automatically managed on a daily basis.

Smartleaf automatically manages a level of portfolio detail that is beyond the technical proficiency of most advisors and is done more efficiently than even those who are technically proficient, thus assuring a very high level application. All of Smartleaf's investment recommendations have an explanation, which creates documentation in support of a prudent investment process. Smartleaf empowers the advisor to prudently, directly and automatically manage a broad range of investment and administrative values against a custom benchmark. The advisor simply has to setup an account for each client establishing an idealized target (custom performance benchmark). This idealized target is a blended portfolio of investment mandates by investment management style appropriate for each client's (diagnostically determined) risk and return objectives. The advisor then establishes the constraints and parameters within the portfolio, such as "do not buy/sell" considerations, risk, tax efficiency, liquidity, cost structure, time, etc. Each day, Smartleaf issues an actionable trade recommendation report with documentation explaining the rationale behind each trade recommendation. This keeps an unlimited number of client portfolios, incorporating an unlimited number of managers, on track against its target objectives and an unlimited number of investment constraints/portfolio restrictions. On a daily basis the advisor fulfills their fiduciary obligation of providing continuous comprehensive counsel on a large number of unique custom portfolios (unlimited restrictions on each portfolio) in compliance with the goals and objectives of each client. Importantly, under Regulation 9 of the Office of the Comptroller of the Currency (OCC), banks are required to review client accounts against the client's goals and objectives annually; with Smartleaf, advisors can do it daily.

For the brokerage industry Smartleaf is a technological innovation that can empower the broker to continuously and comprehensively manage the incredible amount of portfolio detail necessary to full the advisors fiduciary obligations. A very high level of counsel becomes scalable so a large number of portfolios can be managed without incurring a proportional increase in cost. This new process-driven business model has a lower cost structure, higher margins and lower compliance risk than conventional commission sales. It also adds far more value than is possible in a series of disjointed unrelated trades where no one is accountable for results and there is no disciplined investment process tied to fiduciary principles.

In the unbundling of model portfolios, the banking industry also finds a solution in centralized sleeveless overlay management. Smartleaf resolves the challenge of banks face when confronted with the need to adopt to an 'open architecture' environment, outsourcing to best in class third-

party managers, without killing their profit margins associated with proprietary management. By unbundling account administration, the cost of managing separate accounts decreases from 40-65 basis points (for 'traditional open architecture) to 15-35 basis points for overlay. This savings makes it possible for banks to access best in class outside managers and still maintain the attractive profit margins historically ascribed to proprietary management. Most importantly, it opens the door of the banking industry to outside separate account managers. As banks move to a more competitive business model and utilize third party model portfolios and research, it could have profound implications in the future growth of the separate account industry.

The third party manager's job is also simplified and made far less cumbersome. Because there is no common communications protocol in traditional separate accounts, and because every platform has a different way of managing these accounts, the operational burden on the third party management firms can be significant. For example, if a management firm is working with twenty distribution firms employing twenty different platforms, there would be twenty different ways for the managed account manager to administer their accounts. By unbundling the money manager's model portfolio from account administration, the manager can remove himself from the burden of the complex account administration business, which adds no value, and focus upon their core competency: asset management.

Case Study

The implications of Smartleaf's centralized sleeveless overlay management technology for the banking industry are profound. Todd Smurl of Compass Bank explains, "for most banks looking to make a change from a purely proprietary approach to asset management, the outsourced separately managed account platforms popularized by the brokerage industry for their mass affluent client base were notoriously expensive at 85 to 100 basis points. We needed an approach to separately managed accounts (SMAs) that was in keeping with trust services. The continuous comprehensive counsel necessary to fulfill our fiduciary obligations as a trust company was difficult to fit into outsourced SMA platforms because of their limited ability to customize each client's portfolio and accommodate other assets. By giving up custody, reporting and trade execution to an outsourced SMA platform, we would lose control of the investment process and thus limit in our ability to customize accounts as needed. Essentially we found the industry's outsourced SMA platforms out-dated (old technology), out-moded (poor portfolio customization capability) and over-priced. Our mission at Compass Bank was to maintain our margins as a trust company while bringing in best in class outside managers. When you add 10 to 15 basis points to compensate for the extra cost for overlay management, conventional outsourced separate account platforms were a non-starter for us. We decided in order for us to better control our cost, our investment process and the customized nature of our services, a new approach to outsourcing SMA management had to be formulated. In the December 2002 issue of SENIOR CONSULTANT Steve Winks wrote the article "Overlay Management: The Whole Product Solution", where he spoke of an more expansive concept of overlay management in a more advanced form that went beyond Multi-Discipline Accounts (MDAs) and Unified Managed Accounts (UMAs). In this article we found the means to gain best in class outside managers and maintain our margins. It had never been done before but the deeper we went into researching the idea the more appealing it became. We decided this sleeveless approach to in-house overlay management was the new approach we were looking for. After eighteen months of development the resulting advisory services platform incorporating the best and brightest of outside managers accomplishes everything, and even more, that we hoped for. In fact we are now planning to even make it available to other banks and RIAs."

Compass Bank has gained better control of its investment process, has gained access to best in class outside managers at a lower cost so it can maintain its margins, has reversed the outflow of assets to the brokerage industry with a comparable if not superior value proposition at a lower cost, has eliminated an entire layer of cost structure that adds no value, has made better use of existing technology not requiring duplicate sub accounting, trade and order routing and reporting systems just to accommodate managed SMA account connectivity, and has made better use of its CFA level human capital in portfolio construction utilizing the best and brightest of outside managers.. Essentially with Smartleaf, Compass Bank has created a faster, better cheaper advisory services platform than is presently available within the brokerage industry. In order for the brokerage industry to compete it not only must acknowledge the fiduciary responsibility of its brokers but also must find a way to match or beat the operating efficiencies made possible by Smartleaf. Given Smartleaf is agnostic on how their technology is used, if the brokerage industry is interested in protecting the competitive market position of its advisors, it must start thinking beyond they way it has historically conducted business. Smartleaf can be an extraordinary solution for brokerage industry as well. At the moment the banking industry is far more progressive in the development of their advisory services platform than the brokerage industry by virtue of their historically assuming discretion and acknowledging their fiduciary obligations. The brokerage industry's acknowledgement of their advisors fiduciary obligations begins the convergence of how high level counsel is provided in both the brokerage and banking industry. For the moment the pendulum has clearly swung in favor of a Compass Bank type platform, and the tables may have been turned on who is picking up HNW market share. This advantage will not last long given the entrepreneurial nature brokers and the fast growing ranks of RIAs coming from the brokerage industry. Indeed the financial services in being reordered around fiduciary principles and the industry will never be the same.

There are several innovations implicit in the Smart leaf technology that may not be clear that should be noted.

1. Access to client-level holdings data facilitates a high degree of portfolio customization possible through Smartleaf which is not possible in a SMA program.
2. By avoiding the expensive and complex sleeve structure of a SMA program, there are significant cost savings to be achieved that allow banks to use best in class outside managers and still protect their profit margins.
3. By the advisor model portfolios from a 3rd party investment manager, the \$100,000 to \$10 million-investment minimums in SMAs are eliminated, exponentially growing the use and application for managed accounts.
4. By banks opening up to outside managers, the SMA business is on the verge of exponential growth, with banks not brokerage firms becoming the single largest users of SMAs. Because banks work within a fiduciary construct where they have discretion, a highly scalable investment process that makes use of outside SMAs is the key to their winning back their 89% market share, having eroded to 39% share today.
5. SMA managers no longer have to deal with the highly inefficient, complex SMA administration process and can focus on asset management where they can add value.
6. The broker is empowered to manage an unlimited number of custom portfolios entailing detail that is beyond their technical proficiency that constitutes the continuous comprehensive counsel implied by regulatory mandate.
7. The bank gains better control of their investment process and better utilizes their CFA level human capital in constructing portfolios utilizing best in class outside managers.
8. The role and counsel of the advisor is greatly elevated as the advisor attains professional standing in acting the clients best interests in addressing and managing a broad range of investment and administrative values.

9. Smartleaf modernizes advisory services with a faster better cheaper, technology.

Historically investment advice has not been scalable. Advice means different things for every advisor and by extension each advisor has their own unique investment process. The vast majority of advisors will acknowledge their prudent investment process is incomplete, yet the advisor had no where to turn for support as the industry is just now beginning to understand it is in its enlightened best interests to support fiduciary counsel. Smartleaf is a scalable expert system, which can manage an unlimited number of custom portfolios, and is a brilliant starting point for any advisor or institution that must find a scalable solution in helping advisors to fulfill their fiduciary obligations. Nothing else in the industry compares to its functionality, cost structure and the resulting end users value proposition.

***About the Author:** Stephen C Winks is the Chairman of PCT Research and Consulting, has done extensive research on the enabling processes and technology of fiduciary counsel, and is the founder of the Society of Fiduciary Advisors which is defining fiduciary counsel based on statute, case law, regulatory opinion letter, process, procedure workflow and task. Winks publishes SENIOR CONSULTANT at www.SrConsultant.com which is read by more than 77,000 readers and is considered one of the industry's thought leaders. Winks insight and counsel on advisory services has been engaged by our industry's leading institutions.*