InvestmentNews
The Leading News Source for Financial Advisers

Overlay managers relieve tax headaches

But only if a well-conceived plan is implemented, a rarity in the separate-account business

By Ron Brounes
September 24, 2007

Does this scenario sound familiar? You have a client with large, concentrated equity positions with a low-cost basis and huge embedded gains, perhaps from working at the same company for years and accumulating options and stock as part of the compensation package. You would like to structure a more diversified portfolio for the client, but cannot bear the thought of the large tax liability that will be incurred in the current year.

Or maybe you have clients who want you to consolidate their investment accounts, which in each case are managed by a few different advisers.

You are thrilled to have gained their confidence and you realize that they have significant security overlap, as none of the advisers have ever communicated with each other about the clients.

While you feel certain that you can create a more diverse, stronger-performing portfolio, once again the dreaded tax issue comes into play, and you are unsure how to go about initiating a transition plan without forcing your clients to write Uncle Sam sizable checks in Year One.

Tailored tax strategies

Managing taxation and the related transition planning have long been among the most important yet least considered aspects of portfolio management.

While the opportunity for a custom approach to tax management is among the greatest benefits for managed-account investors, studies show that few of them (or their advisers) have chosen to take advantage of that opportunity.

“Only a small percentage of the $1 trillion separate-account business is being customized,” said John Phoenix, president of Metamorphosis Money Management, a Denver-based registered investment adviser that provides advisers with turnkey tax-transition planning and overlay services for their wealthy clients.

“Yet, by applying the same overlay service used by institutions such as [the California Public Employees’ Retirement System in Sacramento] to portfolios, advisers can save their clients real money and deliver higher absolute returns,” he said.

Investors focus a great deal on overall investment expenses as they pertain to manager fees, administrative costs and additional wrap fees. Yet they fail to consider taxes, which may represent the single largest portfolio-management expense to many clients who have large portfolios, Mr. Phoenix said.

“Investors often are forced to bite the tax bullet with significant capital gains when a manager is changed or a new allocation is made due to a re-evaluation of goals and/or risk tolerance,” he said.

“Such moves may come with an adviser ‘promise’ that associated losses will be harvested by yearend and the liability will be reduced. In reality, an effective overlay manager can help the adviser by providing customized front-end tax management for each client.”

Metamorphosis works closely with financial advisers to devise an optimal asset allocation formula and uses active and passive separate-account products to construct the targeted portfolio to meet the needs of clients.

It then compares the current holdings with those in the targeted portfolio to determine the tracking error or expected risk-return differential.

However, rather than merely selling one portfolio and investing in another, Metamorphosis analyzes the tax ramifications of making the changes and works within the capital gains budget that the adviser and investor have established.

“Our goal is to generate the lowest level of costs, both taxes- and transaction-related, that will be needed to closely replicate the targeted portfolio,” Mr. Phoenix said.

“The investor shares a capital gains budget which allows us to reallocate the portfolio over time and reduce the tracking error between the current holdings and the target.”

The aim is to compare securities overlap and outliers throughout the transition as the portfolio moves closer to its target, while staying within the budget.

Strong managers with low turnover ratios are selected to keep transaction costs low as well.

Adviser ingenuity

Mr. Phoenix says several important developments led to the firm’s tax transition strategy. “Our approach benefited from innovations in technology, the models management approach to managed accounts as championed by Merrill Lynch & Co. Inc. of New York and a little front-end adviser ingenuity,” he said.

In early 2007, Merrill Lynch made the decision to start trading its Consults managed account platform, leaving the managers to simply provide their intellectual capital in the form of their model portfolios and buy/sell decisions.

This move opened the door for overlay managers to assume similar relationships with their managers and offer more customized services for their clients.

“Overlay management makes it a heck of a lot more accessible to leverage what separate account management is capable of doing, namely, true tax-efficient strategies,” said Paul Wichman, a managing director at Pershing Advisor Solutions LLC of Jersey City, N.J., a subsidiary of The Bank of New York Mellon Corp.

“With one [overlay] manager overseeing the trading and administration functions, investors can better reap true benefits within their multi-manager portfolios. Additionally, they now can accomplish everything more efficiently under a single account, which has long been the Holy Grail in the managed-account business.”

Mr. Wichman believes this trend is here to stay and thinks that over the next several years overlay managers will become involved in some form or another in the vast majority of separately managed accounts. Pershing works with various overlay managers, and it has made Metamorphosis’ services available.

“While firms like [Boston-based] Placemark [Investments] had previously gained some traction with the managers, the Merrill Lynch move represented a major shift in the business, and I expect other wirehouses to follow suit with similar models-based approaches," Mr. Wichman said.

"Overlay managers make the process more efficient and increase the advisers' capacities to handle more clients while providing a powerful new tool for prospecting those coveted high-net-worth clients," he said.

"Anything that helps advisers move out of the back office and into the front office where they are capturing more assets, that is a good thing for everybody. The industry should experience significant upturn in the velocity in the near future," Mr. Wichman added.

Tax specialists needed

Investors who hold large concentrated-equity positions with significant embedded capital gains may have much to gain from overlay managers who specialize in tax transition.

"Today's sophisticated investors have higher expectations for their portfolios and are retaining wealth-management firms to assist in cost-effective tax transitions," Mr. Wichman said.

"As such, specialized overlay managers that are able to minimize the capital gains components are in high demand."

Christopher Beringer, managing director of the Beringer Group of Radnor, Pa., agrees.

His investment advisory firm, BC Advisors, offers family office consulting and focuses on performance returns after fees and capital gains or estate taxes.

"Tax transition is a powerful proposition for us and our clients," Mr. Beringer said.

"We need the ability to move from one portfolio to another in a way that makes sense. We want active management with an acceptable tracking error and without incurring an immediate 20%-plus [capital gains and applicable state] tax liability."

Low cost basis

The Beringer Group has developed relationships with investor clients with both large concentrated positions and with numerous legacy holdings with very low cost bases.

Mr. Beringer has used Metamorphosis as the overlay manager on several occasions to develop transition plans to limit the potentially significant tax issues that can affect many investors.

He agrees with Mr. Phoenix that low-turnover managers make the most sense for this tax-efficient approach.

“There are only a certain number of managers where tax transition even makes sense,” Mr. Beringer said.

“If they are wildly active traders with 200% or 300% turnover, it would be difficult for us to achieve an appropriate tracking error within the capital gains budgets we develop with our clients.”

The demand for overlay management is projected to grow and the tax-transition piece is of utmost importance to firms that focus on after-tax returns within the portfolios they manage.

“Advisers with taxable clients would be making a serious mistake [if they were] not aware of what is going on in this tax-transition area,” Mr. Beringer said.

“They need to pay attention to the extra services offered by overlay managers and the value they can add for investor clients. Frankly, separately managed accounts are now functioning in the ways for which they were originally designed.”

And for a trillion-dollar industry, it’s about time.

Ron Brounes, CPA, is a technical financial writer and president of Brounes & Associates (ronbrounes.com), a Houston-based consulting firm that provides writing, communications and educational services for financial services professionals. His e-mail is ron@ ronbrounes.com.