Achieve SCALE for Better Practice

Advisors want to grow their practices, adding assets under management (AUM) and achieving greater profitability. After all, the “great American dream” means going after bigger and better, doesn’t it? Unfortunately, advisors often find that bigger means more work – to the point of overload.

How do advisors approach growth? Typically, the lead advisor (owner or partner) – in between doing the “real work” - will actively market by meeting the public, publishing, giving presentations, asking for referrals, and/or joining organizations. In other words, the advisor must juggle his or her workload while fitting in marketing efforts. As these marketing efforts pay off, the workload increases. And, the advisor works harder!

In most cases, the advisor’s solution is to hire more people. But, there are problems with this solution. It is difficult to find the right combination of talent, experience, skills and compatibility. Even if appropriate hires can be made, the advisor must supervise and direct his or her employees. For most advisors, who prefer to control what goes on in their own practices, it is difficult to truly delegate and fully utilize the expertise of those they hire.

The bottom line is that most advisors find it difficult to grow beyond a certain point. Ultimately, they must choose between limiting growth and cutting back on services. What if there was a solution that would allow growth without any drop in quality? What if the solution would actually increase quality?

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There is such a solution. However, to benefit, the advisor must be willing to revisit some pre-conceived ideas. The solution to building a scalable investment management practice is twofold: standardization and automation. Although both aspects are recommended, automation is not required in order to benefit from standardized models and procedures. Standardization alone will go a long way toward allowing growth and increased profitability.

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The primary areas requiring standardization are:

Client process

Models and investment strategy

Portfolio management procedures

Billing and reporting

Upon reading this list, some advisors will react with instant reluctance. Merely suggesting standardizing models and investment choices conjures up the image of a "cookbook" approach to portfolio management. This paper does not advocate a "one size fits all" approach. Rather, the goal is an approach that will allow implementation of the advisor's strategies in a consistent manner over time and over his or her entire client base. (Hence, the necessity for the advisor to be willing to revisit some pre-conceived ideas.)

Achieving SCALE

The simple acronym "SCALE" will help in remembering how to apply a standardized approach to an investment management practice:

Simplicity: Research has shown that a properly maintained, diversified portfolio will outperform an actively managed portfolio over time.

Consistency: Consistent models and procedures will help build internal infrastructure and allow for smoother transition of new clients.

Accuracy: With simplicity and consistency, comes enhanced accuracy. This is essential for quality control as well as SEC compliance.

Leading-Edge Theory: Modern Portfolio Theory, location optimization, and tax-efficiency are the driving factors behind leading edge-portfolio management. Investors are more tax conscious than ever and expect their advisors to be on top of best practices.

Excellence: Applying leading-edge theory consistently and accurately will result in excellent quality and service. And – that will lead to greater client satisfaction, more business and increased.

Client Process

It is important to use the same process for all clients. Advisors should not "wing it" or create a new plan for each client. A documented process will help insure consistency. Using a checklist with clients helps to define tasks and responsibilities.

Financial plans need to be prepared and documented carefully. Many clients have the same financial needs: Saving for retirement while helping their kids through college, paying off their house, and living comfortably in retirement. Creating a basic template that includes common explanatory passages and tables will help enormously when preparing financial plans. Of course, financial planning software can be a great help!

Consistency must also be established in the area of investment expectations. A risk tolerance questionnaire should be used with every client. An Investment Policy Statement (IPS) is also critical to documenting clients' expectations as well as providing written parameters for ongoing management.

Models and Investment Strategy

There are five aspects to investment models that cry out for standardization:

Number of models

Number of "slices"

Investment structure

Funds vs. individual positions

Exceptions

Number of Models:

Let's start with the number of models. Many advisors feel that they would not be providing personalized service if they only offer a limited number of models. Personalized service does not mean that each client needs his or her own asset allocation model. Even if all of an advisor's clients were assigned the same model, the implementation would be different! There are differences in clients' number of accounts, types of accounts, taxability, cash needs, etc. Additionally, advisors also provide advice! It is the personal touch, not the composition of the pie chart, that clients value.

Skeptical advisors should try running the numbers on expected returns and standard deviations between a model of 65% equities/35%% fixed income vs. 60% equities/40% fixed income. The differences are minimal and certainly not enough to justify multiple models. If an experienced advisor believes that every portfolio should contain some equities, then why maintain a 100% fixed income model? It is the advisor's job to explain why he or she is recommending a particular model for a client. If clients might waver between a 70/30 allocation and a 60/40 allocation, the advisor must be prepared to discuss the pros and cons and allow the clients to make informed decisions. Including a 65/35 allocation option will not significantly impact clients and it will make maintaining that allocation more difficult for the advisor.

An optimal number of allocation models could be represented by the following group:

100% Equity

80% Equity/20% Fixed Income

60% Equity/40% Fixed Income

40% Equity/60% Fixed Income

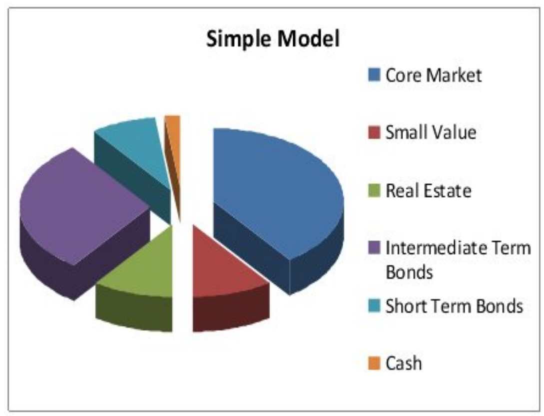
20% Equity/80% Fixed Income

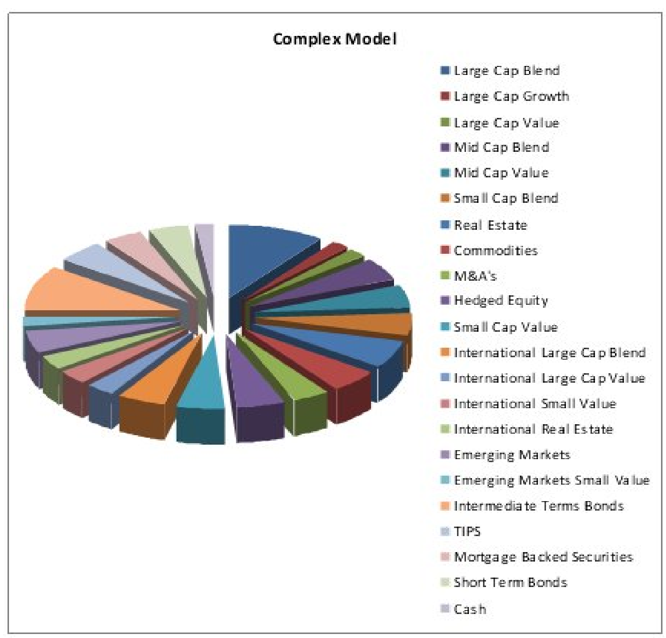
Number of Slices:

Once an advisor has established the basic allocation parameters, it is necessary to create full "pie charts" with "slices" containing the eventual investments to be held in the portfolios. Again, this is an area where advisors can complicate their lives for very immaterial client benefits – or even potential cost detriments.

As above, running the numbers is a worthwhile exercise. What is the marginal difference in expected return and standard deviation between a model containing ten investments and a model containing thirty investments? Is it truly necessary to hold three different small cap value funds? Is it beneficial to allocate 1% or 2% to certain positions? Additionally, having too many "slices" in the allocation "pie" can result in excessive trading.

Illustrated is an example of a "simple" model and a "complex" model. It is clear that the simple model will be much more easily and properly maintained than the complex model.





Investment Structure:

Discussing standardizing models and allocations is useless without proper implementation. While it takes time to set up models and code asset classes in portfolio management software, it will reap great benefits in efficiency down the road.

Models should be set up at consistent levels, avoiding security level models. Security level models do not allow for easy substitution of a position. Switching from one mutual fund to another requires changing every model when security level models are used. However, using a "categorized" model system allows effortless fund replacement.

Setting up "categorized" models requires three steps:

1. Choose a consistent category level.
2. State each model at the consistent category level.
3. Classify all holdings consistently at each category level.

For example, you might set up models in your portfolio accounting software in any of the following three formats:

1. Class
2. Class and Sector
3. Class, Sector and Subsector

Let's assume that you wish to create the following model in your portfolio accounting software:

Cash	5%
U.S. Large Cap	25%
U.S. Small Cap	10%
International Equity	15%
Real Estate	5%
U.S Fixed Income	30%
International Fixed Income	10%

A class level model would simply categorize each investment as its own class, shown below:

CLASS	%
Cash	5%
US Large Cap	25%
US Small Cap	10%
Int. Equity	15%
Real Estate	5%
US Fixed Inc.	30%
Int. Fixed Inc.	10%

A Sector level model could be constructed as follows:

CLASS	%	SECTOR	%
Cash	5%	Cash	5%
Equity	50%	US Large Cap	25%
		US Small Cap	10%
		Int. Equity	15%
Real Estate	5%	Real Estate	5%
Fixed Income	40%	US Fixed Inc.	30%
		Int. Fixed Inc.	10%

Finally, a Subsector level model could be constructed as shown below:

CLASS	%	SECTOR	%	SUBSECTOR	%
Cash	5%	Cash	5%	Cash	5%
Equity	50%	US Equity	35%	US Large Cap	25%
				US Small Cap	10%
		Int. Equity	15%	Int. Equity	15%
Real Estate	5%	Real Estate	5%	Real Estate	5%
Fixed Income	40%	US Fixed Inc.	30%	US Fixed Inc.	30%
		Int. Fixed Inc.	10%	Int. Fixed Inc.	10%

More on Investment Structure:

It is important that models be constructed to have separate "categories" for each position the advisor desires to hold in the model. For example, if the advisor plans to hold both a U.S. corporate bond fund and a TIPS fund, then the Class level model should contain separate classes for both U.S. corporate bonds and TIPS. A Sector level model should contain separate sectors for both U.S. corporate bonds and TIPS. Likewise, a Subsector model should contain separate subsectors for both U.S. corporate bonds and TIPS.

Classifying securities consistently is also imperative. For example, a Vanguard S&P 500 fund should not be classified as Real Estate. Or, a U.S. Small Cap fund should not be classified as International Equity.

As stated earlier, the effort involved with setting up models consistently in the portfolio accounting system will save countless hours in the future.

Funds vs. Individual Positions:

What about mutual funds versus individual stocks? How can an advisor justify choosing individual positions for clients? Is it possible that he or she is equally or more knowledgeable than managers running specific, targeted mutual funds? The professional management, low cost structure and economies of scales offered by no-load, institutional mutual funds make a strong argument for not doing it yourself! And, by utilizing professional managers, the advisor is relieved of the economic and regulatory risks of choosing individuals stocks for clients.

Finally, there is the issue of bond ladders versus bond funds. Again, choosing individual bonds opens up the same risks as choosing individual stocks for clients. Using bond funds can provide diversification in core bonds, TIPS, international bonds, emerging markets bonds, etc. For clients that object to the principle risk of bond funds, the advisor should explain that this risk avoidance is illusory. At any point in time, should the client decide to sell out of a particular bond or bonds, he or she would only receive the market price. In reality, most clients will simply reinvest as each bond matures. This is not dissimilar to what a bond fund does; however, a fund is professionally managed, has economies of scale and is more diversified.

Exceptions:

Once an advisor has limited the number of models as well as the number of "slices" within those models and has committed to using mutual funds, there is the issue of exceptions ("one-off's"). An advisor can be as organized and as streamlined as possible, but if every client is an exception, all efficiency is lost.

What are the reasons for exceptions? In most cases, it's either because the client wants to avoid over-weighting due to outside holdings or because the client wants to include or exclude a particular asset class. Rather than try to manage around particular clients' personal preferences, it is recommended to take the following approach(es):

If a client wants to avoid over-weighting due to outside holdings, suggest moving to a more aggressive or conservative allocation, as appropriate. For example, a client that owns a significant amount of real estate might select a more conservative allocation rather than excluding REITs from the managed portfolio. Or, a client that holds a large number of municipal bonds might select a more aggressive allocation in the managed portfolio.

If a client wants to exclude a particular asset class, it is the advisor's job to educate the client on the diversification benefits of that asset class.

If a client wants to include a particular asset class, or investment, that is not part of the recommended strategy, it is the advisor's job to educate the client on the cohesiveness of the portfolio allocation. Absent that, the client should simply hold the desired position as an unmanaged, outside investment.

Along with maintaining the integrity of the advisor's strategies and streamlining the investment approach, by avoiding exceptions, the performance numbers reported to the clients will be consistent and comparable to appropriate indexes.

Portfolio Management Procedures

Setting up allocation models and choosing specific investments are just the beginning of the process. Maintaining the allocations, and thus the clients' risk/return profiles will require ongoing management. Standardizing these procedures will not only help to streamline operations, it will also create consistency. Procedures should be established and documented in the following areas:

Timing of rebalancing

Rebalancing parameters

Tax saving strategies

Timing of Rebalancing:

Absent automation, rebalancing opportunistically – when the particular accounts are out-of-balance by more than specified tolerance ranges – is not viable. The timing of manual rebalancing is often determined based on human capacity. According to a 2005 survey of 100 advisors by Gobind Daryanani, CFP®, Ph.D., and the Financial Planning Association, over 90 percent use some structured methodology, with a preference for quarterly, semiannual, or annual rebalancing. To spread out this tedious work, many firms rebalance only a portion of clients' portfolios at a time.

Due to the time involved with rebalancing, advisors should set up a regular schedule of reviewing portfolios. For example, rebalancing each client quarterly could be broken down into rebalancing one-third of the clients each month. For those advisors that prefer to rebalance - or at least review - more frequently, consider rebalancing one-quarter of the clients every two weeks.

Rebalancing Parameters:

Once a schedule is set up, rebalancing parameters should be determined. It is important to avoid rebalancing immaterial amounts while not allowing excessive deviations from the models. In most cases, a tolerance range of plus or minus twenty percent will maintain the integrity of investment strategy without requiring unnecessary trades.

For example, a twenty percent tolerance range is illustrated as follows:

Subclass:	Target:	Tolerance Range:
Cash	5%	4% to 6%
U.S. Large Cap	25%	20% to 30%
U.S. Small Cap	10%	8% to 12%
International Equity	15%	12% to 18%
Real Estate	5%	4% to 6%
U.S Fixed Income	30%	24% to 36%
International Fixed Income	10%	8% to 12%

In practice, having the same tolerance percentage for each piece of the portfolio might have undesirable results when target percentages vary significantly. For example, applying the above model to a $1 million portfolio will allow a variance range of $120,000 for U.S. Fixed Income ($240,000 to $360,000) while only allowing a variance range of $20,000 for Real Estate ($40,000 to $60,000). Thus, a Real Estate value of $39,000 (off target by $11,000) will trigger a rebalance transaction while a U.S. Fixed Income value of $241,000 (off target by $59,000) will not.

When target percentages vary significantly, it might be advisable to set different tolerance range percentages. Applying this strategy to the above model could result in the following:

Subclass:	Target:	Tolerance Range:
Cash	5%	1% to 9%
U.S. Large Cap	25%	20% to 30%
U.S. Small Cap	10%	6% to 14%
International Equity	15%	12% to 18%
Real Estate	5%	1% to 9%
U.S Fixed Income	30%	24% to 36%
International Fixed Income	10%	6% to 14%

Using the same $1 million portfolio with this new set of tolerance ranges, the variance range allowed for Real Estate is now $80,000 ($10,000 to $90,000) and the variance range for International Fixed Income is also $80,000 ($60,000 to $140,000).

Financial Planning Association,
Survey on Rebalancing,
conducted for FPA's 2005
Annual Conference, San Diego

Tax Saving Strategies:

Rebalancing at set intervals based on specified tolerance ranges comprises a basic procedural framework. To truly deliver high quality portfolio management, tax implications must also be considered. However, implementation of tax saving strategies can be very difficult without automation and will require simplified methods.

Tax efficient portfolio strategies can include:

1 Selling from high cost lots—Selecting high cost lots instead of FIFO or average cost will reduce currently recognized taxable gains.

2 Location Optimization—Holding fixed income in IRA s and retirement accounts provides tax deferral while holding appreciating investments, like equities, in taxable accounts creates an opportunity for lower capital gain rates.

3 Avoiding short-term gains—Short term gains are subject to ordinary tax rates, while long-term gains are taxes at lower capital gain rates.

4 Tax loss harvesting– Selling loss positions in a taxable accounts in order to recognize a tax loss, replacing the sold positions with similar securities (not substantially identical) to avoid being out of the market during the 30-day wash sale period.

Selling from High-Cost Lots -

With new cost basis rules, it will be necessary to specify tax lots or standardized cost methods to custodians. A manual system will make specific identification tricky; thus, specifying the "high-cost" method will provide a simple way to achieve maximum tax deferral for clients.

Location Optimization -

For management simplicity, many advisors will manage portfolios at the account level. Although simplicity and efficiency is essential to creating scale, the benefits of household level management – location optimization – should not be ignored. Implementing location optimization, when rebalancing manually, will need to be limited to significant transactions and particular investment types. Rather than attempting a perfectly optimized portfolio, the following main principles should be observed:

1. Place fixed income investments in IRAs and other tax-deferred accounts.
2. When required to own fixed income in taxable accounts, consider municipal bonds.
3. Place appreciating investments in taxable accounts.
4. Place investments with high volatility/high expected return in Roth IRAs.

According to research by Gobind Daryanani and Chris Cordaro, portfolio returns can be improved by an average of 30 basis points (bps) through optimal location vs. pro-rata distribution of asset classes.

Avoiding Short-Term Gains -

Avoiding short-term gains can also be difficult when determining trades manually. In fact, it might not be practical to avoid short-term gains with a manual system, since it would require looking at specific lots held in each client's accounts. To assist with this issue, advisors should check with their custodians for available options. For example, for securities other than mutual funds, Schwab now offers the Tax Lot Optimizer™. Under this option, lots will be selected in the following order:

Short-term losses—Lots that reflect a short-term loss are sold first, beginning with lots that generate the greatest short-term loss down to the least short-term loss.

Long-term losses—Lots that reflect a long-term loss are sold, beginning with lots that generate the greatest long-term loss down to the least long-term loss.

Short-term, no gains or losses—Short-term lots that reflect no gain of loss.

Long-term, no gains or losses—Long-term lots that reflect no gain or loss.

Long-term gains—Lots that reflect a long-term gain, beginning with lots that generate the least long-term gain up to the greatest long-term gain.

Short-term gains—Lots that reflect a short-term gain, beginning with lots that generate the least short-term gain up to the greatest short-term gain. In response to the new cost basis rules, custodians

2Daryanani, Gobind and Chris Cordaro. 2005. "Asset Allocation: A Generic Framework for Maximizing After-Tax Wealth." *Journal of Financial Planning 18, 1 (January): 44-54*

Tax Saving Strategies Continued:

Tax Loss Harvesting -

Tax loss harvesting should be pursued throughout the year, not just at year-end. Although this strategy merely postpones tax, clients will appreciate the immediate tax reduction. To accomplish tax loss harvesting without automation, the advisor should look for significant market downturns affecting particular security holdings.

For example, a large drop in emerging markets equity could result in loss opportunities for clients holding Emerging Markets Fund A. The advisor can sell Fund A for clients holding sizeable positions and replace those shares with a similar Fund B.

Because the market could turn around during the 30-day wash sale period, it is important to maintain the integrity of the investment strategy. Therefore, it is necessary to purchase a suitable replacement position when selling an investment solely to harvest a tax loss. Absent a suitable replacement – one that could willingly be held long-term – tax loss harvesting should not be pursued.

Additionally, due to short-term market fluctuations and transaction costs, losses should only be harvested when they will produce a material benefit. In general, losses should be harvested only when the loss is at least 10 percent of market value and only when significant enough to overcome transaction costs.

Finally, the tax savings should be significant compared to the costs of the transaction. A good rule-of-thumb (as utilized in DFA's tax-managed strategies) is that the savings must be at least eight times the cost.

Billing and Reporting

As with portfolio construction and management, the key to efficiency with billing and reporting is standardization. Limiting the number of fee schedules will simplify administration while achieving compliance-friendly uniformity among clients.

If the advisor has many different fee schedules in place and wishes to move to a more standardized approach, he or she should calculate a standardized schedule that will involve the least amount of change in total revenue.

For example, let's say an advisor has the following three fee schedules:

AUM Range:	Schedule 1:	Schedule 2:	Schedule 3:
0 - $500,000	1.25%	1.00%	0.90%
$500 - $1 Million	1.00%	1.00%	0.80%
$1 - $2 Million	0.75%	0.80%	0.75%
$2 - $3 Million	0.75%	0.70%	0.60%
$3 - $5 Million	0.60%	0.70%	0.60%
$5 - $10 Million	0.50%	0.60%	0.60%
Over $10 Million	0.50%	0.40%	0.40%

Assume that each fee schedule is applied to six clients each with portfolio values of $2 million, $4 million, $6 million, $8 million, $10 million and $12 million. Total annual revenue will be $854,000 as follows:

Client:	Schedule 1:	Schedule 2:	Schedule 3:	Total:
$2 Million	$18,750	$18,000	$16,000	
$4 Million	$32,250	$32,000	$28,000	
$6 Million	$43,250	$45,000	$40,000	
$8 Million	$53,250	$57,000	$52,000	
$10 Million	$63,250	$69,000	$64,000	
$12 Million	$73,250	$77,000	$72,000	
Total Fees	$284,000	$298,000	$272,000	$854,000

A suggested standardized schedule would be:

0 - $1 Million	1.00%
$1 - $2 Million	0.80%
$2 - $5 Million	0.70%
$5 - $10 Million	0.50%
Over $10 Million	0.40%

This would result in total revenue of $852,000 as follows:

Clients:	Fees:		
$2 Million	$18,000		
$4 Million	$32,000		
$6 Million	$44,000		
$8 Million	$54,000		
$10 Million	$64,000		
$12 Million	$72,000		
Total Fees	$284,000	x 3 =	$852,000

To implement this, the advisor can call or send a letter to clients explaining that, for compliance reasons, fee schedules are being standardized. In this example, most clients will pay the same or lower fees than before, while no client will pay more than an additional $1,000 per quarter. If a client objects, the advisor may propose a discount in the first quarter of implementation.

Although one standardized fee schedule is recommended, there might be justification for one alternative schedule that can be utilized for family, friends, charitable organizations, etc.

Quarterly reporting can also be standardized, eliminating delays or excessive employee hours. Accordingly, reports should be limited to those that can be produced automatically by the advisor's portfolio accounting system.

Automation and the Benefits of Achieving SCALE

To achieve maximum efficiency, scalability and consistency, automation is recommended. Rebalancing software, such as Total Rebalance Expert® can automate portfolio management, incorporating tax saving strategies. Likewise, software such as Trumpet, Inc.'s Assemblage™ can automate quarterly performance reporting, integrating document assembly with other key applications, including portfolio accounting, contact management and word processing.

The benefits of standardization, with or without automation, include:

Ability to grow – both in AUM and profitability

Scalability – with less reliance on the primary advisor(s)

Greater consistency – increased SEC compliance

Quality control – less errors

Peace-of-mind

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Summary

The following guidelines will help the advisor to achieve SCALE and increased profitability:

1. Establish standardized procedures and checklists for the client process.

2. Document investment engagements with risk tolerance questionnaires and Investment Policy Statements.

3. Limit the number of allocation models.

4. Limit the number of investment positions within allocation models.

5. Set up models consistently in the portfolio accounting system.

6. Classify positions consistently in the portfolio accounting system.

7. Utilize mutual funds.

8. Avoid exceptions.

9. Establish a regular rebalancing schedule.

10. Determine appropriate tolerance ranges.

11. Select the "high cost" method with custodian(s).

12. Consider other tax-efficient cost method options, as offered by custodian(s).

13. Place fixed income in IRAs and retirement accounts; place equities in taxable accounts; place high volatility/high expected return investments in Roth accounts.

14. Consider municipal bonds when fixed income must be held in taxable accounts.

15. Pursue significant tax loss harvesting opportunities throughout the year.

16. Limit the number of fee schedules.

17. Standardize quarterly reporting by utilizing reports produced from portfolio accounting system.

18. Implement automated rebalancing software.

19. Implement automated report assembly software.

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