ASTRO

WHITE PAPER

How RIAs Can Un-Commoditize Investing Through Portfolio Optimization

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Introduction

It's no secret that change is coming to financial services.

As the wealth management industry has evolved through the impact of technology innovation, new competitive offerings and changing consumer expectations, the role of the financial advisor is evolving. Now, more than ever, advisors need to redefine their value proposition to further differentiate the expertise and advice they provide.

New technology players, discount brokers, low-cost products such as ETFs, robo advisors and changes in distribution strategies from the mega-asset managers are rapidly commoditizing the core service offering that advisors have historically provided: Investment management.

As a result, these changes are impacting the fees that advisors charge, with many firms lowering fees in response to the new competitive environment. While not completely widespread, Fidelity's recent Benchmarking Study[1] shows that 60% of advisors are discounting their published fees, on average, by 20-30 basis points to maintain and win new clients.

On the other hand, the increase in technology innovation that is commoditizing traditional investment management is also creating new opportunities for advisors to provide more flexible solutions and advanced investment management services that were previously only available through high-cost, separately managed account (SMA) platforms.

This investment management innovation being driven by leading technology companies is providing advisors with access to low-cost, customizable and powerful portfolio management, trading and rebalancing systems. These purpose-built tools can replicate the same personalized portfolios that SMA platforms were used to manage high net worth investors' tax management, legacy positions and environmental, social, and governance (ESG) objectives.

The ability to provide these advanced services directly to investors is now becoming a promising area for independent advisors. So much so, that they can now optimally position themselves against expensive Wall St. overlay management SMAs as direct providers of these premium services.

By incorporating this approach, advisors are able to differentiate themselves from the low-cost robo advisors and discount brokers, while enjoying the ability to maintain premium pricing for investment management services.

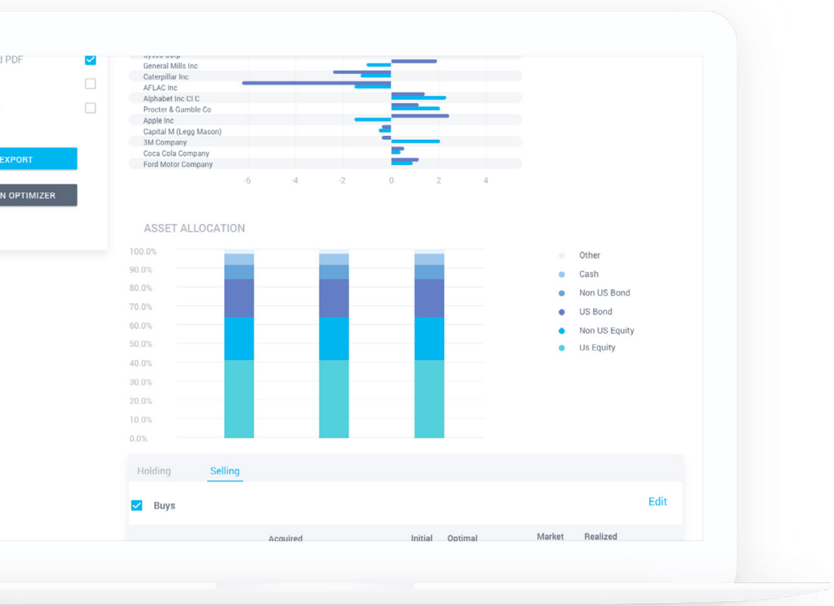
In order to provide context and an action plan for integrating this new optimization technology into advisors' businesses, this white paper will provide the industry analysis, background and best-practices approach for enhancing investment management service offerings so advisors can continue to demonstrate their value in an increasingly digital world.

Chapter 1

Industry Trends

Portfolio Optimization

One of the hallmarks of the wealth management industry is the constant drumbeat of technology change. In fact one area of wealth management that has seen a disproportion amount of technology change is in investment management.



From online trading, to new product structures such as ETFs, all the way to robo advisors, the investment process has been disrupted multiple times over the years, bringing costs down, and transparency up - all of which has led to further commoditization and declining revenues for the industry.

On the flipside, the proliferation of choice, access and flexibility in the investment process has led to tremendous benefits for end investors in terms of lower costs and for financial advisors to be able to provide enhanced services.

For example, the next revolution in investment management after ETFs may very well be the idea of "direct indexing" – a new, more flexible approach to mimicking a separate account structure to track an index or adhere to a model portfolio in order to accommodate for constraints in a portfolio, such as a tax management issue, a large concentrated position, or for ESG reasons.

Previously, SMAs and customized model portfolios in wrap-like accounts have been the go to product for high net worth investors and their advisors in order to accomplish these objectives. However, those SMA programs have high costs and complexity that prevent advisors from using them with all of their clients and as a result are stuck with either manual workarounds, or the ability to only offer this enhanced service level to their top few clients.

However, the new optimization technology behind direct indexing makes it possible to replicate the SMA process to be able to create model portfolios or manage to an index by using fractional shares of stocks, or the individual securities themselves that make up the index – rather than defaulting to a pooled investment vehicle like a mutual fund or ETF.

The benefits of this type of technology brings up the ability to better manage tax loss harvesting, accommodate a large legacy position or manage to an ESG objective without changing the risk profile of the portfolio.

Industry observer Michael Kitces sees this concept as the next big disruption in financial services:

> "...Many of those (TAMPs, SMAs) still commonly use ETFs (or even mutual funds) as their "building blocks", instead of individual securities like stocks and bonds. But it seems only a matter of time before ever-improving rebalancing and model management software makes it feasible to manage a wide slate of individual securities, and just eschew the ETF or mutual fund wrapper altogether."

The idea is that advanced portfolio management, trading and rebalancing technology can be "optimized" to be able to replicate the benefits of index funds, ETFs and other pooled vehicles, but at more flexible levels and lower costs to achieve tax, ESG and concentrated position management objectives.

1 http://www.wealthmanagement.com/etfs/build-your-own-index

2 https://www.kitces.com/blog/cross-subsidy-industry-disruption-financial-advisors-bps-custody-indexing-2-0/

For example, suppose an advisor wanted to better manage taxes in a portfolio indexed to the S&P 500. By mimicking the make up of the S&P 500 with a smaller set of individual stocks, the advisor can identify which positions the client holds that have losses and take action to capture that loss for tax savings, however, the advisor does not want to deviate from the model or index she is benchmarking to, or increase the risk profile of the portfolio.

Through powerful optimization technology, algorithms run to identify the best strategy and then deliver the recommended trade list to be executed given these constraints. All of this happens in real time through powerful automated workflows saving hours and hours of manual work.

Similarly for a large legacy concentrated position, by optimizing the portfolio around not selling that position (for client-stated reasons, low-cost basis tax issues, etc.) and replicating the index or model portfolio, the optimizer calculates the best strategy of individual securities or fractional shares to again maintain risk profile and minimize tracking errors.

A third objective commonly used in optimizing portfolios is for socially conscious investing such as ESG or Impact investing. Advisors can mimic an index through a smaller set of stocks and eliminate the sin stocks (gambling, tobacco, guns, alcohol) for example, through the optimizer.

Previously, the ability to manage around these ESG, tax loss, and legacy positions were only available through high cost and expensive “overlays” via a separate account structure, or advisors would have to spend hours using manual, error-prone spreadsheets to build and manage custom portfolios around those positions or objectives.

In order to provide a solution to the problems of choosing either a manual workaround or a high cost SMA option, what has been needed is a powerful, scalable portfolio optimizer that is available for independent advisors to use themselves directly.

By doing so, advisors can reposition themselves and demonstrate their value by becoming the central delivery role for clients in the investment process vs. having to outsource to expensive alternatives, or having to default to non-optimal pooled investments.

"The real innovation and horsepower of this type of optimization technology is that it provides substantial efficiencies with an area of investment management that requires manual efforts.

In order to streamline the process to become automatic, to do the heavy lifting on an individual account basis, advisors need a powerful engine that is typically only available in the institutional setting.

We see this technology, the ability to make 20 different decisions simultaneously, as leveling the playing field between advisors and the large asset managers."

~ Joe Smith, CFA, Senior Market Strategist for CLS Investments

"As trading costs continue to decline and ultimately go to zero, the value proposition for mutual funds and ETFs goes away. The entire value proposition for these products rest on delivering low-cost diversification, but with zero trading costs, you can easily and affordably replicate those benefits by holding the underlying securities directly.

It is always preferable to own the underlying securities for transparency, social impact and tax management purposes. You can also be more surgical in how you build and manage portfolios when you own the underlying securities. Subsequently, owning the underlying securities instead of a pre-packaged product, empowers RIAs to deliver real world alpha to clients.

What has been missing for advisors, however, is the trading and rebalancing technology needed to efficiently replace mutual funds and ETFs in the supply. With this type of new optimization technology, advisors and their clients will no longer have to pay a basis points fee to product manufacturers in the supply chain, only, a flat fee per account – something that will be extremely disruptive in the industry."

~ Don Calcagni, Chief Investment Officer for Mercer Advisors

"If you can effectively mimic an index with individual securities, then you reduce the need for an ETF or mutual fund structure and can immediately save your client those costs. Additionally, the ability to then tax loss harvest with those underlying securities in a taxable account can add up to substantial savings for clients in the hundreds of thousands of dollars range for million dollar plus portfolios. These savings are there for the taking.

We've been doing this process for years; however, we had to cobble it together with a third-party optimizer and our rebalancer. With this new technology, we will basically have our own institutional trading desk on our desktop – something we believe that contributes significantly towards our value as advisors."

~ Alex Murguia, Managing Principal for McLean Asset Management

Chapter 2

Orion ASTRO

Un-commoditize Investing

Orion Advisor Tech ("Orion") ASTRO quickly and easily optimizes portfolios around existing positions, tax loss opportunities or ESG goals

Two Levels of Interface

Express has been designed to be user-friendly, streamlined to the most common functionality to get up and running quickly

Reusable Templates

Establish pre-constructed templates for models, blended index's and more that are mimicked through a smaller set of individual securities such as 50 for the S&P 500

Customize Portfolios

"Constraints" feature quickly sets up the parameters to optimize the portfolio around number of securities to be used, settings for what percentages to hold and more

Tax Alpha

"Tax Aware" feature identifies and calculates tax savings, down to the individual lot level to inform buy and sell decisions within the model portfolio or index benchmark

Asset Allocation Sensitivity

“Sector Constraints” feature provides flexibility to set up parameters around asset allocation, sectors, growth vs. value, and more.

One Click Optimization

Generates buy list to be uploaded to trade order management or rebalancer such as Orion Eclipse.

Alerts

Automated alerts to actively monitor the portfolio and let advisors know of excess or new cash levels for investing, as well if the portfolio gets out of line with pre-set constraints.

Client Presentations

Rich, visual summary screens, charts, tables and graphics visually show to the client the impacts of their advisor’s recommendations, the level and amount of tax savings, as well as risk management, demonstrating the advisors’ value.

Prospecting Tool

Ability to load prospect positions and showcase advisor recommendations for optimizing portfolios and how it will benefit the prospect such as minimizing risk, maximizing returns, showing tax sensitivities and more.

Chapter 3

Practice Management Benefits

There are a number of practice management benefits that arise from incorporating investment management optimization technology:

Scalability

Through powerful computational capabilities, robust algorithms and an intuitive user interface, advisors can run optimized portfolios for all of their clients, increasing efficiency, capacity and accuracy - all if which lead to an enhanced client service experience and a more profitable advisory firm.

Advisor Centric

Advisors offering this level of customized portfolio and investment management services demonstrate their value of being actively involved in their clients' investments in order justify premium pricing beyond simple buy/hold investing or outsourcing to an expensive SMA platform.

Growth

The ability to showcase prospect portfolios and how they can be optimized goes a long way to closing new business, along with a powerful marketing message that showcases advisors' value above and beyond what the discounters and robos can offer.

Cost Savings

Directly optimizing portfolios is dramatically less expensive than high-cost SMAs, as well as more transparent and flexible for the client. These cost savings can be passed along to the client as well as potentially harvested by advisors to enhance profitability.

Manage Volatility

By owning true direct indexing, advisors are now able to do true portfolio risk management and correlation analysis, etc., at the individual security level which can be very important, especially in times of market stress when correlations are rising.[3]

3 http://www.wealthmanagement.com/etfs/build-your-own-index

Conclusion

As technology innovation continues to alter the investment management landscape, new opportunities are being developed to optimally position advisors as central to their client relationships. Despite the commoditization of investment management services being driven by low-cost, online competitors, discount brokers and the large asset managers, advisors can now harness the capabilities of portfolio optimization technology to continue to differentiate the value they provide.

What was once only available to institutional platforms, independent advisors can now access this powerful portfolio technology at disruptively low costs that will continue to validate the role they play in the investment management supply chain. Advisors owe it themselves, their clients and their businesses to adopt this powerful, differentiating technology today.

About Orion

Orion Advisor Services, LLC (Orion) is the premier portfolio accounting service provider for advisors. Our firm has unique insights into the advisory profession because it was founded for investment advisors by an investment advisor in 1999. Orion frees advisors from back-office tedium so they can enjoy their business again by devoting their time and energy to better serving clients. Orion provides the integrated and fully customizable technology solutions that advisors need to help grow their businesses over the long term. The firm's technology solutions empower more than 1,300 firms, have $600+ billion in AUA and over 2 million accounts.

Don't Work With Us Yet?
Let's change that.

Contact Us

Get more information about Orion by visiting orionadvisortech.com or contact us at 402-496-3513 or empower@orion.com.

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