Wealth Management Solutions

HOW OVERLAY MANAGEMENT CAN HELP BANK TRUST DEPARTMENTS

Deliver Better, More Profitable Wealth Management Services

Although it may be hard to remember life before ATM machines, 30 years ago getting cash for the weekend meant getting to the bank by three o'clock Friday afternoon. Today, technology has put cash at people's fingertips any hour of the day, and throughout the financial services industry, technology has been used to create better products and services. Nowhere is this truer than in the burgeoning field of wealth management.

Prudential

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Introduction

The wealth management landscape is rapidly evolving as innovation and technology provide increasingly more automated, integrated, and efficient ways for financial institutions to conduct business. Yet many trust departments remain stuck in the past, expecting clients to let them manage their money as they did back then, utilizing an inconsistent profiling and asset allocation approach, limited and mostly proprietary product, and multiple, nonintegrated systems. It is costly and time consuming for the bank and unsatisfactory for the clients.

Banks now have an alternative to this old-fashioned approach. With unified managed accounts and overlay technology, portfolio managers can build and oversee client portfolios more effectively and efficiently and trust departments can offer a consistent client experience, optimal blend of third-party and internal asset management, and state-of-the-art risk management. This white paper traces the development of wealth management investment platforms and examines how overlay technology can help banks deliver a competitive and compelling investment proposition.

A Force for Change

The arrival of open architecture in the 1990s revolutionized wealth management investment platforms. Institutions were no longer locked into a single format or feature but able to customize various elements of their platforms. This change in the wealth management landscape and emergence of innovative technology solutions resulted in a more sophisticated and efficient delivery of both proprietary and nonproprietary products and accounts. Over the years, these products have come to include individual stocks and bonds, mutual funds, exchange-traded funds (ETFs), proprietary and nonproprietary model portfolios, and separately managed accounts (SMAs).

One of the factors driving the open architecture movement was the growth in the independent investment advisor segment. These advisors positioned themselves as product neutral and able to select the "best of breed" in whatever product area met their clients' needs. Over time, this promise of objectivity has come to resonate with high net worth clients as soundly—some might say even more so—as the trust officer's fiduciary pledge to manage assets for the benefit of the client rather than for his or her own profit. Today, there is much debate over whether or not closed proprietary offerings enable the trust officer or advisor to be completely objective and fulfill his or her fiduciary obligations.

Among wealth management providers, bank trust departments were the most reluctant to embrace this change and offer nonproprietary products. While almost all now offer third-party mutual funds, most often through a wrap-fee program, their programs may not be on the trust department's main platform. Some banks only offer nonproprietary products to fill empty spaces in the bank's investment set, and sometimes the proprietary and nonproprietary products are not integrated so their offering is disjointed.

While platforms have been growing more sophisticated, so has investor knowledge. With advancements in the area of performance benchmarks, analysis, and reporting, clients are better able to understand their portfolios' composition and performance. Their use of the Internet makes it easier for them to compare their products and performance with that of the marketplace and easily learn about offerings at other financial services firms. The 2008 Mendelsohn Affluent Survey found that over half of the 13,522 heads of affluent households surveyed checked their financial accounts online.[1]

As investors have become better informed, it has become almost impossible for trust departments to compete with their closed, proprietary platforms.

The Cost of the Wrong Platform

One of the costs of using a platform that can only accommodate proprietary products is that it results in a limited offering based on the institution's capabilities, rather than clients' needs. While it might seem that a solely proprietary offering would produce the most profitable revenue scenario for a bank, a study by ECHELON Partners found that was not the case.

According to their report, "Platform Made Perfect: A Wealth Manager's Guide to Optimizing Product and Service Platforms for High-Net-Worth Clientele," the products and services on bank trust platforms are typically designed and priced to meet the needs of the mid-tier millionaire (those with \$5 to \$30 million in assets).[2] Although clients in the first tier (with \$1 to \$5 million in assets—approximately three-fourths of the client base at the average bank) are charged higher fees, the differential does not make up for the lower asset levels and high cost of service delivery. Consequently, these clients tend to be less profitable for the bank. In the top tier, where clients have \$30 million in assets and above, fees are typically reduced to reflect the volume; and the service needs of this group can be very high, again hurting profitability.

With an open platform, a bank can have a much broader offering and target products and services for each tier. As the report states, "Different levels of wealth necessitate different product and service requirements and the delivery of these offerings has a powerful impact on the resulting financial profile…Firms need to take advantage of platform structures that allow them to avoid overspending or undercharging for each level of products and services offered to each wealth tier."

While some financial institutions elect to build de novo open platforms, it is a very expensive and complex undertaking, particularly with the legacy systems at most institutions. Alternatively, financial institutions have turned to third-party platforms, which can support both the bank's proprietary product and nonproprietary product. These platforms enable the bank to serve multiple segments, from mass affluent to ultra high net worth, from a single system.

Beyond the opportunity to create a product offering with the optimum balance between products and services and the appropriate levels of fees and assets, third-party platforms can offer trust departments sizable savings. With a third-party platform, significant sales, marketing, investment management, and operational activities are outsourced. ECHELON Partners calculated the cost of servicing a \$5 million client on a proprietary platform versus a third-party platform and found the third-party platform has the potential to generate 30% to 50% more profitability, based on the following assumptions.

Costs of Proprietary Platform

Costs	Average Percentages
Sales and Marketing	29%
Research and Portfolio Management	27
Operations and Technology	15
Administration	9
Profit	20
Total	100%

Source: ECHELON Partners

Whether the exact numbers they estimated would play out for any individual bank, few would dispute the probability that with a third-party platform expense reductions would result from a wide range of savings:

- Reduced headcount and lower staff costs
- Reductions in overhead and non-compensation expenses
- Volume discounts for activities such as trading and investment management
- Time savings from automating time-consuming manual processes
- Increase in workflow, routine, and mass customization
- Additional division of labor and specialization of tasks
- Lower cost of sales and marketing and client interface

There are other benefits to banks from working with a third party rather than building a new platform on its own.

With a partner, the bank gains expertise that might not be available internally, including insights the partner has gained from working with other clients.

Generally, an experienced third party can move faster and help the bank achieve profitability sooner than the bank could on its own. Additionally, the bank is spared the need for significant capital spending up front and development costs that can quickly add up.

Costs of Third-Party Platform

Costs	Average Percentages
Sales and Marketing	7%
Manager Due Diligence	2
Investment Managers	21
Operations, Technology, and Service	12
Custody, Clearing, and Trading	10
Administration	18
Profit	30
Total	100%

Source: ECHELON Partners

Barriers to Change

Many trust departments have given lip service to the benefits of open architecture. According to a study by the Money Management Institute (MMI), "The State of SMA Distribution Through Bank Trust Divisions," 69% of the banks surveyed said they employed an "open architecture" strategy.[3] Yet when the researchers drilled down, they found only 30% had actually implemented an "open architecture" strategy and that the rest, in fact, had limited nonproprietary options, showed a reluctance to sell the nonproprietary options, or priced them at a disadvantage.

With so many reasons to change, and so little to recommend the status quo, what is holding banks back?

According to the MMI study, the biggest obstacle to implementation was infrastructure, followed by culture, lack of customer interest, and disintermediation.

While it is certainly reasonable for banks to be concerned about the money already spent on existing infrastructure or the additional cost of bringing in a third-party platform, the costs should be weighed against the opportunity they are missing.

Much has already been written about the loss of market share at bank trust departments while the number of millionaires in the U.S. was nearly doubling to approximately 9.3 million households in the last 10 years.[4]

While the bull market engendered what appeared to be a high level of client loyalty, the "panic" of 2008 has put money in motion. Banks have a brand new opportunity to reclaim their share of the market.

Some trust officers believe the adoption of a third-party platform conflicts with their trust department's value proposition, which is founded on their direct management of client assets. However, the stunning success of managed money programs among wirehouses and independent advisors clearly proves that most high net worth clients are indifferent to the source of their money management.

What clients do care about is the quality of the investment advice they receive. The Spectrem Group, which regularly surveys the profiles and attitudes of high net worth clients, found the most important feature these investors sought from their financial firm was investment advice (61%), followed by brokerage services (52%) and tax specialist (41%). Investment management was ranked fourth (40%).[5]

It is important, of course, that the platform meets the technology needs of the bank. In the MMI study, based on surveys and interviews with banks ranging in size from $2 to $100 billion in assets, five infrastructure requirements[6] were cited as necessary for any technology solution:

1. Ability to integrate current proprietary offerings
2. Capability of accommodating multiple investment options in the same relationship

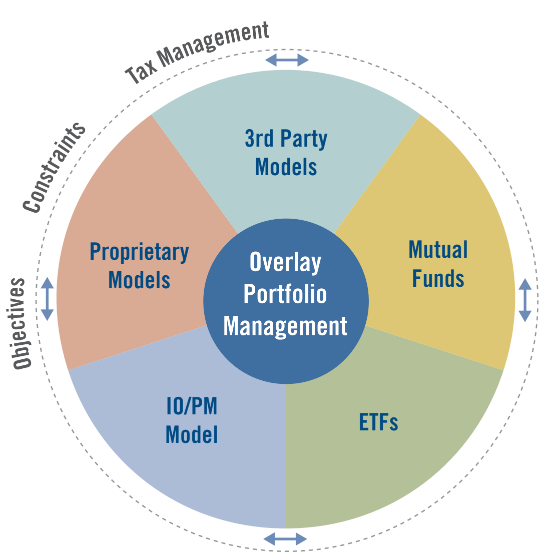
3. Bank discretion over manager selection
4. Leveraging of bank's existing operational infrastructure, particularly in trust accounting systems and custody
5. Adaptability to future needs such as the addition of alternative products

The Wealth Management Investment Platform of Today

Most current wealth management investment platforms support unified managed accounts (UMAs). Over the last five years, UMAs have grown in popularity and with good reason. They have allowed firms to combine client holdings into a single account, simplifying the account opening process and reporting. But it is overlay management that enables all the components to work together, taking wealth management services to a new level.

The new wealth management investment platform powerfully meets the growing needs of all participants: clients, institutions, trust officers, and senior management. Each benefits significantly from its adoption. Clients' unique investment needs are met through an account that offers a broad array of solutions in a single, tax-optimized portfolio. Banks, leveraging overlay technology, have an opportunity to integrate the best thinking of the industry and their own market views through a model-driven approach. Trust officers can assume the role of "trust advisors" and become architects of their clients' portfolios, determining which investment solutions best meet their goals given a client's risk tolerance and preferences and the bank's market views. Senior management can oversee the transformation of their trust departments into more efficient and competitive businesses and increase their assets under management without increasing overhead.

Portfolio Optimization



The platform can also deliver on each of the infrastructure requirements. Since it is product-neutral, it handles a wide range of investments including a bank's proprietary offerings as well as unaffiliated investment manager models, mutual funds, ETFs, and individual securities. Unlike software solutions, where the investments on the platform are driven by the functionality of the software, the bank has discretion over the inclusion of third-party offerings such as outside money managers, and all of the investment options are housed in a single account that can interface with the bank's trust and custody systems.

Overlay technology helps banks create a more consistent investment approach across their distribution channels—trust, private banking, and brokerage services—so that every client at a given investment range has access to the same models, menus, and oversight. The chief investment officer (CIO) can more easily set the broad investment strategy and then bring it down to fulfillment and implementation. It also allows the CIO to be more nimble in a moving market, to implement his or her thinking more efficiently, and to react to changes in the marketplace more quickly.

The Need for "Investment Efficiency"

As discussed earlier, managed money programs have been successfully capturing assets for many years. While clients have liked the concept of utilizing third-party institutional money managers, each manager operates independently. There is no coordination between the managers or any other investments in a client's portfolio so the opportunity for tax management is severely limited. The impact that tax planning, or the lack thereof, can have on a client's ultimate returns is well established.

Another serious limitation is the absence, in most cases, of pre-trade compliance. Pre-trade compliance is the imposition of client-specific restrictions on the portfolio. Although portfolio customization is widely promoted as one of the key product benefits of these programs, in reality there is very little customization. In fact, many managers strictly limit the number and kinds of restrictions they will accept on the portfolios they manage. This is for two very realistic reasons.

First, most managers do not have the kinds of systems in place that would enable them to automatically enforce client restrictions, nor do they have the manpower to undertake the task manually (which would raise a series of other concerns about compliance risk). Second, their business is dependent on their track record, which is based on their composite returns. The more variability in the individual portfolios, the more likely the manager's performance will deviate from the benchmark. Typically this deviation will be viewed as the manager's inability to maintain his strategy, since there is no practical way to take into account all the separate restrictions the manager may be attempting to accommodate.

Overlay management helps address these problems.

The overlay manager can be either an internal or external service that sits "on top" of the various investment vehicles with a comprehensive view of each investment.

From this vantage point, the overlay manager provides several key services including:

- A single view to increase the likelihood of attaining the portfolio's overall goals
- The ability to better manage client restrictions including social criteria, industry or sector limitations, style or capitalization preferences, or situations where there are concentrated stock positions
- Greater tax optimization when harvesting losses, selling tax lots, deferring short-term gains, monitoring potential wash sales, and conducting withdrawals
- The elimination of unnecessary trading, for instance a manager taking profits on a stock that another manager has deemed a buy
- Automated rebalancing functionality

The Tower Group in its study, "Managed Money: On the Road to Effective Wealth Management Delivery," calls overlay management the "linchpin that institutionalizes the execution of managed money programs."[7] Without it, clients can't achieve "investment efficiency" or benefit from "the power of managed money programs to produce desired results, such as a target return over inflation, more consistently and effectively."

Improving Profitability

Overlay management improves profitability in two important areas: operations and portfolio management. On the operations side, being able to open and manage one account, rather than several, can add up significantly. While all bank operations vary somewhat, this technology can potentially save a bank the cost of:

- Opening an account
- Housing it on the custodial system
- Generating multiple statements
- Creating a view of the client's whole investment picture
- Producing a unified statement for the client

In particular, by utilizing just the asset allocation and security recommendations from third-party managers and implementing it all in-house, there are considerable savings of time and cost. Not only does the client get the optimal execution, but there is no need for coordinating the operations between the manager and the bank—no need to check if there are prior restrictions, if cash is available, or the reporting is correct. Not only does the bank save the cost of this work, but the managers save this expense as well. This means the cost of providing third-party management can be greatly reduced, while the cost to the bank of implementing the trades is relatively small.

In the portfolio management area, the platform will eliminate, automate, or streamline many of the tasks that portfolio managers perform. Although their responsibilities may vary from one bank to the next, typically the portfolio manager job has included:

- Opening new accounts (including data gathering, risk analysis, setting investment objectives, creating investment policy statements, and recommending asset allocations)
- Implementing portfolio strategies
- Executing tactical adjustments and rebalancing
- Preparing quarterly reviews
- Researching and monitoring the market
- Managing clients
- Participating in business development

With so much to do, there was often little time left for the last two (client-facing) activities, but these are crucial if the institution wants to grow its asset base. It is while spending time with clients that portfolio managers usually learn about funds invested elsewhere and build the kind of relationship that will produce referrals. Their role in business development is equally important, since it is one of the advantages the bank has over wirehouse and independent advisors, who usually do not have access to portfolio managers for this activity.

> *By creating more time for portfolio managers, banks have the opportunity to be not only great service firms, but great business development firms as well.*

From an oversight perspective, the overlay allows the CIO to set the bank's recommended weightings for sector, style, and securities at multiple levels and then easily monitor drift from those targets. With this in place, some banks have achieved savings by reorganizing their portfolio management teams.

For example, banks have created smaller groups of portfolio managers who focus only on the tactical portfolio business. Each manager can handle more portfolios because

PM Perspective

What changes can a bank expect with a wealth management investment platform from Prudential? A portfolio manager at a money center bank who has been working with the platform since 2007 talked about its impact:

The biggest change for us has been going from sponsorship to ownership. In the past— when we had everything outsourced—we were only overseers making sure that each manager did what they said they would do. Through our partnership with Prudential, we were able to bring our complete program in-house so we have much more control over the program and the process.

We have a traditional third-party manager program where we utilize the best thinking of third-party managers in each asset class. Now, instead of outsourcing the program to the managers, we are using their best thinking and internally managing and monitoring the program so we're able to combine our bank's views with the expertise of the third-party managers.

We run the client's risk profile, propose an asset allocation, and suggest the fulfillment. Then we tactically manage the account based on the bank's point of view on asset allocation. We use our own models for asset allocation—we currently have seven.

Bringing it in-house has enabled us to be more tactical, more nimble and to offer our clients more customization. For instance, if a client doesn't want small- or mid-cap allocations, we can create and manage that portfolio for him and look at drift and rebalance as needed. In the past, we would get the client's quarterly statements and were as surprised as they were about the results. Now we monitor their accounts each day, trimming or adding as needed. Clients are saying, "Wow, I never had that from a manager before."

In some senses, what we are doing is more traditional than what we had before, because the best feature of traditional portfolio management was the dedicated portfolio manager working on a daily basis on the clients' behalf. Now we have that plus the best thinking of the third-party manager. The advantage is that the portfolio manager knows the clients personally, which the third-party manager cannot, so this is a much more client-centric approach.

This approach leverages the resources of the third-party manager without the added operating costs. In the past, every time you hired another manager you had to recreate the setup, handle the multitude of accounts, and work with their operations. Now you can just take their best part: their demonstrated expertise in stock picking.

The platform presents a huge opportunity for us. With it we can grow five times from where we are now without adding to staffing or resource. And we can have a conversation with a client, find out what their brokerage firm or advisor is doing for them, and tell them, "We can do that too, plus the lending, banking, and other services."

We have changed from passively to actively managing our clients' accounts. We now handle all the processes involved—we provide the solution, implement it, monitor and manage it. We're offering them a much more sophisticated product and doing much more for them. Bottom line, we're a hell of a lot busier, but in a more proactive and productive way!

of the new efficiencies and the need for fewer "judgment calls" at the implementation level. In some instances, there is a savings since more junior people can handle these tasks because they don't require the same support or expertise.

Other banks have aligned their resources against their client segments and some have used the platform to ensure greater consistency among their portfolio managers. Banks want their clients to have the same experience and results given the same risk, time horizon, and objective, or at least have any variation be due to the needs of the client not the delivery system. The platform is instrumental in delivering this.

Banks that embrace overlay management begin to realize efficiencies fairly quickly. They are able to utilize third-party management without extensive setup since there is no need for separate account management. The rebalancing process is immediately easier and oversight simpler. With overlay management in place, risk control is straightforward and banks can immediately take advantage of scalability.

To realize these savings requires a major change by the trust department in their business practices, and even positive change can be challenging. Typically, banks are late adopters, and do not embrace change. In this instance, the change will be profound, from the top of the organization to the bottom, and will require a high degree of commitment and a willingness to change.

Additionally, banks will need to recognize that this change is about not only cost and efficiency but how they articulate and deliver their investment proposition to the marketplace.

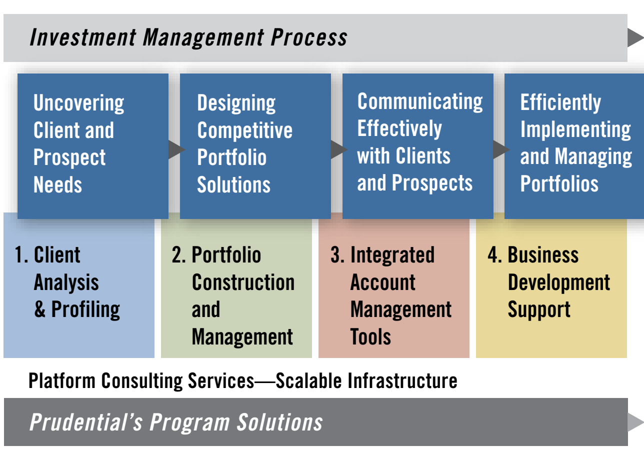
The Wealth Management Investment Platform from Prudential

Prudential Wealth Management Solutions offers one of the most advanced and flexible platforms available today. A leader in the industry, Prudential has been consistently enhancing the investment platform it offers financial institutions. It is one of the few firms that utilize an optimization engine within the overlay management function. This software enables the system to look across an account and into its various investments, and then determine what the best trade for an account is at any particular time.

The engine takes into account the client's asset allocation, style allocation, any security restrictions or percentages placed on securities, and, if it is a tax-managed account, the appropriate tax rates. A portfolio manager working from a spreadsheet might be able to approximate the trade, but could not consistently make the most advantageous trade for the client on a day-to-day basis.

Each investment that a client has is housed in an individual sleeve. In addition to the investment sleeves, each account has a funding and a holding sleeve. The funding sleeve is the main repository for money and securities coming into and out of the account and is used when an account is rebalanced. The holding sleeve is for those assets a client does not want touched, such as cash or concentrated positions. The holding sleeves are not involved in the rebalancing but are included in performance reporting.

Recently, Prudential improved its platform by enhancing its asset allocation model and rebalancing tools, automating the creation and management of model portfolios for overlay managers. With this improvement, the chief investment officer and investment policy committee can set up model portfolios online, enable selection of a model in the client profiling process, and manage updates, rebalancing, and trading across multiple accounts within the same profile.



Another new enhancement to the platform is the ability to evaluate investment results by sleeve within an overall portfolio, offering a robust view of how each investment contributes to the portfolio's overall returns. In today's market environment, high net worth clients demand an increased level of service and expect their advisors to address portfolio performance, including the factors contributing to it, as part of the performance review process.

Partnering with Prudential

"Prudential offers a highly customized solution that satisfies banks' desire to offer outside managers, while accommodating their need to retain control and to leverage any well-developed internal capabilities that can include proprietary investment management, manager selection, custody, or other areas per the bank's request. This offering, which is available to larger bank and trust groups, has received strong client feedback. Prudential is a good choice for large banks that have achieved the scale to merit a completely customized approach to designing their program." [8]

—Dover Financial Research

Given the potential costs, chances for missed opportunities, and that a trust department's survival may be at stake, selecting the right platform partner is crucial. Banks will want to consider not only a platform's components, but the size, reputation, and skill of the provider. Before reviewing providers, banks will want a thorough understanding of their own strengths and weaknesses in all areas—marketing, sales, investment management, operations, etc.—so that they can better evaluate the features and benefits of prospective partners.

Prudential offers banks a comprehensive package: a scalable platform that leaves the bank in control, tools that allow the bank to deliver a highly refined product offering, and a combination of scope and experience that no other provider can offer.

A global leader in financial services, Prudential knows and understands the challenges facing bank trust departments. They bring not only a robust technology environment but hands-on experience that comes from serving a variety of financial services sectors, wealth management organizations–their portfolio managers, wealth advisors, and client accounts. In selecting Prudential Wealth Management Solutions, banks can feel confident they have a partner that is a leader in the industry.

Moving to Overlay Management

Mortgages, online banking, debit cards—all these products and services have been enhanced and made more profitable for banks through technology. Overlay management holds the same promise for trust departments. With the right provider and platform, this new technology can help:

- Create a compliant, consistent customer experience, and ensure a trust department's investment philosophy is implemented across its accounts
- Deliver a compelling, competitive product for the rapidly growing wealth management sector
- Build and manage better portfolios for clients and re-envision the role of trust officers as trusted advisors and portfolio architects
- Improve productivity by streamlining operations, outsourcing those tasks where the bank can benefit from third-party expertise or volume, and increasing the effectiveness of sales and marketing
- Transform the trust department from a backwater to a crown jewel with steady, rising profits and the potential for much greater growth

Source Notes:

1. 2008 Mendelsohn Affluent Survey. Ipsos Mendelsohn, 2008.
2. *Platform Made Perfect: A Wealth Manager's Guide to Optimizing Product and Service Platforms for High Net Worth Clientele*. ECHELON Partners, 2005.
3. *The State of SMA Distribution Through Bank Trust Divisions*, Money Management Institute. Dover Financial Research, 2005.
4. *2007 Phoenix Wealth Survey Executive Summary.* The Phoenix Companies, 2007.
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6. *The State of SMA Distribution Through Bank Trust Divisions,* Money Management Institute. Dover Financial Research, 2005.
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