Compass Bank Uses Hybrid Platform Architecture

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Compass Bank recently finished converting its equity investment platform to Smartleaf's *Portfolio Manager* overlay software. The Birmingham, Ala.-based regional says the installation helps it sidestep traditional SMA providers in favor of an in-house approach to "second-generation" unified managed accounts (UMAs), characterized by lower administration costs, more control over investment processes, custody neutrality and enhanced customization for the end client.

"[Compass] came to us with the specific intention of putting an open-architecture separately managed account (SMA) platform in place," says Sam White, director of business development at Cambridge, Mass.-based Smartleaf. "But they quickly realized that our system could take them way beyond SMAs."

In common with many others in the investment arena, White uses the term "open architecture" to mean a combination of third-party investment products and proprietary offerings. Others, however, refer to that as "enhanced" or "hybrid" architecture, reserving the "open" designation for platforms with no proprietary offerings at all.

What it takes

Hybrid architecture is becoming the approach of choice for banks that "understand what it takes to compete in the [high-net-worth] space," says Dan Seivert, managing principal of 3C Financial Partners, a Los Angeles-based investment bank and consulting firm. "Hybrid platform architecture is not entirely reliant upon the products and services of a third party, and it has the ability to offer a greater breadth of products and services than a proprietary solution."

And that's essentially what Compass was after. "We had been organized as a traditional trust with a proprietary focus on a large-cap core product, fixed income and individually managed securities," says Todd Smurl, head of portfolio management in the bank's wealth-management department. But then about two years ago Compass decided to broaden its investment platform by putting outside managers on an SMA platform.

But in its search for an approach to SMAs in keeping with its wealth-management style, Compass says it found many of the industry's outsourced offerings to be decrepit, over-priced and substandard. Given Compass' experience in vetting some of the SMA industry's mainstay vendors, Smurl says it's little wonder the product accounts for less than 1% of the $4 trillion in high-net-worth assets that he says are overseen by chartered financial analysts.

For all that, Compass was determined to make hybrid architecture – though it too calls it "open" – the centerpiece of its wealth-management platform. And it isn't the only bank to have hit on SMAs as a way to compete for private-client assets. The Money Management Institute (MMI), a Washington-based industry association of SMA managers and sponsors, says that banks – including private banks and trust companies – added SMA assets more rapidly than any other financial-service category in 2004.

That sounds impressive, but it masks a stark fact: banks are hemorrhaging high-net-worth assets. Seivert reckons that North American private banks saw their share of high-net-worth investors' *professionally managed* assets decline from around 86% in 1995 to 38% percent at the end of 2004. By 2010, he adds, private banks could be managing just 29% of those assets in North America.

Such losses appear in sharp relief against a backdrop of rising high-net-worth assets. The total wealth of individuals and families around the world with at least $1 million invested went from $14 trillion in 1995 to about $31 trillion at the end of 2004, according to Seivert. By the end of the decade, he adds, high-net-worth assets could reach $44 trillion, with North America's wealthy accounting for a good third of that total.

Fighting back

The main beneficiaries of the bank channel's failure to keep high-net-worth assets have been the big brokerage houses and other competitors that have either made product and platform enhancements or offer more personalized service to help them compete for wallet share. SMA assets, including those in multiple-discipline accounts (MDAs) and UMAs, had grown to $576 billion by the end of 2004, up nearly 16% from year-end 2003, says the MMI. And though the industry group expects to see them hit the $1.3-trillion mark by 2009, with non-wirehouses gaining market share along the way, the bulk of those assets – now at around 80% – will likely remain with big-name brokers.

Proponents say SMAs work for well-to-do clients because they combine "investment planning, policy development, manager search and selection, portfolio management, performance measurement and trade execution" for a single fee, as the MMI puts it on its website. The industry group adds that SMAs can also be customized "to reach specific financial objectives" and to lessen the impact of taxes.

But with minimums that typically range from $100,000 to $1 million per account, it can be costly to achieve adequate diversification using traditional, single-sleeve SMAs.

That's where MDAs and UMAs come in. MDAs are managed accounts that hold different styles of a single security class, generally equity. UMAs can include equity styles as well as other asset classes and investment vehicles: fixed income, alternatives, mutual funds, exchange-traded funds – in short, just about anything that can be crammed into a single-registration account. And for the most part MDAs and UMAs have lower hurdles than the aggregate minimums for comparably diversified portfolios of stand-alone SMAs.

Like many other regional players keen to upgrade their investment offerings to compete with national wirehouses and local boutiques, Compass turned to outsourcers to help it get an SMA platform up and running. It found, however, that many of the third-party platform providers simply couldn't give it what it wanted .

"We were unimpressed by the third-party vendors out there," says Smurl. Specifically, Compass wasn't keen on "broker-oriented" programs and connectivity providers that Smurl says bundle services the bank didn't want or need.

For one thing, Smurl and his colleagues thought they could do some of those things better in house. In addition – and perhaps more pressingly – they had a mandate from their bosses to "maintain the profit margins of a trust" even as they brought in outside managers and introduced more sophisticated products. Profit margins in bank trust departments are generally fatter than those of wirehouses, according to Smurl.

Compass wanted access to outside managers and a trade-management system, but, along with keeping costs to a minimum, it was determined to control the entire investment process, keep custody of its clients' assets and be able to offer closer customization than anything an all-in-one third-party could provide.

Points of contention

"Partly because of their creation by wirehouse brokerage firms with a traditional mass-affluent clientele, and partly because of the antiquated technology that underlies the majority of the platforms that exist today, the cost to a wealth-management firm for [an] open architecture [program] is [between 85 and 100 basis points] for equity management," Smurl writes in an letter to *CFA Magazine* that he shared with *Family Wealth Report*. "For most firms looking to make a change from a purely proprietary approach, this is a non-starter."

Compass wanted control of the investment process in order to provide its clients customized asset allocations across investment managers and products – including, where appropriate, in-house styles – in addition to aligning trades, managing cash flow and enhancing the overall tax efficiency of their portfolios.

In other words, it didn't want an outside overlay manager in the mix. "First-generation UMAs, for all their benefits, are still cookie-cutter asset-allocation models that deny wealth-management firms the control they need to provide full value to their clients and usually outsource money-manager due diligence," Smurl writes in his letter to *CFA Magazine*.

Custody was another sore spot for Compass in its search for an outsourced SMA solution. Many wealth management outfits are custody-neutral, either out of preference or to suit their clients. But "most separate account programs, UMAs included, want to control the custody of assets and tend to charge a premium for custody, clearing and execution," he says. "This is consistent with the brokerage channel's desire to wrap the trading costs into a single fee to the client, [an imperative born of a time, prior to 1 May 1975, when brokerages charged standardized rather than negotiated commissions for trades that is no longer] relevant in the low-trading-commission environment of today."

But most critically, Compass felt that SMA platform providers don't give wealth managers enough leeway to provide adequate customization. "Clients rarely arrive at the front door with 100% cash, begging us to immediately invest them into the efficient frontier," says Smurl. Rather, they're apt to have multiple account registrations, pre-existing holdings – some with low tax bases – and personal preferences they want expressed in their portfolios.

Sorting through such complexities calls for a "local, hands-on investment professional" who works with the client to make "security-specific decisions," Smurl writes. Customization on that level calls for "minimizing net recognized gains, allowing short-term gains to mature to long-term status, swapping tax lots among managers, and actively harvesting losses throughout the year" – things that Smurl says "first-generation" UMAs simply can't handle to the degree required by Compass' clients.

In fact, says Smurl, inadequate customization is the main reason "that there is such a low adoption rate among wealth-management firms of non-proprietary investment programs."

Brave new world

Compass came across Smartleaf early in its hunt for a suitable approach to SMAs. Smurl says the software maker's portfolio-management was impressive enough, but the bank was reluctant at first to go whole-hog with a small and little-tested company. Smartleaf's White says his firm now has 15 clients, thanks in part to a year-old partnership with SunGard. But in 2004, when Compass was giving Smartleaf the once-over, it had only three.

Still, a few months after signing on with an SMA platform provider that Smurl prefers not to name, Compass decided to use Smartleaf's overlay-management software for its all-proprietary equity products.

White says Compass could do that because reconciling trades of assets managed in house doesn't require connectivity with outsiders. But then neither does reconciliation for multi-manager offerings in UMAs, since outside managers participate solely as providers of intellectual capital, not as account administrators.

Compass saw that too, says Smurl, and – impressed with Smartleaf's on-time delivery and "exceptional" training and support – decided to use Smartleaf's software to manage its entire equity platform. That, combined with Denver-based Prima Capital's manager research and due diligence, has given Compass the advisor-driven overlay management it wanted at heart of its UMA program. "Doing the overlay in house is part of our value proposition to the client," says Smurl.

Smartleaf's software subjects portfolios to a daily round of rules-based and mathematically optimized tests. The result is a set of security-specific recommendations that goes into a web-based report, giving the advisor a steady flow of up-to-date account data for checking model drift, reconciling redundant holdings, or improving the overall tax efficiency of the portfolio.

"Smartleaf improves our operating efficiency," says Smurl. "It's really a workflow tool." Smurl also likens it to MapQuest, an online location-search provider. "You already know where you want to go; Smartleaf tells you how to get there."

For all of that, Smartleaf has a reputation for complexity – for which White makes no apologies. "It *is* sophisticated," he says. "It's for portfolio managers, not brokers."

Meanwhile, investors are responding positively to Compass' "SmartPath Portfolio" platform, according to the bank. "Everybody loves it," says Smurl.

Compass' "a la carte" approach to building an SMA platform makes sense for banks with "in-house investment expertise," says Scott MacKillop, head of investment services at U.S. Fiduciary, a Sugar Land, Texas-based wealth management firm and third-party investment provider. "They don't necessarily need the client profiling and performance reporting offered by some of the [third-party providers]."

But Smurl says Compass' approach to SMAs isn't just a matter of a bank using a little ingenuity to get what it wants from the marketplace. In his view it's "a paradigm shift" that could usher in broader adoption of hybrid architecture by wealth managers. "Cost, control, custody and customization are no longer [obstacles] for wealth-management firms looking to implement separate-account platforms for their clients" – and that, he says in his letter, opens up "new frontiers in investment management."

Compass has more than 380 branches in Alabama, Arizona, Colorado, Florida, New Mexico and Texas. Its Houston-based wealth unit manages assets of about $4 billion. –FWR

Daniel Seivert

Managing Director

dseivert@echelon-group.com