Individual Allocation Mix

Steve Young, CIO at Curian Capital, believes that separately managed accounts provide a real alternative to mutual fund investing. In addition to the tax benefits and flexibility, common for all SMAs, Curian tries to make the product suitable for most investors, not just for the largest ones. Using four managers and 320 models, the company focuses on selecting the right allocation mix and the right managers for each client.

Q: What's your philosophy for managing the individual investors accounts?

A: I believe that separately managed accounts are becoming a real alternative to mutual funds, as they provide a number of benefits. Clearly, the flexibility to customize the portfolio is such a benefit. Investors can exclude certain individual companies or industries if they have concerns about social responsibility, or if they work with a high-tech company, for example, and already have adequate exposure to that industry through their stock purchasing plan.

The other benefits of SMAs, at least with Curian, include the transparency and the ability to go online and look at all the individual holdings, and their price on intra-day basis, if you have that level of interest. It is your portfolio and you're not co-mingled with other investors' assets, so you're not influenced by inflows and outflows within the mutual fund.

That can make a big difference particularly for taxable investors. When you open a SMA account, you establish your cost basis as you open the account, so you don't have the embedded tax consequences of mutual funds. When buying a mutual fund, you're essentially buying the history of that fund. If there are embedded gains, they become a tax liability even though you didn't benefit from these gains in previous years. So from a tax situation, there are significant advantages to a SMA.

Compared to other separately managed accounts, Curian offers the ability for the common investor to benefit from the investment style previously reserved for the ultra high net worth investors. The investment minimum used to be approximately $250,000 per manager, but through technology, Curian has been able to offer up to four managers in a diversified portfolio with an investment minimum of $25,000.

So we're opening the door for more investors to take advantage of a separately managed portfolio. Another differentiating factor is that we have the same SMAs for the very large clients and for the smaller clients. In other words, we manage the accounts in a more uniform fashion as opposed to choosing from different SMAs depending on the size of the client.

Q: What's your approach when you create these customized accounts? Do you have several pre-defined varieties or you take one client at a time?

A: We certainly address one client at a time. It's a matter of focusing on asset allocation, on the right asset classes and the right mix to address the investor's long-term objectives. Then it's a matter of selecting the right managers that fill that asset allocation pie and that's where we apply most of our effort. We aim to find those institutional managers that fit well together as a group and achieve competitive returns.

We mix those managers as opposed to asking the advisor to take the responsibility of choosing among an array of managers. That challenge is the same as picking and choosing among thousands of mutual funds, and often the advisors don't have the resources to do that effectively. If they're the ones responsible for finding the best manager or the best mutual fund, that takes time and effort away from growing their business and attracting new assets. So what Curian does is select quality institutional money managers to fit their client's objectives.

Q: What type of customizations do you find most popular in your segment? Also, what are issues that come up in terms of reporting, transparency, and monitoring?

A: There's a significant number of investors that are taking advantage of the ability to exclude securities from their portfolios. Probably more than 20% of our clients take advantage of these restrictions because they have socially responsible motivation in their investment strategies.

What we do in terms of reporting, we take advantage of technology and web access. Advisors and clients have access to their portfolios on a 24/7 basis. They can review not only the individual holdings, but also their current and past statements, as well as the investment policy statement that they establish when they open the account. All their preferences included in the investment policy statement are at their fingertips whenever they have access to the Internet. So from an information and client service standpoint, we've leveraged the technology to provide complete access to the account. We've gone to the extent that we can go paperless, but we also offer paper statements for clients that are more comfortable with such type of reporting.

Q: Could explain your research process in more detail, including the research on managers?

A: That's a great question because that's where we put most of our effort and resources. We partner with an institutional consulting firm, CRA Rogers Casey, which is one of the industry's largest institutional consulting firms. They're working with large pools of money, including Fortune 500 companies, large endowments, or foundations related to universities or hospitals.

They're actually out there selecting, evaluating, and doing due diligence on hundreds of money managers and they've built a database of about 1,400 different managers that they're very familiar with. They have every statistic you can imagine on those managers, but they also focus on some qualitative aspects, including the personnel that created the track record, the structure of the organization to keep them motivated, the rules allowing key investment personnel to focus on managing money, not on administrative or client service responsibilities, etc.

We have full access to their database and their consultant expertise of what makes a manager successful. Then we look for the managers that fit well together and create a portfolio that we think works well for our client.

Q: Do you search within this database for every new client or you've narrowed down the universe to 20 or 30 managers you usually work?

A: It's primarily looking at what we already have on the platform and if there is something we can do to improve the risk/return characteristics of the entire portfolio, and what type of manager would do that. So we'll go to CRA Rogers Casey and suggest that we want to find this type of manager and we'd like to focus on these characteristics that fit with the rest of the managers on the platform.

We differ from other SMA providers in that respect because we don't just bring a stable of managers for the advisors to pick from, but we assemble the managers in a portfolio that's delivered to the client. So we're the ones that make sure that these managers fit well together.

We have one model portfolio of managers, and then the allocations amongst asset classes are customized for the clients in 320 different models. But our clients essentially get access to the same four managers in our platform, while the allocation to those managers are customized relative to their objective.

Q: Could you give us more details about these managers and the models?

A: They're actually four institutional money managers. And the models are defined by the allocation amongst asset classes, or by how much you might have in bonds versus international stocks versus domestic. That's what defines the model. But within the equity allocation, those four institutional money managers are responsible for the returns on the domestic equity.

Q: So you and your staff would add, replace, or broaden the mandate depending on your investment view at the macro level?

A: Yes, both on the macro level and on the level of the managers that we've selected. We monitor them formally on a quarterly basis through our investment policy committee, and CRA Rogers Casey is a key part of that formal evaluation. We want to make sure that the managers are managing money consistent with their historical process, and that their performance is in line with our expectations based on what we've observed historically.

Then we look at the allocations and think about adjustments based upon what the market's doing. So, the other level would be modest adjustments to allocations to small-cap, or to emerging markets, for example. On the bond side, we have the flexibility to modestly adjust maturities or duration based on where interest rates are headed. So on two key levels, we're monitoring the managers and the portfolio allocations.

Q: How did you arrive at such a large number of models?

A: We wanted to meet a very broad spectrum of investor objectives and risk tolerances. There are certainly many models that you could come up with, because of the broad array of investors out there. But with the 300+ models that we have, we cover quite a broad spectrum of individual objectives almost on a customized basis. If one of those models doesn't precisely meet the investor's objective, we can fine-tune the allocation based on that objective. More often than not, we find that the 300+ models are adequate in meeting most investors objectives out there.

Q: How often do you review that list and change it?

A: The strategic allocation of the 300+ models doesn't change very often. The mix between stocks and bonds won't change very often because they were constructed based on long-term assumptions. Again, we did that in conjunction with CRA Rogers Casey using mean-variance optimization and some fairly sophisticated modeling techniques to come up with these allocations. These models would only change when long-term expectations for the capital markets change significantly. We review that formally on an annual basis and it's not unusual to go several years without changing those assumptions.

Q: Could you give us a couple of examples of model portfolios that are broadly used across your client base?

A: It is a matter of diversification over a number of assets classes. For a typical investor, if there is such an investor, but if he is looking for total return, we'd provide exposure to domestic equity markets, international developed markets, international emerging markets, real estate, and fixed income. So it's a well-diversified portfolio with sub-asset classes like exposure to large, mid, and small-cap stocks, both growth and value, while the fixed income side would traditionally include investment grade bonds plus investment in TIPs. So that would be a very well-diversified portfolio.

Q: Generally, what kind of risks do you perceive in SMA accounts? How do you monitor and mitigate them?

A: It's similar to monitoring the risk of any portfolio. We use a range of asset classes whose performance tendencies complement each other, so correlations are low. For example, asset classes like investment grade bonds tend to do well when the economy struggles, so using a range of asset classes is a way to control the risk. Monitoring the managers every quarter, looking at their performance within the context of the previous quarter and longer-term performance, the focus on the personnel, the process, and the consistency, really helps to avoid surprises. So the due diligence that we do on a regular basis helps to control risk over time.

Q: The tax-efficiency issue seems to be widely perceived as the one of the most prominent features of SMAs. Do you find this issue to be important for your client base?

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STEVE YOUNG is responsible for strategic asset allocation and capital market analysis for Curian Capital and chairs the Investment Policy Committee. Additionally, he has primary oversight of the asset manager selection and monitoring process.

Before joining Curian, Mr. Young served as Chief Investment Strategist, Head of Asset Allocation and Chairman of the Investment Strategy Committee for Bank of America's Wealth and Investment Management Group. He also managed the billion-dollar series of Nations LifeGoal Portfolio mutual funds. Prior to that, Mr. Young was a Principal with the institutional investment consulting firm, DeMarche Associates.

He holds the professional designation of Chartered Financial Analyst and received his undergraduate degree from Kansas State University.

A: Absolutely. Certainly, relative to mutual fund investing, you've got considerably more flexibility in managing taxes because you have control. With Curian, you can have control on two levels. The first one is selecting the so-called "tax lot preference strategy" so that if a holding has multiple tax lots and you sell a portion of that holding, you can prioritize which tax lot is sold first. If you're trying to minimize taxes, obviously, you'd want the tax lot that minimizes your taxes to be sold first.

Probably the more influential level of controlling the taxes is the ability to harvest your gains and/or losses at year-end. You have the ability to sell individual securities that have a loss if you want to minimize taxes, stay out of that security for at least 30 days, and then get back into that security. That may offset the gains that have occurred through the year, even if those gains are outside the Curian portfolio. That flexibility is certainly not available through mutual fund investing.

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