

# Creating Value in a Customized Way



**A** relatively new company, Gallatin Asset Management is built on A.G. Edwards' experience in separate account management. Although known as a value manager, the company offers a wide range of options in equities, fixed income, and ETFs. Mark Keller, CIO of the company, firmly believes that high net worth investors should take advantage of the lower fees, tax flexibility, and restriction capabilities of separate accounts.

**Q:** Who should consider investing in separately managed accounts? What are the benefits of this type of investing?

**A:** Separate accounts are particularly attractive to high net-worth individuals who want a higher level of control over their portfolios, but still want to have professional money management. I believe that separate accounts have several advantages over a mutual fund, which is the other primary managed vehicle for an individual.

The first advantage is quite direct - the larger the account, the lower the fees. As a percentage of assets under management, the fees get lower as the size of the account grows. With a mutual fund you pay the same percentage across the entire account. That's great for small investors who get the same fee as large investors, but large investors can obtain better fees.

Second, there are significant tax advantages. With separate accounts the cost basis is established at the time the money manager begins to buy stocks or bonds for the investor. With mutual funds, there can be capital gains embedded when you buy a share of the fund, so you are incurring the liability for these gains immediately. A lot of investors overlook the fact that if it's a good fund, it should have capital gains already accumulated. For a small or non-taxable investor that may be insignificant, but for a large investor, it's a meaningful drag on returns.

Also, most separate account managers would consider taking losses for their cli-

ents at year-end if such are needed for a tax loss. We receive requests in November and December to see if we can produce losses. Sometimes we're not able to do it, either because there aren't any losses, or because it's not advisable in a certain stock, but this is common practice. You certainly can't have that type of input as a mutual fund investor.

Finally, a number of investors take advantage of their ability to restrict the separate account manager from buying certain stocks. This can be a matter of conscience as in the case with tobacco or alcohol producing companies, but there are also practical business restrictions. For instance, if an individual is the manager of a pharmaceutical company, he may already have the lion's share of his net worth tied up in pharmaceuticals, so he may not want any further exposure to that industry.

Overall, a separate account manager can customize the portfolio in a way that cannot happen in a pooled account. Mutual funds are wonderful, but they're ideally suited for the small investor. The larger one's assets become, the less attractive the mutual fund format becomes.

**Q:** Could you give an overview of what Gallatin Asset Management does?

**A:** Gallatin Asset Management was set up last year as a subsidiary of A.G. Edwards, Inc., but even though it's a new company, its business is not new. Overall, we either manage directly or advise the broker/dealer

on assets of about \$20 billion. There are two primary sides of Gallatin - the separate account management business and the manager evaluation business.

The separate account management is a successor of A.G. Edwards Asset Management. We manage equities, fixed income, and ETFs, or exchange traded fund portfolios. The traditional stock and bond separate account business manages over \$2.4 billion of assets, while the ETFs have about \$4 billion under management.

The manager evaluation business is analyzing both separate account and mutual fund managers. That's the successor of two research groups within A.G. Edwards, which we put together into one unit. They advise Gallatin's money management business and A.G. Edwards & Sons brokerage business regarding the managers that the clients would want to consider. We advise the broker-dealer on about \$5 billion worth of mutual fund portfolios and \$8 billion worth of separately managed account portfolios.

**Q:** What are the investment minimums at your company?

**A:** We have relatively low minimums for in-house money management programs to give the financial consultant as many options as we can. The equity program starts at \$50,000 and the fixed income program starts at \$100,000. For programs that utilize outside managers, the minimums vary depending on the manager. Some of them

start as low as \$50,000, but some of them run much higher, all the way up \$500,000.

**Q:** *What's your approach to building the separate accounts? Do you rely on a collection of strategies to meet the client's requirements?*

**A:** We usually leave the primary issues of strategies selection to A.G. Edwards financial consultant because he's closer to the client and knows the specific needs better. But we offer a number of different strategies and we can do an individual search for clients. We employ staff that looks at client's needs, and particularly, if they need a certain type of manager. In such cases we'll search for that manager and respond back with a narrowed list of three managers that we believe fit the bill.

If the clients need a diversified portfolio, or if they don't have any idea what they need, we have two programs they can go with. In the Select Advisor program we come back with recommendations for a portfolio of managers. But again, the size of the account, the needs of the client, his investment objectives and risk tolerance, are very important in providing cost-effective diversification. In another program, clients can select some pre-assembled diversified models of money managers. We have over 40 managers on our reference list, which grows all the time, and the client can choose the model according to his objectives and risk tolerance.

All the models are derived from our investment strategy committee's recommendations on asset allocations for our clients. The committee consists of 11 strategists and analysts drawn from all disciplines and ranging from individual market and asset class strategists to money managers. We develop asset-allocation models that are based upon time horizons, investment objectives, income needs, and risk tolerance.

We have a total of 10 models divided in two sets. Five of the models have long-term goals and 10-year time horizons, while the other five are intermediate-term models with three-year time horizons.

**Q:** *Do these models change over time? Is there any specific strategy behind them?*

**A:** The pre-selected account management program uses strategic models that don't change often because they're based

on very long term time horizons. We believe that investors who truly have long-term horizons, should not be making short-term adjustments to the portfolio, except for the periodic balancing which usually takes place on an annual basis. We don't think there is a need to do much more than that, but the asset classes used in those models depend upon the individual investment objectives of the client.

**Q:** *Do you have programs for international equity or high-yield bond exposure, for example?*

**A:** On the separate account side, we offer a number of options for international investments. We have some global managers, including one in-house portfolio that can invest overseas to whatever extent they feel is appropriate. Of course, one could also hire separate account managers who specialize in international stocks, and there are a number of outside managers on our reference list that fit that qualification. But we don't have an international only program internally, even though our global portfolio has a healthy percentage of global stocks.

Regarding bonds, we have a little less offerings. The large account size is very important for liquidity in the fixed income business, so when you get into unusual asset classes, such as high yield, you need large account sizes to manage those portfolios effectively. That reduces the attraction of separate account management if the size isn't into the millions of dollars, so we don't offer anything in the high-yield category right now.

We offer investment-grade fixed income products, including Treasuries, corporates and mortgage-backed securities, as well as muni-bond programs, which have been Gallatin's fastest growing fixed income separate account type. Here we're able to do all the customization that really makes separate accounts attractive. In particular, we're able to offer state-specific muni-bond portfolios for investors who have residence in states offering state tax exemption and federal tax exemption. This is something that's much harder to do in a pooled account world.

For example, if you own a Missouri bond, you not only get the federal tax exemption, but also a state tax exemption, or income tax exemption on bonds issued by

Missouri municipalities. That's the case in many states, so a lot of muni-bond investors are looking only for bonds issued within their state. In some very large states, like New York or California, that may be less attractive as there are mutual funds available. But in many smaller states there are no mutual fund options, so a separate account is an ideal structure to meet that need.

**Q:** *Since Gallatin works with diverse internal and external managers, how would you describe your core offerings?*

**A:** Our equity business has been a value management business from the very beginning. We offer a large-cap value portfolio, a small-cap value portfolio, and an equity income portfolio, which is an all-cap portfolio with an emphasis on dividend income. Those are the three primary equity offerings of the internal Gallatin Asset Management.

We also offer the Value Opportunity portfolio, which is a concentrated all-cap portfolio, and All-Cap Global, which is our newest portfolio that can allocate a significant portion of the assets internationally. On the fixed income side, we're mainly an investment grade manager, which invests in munis. We also offer investment grade corporate and US Treasury portfolios.

**Q:** *Could you describe the manager evaluation division? How do you identify managers and what kind of research do you perform?*

**A:** We merged the two groups that focused on mutual funds and on separate account managers and reorganized them according to investment style and asset class. For example, our fixed income analysts evaluate fixed income managers regardless whether they're separate account or mutual fund managers. The same refers to our value, growth, small and large-cap managers.

The analysis is not just a quantitative comparison. The analysts travel to visit these managers and evaluate not just the money or portfolio management skills, but also the structure of the organization, the stability, the experience, the ownership structure. It's a very complete program that involves a thorough understanding of the operations.

A separate account manager must have certain qualifications to get on the reference list, such as minimum years of experience in the business, minimum staff requirements, etc. We're not too interested in small one- or two-man shops, but we're looking for some redundancy in the organization and a minimum of assets under management.

**Q:** *How many portfolio managers and analysts do you have in the firm, both in the internal and external programs?*

**A:** I have 8 equity and 3 fixed income portfolio managers and analysts and that doesn't include our trading and back office staff.

**Q:** *What is your view on risk control? Do you employ controls similar to those of mutual funds or you customize that as well?*

**A:** We believe that our primary investment risk is addressed through our valuation analysis and that's quite typical for value managers. We believe that we mitigate risk by not overpaying for stocks, so we need a very good idea of what a company is worth in a given industry. We do company analysis as opposed to just stock analysis, and we view ourselves as if we're buying the entire company.

We also believe that the types of companies we buy is important. We only buy companies that have substantial competitive advantages within their industries, and we avoid the ones with no pricing power, such as commodity businesses, for instance, or companies that are fourth or fifth in their industry.

Finally, we look for companies that are cash flow positive. We just don't have any interest in cash flow negative companies even if they're growing fast, and that's important in terms of risk control. So stock selection and evaluation is the primary risk control. Second is the proper diversification of our portfolios. We believe that if we do that right, our investment risk is under control.

For separate accounts it's also very important to make sure that an investor's account isn't off the beaten path. I believe that this should be a consideration for separate account clients because most managers have thousands of individual accounts. It's important to know that

your manager hasn't lost track of your account, so we have first-rate systems

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**about**

**Mark Keller**

**Mark A. Keller** is senior vice president of A.G. Edwards & Sons, Inc., the brokerage subsidiary of St. Louis-based financial services firm A.G. Edwards, Inc., and chief investment officer of A.G. Edwards Asset Management.

Having joined A.G. Edwards in 1978, Keller has more than 25 years of experience in investment analysis and portfolio management and is well versed in the value approach to equity investing. As chief investment officer of A.G. Edwards Asset Management, he oversees more than \$2 billion in client assets.

Keller has been a member of the brokerage firm's Investment Strategy Committee since 1985, and has served as Chairman of committee since 1999. A holder of the Chartered Financial Analyst designation, Keller is a member of the CFA Institute and the Investment Analysts' Society of Chicago. Keller received a bachelor's degree in 1977 from Wheaton College (Illinois).

that allow us to keep track of all the accounts minute-by-minute. We make sure that all the portfolios are following the model and that no one suffers from something that doesn't happen to the overall portfolio. That's a very important part of what we do. ■

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