Flaws of managed-asset products

High fees, poor portfolio structure help explain the uninspiring returns

By Dan Hallett

Financial advisory firms are very pleased when advisors use turnkey solutions for giving clients investment advice. Advisors and dealers look to managed-asset products for a consistent process to follow with clients, as well as a consistent set of investment recommendations.

On the surface, many of these products appear to deliver a level of discipline and rigour that is lacking in most financial advisory practices. Not surprising, many dealers are on a mission to find the ideal solution to suit their end-clients and corporate cultures. But this is a road riddled with potholes.

Managed-asset products have improved over the years, but most have long suffered from disappointing performance. After more than a decade of following and analyzing various managed-asset products, I've found that most are hindered by at least two of the four "fatal flaws" that I have identified. High fees, poor portfolio structure, investment constraints and misguided portfolio manager hiring/firing processes can explain the uninspiring returns posted by such products.

Ironically, any advisor wanting to offer an unbundled version of a managed-asset product directly is likely to get push back from the dealer.

Picture an advisor pitching his or her compliance officer on a process the advisor will run to gather information from clients, write proposals, construct portfolios, prepare enhanced statements and perform ongoing monitoring. The advisor would have to hire staff to support it (and probably charge more to clients) and the advisor's role would probably shift more to one of fostering and managing relationships and, perhaps, doing more financial planning.

I expect this hypothetical compliance officer would balk because of the expected higher client costs and potentially lower returns to clients, which has been the experience of most managed-asset products. Yet a prospectus-sold, managed-asset product is almost guaranteed to pass muster with the compliance department because the negatives are harder to see through big-name companies and slick marketing material.

But a problem bigger than the four "fatal flaws" becomes apparent, whether looking at a managed-asset products or investor-profiling software. The very foundation of such solutions — the investor profiling questionnaires — is seriously lacking, in most cases.

A turnkey solution, by definition, is simple and easy to implement. This is one of the reasons why so many fund-of-funds products have gathered billions in client money. The data-gathering effort is often compromised for the sake of simplicity. For example, few questionnaires ask explicitly for a client's minimum target return requirement. This is a fundamental piece of information that speaks directly to a client's expectations.

But with advisors increasingly dealing with clients having portfolio cash-flow needs, establishing a minimum return requirement is as important as ever. Failing to determine this requirement and then designing a portfolio around it from the get-go risks setting up the client for disappointment. Typical questionnaires rightly devote more questions to fleshing out a client's risk tolerance. But many risk assessments miss the mark by averaging a client's need and willingness to assume risk instead of dealing with these issues separately.

The ideal solution is an open-architecture platform that is guided by a true goals-based profiling process. This platform would address some of the portfolio construction challenges that so many products face. And a more robust profiling methodology, driven by goals and future cash-flow needs, can ensure more suitable portfolios.

Such a solution has all of the positives of today's most popular managed-asset products, but without virtually all of the performance hindrances that drag down so many. In other words, everybody wins. **IE**

Dan Hallett, CFA, CFP, is president of Dan Hallett & Associates Inc. in Windsor, Ont., which provides a mutual funds recommended list and investment research to financial advisors across Canada.