UNWRAPPING WRAP ACCOUNTS

By Dan Hallett

Embraced by many advisors, wrap products still have serious flaws—and yet, great potential.

As advisors become more conservative and watch previously enviable money managers plunge beneath the surface along with their fund's performance, some advisors are favouring wrap programs as the fund industry's saviours. According to IFIC, wrap programs have had better luck attracting new money than conventional mutual fund assets (excluding wrap assets), which shrunk by 7% during from June 2002 to June 2003. Mutual and pooled fund wrap assets grew by more than 11% over the same period.

Wrap accounts are appealing because they offer a disciplined, scientific approach to designing, monitoring and rebalancing portfolios. Advisors can "outsource" all of these functions, as well as client profiling and the drafting of investment policy statements, leaving them to spend more time on such value-added services as planning and client meetings. For clients, wraps have the potential for significant behavioural benefits. The temptation to invest in the newest product is resisted because pooled and mutual fund wrap products typically offer limited exposure

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to specialty funds—the types of investments with which clients have had the poorest returns.

Despite their obvious benefits, however, wrap accounts are still a work in progress. The industry recognizes this, too. Companies fighting for market share are continually modifying and improving their programs. The wrap concept is solid and could potentially flourish into a billion-dollar industry, but true success depends on how well the companies can solve these fundamental problems of this product.

1. The fees are too high.

The term "too many hands in the cookie jar" comes to mind when discussing wrap fees. Advisors are being paid just as much (sometimes more) while the client pays extra to have a consulting firm create and maintain his portfolio—a task the advisor once performed.

Mutual fund wrap fees range from 2.5% to 3.5% annually. Pooled wrap programs fall into the same range but generally offer the advisor more flexibility in setting the fee. Pooled wrap fees tend to start at about 1.6% (i.e., no compensation for the advisor) while topping out at 3.6% per year. Separately managed account fees tend to fall into the neighbourhood of 2.5% annually.

Some advisors may argue that outsourcing leaves them more time to provide other value-added financial planning and non-investment services, such as tax and estate planning advice, assessments on current insurance needs and education planning. But not every client needs or wants these extras so charging for them by default is a poor practice. The compensation structure is ripe for abuse by the industry's "ethically challenged" contingent—many advisors use the extra time to allow them to see more clients and do more business—not necessarily to provide better service to existing clients.

In theory, outsourcing should actually reduce a client's fee. If the client opts for extra services, the advisor should have the flexibility to charge accordingly. The current system allows the wrap fee to stay higher by default unless negotiated down by the client.

2. Portfolio design and rebalancing are severely constrained.

While most mutual and pooled wrap programs are presented as high-end services, they're nothing more than mutual funds dressed up in different packaging. If a client currently holds a portfolio of funds and/or securities and wishes to take advantage of the wrap program's benefits, most or all of the existing holdings must be liquidated to buy the wrap pools—possibly incurring costs and taxes in so doing. Qualifying minimum investments for wrap accounts span a wide range from $2,000 to $100,000 (see "Defining Wraps," left).

Further, while some wrap programs incorporate external investment holdings into the initial portfolio design, most are designed on a closed platform, which means a client can only fully benefit from a wrap program if most of the portfolio is invested in that program. In other words, they don't give individual advice based on a client's existing

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DEFINING WRAPS

There are three broad types of wrap or asset management programs in the Canadian market.

MUTUAL FUND WRAP PROGRAMS offer "cookie-cutter" portfolios tied to basic questionnaire-driven objectives such as "growth," "aggressive" and "income." Portfolios may be comprised of proprietary, third-party funds or a combination thereof. Examples include Mackenzie STAR and Assante's Artisan funds. Mutual fund wraps typically have a minimum investment of $2,000 to $5,000.

POOLED FUND WRAPS supply portfolios of proprietary pooled funds. Typically, a profiling questionnaire leads to a recommended mix of the program's pools. Most produce an investment policy statement outlining the merits of the recommended portfolio, which is usually based on Modern Portfolio Theory. Examples include Frank Russell's Sovereign program and Dynamic Viscount. Pooled fund wraps require an investment from $25,000 to $100,000.

SEPARATELY MANAGED ACCOUNTS (SMAs) are, as the name suggests, separate portfolios of individual securities held by the broker and managed by a professional money manager. The managers in these programs are similar to those found in mutual and pooled funds. Their main selling feature is that the client gets individual securities instead of a fund. Examples include RBC Access and BMO's Advance programs. SMAs usually have a minimum of $100,000 per mandate.

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portfolio. No wrap program has integrated non-investment assets such as pension assets, business interests, stock options and income sources into the recommended strategy. For instance, an employee of a high-tech firm may be compensated in part with stock options. This client's net worth would be dominated by the health and performance of the tech sector, and of her employer in particular. A prudent advisor would exclude tech stocks from the portfolio he recommends and look for ways to hedge such exposures to stabilize the client's net worth. This strategy is not possible in mutual and pooled fund wrap programs, as an advisor cannot instruct the managers in a wrap pool to exclude a certain type of stock.

Another problem is that advisors can override recommendations or simply build their own portfolio using the wrap's pools. A common example is using the wrap only for equity funds while buying bonds directly to cut costs. This is admirable but brings us back to the limitations of incorporating external assets. Wrap programs don't rebalance out of the equity exposure in the wrap program into a client's external bond holdings. These limitations can effectively render the wrap program—and its design and rebalancing features—worthless.

3. Internal manager monitoring raises potential conflict but does not reduce costs.

Some programs do not hire third parties to select and monitor managers, choosing instead to handle these functions in-house. Ironically, many firms that monitor in-house also manage a significant portion of the assets. Hence, the obvious question is whether the in-house consulting team would ever expel the firm that pays their salaries for poor performance. Seemingly, in-house monitoring does not reduce fees either.

4. Indexing benefits are cancelled out by a high markup. Multiple styles within a wrap lead to "diworsification."

A couple of programs, including one of the largest by assets, include significant indexing as one of its equity styles. This presents two problems.

From a pure dollars-and-cents perspective, the primary reason indexing works so well is because of its massive cost advantage. A wrap sponsor can hire an indexing specialist to handle the passive portion of a Canadian equity portfolio for a mere 0.08% to 0.15% per year. However, wrap pools charging a typical 2.5% in annual fees eliminate the indexing benefit.

The second issue relates to market depth. Most wrap pools include value and growth styles for mid- to large-cap Canadian equities. However, the Canadian market is too small to have growth, value and indexing. The TSX lists more than 1,600 securities issued by 1,300 companies with a total market capitalization of more than $1 trillion. It sounds impressive until you realize that the entire TSX is slightly smaller than General Electric, Microsoft and Pfizer combined. These three U.S. heavyweights, however, make up just 9% of the market value of the companies that comprise the S&P 500 stock index. As a result, domestic equity markets don't leave much room for a variety of styles.

To illustrate, I monitored the value and growth Canadian equity pools of one bank wrap program over time. On average they had overlap equal to about 60% of each pool's assets. Adding to that overlap by including an indexing mandate isn't diversification, it's "diworsification."

Possible Enhancements

Fortunately, there are solutions. With a collective voice from advisors to the manufacturers, wraps can have a secure future in Canada.

The ideal wrap program has three characteristics: an open platform, a rigorous scientific approach and a flexible fee structure that allows the advisor to customize the fee level based on each client's desired service level without the constraints of rigid pricing policies of some current programs.

Most products have at least one or two of these features. Broker-managed, fee-based programs have the open architecture. These accounts may include everything from F-class mutual funds, bonds, stocks and other securities for integrated advice and one all-inclusive fee. And, as noted above, some pooled wrap programs have flexible pricing. Almost all are backed by a rigorous scientific approach.

However, I've yet to come across all three key characteristics in one package. It's an elusive concept that will only come to market if enough advisors demand it. So, if you agree with my ideal wrap concept, it's up to you to make it happen. AE

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