PMC Quantitative Portfolios

Overview of Portfolio Construction and Ongoing Portfolio Management

December 2013

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Quantitative Portfolios (“QPs”) are separately managed accounts designed and constructed to offer several primary attributes, including: cost-efficient exposure to beta, tax-efficiency, and the ability to be customized. At their core, QPs are passively managed, and are structured to provide a pre-tax return similar to a broad-based benchmark index at a cost that is competitive with ETFs. We attempt to enhance after-tax return through active tax management. As their name suggests, the portfolios are constructed quantitatively, with risk assessment and tax management considerations being the sole criteria. We do not attempt to select stocks through fundamental research. PMC currently offers QPs tracking a variety of equity indices, and we have the ability to create custom tracking benchmarks to fit an advisor’s specific objectives.

Portfolio Construction

The first step in constructing the QPs is selecting the indices which will be passively tracked. PMC has identified several broad-based and well known equity indices from Russell, S&P and BNY Mellon that the initial set of QPs will mimic. In selecting these indices, consideration was given to their use as benchmarks by institutional investors and advisors to high net worth clients, the index constituent composition and the frequency of index reconstitution. While these indices are used for the standard set of QPs that PMC has constructed, we can tailor a custom solution meeting a specific need through selection of any number of tracking benchmarks.

Once the appropriate index has been selected, the portfolio management team creates the QP by establishing the target benchmark drift (tracking error) and desired portfolio concentration (a function of the number of holdings and the minimum investment amount for the account). We use a sophisticated proprietary risk model to determine each index constituent’s exposure to a number of factors affecting security price movements. The team then uses each of these elements—the target benchmark drift allowance, desired number of portfolio holdings and the risk model—to create concentrated separately managed account versions of the tracking index.

While QPs are constructed using quantitative processes, a portfolio manager reviews the resulting portfolio composition and any proposed trades prior to implementation.

Managing Risk

One of the fundamental features of QPs is that they are designed to track a selected benchmark's performance over time. To that end, we carefully monitor the estimated tracking error—or benchmark drift—of the QP to its tracking index. The goal is to keep the QP's benchmark drift at the desired target level. Our portfolio team monitors QP benchmark drift on a daily basis, and will make adjustments if the drift exceeds the target.

In addition to monitoring benchmark drift, we control risk by aligning the QP's fundamental portfolio characteristics—such as weighted average market capitalization, dividend yield and price/book ratio—with that of the tracking index. Our proprietary risk model enables us to construct an optimized portfolio that aligns closely the QP's aggregate exposures to common risk factors to those of the tracking index.

Another level of risk control comes in the form of diversification. Despite their more concentrated nature, QPs are broadly diversified across sectors, industries and securities. Depending on the tracking index selected and the target benchmark drift, QPs will typically hold anywhere from 100 to 300 or more positions. For accounts with lower minimum investments, such as Unified Managed Account (UMA) sleeve models, we allocate a portion of the QP to an ETF of the underlying index in order to hold fewer positions but still maintain the target risk characteristics and benchmark drift.

Tax Management

While many advisors select QPs as a way to obtain cost-efficient beta exposure, perhaps the primary appeal of QPs is their ability to be actively tax-managed. The separate account structure of the portfolios allows us to target individual positions for tax-loss harvesting, and within a position, specific tax lots. While it is normally our policy to defer gains, there may be situations where establishing a higher cost basis through realizing a gain could be beneficial to the overall strategy the advisor would like to employ. In such cases we strive to offset the gain with commensurate losses to minimize the tax impact.

There are three levels of tax management that can be conducted for QPs. For the UMA Sleeve version, PMC does not provide ongoing tax management, however, in the proposal generation process advisors can select the tax management "portfolio overlay feature" (POF), which uses a rules-based approach for capturing losses across a UMA's sleeves. We also do not provide proactive tax management in the SMA Beta version. However, advisors may elect to conduct year-end tax-loss harvesting by providing instructions to Envestnet's Operations team.

It is for the *Tax-Optimized and Custom Tax-Transition* versions which PMC proactively harvests losses on a year-round basis. We attempt to realize meaningful losses, balancing the size of the loss against the cost of performing the transaction. When losses are harvested, the team uses our proprietary risk model to identify replacement securities having similar risk characteristics so that the aggregate risk profile of the portfolio continues to maintain benchmark drift at the targeted level. During the process, we adhere to wash sale and other rules so as not to jeopardize the benefit of the realized loss.

In situations where the account is funded in-kind, the portfolio frequently contains low-cost basis or concentrated positions. In such cases, we work closely with the advisor to develop a customized transition plan to diversify the portfolio over time in a tax-efficient manner, while at the same time striving to enhance the portfolio's risk controls. If the account is moved into a QP from another manager, we follow a similar process in which we carefully consider the tax implications of portfolio transition.

Customization

Because QPs hold individual tickers and unique tax lots within positions, they lend themselves well to customization. While our standard QPs are appropriate options for the vast majority of client mandates, we provide several different dimensions of customization for advisors seeking a more individualized solution meeting specific client needs. The areas of customization generally fall into one of three categories:

Ticker- and industry-level restrictions. We can typically exclude individual tickers from a QP and still maintain overall portfolio risk controls and remain within the target benchmark drift. An example of such a restriction would involve an investor who is a CPA for a firm which audits publicly traded companies. The CPA is likely restricted from owning shares directly in those companies, and would therefore need a restriction on owning those securities placed on the QP. Industry-level restrictions work in much the same way. For example, clients with significant holdings in a particular industry in other accounts may want to restrict owning more of that industry within the QP.

Tax transition cases. QPs do not need to be funded with cash. In-kind transfers are common, and contributed positions often have significant unrealized gains. Our portfolio management team is experienced in working with the advisor to create a plan to transition from the current portfolio to the QP in a tax-efficient manner. We collaboratively establish a framework that includes tracking error and capital gains budgets, as well as a desired timeframe over which the transition takes place.

Tracking of custom benchmarks. Our standard QPs are designed to provide exposure to well-known, broad market indices. The indices have been selected because of their near-universal acceptance by institutional investors and advisors to high net worth clients. When a different index or more tailored exposure is desired, we work with the advisor to identify the appropriate benchmark, or blend of benchmarks, best meeting the investment objective.

Implementation

Management of the QPs is highly automated. We leverage two unique, but integrated, proprietary technologies for constructing portfolios and effecting transactions. Envestnet's core Unified Managed Portfolio (UMP) technology provides the backbone for our model maintenance, portfolio accounting and reporting engines. Envestnet | Tamarac's indexing application provides the risk model analytics enabling daily monitoring of account-level benchmark drift and optimization of tax loss harvesting. These two applications form a robust system allowing our portfolio management, trading and operations teams to effectively implement, manage and monitor our QP program.

Summary

QPs offer a combination of the best of separately managed accounts—the ability to be actively tax-managed and customized—and cost-efficient beta exposure. Our experienced portfolio management staff, the analytical support provided by PMC's Quantitative Research Group and state-of-the-art proprietary technologies enable us to provide both pre-tax returns aligned with the desired index and enhanced after-tax performance resulting from active tax management.

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