The New Frontier of Managed Accounts

A Fund Strategist Portfolios Primer

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A New Frontier of Managed Accounts

A series of financial crises over the last dozen years has forced many investors to reassess their investment choices and their tolerance for risk. There are new factors to consider: Financial markets are more globally connected than ever before. Product innovation has become complex, and so have portfolio solutions and asset allocation decisions. Compliance and regulatory mandates for advisors have increased dramatically, leading to a lot of confusing conversations about fine print.

So how can advisors meet investors' needs, stay on top of emerging best practices—and still have time to select great investment products in a rapidly changing, globally connected complex and even chaotic marketplace? One way is to outsource to a new type of investment product that manages both product selection and asset allocation, called a Fund Strategist Portfolio ("FSP").

For those advisors that do not have the time or inclination to do their own asset allocation and manager research, monitor underlying investments and rebalance multiple accounts, FSPs can provide an effective solution—which is why they have quickly become an integral component of many financial advisory practices. As advisors seek to cushion the potential volatility of long-term strategic portfolios – in an effort to prevent the kind of panic that possessed investors in the wake of the 2008 market meltdown – they have sought to expand their toolkit, incorporating more dynamic strategies that adjust portfolio allocations in an effort to protect or even profit from market swings. For instance, advisors are starting to incorporate liquid alternatives, sector rotation, tactical "go anywhere" managers and other investment styles. Today, with the help of FSPs, advisors can embrace a flexible framework for portfolio construction that incorporates long-term strategic, core-satellite and more tactical investment solutions, using a single FSP, a combination of FSPs or a combination of open-architecture FSPs that they can populate with their own chosen managers.

What is a FSP?

Fund Strategist Portfolios ("FSPs") can provide advisors access to investment strategists who construct distinct portfolio solutions to help meet the ever increasing demands of today's investors. They typically comprise a set of mutual funds and/or exchange-traded funds (ETFs). FSP solutions espouse various approaches to portfolio construction and asset allocation: whereas most FSP portfolios employ a long-term, strategic asset allocation approach, others take a dynamic or tactical approach and actively shift allocations in order to take advantage of short-term market movements.

FSP Investment Styles

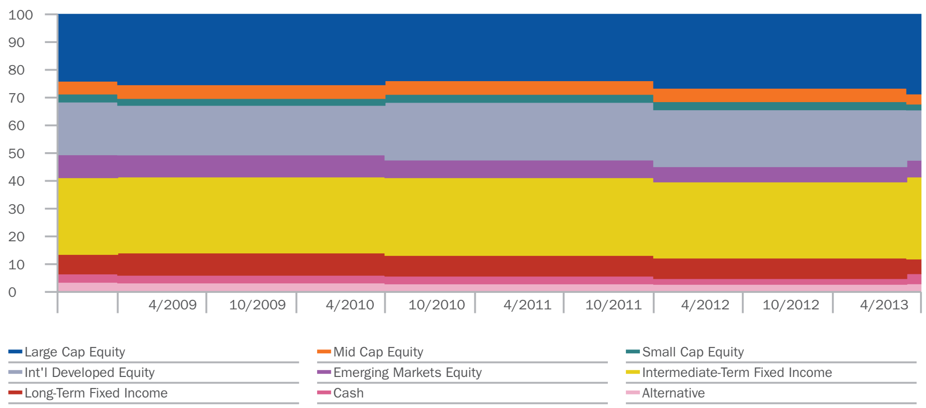
Fund Strategist Portfolio solutions range from traditional long-term, buy-and-hold investment mandates all the way to tactical solutions that utilize quantitative, short-term market-timing investment techniques. FSP solutions can provide investors with a variety of asset classes, investor goals, and risk tolerances.

Envestnet | PMC categorizes FSPs into four distinct categories: Strategic, Dynamic, Tactical and Satellite.

Strategic

A long-term, buy-and-hold investment approach that attempts to balance capturing broad market returns with an appropriate level of risk. Strategic FSPs tend to be highly diversified across major asset classes and rebalance periodically to their original target allocation. Strategic FSP solutions can serve as the core portion of a client's portfolio or as a total portfolio solution. Options provided in this space span the risk spectrum from conservative to aggressive.

Strategic FSP – Historical Asset Allocation

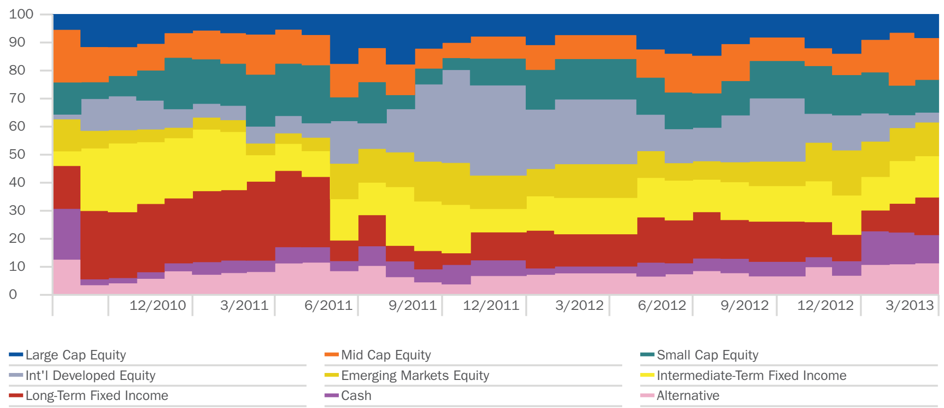


Source: Envestnet | PMC. Representative sample asset allocation of an FSP categorized by Envestnet | PMC as Strategic.

Dynamic

A flexible investment approach that combines a strategic approach with a limited amount of short-term, tactical moves. Dynamic FSPs typically remain fully invested and diversified—plus, they attempt to take advantage of short-term macroeconomic and/or market factors to enhance their returns. Like Strategic FSPs, these flexible portfolio solutions may serve as the core portion of a client's portfolio, or as a total portfolio solution. Dynamic FSPs are typically available across the entire risk spectrum.

Dynamic FSP – Historical Asset Allocation

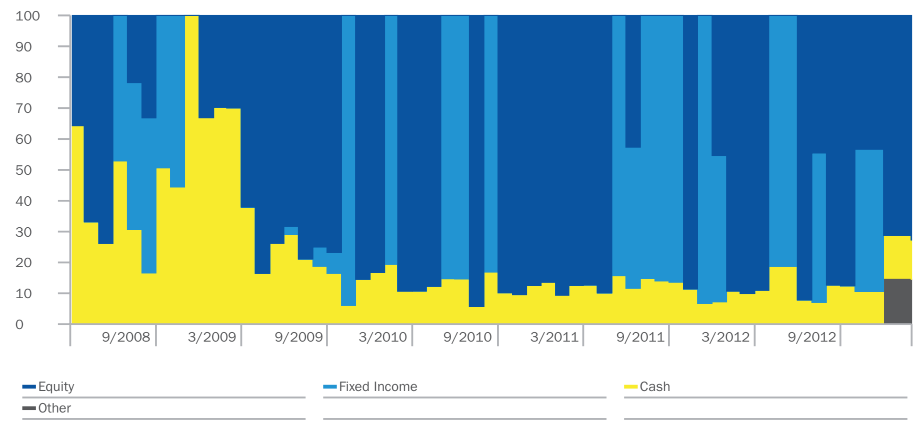


Source: Envestnet | PMC. Representative sample asset allocation of an FSP categorized by Envestnet | PMC as Dynamic.

Tactical

An unconstrained investment approach that can quickly change its allocation and risk profile by moving portfolio allocations from as much as 100% equities to 100% fixed income and cash (and vice versa). Tactical FSPs attempt to actively move in and out of asset classes, sectors or countries based on their forecasts of short-term changes in market environments. Tactical FSP strategies typically employ a combination of technical and quantitative factors, using "rules-based" methods that may combine macroeconomic analysis and quantitative statistics such as momentum, moving averages, relative value and relative volatility. These strategies are typically utilized as a complement to a client's existing portfolio, with the goal of protecting capital in down markets while participating in up markets.

Tactical FSP – Historical Asset Allocation



Source: Envestnet | PMC. Representative sample asset allocation of an FSP categorized by Envestnet | PMC as Tactical.

Satellite FSPs

In addition to the specific styles of FSPs, there are specialized portfolio solutions that either aim to manage or reshape portfolio risk, or focus on a single asset class. Most of these Satellite FSPs incorporate various elements of strategic, dynamic and tactical investment approaches. They typically serve as a complement to a client's overall portfolio; or, a Satellite FSP may serve as the dedicated portion of the asset class that the FSP attempts to capture through its investment mandate, such as:

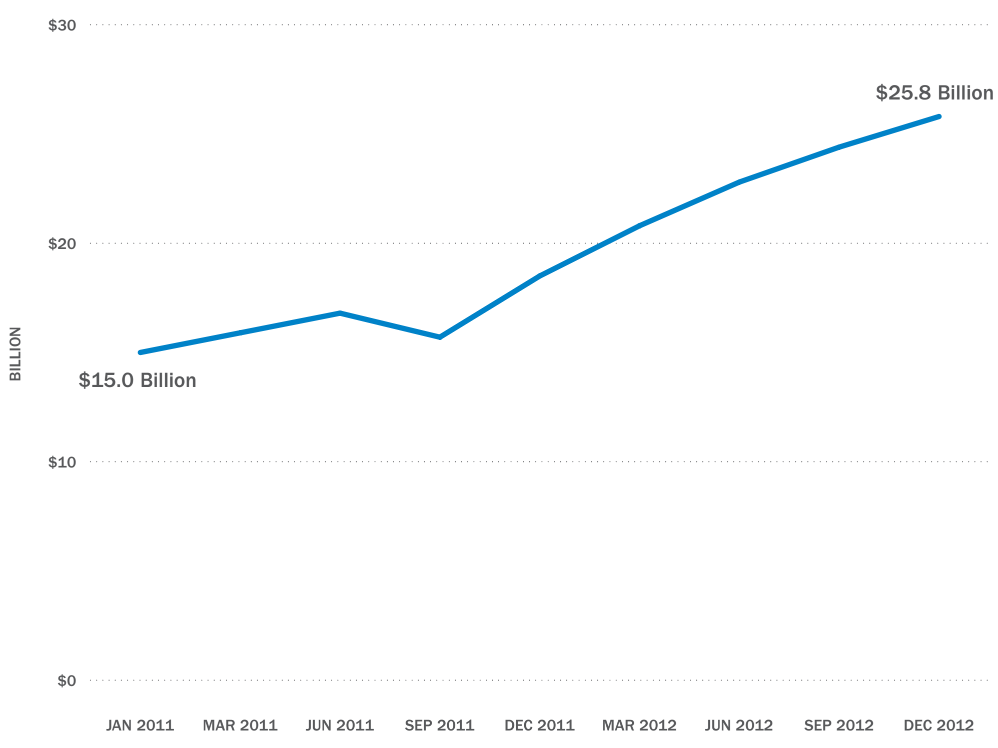
- Long/Short
- Global Macro
- Alternative Fixed Income
- Hedged Equity
- Multi-Asset
- Commodities
- Income/Yield

This collection of FSPs has grown rapidly as the demand for unique mandates—which may focus on lowering portfolio volatility, reducing downside capture, lowering correlations, enhancing income and yield, or hedging—has steadily risen. With the continued evolution of the ETF universe, FSP strategists have a growing number of levers and pulleys to choose from as they attempt to capture specific market trends.

Growth of FSPs

It is no surprise that the growth in the number of FSPs, and their assets under management, have coincided with the rise in demand for ETFs—the vehicle used by many third party strategists. ETFs have transformed the way investors can access various asset classes around the world, including, in addition to equities and domestic bonds, commodities, foreign equities, and non-U.S. bonds. As of the end of 2012, BlackRock counted a universe of more than 100 ETF-only managers offering 225-plus strategies which represented $54 billion in assets. Those figures are up from 95 strategists offering 206 portfolios and $38 billion at the end of 2011. Morningstar estimates the market to be even bigger (which includes strategies using mutual funds), with $63 billion in assets across 530 strategies from 125 firms as of December 2012 (ETF Managed Portfolios Landscape Report). The amount of assets in FSPs on the Envestnet® platform has experienced this same rapid growth, as seen below. Empowered by the rapid evolution of ETFs, FSPs are changing the way advisors invest, allowing their clients both big and small to gain access to institutional-caliber portfolios that are designed to provide lower costs, better transparency and greater tax efficiency than ever before.

All FSP Assets
December 31, 2012



Source: Envestnet Inc.

Attributes Resonating with Advisors

A majority of advisors today are spending more time conducting manager research and asset allocation work, monitoring underlying investments, and rebalancing client accounts than they do servicing existing relationships and recruiting new investors. FSPs' ease of use provides benefits both to the advisor and to the end investor. The Strategists provide an effective way for advisors to access institutional caliber asset allocation and manager selection expertise while freeing time to communicate with existing clients and concentrate on growing their business. One of the advantages of FSP strategies is that advisors do not have to have an explicit view on the markets but can rely on the expertise of the third-party strategist to make those difficult asset allocation and manager selection decisions. This provides a more objective approach to managing client assets and, again, allows advisors more time to service their existing relationships and build new ones.

Top Decision Drivers for Outsourcing
• Access to asset allocation models
• Advisor access to managers they could not access on their own
• The potential to generate alpha through best investment ideas
• Portfolio construction
• Portfolio monitoring
• Access to managed account expertise
• Access to alternative investments expertise
• Superior back-office technology and support
• Access to unified managed account (UMA) capability
• Overlay management

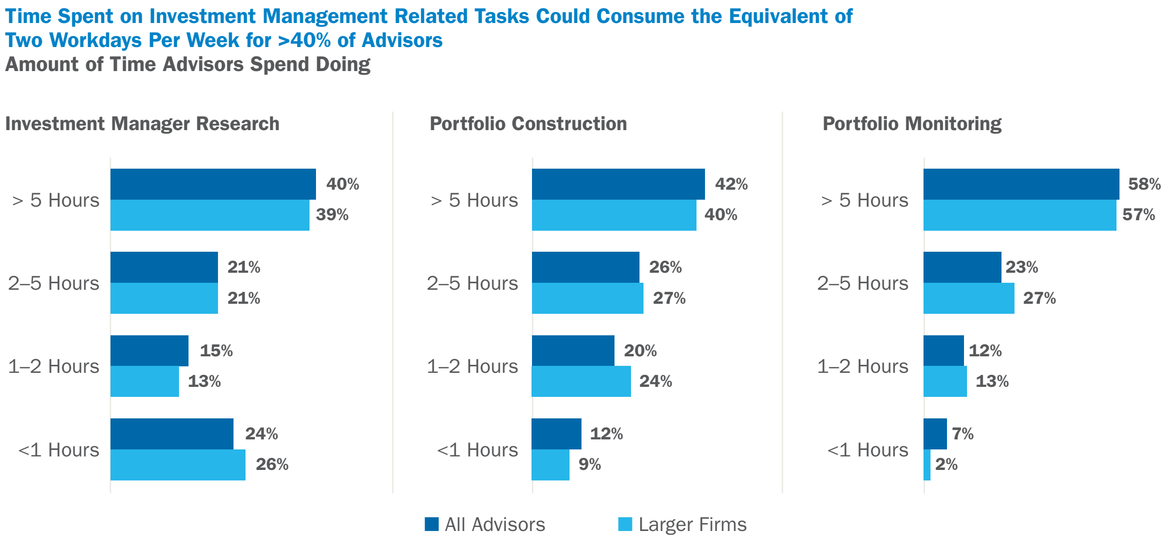
Outsourced Investment Management Activities

According to a recent survey conducted by Northern Trust nearly 50% of polled advisors outsourced all investment management activities, while 6 out of 10 advisors outsourced more than half of their clients' assets.

Source: "Investment Management Outsourcing: The State of the Art 2012," Northern Trust 2012.

Time:

A vast majority of advisors' time is spent on investment related tasks.



Source: "Investment Management Outsourcing: The State of the Art 2012," Northern Trust 2012.

Cost

At a time when many asset classes proffer low average returns, cost becomes an important factor in clients' ability to grow their assets. As a result, advisors and their clients are demanding lower-cost investment options, without sacrificing access to sophisticated solutions. Most FSPs provide a total portfolio solution at a very competitive cost. According to the Northern Trust survey , nearly 60% of the advisors who outsourced to third party strategists reported no change in fees charged to clients, while 15% reported that fees had decreased. And the typical minimum account size for many FSPs is $50,000 or below, making these portfolio strategies accessible for clients of all sizes.

Transparency

Faced with ever-increasing rules and regulations and investor demands, as well as constant changes in investments and technology, advisors and their clients now have more have more need (and ability) to "know what they own." Since most FSP strategies use liquid ETF and mutual fund vehicles to create their solutions, advisors and clients have daily insights into their underlying positions, and how those positions might be affected by developments in the global financial markets.

Liquidity

Today, liquidity is a major concern for both advisors and investors. In our opinion, most clients do not want their wealth locked up in an investment that cannot provide them with access to their funds within a short period of time. Liquidity is comforting – and the uncertainty associated with illiquid investments can be stressful for both investors and advisors. Liquidity is one of the key operational benefits of FSP solutions.

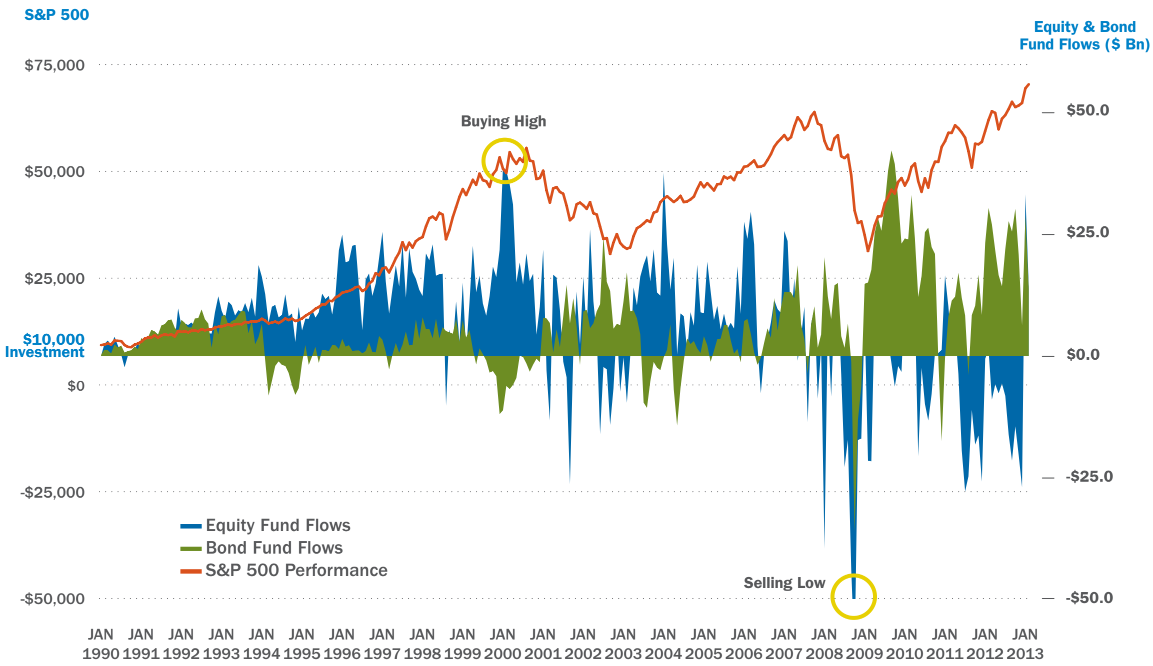
Access to Various Investment Styles, Philosophies and Portfolio Construction Methods

An advisor looking for a strategist portfolio solution will be able to find one to suit practically any need, and practically any investment style. FSP solutions can range from the plain-vanilla to complex, tactical solutions featuring a pinpointed asset class. Each FSP has its own take on the markets and associated risks. This enables an advisor to pick the strategist whose views on the general markets, risk and portfolio construction align with his or her own practice and the client's needs. FSP solutions provide unique solutions across the traditional asset classes, specific countries or regions, different sectors (domestic and non-U.S.), alternatives, commodities, or specific risk profiles. Some FSPs serve as the core of a client's total portfolio while others can act as a diversifying complement to an existing core allocation.

Stay Invested - Stay Diversified

When portfolio construction, manager selection and portfolio rebalancing responsibilities are outsourced to a third-party strategist, advisors and their clients are at "arm's length" from the daily investment decisions. This can help avoid ill-timed decisions based on emotions. Historically, investors who attempt to move in and out of the market typically erode alpha and trail behind traditional buy and hold strategies. And, as the chart below suggests, investors have typically done a poor job at attempting to time the market.

S&P 500 Performance of a $10,000 Investment vs. Industry Equity & Bond Fund Flows
January 1990 – February 2013



Source: Strategas & S&P 500; Adapted from Franklin Templeton "Time to Take Stock" Brochure

A New Frontier of Research and Due Diligence

FSPs range from simple to sophisticated; however, only limited research is available on most of these firms and their underlying strategies. The multiple, sometimes complex dimensions of FSP strategies require in-depth research and due diligence in the areas of asset allocation, investment vehicle usage, strategy flexibility, risk controls, investment time horizon and many other areas. The continued growth of unique FSP offerings, along with product innovation within ETF and mutual fund strategies, warrants a high level of research and due diligence when selecting FSPs for clients. Given their broad and flexible investment mandates, FSP strategies are all quite different from one another. Both investor education and research and due diligence on these popular products remains a near-term hurdle. We would encourage advisors to thoroughly review the multiple areas of potential risks at both the firm and underlying strategy level.

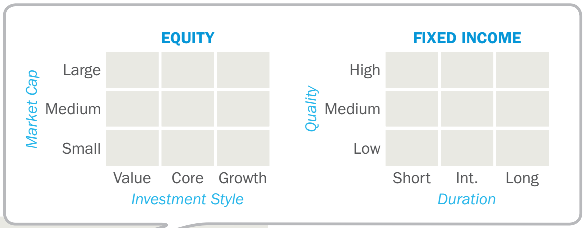
Traditional manager research and due diligence can be effective in selecting and monitoring FSP strategies. However, additional elements outside the customary quantitative and qualitative metrics need to be used to better evaluate many FSP strategies.

Focusing initial research and due diligence efforts at the firm level is a critical component. Many FSP firms are relatively small and some have a history that is more like a traditional RIA than an asset management firm. Focusing on the firm's holistic approach to money management is an essential part of the research and due diligence process on

FSP Elements Worth Evaluating

Qualitative	Quantitative
Firm	Track Record – actual or hypothetical
Investment Team	Minimum/Maximum Asset Class Exposures
Investment Philosophy & Process	Risk Profile & Risk Controls
Investment Type & Style	Benchmark Performance Evaluation
Investment Mandate & Portfolio Fit	Peer Group Performance Evaluation
Quantitative Models / Signals	Underlying Investment Vehicles Used
Product Lineup	Trading

A Broader View of FSP Style Considerations



Strategy Type	Vehicles Used: Individual Stocks/Bonds	ETFs	Mutual Funds
Strategic	Traditional MF & SMA Portfolios	X	X
Dynamic	X	X	X
Tactical	X	X	X

FSP firms and their respective strategies. Most, if not all, FSP managers have distinct investment philosophies and views on the markets, follow different approaches in constructing their portfolios, and utilize varied investment vehicles to implement their views and portfolio construction. Additionally, each firm typically has its own view of risk, whether it is risk as measured by volatility of the global equity markets or the risk of losing money. Some managers attempt to reduce risk, or volatility, while others purposefully increase risk with the goal of increasing return.

Finally, benchmarking or peer group comparisons can be a challenge, especially when the strategies have flexible investment mandates and variable market exposures. For these strategies, it's important to understand which securities the strategist qualifies as "cash" or "out of the market." When tactically rotating out of asset classes, it's important to understand placement of those assets and the maximum defensive allocation. Some strategies hold U.S. Treasury ETFs or high-quality fixed income mutual funds, while others prefer short duration credit vehicles or a simple money market fund. Some strategies employ a tactical fixed-income model to manage the non-equity portion of the portfolio, which can have additional implications on a strategy's total risk profile.

FSPs—An Effective Answer to the Complexities of Investing

FSP strategies provide a simple and effective investment solution for advisors who lack the time or resources to do extensive manager research and asset allocation work, monitor underlying investments, and rebalance multiple accounts.

From among the various types of investment styles, philosophies, methodologies, and investment vehicles used to implement these portfolio solutions, most advisors will find solutions that suit the needs of any investor. In a universe that encompasses a wide variety of unique investment mandates, the Envestnet FSP network offers clients choice and guidance for its clients. Our network offers more than 65 third-party firms and more than 700 unique investment strategies. Envestnet's FSP network empowers advisors to help develop a sound, long-term asset allocation and build portfolios designed to keep their clients disciplined through varying market cycles. Whether you seek a long-term, strategic diversified portfolio or a manager with a near-term tactical viewpoint, Envestnet's FSP network provides access to high-caliber investment strategists who lead the industry.

Author's disclaimer

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About Envestnet

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