Innovation in separate accounts:

Exploring product opportunities and operational advancements

SEI Investment Manager Services

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Introduction.

Historically, separate accounts have been a primary option for institutional investors who wanted more customization than is available with a mutual fund investment and were satisfied to choose from a standard menu of investment strategies. As the industry has evolved and complexity has increased, the demand for these accounts has grown considerably. Today, in order for institutional asset managers to attract and retain clients, customization and personalization are a key requirement; for many institutional investors, standard out-of-the-box investment strategies are no longer practical, let alone acceptable. Today's institutional investors are more keen to direct the investments in their portfolios at the individual sector, stock, and/or asset level.

The trend towards customization is not limited to the larger, institutional investor, however; high-net- worth individual clients (or the broader "wealth" market as it is often referred to) are also demanding customization from their separately managed account (SMA) managers, creating an operational, technological and financial challenge in a space designed to scale based on standard models.

In this paper, we'll discuss the evolution of the separate account and the operational challenges associated with managing a high volume of customized institutional and wealth accounts, including those that incorporate directed investment in private markets, ESG mandates, and digital assets. In addition, we will explore how an outsourced service provider can help asset managers overcome the operational and system challenges across middle office functions.

The evolution of the separate account space.

The invention of the separately managed account

In 1965, A.G. Becker & Co. (later acquired and divested by SEI) performed a comprehensive study of mutual fund managers that revealed that most managers failed to beat their indices. This could have been an indicator that active management was ineffective, but, counterintuitively, the study instead helped re-shape and bolster the active management space. A.G. Becker found that while most managers were underperforming, a few managers were beating their indices. Using the data they collected, A.G. Becker published comparisons of plan performance which not only helped institutional investors understand where to invest, but also contributed to launching a new industry for investment consultants to offer similar services.[1]

Today's institutional and wealth market

Today you would be hard pressed to find an asset manager that does not offer institutional separate accounts or SMAs. Of the $103 trillion asset management market at the end of 2020, retail portfolios represented 41% of assets ($42 trillion), while institutional assets accounted for the remainder ($61 trillion).[2] The institutional asset management market has become highly competitive, and successful managers are either developing or further building upon their institutional account strategy in order to cater to the increased demand for customization not only to attract prospective clients but also retain their more demanding existing clients.

Simultaneously, the wealth industry is experiencing unprecedented growth and, with that, the demand for personalization and customization is also increasing. According to Cerulli, separately managed account assets in dedicated advisory programs soared 27% in 2021, while SMA assets within unified managed account (UMA) programs increased 11.7%, to $777 billion. Firms such as Parametric and BlackRock, which are responding to the demand by offering unique SMA strategies such as direct indexing, are pioneers challenging the industry to do the same. Direct indexing SMAs are expected to outpace the growth of other types of investment vehicles in the years ahead as advisors seek out customization capabilities for clients.[3]

Challenges of emerging investment solutions.

Meeting the demands of individualized ESG mandates

According to Callan's 2021 ESG Survey, 49% of institutional investor respondents incorporated environmental, social and governance (ESG) factors into their investment decision-making processes, up 7% from the previous year's level and more than double the number in 2013.[4] This trend reflects interest from the broader investment community and supporting institutional asset managers. Globally, even growing at half the past five years' rate, ESG assets are expected to exceed $53 trillion by 2025, making up over 30% of the more than $140 trillion in projected total assets under management.[5]

Investors who are interested in investment products that meet more individualized ESG interests are turning to their asset managers to provide a solution as an alternative to ESG mutual funds and ETFs. Historically, asset managers have used a process that simply screened for, and removed, securities that didn't meet an ESG mandate, rather than tailor a portfolio to specific ESG factors. In order to meet the more sophisticated needs of a growing market, managers are starting to build customized models at scale.

Constructing and customizing around ESG factors requires advisors to use algorithms that leverage new information architecture and data analytics technologies. In today's environment, managers need to solicit client mandates specific to ESG and then use these emerging technologies to update models on a regular basis as client needs, definitions of what makes up ESG, and ESG scores, change. In this emerging investment space, flexibility, speed and efficiency are paramount.

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However, the challenges associated with ESG investing don't stop with portfolio management. The operational impacts specifically on data management, portfolio reconstruction and reporting, as well as the related cost-effectiveness, can vary in complexity based on the level of transparency required by the investor.

Managing the complexities of private markets

While private markets investments may not be growing at the exponential pace of the ESG market, they have grown substantially over the past decade and are an area of ongoing innovation. Assets including private equity and private debt, venture capital, and real estate are characterized by differentiation, lower volatility, and attractive returns for investors looking beyond traditional investments. As institutional and wealth managers expand their product set, many are looking to offer private markets solutions but do not have the necessary infrastructure to support these sophisticated and often opaque asset classes.

To offer a private market or multi-asset strategy within a separate account, managers must address issues ranging from how to structure investments (including setting up entities or pooling resources) to tax treatment, administration and evolving regulatory compliance. These products also often involve ongoing customization requirements from investors, and the ability to access their portfolios and adjust allocations regularly. Another challenge specific to private markets is the need to allocate trades across accounts quickly, which is often difficult when investing in illiquid, non-daily priced assets where it can take weeks to fill an order.

Building the technology and infrastructure to support private markets needs is only possible for firms with both the scale to move quickly and efficiently, and the specialization to understand the operational and administrative complexities of these diverse asset classes. An asset manager looking to offer private markets investment solutions to investors will need to address infrastructure downstream from the investment process as well. The systems and subject matter expertise to support the nuanced operations for private markets assets is currently a niche market and skillset which cannot be adequately or easily supported by traditional, more homogeneous investment operational systems. With demand high, the market opportunity is ripe, yet most firms lack the specific capabilities and expertise to support private markets in-house from start to finish.

Challenges and opportunities posed by digital assets

Investor interest in digital assets has exploded in recent years. Crypto, NFTs, and memecoins dominated headlines in 2021 and early 2022 (the Ukraine/Russia conflict notwithstanding) and were met with a corresponding increase in investment among retail investors. While individual investors have been bullish on crypto, institutions have been more reserved and experimental. According to research in late 2021, institutions investing in crypto assets had outperformed their peers by about 2.8% per year.[6] However recent volatility amid "extreme market conditions,"[7] when Bitcoin and Ether plummeted 58% and 69% respectively in the second quarter of 2022 alone[8]—has validated the reticence by some of the largest asset managers to launch crypto investment vehicles. Regardless, even in May 2022 when values plummeted, retail investors still put $66.5 million on average each week into digital asset investment products, according to data from CryptoCompare.[9]

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Much of the reticence to invest in crypto may stem from regulatory concerns. The SEC has yet to approve direct investment in digital currencies, forcing investors to turn toward investment in futures, ETFs and packaged products that hold Bitcoin. But with unprecedented crypto demand, there is rampant innovation to bring the direct ownership and customization of crypto portfolios to RIAs, advisors, and institutional investors. In 2021, the first actively managed crypto-asset SMA was launched, pushing the crypto market forward.

As this market continues to mature, asset managers who offer a diverse set of products will likely want to expand their product offerings to crypto and other digital assets. Digital currency portfolio strategy is a nascent space, but solutions providers are actively working on platform innovation to marry crypto models with best-of-breed onboarding, allocation, reporting, distribution, and data management technology.

Partnering with solutions providers to meet demands.

Achieving scale

The very concept of customization in the SMA market may seem like a contradiction: high levels of customization at scale. For asset managers without a robust support model, it is certainly a difficult balance to strike. It's not uncommon for service levels to go down and performance to dip as managers take on a high volume of accounts, let alone those that are heterogeneous. As the demand continues to boom, however, asset managers will have no choice but to keep pace with ever-increasing demands on both volume of accounts and customization.

The standard benefits of partnering with third-party service providers for middle office operations applies in this scenario for both institutional and wealth managers but at a larger scale. Partnering with an experienced service provider re-allocates the burden of account administration for a high number of custom accounts, reconciliation, corporate actions, settlements, cash instruction, security master, performance composites, and arguably most importantly, client reporting packages. It also gives access to data management services that aggregate disparate data across multiple platforms from a single point of entry and produce on-demand reporting. By leveraging an integrated operating solution offered by a valued third-party partner, managers free up their resources to focus on client attraction, investor relationships, product development, and ultimately asset growth.

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Embracing innovation

Institutional asset and wealth managers looking to differentiate themselves are moving into emerging asset classes and investment types. As mentioned, ESG investments, illiquid private assets, and digital assets are just three promising examples for managers looking to maximize returns and differentiate themselves in a crowded and competitive market. However, leading-edge investment solutions require similarly leading-edge technology and operational support structures to bring them to market and support them over time.

This area offers enormous opportunity for differentiation but requires the scale and technology stack to support evolving administration, automation, onboarding, and allocation needs, let alone developing regulatory compliance. In these non-traditional markets, a solutions provider can offer the flexibility to scale with client growth and the ability to invest in customizable technology solutions that evolve with the market.

It can be a daunting task, and indeed a risk, for investment managers to take on the complexities in-house of building a portfolio management solution that supports complex and custom investment requirements of private assets, ESG, and digital currency, each of which may evolve rapidly in terms of downstream operational, reporting, and compliance requirements, as well as new client mandates. A solutions provider focused on operations and technology to support a full range of traditional and alternative asset types and clients can more easily pivot with the market, without placing undue strain on internal technology and operations teams.

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DaaS

Data as a Service

Some service providers make their own data management platforms available to clients.

Many asset managers that have an insourced operations group may be eager to offer complex asset classes in response to client demand but feel inhibited by the lack of subject matter expertise and the effect on their existing operations and technology resources. While full outsourcing is a well-trodden path, it is not uncommon to explore a component-based outsourcing partnership to support this model. In this so-called "split" model, internal resources continue to support traditional asset classes while the burden of redesigning the operating model and supporting technology to support new and complex investments is shifted to a trusted service provider.

Managing high data volumes

Institutional and wealth asset managers can also partner with solutions providers to meet complex data management requirements. The proliferation of new asset types and portfolio models places significant strain on data architectures, especially when many large investment managers are already facing data inconsistencies and inefficiencies in their current environments. To alleviate the need for managers to develop and implement their own data management platforms, some service providers are now making available their own data management platforms as a Data as a Service (DaaS) offering. DaaS is an appealing option when SMA or institutional products push the boundaries of data volume and integration for both unstructured and structured data. A key example is ESG data where data management (collection and reporting) to enable transparency remains a challenge, most prevalently in private markets, due to lack of commercially available rating sources, evolving definitions of ESG, a proliferation of frameworks, and out-of-the-box reporting solutions. Many asset managers have had to invest in proprietary technology to support this; however, as supporting technology is evolving at a rapid pace thanks to the advent and explosion of new, cloud-native technologies, reliance on proprietary technology may be inefficient and costly as part of a strategic, longer-term operating model.

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Opportunity awaits institutional and wealth managers.

The demand for customization in institutional separate account and SMA products has pushed the bounds of investment technology, operations infrastructures, and data management. As opaque asset types and alternative investment strategies become less rare, or even mainstream, the broader institutional and wealth sector will also inevitably continue to evolve, in lockstep or at a lag. With the benefits of direct ownership and customization more appealing than ever, it is no surprise that the institutional market is forecast to continue double-digit growth in the coming years.

Asset managers looking to differentiate themselves are increasingly looking to broaden their product portfolios in response to client requirements. With rising investor interest in assets and strategies involving digital currencies, ESG and illiquid alternatives, among others, institutional asset managers are taking note and offering new products that are evolving with the market. These complex products often require built-for-purpose technology solutions and robust middle and back office support.

While the vast majority of retail SMAs today consist essentially of long-only domestic equities and are based on predetermined allocation models, technology has the potential to disintermediate the largest institutions; indeed, the technology is improving and standards are being developed such that in the future, personalization and the inclusion of international, private and digital assets could be increasingly cost-effective and available to non-institutional accounts.

To capitalize on these emerging areas of investor interest, asset managers require the ability to scale and aggregate data. Partnering with a solutions provider gives managers the support they need to continue to develop new and differentiated investment strategies while also addressing technology and client service requirements and meeting complex new operational demands. Asset managers—both those focused on the institutional and high-net-worth or mass affluent markets—who can rise to the challenge will be the ones to stand out in a crowded field. **Watch this space!**

Endnotes

[1] Gresham, Stephen, and Orlansky, Arlen, "Chapter 1: The Evolution of Managed Accounts" from *The New Managed Account Solutions Handbook: How to Build Your Financial Advisory Practice Using Managed Account Solutions*, Wiley, Hoboken, NJ, 2008.

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About SEI

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*Based on *Pensions & Investments*' Largest Money Managers 2021 ranking.

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