Portfolio Customization at Scale

Technology Tools that Make It Possible

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Active managers have the chance to differentiate themselves with personalized, niche strategies.

Scalable personalization is the next frontier in asset and wealth management. To compete today and in the future, asset and wealth managers must be able to accommodate highly personal preferences for a large number of investors with optimal efficiency. Intelligent automation technology makes this possible.

Many observers expected active investment management to enjoy a resurgence in 2020, when business lockdown mandates sent global market indices—and the passive strategies that track them—into a tailspin. In retrospect, however, the downturn turned out to be a blip and did little to dampen the popularity of passive investment vehicles—US exchange-traded funds (ETFs) capped a decade of growth with a record $507.4 billion in inflows in 2020, an increase of 55% over the previous year.[1]

As it has become increasingly difficult to outperform the market, asset and wealth managers have been hearing the drumbeat of competitive pressure to stem outflows and rationalize fees, particularly in the new era of zero trading commissions. The challenge is largely one of efficiency and scale. The low costs of ETFs and index-tracking mutual funds make them ideal vehicles for trading by algorithms on robo-platforms. The time and effort required to build and manage an alpha-generating portfolio make it challenging to scale—and threaten to make active management the preserve of the ultra-high net worth investor.

But that is changing, and the change is being driven by high net worth and mass affluent investors who want something more than off-the-shelf products. They still expect competitive returns, but from a more customized investment strategy. Instead of competing with the same basket of brand-name, large-cap stocks and strategies as everyone else, active managers have a chance to differentiate themselves with more specialized, niche strategies—for example, steering investors into emerging markets or low-liquidity small-cap stocks. Moreover, managers further stand to benefit by developing the ability to personalize portfolios to highly individual investor preferences in the mode of a separately managed account (SMA).

Personalization redefined

Until recently, personalization largely meant putting together an investor risk profile, then plugging that investor into a model that delivered a diversified investment blend that suited the risk criteria. Advisors also fell back on the "60/40" allocation model depending on demographics—60% equities, 40% fixed-income for younger investors, and the reverse for those approaching retirement. While these approaches have enabled firms to manage high volumes of portfolios efficiently, calling them "personalized" is a bit of a stretch—they actually allow for very little customization to individual preferences. To compete today, asset and wealth managers must be able to achieve customization at scale—that is, the ability to accommodate highly personal preferences for a large number of investors with optimal efficiency within a portfolio modeling framework.

Many observers see scalable personalization as the "next frontier" in asset and wealth management. In a recent Accenture survey of 250 asset management executives, 80% of respondents said that "customization for the masses" will be a definitive growth driver over the next five years. Because alpha is becoming more elusive, the report states, "personalized products are emerging as an appealing alternative to low-cost beta investing." Moreover, "customization can improve the client experience and overall client-centricity."[2]

Industry M&A trends bear out the belief that this is the wave of the future. Some of Wall Street's most prominent institutions have been busy buying up smaller firms that have built technology-powered platforms specifically designed for personalization at scale.

1. Roy, Sumit, "Record ETF Assets Growth In 2020," ETF.com, January 4, 2021. https://www.etf.com/sections/monthly-etf-flows/etf-monthly-fund-flows-december-2020?nopaging=1
2. "The Future of Asset Management," Accenture, May 12, 2021. https://www.accenture.com/us-en/insights/capital-markets/future-asset-management

The opportunity—and challenge—for asset and wealth managers is to be able not only to respond to investor preferences, but to lead the conversation around diversification into more specialized opportunities, and then deliver on the promise of personalization.

The ESG phenomenon: reshaping investment management

Consider just one example: the surging popularity of investing based on environmental, social and governance (ESG) factors. Socially conscious investing was a fringe field barely a decade ago. Today, ESG is not only mainstream, but by many accounts is reshaping the investment landscape—and reinvigorating active management. It is being fueled largely by investors who want their capital to do good, or at least avoid doing harm, and buoyed by substantial research suggesting that companies with good ESG practices deliver better-than-average returns.

Enthusiasm for ESG is compelling public companies across the spectrum to focus not just on delivering shareholder value, but on aligning with shareholder values. Europe has already introduced regulation that will require fund managers to report on the ESG content in their portfolios, and similar initiatives are under discussion in markets around the world. Institutional investment consultants ask about ESG in their RFPs to asset managers. For private clients, ESG preferences increasingly come up in the initial conversations.

ESG comes in many flavors. At a basic level, companies are measured on their progress in reducing their carbon footprint, for example, or on the number of women and minorities in management positions. At the other end are companies working on ESG solutions, such as renewable energy or clean water, that represent investment opportunities. Then there are the negative ESG categories that investors may explicitly wish to exclude from their portfolios, such as alcohol, tobacco or firearms.

In other word, there are a variety of ways to interpret ESG and implement it into investor portfolios. To accommodate investor demand, asset and wealth managers need tools that enable them to develop customized ESG strategies, and then demonstrate progress on the client's ESG objectives.

Tax alpha: improving returns through optimization

Another area in which active managers can demonstrate an advantage over passive strategies is through tax optimization. "Tax alpha" refers to the extent to which a manager can improve performance relative to a passive benchmark through deliberate tax-aware trading decisions. Tax sensitivity again is largely a matter of client preference. The average ETF investor is unlikely to pay much attention to the tax impact of trading that goes on within a fund, while a higher net worth private client will be very interested in minimizing tax liability and optimizing after-tax returns. This typically entails strategies such as tax-loss harvesting to offset capital gains.

To deliver tax-advantaged strategies tailored to individual clients' tax goals and circumstances, wealth managers need tools that enable them to identify tax optimization opportunities within client portfolios. They also need the means to show clients how they were able to improve performance as a result of the tax impacts of their buy-and-sell decisions.

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Direct indexing: where passive gets personal

Recent years have seen a rise in direct indexing SMAs as an alternative to investing in ETFs or mutual funds. Direct indexing refers to the creation of a portfolio that replicates a popular index—for example, the S&P 500—by investing in the underlying equities directly. This enables the investor to realize the benefits of the index's growth without having returns diluted by fund fees, expenses or capital gain taxes.

The bigger advantage, however, is that the portfolio manager has the flexibility to substitute the original stocks with ones more in line with the investor's preferences and goals, so long as they essentially mirror the performance of the original stocks and don't cause the portfolio to deviate substantially from the index. For example, if the index includes holdings that are at odds with the investor's ESG goals, the manager can swap them out for more ESG-friendly stocks that in all other respects are comparable to the original stocks. Similarly, managers can employ tax optimization strategies within the portfolio to offset the impact of capital gains, which is simply not possible with an ETF or passive mutual fund.

Direct indexing got a boost when the major custodial trading platforms moved rapidly, one after the other, to zero-commission trading. This eliminated trading costs as a barrier to stock substitution, and freed the manager to trade as often as needed to keep a direct indexing portfolio in line with the target index. However, to make direct indexing scalable, managers need portfolio construction and rebalancing tools that bring speed and efficiency to the process of security selection and portfolio modeling, largely through automation.

Tools of the trade

It's no exaggeration to say that the breadth of portfolio customization at scale, and the opportunities it affords investment managers, would not be possible without intelligent automation technologies that have become available in recent years. To reap the benefits of portfolio customization at scale, portfolio managers need technology solutions that:

- Automate and accelerate portfolio modeling, construction, rebalancing and trade creation, based on the unique preferences and investment demands of individual and institutional investors
- Identify and manage portfolio drift and its sources in order to keep portfolios on strategy
- Enable managers to quickly identify tax harvesting opportunities and manage to specified tax goals to support investors' tax management needs
- Enable the efficient substitution of equivalent securities into model-based portfolios or strategies
- Provide analytics to help managers understand and explain the reasons for a portfolio's performance, and to fine-tune the portfolio accordingly to optimize performance

Growing a separately managed account business, powered by advanced technology, represents a huge opportunity for active investment managers to compete more effectively against passive strategies, and to attract clients willing to pay a premium for strategies aligned with their values and goals while still delivering alpha, which is at the core of the asset managers value proposition. Firms that differentiate themselves with a more client-centric approach, backed by measurable outcomes, stand to gain a sustainable advantage from this trend.

Automating portfolio customization with Advent Genesis

Advent Genesis® makes portfolio customization at scale possible. It is a portfolio management solution that gives asset and wealth managers a flexible and intuitive means of managing models, constructing portfolios and creating orders at scale. **Genesis** is designed to support complex, customized portfolios requiring active management across multiple asset classes and geographic markets.

For active asset managers, **Genesis** offers a technology-powered solution for creating new distribution channels for their strategies by allowing them to accommodate a wide variety of customizations sought by end investors and advisors. For private wealth managers, **Genesis** provides the means to establish parameters within a model or strategy based on individual client preferences and tax objectives, and will automatically propose appropriate trades to meet those goals.

Genesis dramatically accelerates the process from trading decisions to execution, and enables portfolio teams to manage the growing volume and complexity of portfolios with less time and effort, driving greater productivity and freeing managers to focus on clients' preferences and goals.