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Fuse Research Network*



INVESTMENTS & WEALTH INSTITUTE®

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Tony Davidow, chair of the *Investments & Wealth Monitor* editorial advisory board, recently sat down with T. Neil Bathon, founder and partner of the FUSE Research Network, to discuss the need for personalized portfolios.

Davidow: You have been advancing the need for personalization for quite some time. Have you been starting to see this new wave of direct indexing products coming to market? Are we at the beginning or end of hyper-personalization?

Bathon: I believe we are at the very beginning of what will be a long path to personalization.

Davidow: What do the beginning innings mean and how does this trend evolve?

Bathon: Customized indexing has been almost exclusively the domain of high-net-worth clients who require special solutions to work through complicated tax issues. The technology now exists to bring customized indexing to the mass affluent in the form of personalized portfolios, but substantial change will be required to broaden its appeal. Specifically, investors need to understand what they could—or should—be asking for, and that requires them to have some appreciation for the possible benefit to their overall portfolio. Advisors need training to have a much more thorough understanding of this overlay offering so that they are comfortable presenting to their clients. While all the technology pieces appear to be in place to offer truly personalized portfolios,

I cannot yet identify the catalysts that will lead to the type and level of change required of financial advisors for adoption rates to reach meaningful levels.

Davidow: Before we get to the advisor perspective, do you see personalized portfolios as a threat to mutual funds or ETFs [exchange-traded funds] or as an opportunity to reach a new investor base that advisors have been unable to cultivate in the past? I am thinking about millennials as one noteworthy example. Could personalized portfolios bring others into this investment landscape?

Bathon: One opportunity offered by a personalized portfolio is that it allows an investor to express—and execute—on their particular ESG [environmental, social, governance] or sustainability goals. I think many people assign a broader interest in ESG to young investors. From that vantage point, this offering could get younger people into the investing mix earlier. Yet there is a big caveat—advisors probably are not going to pursue this segment because they have insufficient investable assets to make them a priority target. Mutual funds and ETFs provide a more effective solution.

At the other end of the spectrum, I believe that private wealth advisors who serve high-net-worth investors already offer a heightened level of personalization and as such retail funds—mutual or exchange-traded—do not have a meaningful market share in this segment. As personalized portfolios move more down-market over time,

they clearly have the potential to displace funds because the first wave of offerings is likely to be slightly modified versions of investment strategies that already have a brand presence—a personalized view of Fidelity Magellan, if you will, to match a client's preferences for sustainability or other factors.

Davidow: The ultra-high-net-worth market is where we see a lot more customization, and private wealth advisors think far more broadly about their clients' needs than the portfolio itself. They are focused on advanced asset allocation, estate planning, or the diversification of large concentrated positions. I don't see the threat to this market at all.

However, I do see a bifurcation at the lower end of the market. Many firms are defaulting smaller clients to a robo-offering so the advisor can more effectively service their high-net-worth clients in order to deliver a broader array of services than portfolio management. From the advisor's perspective, I wonder if this represents a pivot in, or threat to, their value proposition. Should they lean into this or is it something they should be threatened by since it could eventually lead to more do-it-yourself [DIY]?

Bathon: I do not see a meaningful DIY component in the foreseeable future. One of the things slowing adoption among advisors to the mass affluent is that they are pivoting to a more holistic, financial-planning-based approach. Tax issues are not nearly as important for their client base as for the ultra-high-net-worth. The incentive to bring

on new clients and retain existing clients is more about how they deliver full-service holistic financial planning, including estate planning and insurance. Advisors need to reassess their value proposition—their clients' needs have changed and many advisors have not evolved to stay in sync. I think that advisors who base their value on investment selection will be challenged to grow their client base, and perhaps even retain existing clients in the future.

Davidow: So, an advisor's value proposition, as it relates to the investment solution, focuses on the nature of the selected products. Do clients want to express their views and opinions in their portfolios, which means that they might want a custom index solution? The primary example is ESG, but views on ESG are becoming increasingly polarized. Does this mean that personalized portfolios are an ESG play where investors are able to reflect their views and values so the portfolio is aligned with purpose?

Bathon: Any investor who is willing to take the time can build a portfolio from scratch today that aligns with their purpose. What I think many investors really want is to see that their investment is having a positive impact and advancing their values. This is obviously much more difficult to deliver in a packaged retail investment offering meant for the masses. ESG is cited as the catalyst for direct or custom indexing coming down-market, but there is insufficient demand from individual investors, which translates into limited retail advisor support for ESG investment strategies.

At one time there was euphoric hope for ESG, but almost all individual companies can be challenged by some aspect of the factors that go into determining ESG compliance. And without a clear objective standard for evaluating a company's ESG standing, we see all kinds of conflicting rankings—which seem to bring in regulatory risks that fewer and fewer investment firms are willing to accept. For example,

Coca-Cola is thought by many to be a great company and is a holding in many ESG fund portfolios. But what impact on Coke's decision-making comes from including the company's stock in a mutual fund portfolio? Also, might not the health issues associated with many of the products it produces, and the environmental impact of the packaging, be seen by some as a reason to suggest Coke should not be an ESG holding? The way to avoid this mess is to transfer the responsibility, in a sense, to the investor via a portfolio that was constructed following client preferences.

I would also argue that the success of some of the generic ESG products, for example, the \$20 billion in assets in the iShares ESG Aware MSCI USA ETF, are simply a "check the box" mindset by advisors and a lack of understanding by investors. In my opinion, ESG is by definition a personalized strategy, and there is no way individual investors are in agreement about the ESG suitability of all 300+ holdings in the massive iShares fund. Offerings that can show a tangible impact will resonate much more with passionate altruists, but the availability of underlying investments that fit these criteria are few and far between.

Davidow: What is your take on ESG and the backlash from state attorneys general and some pension fund boards?

Bathon: For many due diligence teams, issues around diversity, equity, and inclusion seem to have become more important than ESG. Given that there is limited demand for ESG investments among retail investors and that 401(k) plans are not clamoring for ESG strategies to be added to their fund lineups, I don't see sales of ESG products reaching attractive levels in 2023. Low demand and regulatory uncertainty will put the brakes on plans to forge ahead with ESG-dedicated products.

Davidow: Some advisors may be threatened by change, but that initial discomfort may lead to better opportunities

down the road. Because we are at the beginning of personalization, what's next in this arena? What can be better personalized—whether financial planning or other things that we may not have thought about yet?

Bathon: Advisors are actively deploying asset allocation models for their clients. The proof points of the incremental value of a personalized portfolio, especially when using ETFs given the tax benefits, are not strong enough to expedite change at this time. Advisors serving mass-affluent clients will need to be shown why a personalized portfolio of individual securities is better for them and for their clients. This is going to take quite some time because many will remain suspect until the proof of incremental alpha—other than tax alpha—can be quantified. Advisors who work as part of large teams—where the customization can be centralized—are likely to be the next wave of personalization adopters. However, the average advisor, who is trying to offer more complete support in non-investment areas, is unlikely to take on the risk of additional complexity in client portfolios without a much clearer sense of the reward.

Davidow: One of the real benefits of personalized portfolios is tax efficiency, but it is very difficult for an advisor to do tax-loss harvesting across 500 client accounts. Robo-offerings are introducing technology that can be useful, but the tax-loss harvesting aspect may be challenging to scale. Does this lead to breaking up the pieces that already have been developed and then picking those aspects—the tools that may provide client benefits, in this case the tax-loss harvesting?

Bathon: I do think the technology will be decoupled and the relevant piece applied as an overlay offering. Advisors' dashboards will be able to examine all client accounts and identify attractive tax opportunities for the advisor to implement. Because most advisors' top priority is to grow their businesses with

existing and new clients, all these services will be evaluated in terms of their ability to help advisors achieve their goals. Given how many advisors grew up in the business, they are naturally wired to see themselves as investment experts. As they transition to delivering a full range of advice, any tools that can streamline operations so that they have more time to deliver better and deeper engagement will be embraced. Ultimately, much of the work associated with the management of a client's investments will be largely automated—but change is hard and usually takes longer than expected without a clean and compelling catalyst.

Davidow: If I am hearing you correctly, this is the start—rather than the end—of this particular journey. It is potentially additive for an advisor's practice but is not necessarily the big game changer. There has been a spate of acquisitions in the technology customization arena that have been viewed as a defensive play. Does the advisor need this capability—to marry technology and asset management—and is this a defensive or offensive strategy?

Bathon: Parametric¹ has been the only firm that figured out how to scale this technology and it took them a long time to do so. In Morgan Stanley's case, they are guiding their advisors to be private wealth teams who deal with higher-end clients—many of whom have complicated tax issues that Parametric is built to address. I suspect this fact made it much easier for Morgan Stanley to assign a value to the technology service than other groups that might have been looking at Eaton Vance.

There is meaningful anxiety among investment management firms about whether the ability to offer a direct indexing capability will be required to gain access to the top advisors at the largest distribution platforms. Firms like JPMorgan and Franklin Templeton have completed their own acquisitions that add a direct indexing capability to their

service offerings. RIA [registered investment advisor] platforms, Charles Schwab in particular, also have gone the M&A [mergers and acquisitions] route to jumpstart their efforts to offer customization. An interesting twist has been how quickly the price of these services has fallen—probably not something factored into the valuation models when determining how much to pay for a deal. We already are getting close to the point where just about all high-net-worth advisors have access to a tax transition service, so for the first round of entrants this has been a successful offensive strategy. Like many things in our industry, over time we should probably expect personalization and customization to become table stakes and a more defensive strategic requirement.

Davidow: There clearly is a need for specialization, and asset allocation models require greater sophistication. Alternatives are built for the current environment with equity returns projected to be lower, volatility and correlation rising, and inflation at the highest level in decades. Advisors understand the need for a differentiated toolbox to distinguish themselves from a robo-solution. Do alternatives fit into a hyper-personalized world, especially for advisors focused on high-net-worth investors with a more customized solution?

Bathon: The restrictions on the use of true alternatives lock out a huge chunk of the investing marketplace, essentially imposing a floor at the accredited investor level. At the same time, I have a deep sense that the home offices of distributors are anxious about which advisors should be allowed to use alternatives in their clients' portfolios. There is a perception of much greater risk to the client and to the firm associated with advisors not deploying alternatives appropriately. Alternative investment strategies will see attractive growth rates between expanded use among existing advisors already using these investments and a steady stream of new advisors who

reach the tipping point of being comfortable deploying the strategies in a client's account. There also are a number of workarounds to the LP [limited partner] structure that are gaining traction, such as interval and tender-offer funds and BDCs [business development companies].

As for liquid alternatives, the best environment was 2009–2010, when advisors and their clients were primed for products that provided downside protection and uncorrelated returns. There are a few noteworthy exceptions—Calamos Market Neutral Income Fund has \$16 billion in assets—but many of these offerings proved to not be as uncorrelated as promised and did not perform as needed to fuel momentum. Higher fees and a sustained bull market also didn't help their cause.

Davidow: Post-2008 proved to be the perfect storm and led to the introduction of liquid alternatives. Investors wanted hedge fund-type exposure to protect them from the next correction. Many asset managers introduced products with mixed results. Some were successful and delivered strong results, and others struggled because they lacked the expertise in running a long-short portfolio. Also, beginning in 2009, we experienced the longest bull market in history.

Now we are seeing a growing interest in private markets—private equity, private credit, and real estate. Hybrid structures such as interval and tender-offer funds are available to a broader group of investors accredited or below, provide quarterly liquidity, and have 1099 tax reporting. These structures provide access to illiquid investments such as private equity, private credit, or real estate. What comes next?

Bathon: Tender-offer funds and other similar structures will continue to grow at a nice clip. When the final tally is in, I suspect we will have set a new record for product launches in 2022. With an intense focus on serving clients via a

distributor's advisory platform, these structures suffer a bit from still being brokerage products. Although the operational wiring to connect internal platforms and asset allocation for activities such as rebalancing are not yet in place, I believe the appeal of these offerings is such that finding a fix will be a higher priority than it has been in the past. Once this issue is resolved, I think we will see a big uptick in new product development.

Davidow: What trends that will have significant ramifications across the industry do you anticipate over the next decade or so?

Bathon: I think the biggest changes and challenges arise from the end client. The way clients think about their need for advice and guidance continues to evolve. I think most distributor platforms are doing a decent job of trying

to keep up—largely with the development and introduction of technology that improves the client experience. The advisors who work for many of these firms are a bit behind in their evolution, but there are clear examples of the success that comes from modernizing one's service offering—which seems to guide individual advisors to work in teams. Holistic financial planning will continue to be the goal and will expand well beyond investments to include mortgages, insurance, credit cards, health care, longevity, charitable giving, etc.

Davidow: And this new value proposition will extend to the whole household?

Bathon: Yes, a deeper level of client engagement is critical to future success. The ability to go beyond managing a portion of a client's overall investment portfolio hinges on developing a personal

relationship with the client and the client's family. Most advisors have most of the requisite inputs needed to craft such a relationship beyond the basic investment inputs such as risk profile, but they have incorporated them into a holistic client approach. Advisors know all about the softer aspects of each client's future plans, goals, and concerns—the best advisors are using this information to deliver a truly personalized experience.

Davidow: As always, an insightful interview. Neil, thank you. 🟡

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ENDNOTE

1. Parametric was acquired by Morgan Stanley as a part of the Eaton Vance transaction.



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