

# INSIDE INFORMATION

The newsletter for serious financial advisors. ([www.bobveres.com](http://www.bobveres.com))

## Portfolio Management

# TREND CONVERGENCE

*Here's an asset management outsource company that seems to be living in the future--in several ways at once.*

*by Bob Veres*

**R**ick Ferri, of Portfolio Solutions in Troy, MI, is one of those people who happens to be at the forefront of several trends at once. For one thing, he does the same kind of work that a lot of financial planners do, but he doesn't ever refer to himself as a financial planner. "We are portfolio managers, even though we gather information about our clients and project their retirement needs," he says. "All of the questions we are asking are about their income, and about their taxes, and whether or not they have retirement plans, how much they are spending, just for us to develop the asset allocation for their portfolio, so we can give them the income they need either now or later down the road."

As the planning world segments into areas of specific expertise, you will find more people identifying themselves this way; members of the planning community who specialize exclusively in asset management.

In addition, Ferri's company has recognized and moved ahead of the trend toward creating lower-cost portfolios for clients--without sacrificing the level of service it offers, something that is now taking place at other planning firms around

the country. Portfolio Solutions portfolios are primarily made up of customized mixes of index funds ETFs and individual bonds, including munis and TIPS. Ferri's firm uses primarily Vanguard funds and VIPERS for domestic large cap and international exposure, and DFA for small cap value, emerging markets and international small cap value. "The large institutions that use DFA primarily use them primarily for their small cap exposure," explains Ferri. "We think that's what they're best at." For additional bond exposure not covered by the individual securities, his company will use the Vanguard Ginnie Mae fund, the Vanguard Corporate High Yield Corporate Bond Fund or the TIAA-CREF high-yield corporate bond fund, and there is often exposure to emerging markets through the PIMCO Emerging Market Institutional Shares fund.

Ferri also takes tax management and rebalancing a bit more seriously than most, looking at accounts on a weekly basis to see if the asset allocations are out of kilter. "If they are, we will go in and do some rebalancing, assuming there are no tax consequences to

doing it." Clients receive detailed quarterly portfolio reports, and every relationship starts with the creation of an investment policy statement.

Despite this level of service, Portfolio Solutions may be ahead of the curve in one other way: it has adopted a fee structure that is shockingly low by traditional financial planning standards. "We charge 25 basis points, with a minimum of \$1,000 per household, regardless of the number of accounts they have," says Ferri. Where did he come up with that fee? "Brokers who recommend the American Funds receive a portion of a 0.25% 12(b)-1 fee to manage the account. I think that's a fair wage for asset allocation and investment guidance, so that was the fee I established at this company when I started it."

And Ferri is at the forefront of one other trend as well. "There are a lot of financial planners who really shouldn't be spending their time on asset management," he says, "not because they don't know how to do it, or that they do it badly, but because the other things they do have high value, and tending a portfolio and all the work associated with it is not the best use of their time."

As a result, he has turned Portfolio Solutions into an outsource option for planners who want a low-cost alternative to running portfolios in-house. "So far, twelve planning firms have recognized that it's easier and less expensive to have us do the portfolio management work than doing it themselves," says Ferri. "When they bring their clients to us, we ensure that the planner remains as the point person for the account,

and almost all contact with the client is through the planner. We do not pay for referrals and we do not share compensation; the referral is made strictly because the planner believes it is the right thing to do for the client." Portfolio reports can be sent out on the planner's letterhead, and the company will create the investment policy statement with feedback from the advisor.

Even the cost is discounted for planner clients, and for the right reasons. "Clients of a financial planner pay us a reduced fee of 20 basis points a year," says Ferri. "That's because the planner is expected to do a lot of the asset allocation and tax groundwork and ongoing client contact, which save us a lot of time."

As Ferri sees it, there are two types of advisor who may be interested in the outsource option. "One group is the fee-only retainer-based planner," he says, "who either charges a quarterly retainer fee for services, or who puts an asset-based fee on top of ours to pay for the financial planning work. They would do all the financial planning for their clients, come up with their risk tolerance and the overall stock/bond asset allocation, and then we would go into more detail and do an actual proposal for the client, with the style allocations and tax plan for tax management for any low-cost-basis securities the client already has, and more detailed security-by-security asset allocation."

The other type of planner is Ferri calls hourly as-needed planners--such as members of the Garrett Financial Network. "Those advisors would basically turn the client over to us to manage the

portfolio," he says. "Whether or not the planner is involved after that point, most of the time they are meeting with clients every year and staying as in touch as they feel necessary."

In most cases, the account is custodied at Schwab Institutional, with the planner named as the lead advisor and Portfolio Solutions as the subadvisor. "In those cases, the planner would fill out the new account paperwork and list us as the subadvisor. We would be able to trade the accounts with discretionary authority, but they would receive statements on all activity." This only works if the advisor has \$10 million or more under management, however; otherwise the planner doesn't have access to Schwab Institutional, and Portfolio Solutions would have to serve as the lead advisor until the advisor's assets crossed that \$10 million threshold. "We copy them on all reports until they reach that point," says Ferri, "and then everything flips over the other way and they become the primary contact."

It seems to me that this is one of the best and most cost-effective outsource options available to the planning community--a way to get better service for clients and at the same time save operational costs at the planning firm. Portfolio Solutions (<http://www.portfoliosolutions.com>) doesn't have nearly the size and scale of SEI or the Frank Russell Co., but it happens to be compatible with the way a lot of advisors like to invest on behalf of clients.

And Ferri also has an interesting take on the various

referral networks--the program that Schwab created, and which Waterhouse is now introducing under a very similar structure. Ferri notes that when Smith Barney or one of the other wirehouse firms recommends somebody to manage assets for one of their customers, the firm does extensive due diligence and creates a 50-page report that examines how each company does business and the depth of its in-house expertise. Yes, this is a way to avoid a lawsuit, but the process seems to be missing at the discount brokerage houses, who are looking at a different kind of report. "At Schwab, the issue has always been, how much business are you bringing us?" says Ferri. "They don't do nearly the due diligence that their competitors do. When they were talking to us about joining their program, they never asked us for our performance reports."

But that's a small quibble compared with the conflict of interest over the fees. "We talked about going into their referral program, but they were charging 15 basis points out of the advisor's fee, and when we came to them, they told us that our fee didn't work for them. With most planning firms, they get fifteen basis points of 100, but with us it was 15 of 25, which came to less than five basis points. When we looked at who was being admitted into the program, we realized that it was primarily the more expensive companies."

Finally Ferri pushed the issue, and got an astonishing response. "A representative told me, if we put you into the program, we want all your clients to go into the asset-

based pricing system--their no-transaction-fee program--which would have added anywhere from .25% to .40% to our cost structure--almost doubling it in some cases," he says.

The bottom line, in Ferri's view, is that Schwab has no incentive to recommend a low-cost portfolio manager to its clients. Looking at this story, it occurs to me that Schwab's referral fee is mostly charged on money that should be allocated to the financial planning work that advisors do.

Bigger picture, I think Portfolio Solutions is one of the first companies in the country to have defined what advisors will be able to charge, in the future, as a line item on their fee schedule for passive-oriented portfolio management. With \$500 million under management, the firm is large by traditional financial planning standards, but quite small when compared with institutional management companies. As a result, Ferri is able to offer planning-focused firms the scale they can't achieve on their own--and results that would mimic, or perhaps even exceed, what they offer to their clients in-house.

As the planning profession segments into people with asset management expertise and planning expertise, both sides will get more efficient, enjoy better economies of scale, and do more for less--hopefully without sacrificing the client-first values at the core of the planning profession.

If you want to see the future, this hybrid, planning-like asset management firm may be what one side of it looks like. ■

*Continued on page 15*