



Balancing Acts

Is automated rebalancing worth the time, trouble, and expense?

BY ED MCCARTHY

By late 2006, Mark Willoughby, CFA, knew he had a problem. Modera Wealth Management, the Old Tappan, New Jersey, wealth management firm where he is a principal, had grown to roughly 140 clients. Willoughby was responsible for the periodic review and rebalancing of clients' portfolios, and the task was consuming an increasing amount of time. "We were doing it manually every quarter, and I used to be known as the 'rebalancing monkey' in the firm," he recalls. "I was doing at least 90 percent of the rebalancing, and every quarter, I would work four days nonstop on rebalancing the portfolios. And intra-quarter, you had to rebalance because somebody wanted to withdraw or add money. At that point, it was taking probably between 20 and 30 percent of my time—it was insane."

Cameron Sheehan, director of adviser services with Tamarac Advisor Services, says that in a typical advisory firm, three standard workflows require rebalancing. The first, a general rebalance, is when the portfolio's allocations deviate from their target levels by some predetermined percentage and are realigned. Another form of rebalancing focuses on tax management. Cash management workflows include searching for accounts that have excess or insufficient cash and directing trades to implement overall model-portfolio changes.

Multiple rebalancing programs are available today, but that wasn't true a few years ago. When Don Wilson, CFA, joined Atlanta-based wealth management firm Brightworth in 1998, the firm was rebalancing manually. About six years ago, one of

Wilson's colleagues created a Microsoft Excel rebalancing spreadsheet. "It's no small undertaking," says Wilson, director of portfolio management and partner at Brightworth. "But if you think about the alternative, which is trying to make trades and rebalance portfolios manually, that is extremely time-consuming, and it's very, very difficult. [The spreadsheet] certainly wasn't at the level of the commercial products, but it was a huge step up from the manual process." The spreadsheet was limited to account-by-account reviews; however, and the firm's principals realized they needed the ability to rebalance across multiple accounts simultaneously. At that point, they decided to consider commercial products instead of continuing with in-house development.

Hall Gardner, CFA, director of investments at Legacy Wealth Management in Memphis, Tennessee, also created an Excel spreadsheet to assist with his firm's rebalancing process. Building and maintaining the spreadsheet took considerable effort; however, and the other portfolio managers in the firm jokingly referred to it as the "\$6 million spreadsheet" because Gardner had spent so much time on it.

No rule exists to tell a firm when to buy rebalancing software. Legacy Wealth Management had to choose between hiring another portfolio manager or investing in the technology. For firms with less than US\$50 million of assets under management, manual rebalancing is generally less expensive than buying software, according to Gobind Daryanani, owner of FC Algorithms, a consultant with TD Ameritrade, and developer of the iRebal program, which is now owned by TD Ameritrade. Daryanani

KEY POINTS

- Several sophisticated portfolio rebalancing software programs are now available for noninstitutional advisers and investment managers.
- Factors to consider when evaluating the programs include the degree of permitted customization for trading rules and their ability to integrate with portfolio accounting software.

believes that once a firm surpasses US\$200 million or US\$300 million, it is time to consider more customized software.

Sheehan believes newer firms should automate the rebalancing process. Of course, implementing automation can be more of a challenge for younger firms than for larger, more established firms.

Rebalancing software is not plug-and-play and can be one of the most expensive programs that firms buy. For example, iRebal has a one-time set-up fee of US\$10,000 and costs US\$20,000–US\$50,000 a year for firms with client assets between US\$300 million and US\$1 billion. Prices for Tamarac's Advisor Rebalancing software, a web-based service, start at US\$3,000 for set-up and costs US\$12,000 a year. The programs also require extensive user training. These factors make the software evaluation process critical because changing programs is not easy.

Willoughby was familiar with Daryanani and the New Jersey firm where he worked when he was developing iRebal. That firm's investment process was so similar to the process of Willoughby's firm, that Modera Wealth Management adopted iRebal shortly after it became available.

Eric Jardine, CFA, portfolio manager at Baker Avenue Asset Management in San Francisco said his firm evaluated several programs and found that Tamarac was the option most frequently recommended by the advisers with whom they consulted. Those recommendations were an important consideration in the firm's selection of Tamarac.

Because rebalancing software is largely rules-driven, the ability to customize the trading rules is also vital. Jardine was concerned about the Tamarac software's ability to manage exceptions, such as investment restrictions and cash allocations, that don't necessarily occur in institutionalized accounts.

Integration with multiple portfolio management and accounting software programs is another key factor, according to Sheehan. Otherwise, changing management and accounting systems without being forced to change rebalancing programs can be difficult. Rick Brooks, CFA, vice president for investment management with Blankinship & Foster in Solana Beach, California, cites the integration factor. His firm is currently comparing portfolio rebalancing programs, and a critical consideration is each program's ability to integrate smoothly with Schwab Performance Technologies' PortfolioCenter used by Blankinship & Foster.

Brooks is also evaluating programs' abilities to adjust a portfolio's tax sensitivity. Some clients have all their money in a taxable account; others have their money in an IRA—and everything in between. Consequently, in some cases but not all, the firm must consider tax sensitivity before adjusting a client's portfolio. "Just because all of the money is in a taxable account doesn't mean the client is in a high-income tax bracket," he says. "That varies by client; it's not a firmwide decision. So the system has got to be pretty flexible that way, but it's also got to be simple enough that it's not going to take us a year to figure out how to use it."

Tamarac has a two-part implementation process that lasts about 60 days. During the first 30 days, Tamarac sets up the data transfer and the rebalancing strategy from the new customer, and users attend a three-day training session. During the final three weeks of the 60-day period, the adviser and Tamarac fine-tune and test the system, which includes Tamarac supervising as the adviser completes several trades.

New iRebal users attend 10 one-hour weekly online training sessions that cover a range of topics. The first three sessions focus on the best way to structure asset classes and sub-classes. The final sessions emphasize fine-tuning the system to produce the results the adviser wants. By that point the adviser can start to implement the software with roughly 50–100 clients per week.

The time required for a full implementation varies. Charles Sachs, CFA, vice president and wealth manager with Evensky & Katz Wealth Management in Coral Gables, Florida, says his firm spent about one year building the firm's intelligence into the iRebal system. "I've always likened this somewhat to the farmer who buys a US\$1 million John Deere tractor," says Sachs. "The benefit is incredible, but it's also steep in initial price, ongoing price, and maintenance."

Sachs raises a good point about the program's cost and time spent mastering it, but the software developers report impressive productivity improvements. Sheehan says Tamarac's research has shown that it takes the average adviser about 20 minutes per account—or 35 minutes for a family—to do a standard manual rebalance. The time expenditure changes dramatically with automated software. "We've found in Tamarac that if you have, say, 1,000 accounts, that process is about 15 minutes. If you get up to 2,500 accounts and you're doing 20 minutes an account, that's around 100 workdays. We're talking 15 minutes in Tamarac to get that done."

The advisers interviewed for this article unanimously agreed that the resulting productivity boost justified the purchase. Sachs reports that the immediate productivity boost for his firm's advisers is "quite apparent." From a longer-term perspective, he believes the software will allow the firm to add clients without adding staff immediately. Likewise, Gardner believes his firm is managing its clients' portfolios more effectively. As an example of improved efficiency, he notes that before installing iRebal, it

would take several weeks to unwind clients' positions if the firm fired an outside investment manager. Now that task can be accomplished in one day. Companies such as Legacy Wealth Management, that review portfolios more frequently experience another benefit as they are able to harvest gains sooner than when they did manual reviews.

Daryanani addresses the productivity question from a personnel perspective based on iRebal customers' experiences. He cites a US\$1 billion firm that was growing rapidly toward US\$2 billion. Assuming a rebalancing rate of 20 minutes per account, he says a US\$2 billion firm would require three to four full-time staff members for manual rebalancing. With iRebal, however, the firm can reduce the staffing requirement to half a person, in Daryanani's estimation.

Willoughby estimates the software has saved at least one and possibly two full-time positions at his firm—which has grown from 130 to 300 clients.

Willoughby points to another benefit from automated rebalancing—improved risk management. Trades made to rebalance client portfolios are one of the biggest risk exposures for firms because the firm makes the client whole in the event of a trading error. Even with multiple reviews built into a manual rebalancing process, some risk of error still exists, but the automated system has a safeguard against those errors. "The rebalancing software doesn't allow you to submit a purchase when you intend it to submit a sell," says Willoughby. "It pretty much eliminates that risk, and that is actually a significant and fundamental risk-management benefit to automated rebalancing." ■

Ed McCarthy is a freelance financial writer in Pascoag, Rhode Island.

RECOMMENDED RESOURCES

"Optimal Rebalancing: A Scalable Solution" Summarized in *CFA Digest* (August 2009) (www.cfapubs.org)