DEFINING OPEN ARCHITECTURE

Models for Managing Wealth

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Open architecture seemed like a simple enough concept: eliminate conflicts of interest by separating wealth management advice from the sale of investment products. At least that's what I believed until I received a phone call from the CEO of a public company who needed a bit of advice. A major bank had approached him with what sounded like an appealing investment proposal, and he wanted to know what I thought.

The bank in question had traditionally sold only its own investment products to investors, but had recently begun expanding its product line to include offerings from other investment houses as well. This move was motivated by the fact that the bank, like a lot of other big institutions, was feeling pressure from smaller, nimbler firms that were going after its best clients. These upstart firms were succeeding by providing what had come to be known as "open architecture" service, meaning the only thing they sold was investment advice. They had no financial interest in any of the funds they recommended, and therefore represented their clients' interests exclusively.

Open architecture was proving to be very attractive to wealthy investors, which is why the bank had approached the CEO with a simple and powerful message: *We've got open architecture, too!*

The bank wanted the CEO to know that it had a new open architecture platform, which meant that its investment advisors were now free to select the very best funds available, whether they came from the bank itself or from other companies. To prove it, the CEO had been presented with a portfolio of ten funds, three of them from the bank, and seven from external managers. Instead of paying fees for advice, the CEO would pay only the investment fees associated with each of the funds. Intrigued, the CEO asked me what I thought. That's where things got interesting.

In its presentation, the bank kept referencing its new open architecture platform, but that didn't make sense to me. As I understood it, open architecture was the approach being used by the innovative new investment advisors: no products for sale, no financial interest in any investment recommendations, no potential for conflicts of interest. That didn't seem to describe the bank's approach at all. As far as I could tell, the only thing the bank had done was to begin recommending third-party funds in addition to its own. How was that open architecture?

That wasn't the only question I had. As I studied the proposed portfolio, something about it just seemed off. So I did a bit of digging and quickly discovered a couple of others things.

First, it turned out that of the seven funds in the portfolio that were from third-party firms, three came from a wholly owned subsidiary of the bank. In other words, the bank had recommended six of its own funds, not three.

Next, I learned that the outside firms whose funds were included in the portfolio had paid the bank—by cutting them in on their investment fees—in return for being included on its new "open architecture" platform.

None of this seemed to reflect either the spirit or the practice of what I believed open architecture to be. Intentional or not, the recommended portfolio contained unacceptable conflicts of interest that were difficult to spot. Knowing that, how could the CEO be sure that the funds in the portfolio had been selected primarily for his benefit rather than the bank's? The answer was, he couldn't.

"This isn't open architecture," I told the CEO. It turns out, though, that I was only half right.

It was certainly true that the bank's proposal represented a number of conflicts of interest. So what did I get wrong? I thought I knew exactly what open architecture was. I didn't. Actually, no one does, because the phrase has come to be, essentially, useless. It is the financial—service industry's equivalent of "all natural"—a term used to imply wholesomeness or purity that has no regulatory standard.

Anyone who has strolled down a supermarket aisle and seen all the packages carrying the "all natural" label would probably be surprised to learn that the Food and Drug Administration states on its website that it "has not developed a definition for use of the term natural or its derivatives." Similarly, investors may be disappointed to learn that open architecture has no legal or enforceable definition.

In some ways, then, open architecture has come to mean whatever an institution wants it to mean. For instance, I was recently helping a family office client with a due diligence project that involved evaluating wealth management firms. We were interested in only wealth managers who practiced open architecture, which to us meant that they offered no investment products of their own.

My client was intrigued by one firm that trumpeted its embrace of open architecture, going so far as to list on its website the specific kinds of products it did not sell—proprietary mutual funds, for example. Sounded great! Looking deeper, though, I found that the firm actually did manage some of its clients' money, including U.S. stocks and bonds. These may well have been quality products, but what the firm was offering didn't conform to our definition of open architecture.

So what does all of this mean for you? Whether you're looking to choose an advisor for yourself or are in a role where you have responsibility for someone else's money—a fiduciary, a trustee, a member of an investment committee, or a family office executive—it's crucial that you are familiar with the different business models that are all operating under the umbrella term of open architecture.

That process begins with understanding how wealth managers actually do their job for their clients. A wealth manager starts by identifying a client's specific needs, circumstances, and tolerance for risk. Next, the manager creates what's known as an investment policy statement, or IPS, which details the guidelines for overseeing the client's portfolio.

As part of the IPS, the wealth manager develops an asset allocation, which is a big—picture plan for the asset classes that the client's money will be invested in. When wealth managers talk about asset classes, they mean overarching investment categories—things like stocks, bonds, cash, and real assets, and also alternative investments such as hedge funds, private equity, and derivatives.

Once the client signs off on the IPS, including the asset allocation, the process shifts to what's known as portfolio construction. This is the point where the advisor gets to work putting the client's money into a mix of investment products, making sure that the entire portfolio is in keeping with the goals outlined in the IPS.

It's during the portfolio construction phase—when your advisor starts investing your money—that the varying definitions of open architecture become important. This is where you'll want a clear understanding of what's motivating the investment decisions your advisor makes. It's not enough for the firm to declare that it is open architecture. You need to know what that means, specifically, to the firm.

Each company has its own process for compiling an "approved list" of investment options for the client, but essentially there are three models or platforms. With an Advice Platform, the advisor only uses external investment products, the Product Platform is where the approved list is made of the firm's own proprietary investment products, and the Hybrid Platform is where external and proprietary products are on the approved list.

To help you, we have created this open architecture taxonomy. All of the following business models are marketed as open architecture. Make sure you know which model is being presented to you.

KEY A source of revenue · No revenue · Potential revenue

ADVICE PLATFORM

Wealth Management	IPS, asset allocation, due diligence, portfolio construction				
Investment Management	Cash	Bonds	Stocks	Real Assets	Alternatives

The firm charges a fee for investment advice, but does not use any of its own products, or share in any of the investment fees for the funds that it recommends.

PRODUCT PLATFORM

Wealth Management	IPS, asset allocation, due diligence, portfolio construction				
Investment Management	Cash	Bonds	Stocks	Real Assets	Alternatives

The firm does not charge a fee for advice, but instead earns money from investment fees on its own products or from the products it recommends.

HYBRID PLATFORM

Wealth Management	IPS, asset allocation, due diligence, portfolio construction				
Investment Management	Cash	Bonds	Stocks	Real Assets	Alternatives

The firm charges a fee for advice, and may also use its own products or external funds it recommends.

No matter the open architecture platform you're presented with, the important thing is to understand the advisor's business model, and any potential conflicts of interest the model may pose.

Keep in mind that just because a platform doesn't represent a conflict of interest, it doesn't necessarily mean that your costs will be lower or that your returns will be higher. Similarly, a firm with a platform that has conflicts of interest may actually have excellent investment returns. No one platform will necessarily produce a better overall result than any other. The key is to remember that when you hear "open architecture," it's time to start rather than stop asking questions.

Questions to ask before choosing a wealth manager

Whether you're an investor yourself or you serve as a fiduciary, trustee, or family office executive, sooner or later you're likely to find yourself in the position of evaluating a wealth manager. As part of that process, it's important that you understand the different business models that are common in the industry. The following questions will help you get started.

- **What are the firm's potential conflicts of interest?** When the firm puts your money into an investment product—whether its own or one from another company—does it share in the revenues or receive payments, placement fees, or trading commissions?

- **What are the firm's sources of revenues from your account?** How will the firm make money from your account, exactly?

- **What are the fees—from all sources—for your account?** How much will you be charged, in dollars and as a percentage of your assets, for both wealth management and investment management?

- **Will the firm invest your money in products of its own?** If the firm does invest in its own products, how does the cost compare with comparable products available elsewhere? Also, what is the process for monitoring the results of the firm-owned products, and for shifting assets to external managers when results are subpar?

- **Does the firm have a model portfolio that represents the type of recommendation it's making to you?** What are this historical returns and volatility for this kind of recommendation?

Appendix: Wealth Manager vs. Investment Manager

Open architecture isn't the only financial concept that causes widespread confusion. There's also a lot of misunderstanding out there about how a wealth manager is different from an investment manager. In fact, many of us don't realize that there's a difference at all. Adding to the confusion is the fact that wealth managers and investment managers are often referred to by several different titles. Because it's important for investors to understand these two roles, and the specific work that each performs, let's take a closer look at them.

Wealth Manager

Generally speaking, wealth managers focus on helping clients create an overall investment plan that integrates tax, estate, and philanthropic planning.

Also known as: Investment advisor, investment consultant, financial planner, multi-family office

PRIMARY RESPONSIBILITIES

- Identifies client's needs, challenges, and tolerance for risk.
- Creates an investment policy statement (IPS) that sets guidelines for the client's portfolio.
- Develops an asset allocation plan for investments in asset classes like stocks, bonds, cash, real estate, hedge funds, private equity, and venture capital.
- Conducts due diligence to compile an "approved list" of investment products and managers.
- Oversees portfolio implementation, putting the client's money into investment products from the "approved list."

Investment Manager

Generally speaking, investment managers focus on maximizing risk-adjusted returns within a given investment management strategy.

Also known as: Portfolio manager, investment manager, fund manager, asset manager

PRIMARY RESPONSIBILITIES

- Researches individual securities like stocks, bonds, and futures.
- Makes decisions about buying and selling stocks, bonds, real estate, etc.
- Creates an investment portfolio that balances risk with potential returns.
- Manages investment products like mutual funds, ETFs, or separately managed accounts (SMA) and investment partnerships.

About

Stephen Martiros is a wealth management expert who has advised private investors and family offices for more than 25 years.

Stephen is the founder of Financial Building Blocks®, a modular education system that helps people master the basics of personal finance. This proprietary software application is effective for both individual and group learning, and is easily tailored to the specific needs of individuals, families, companies, and organizations.

Previously, Stephen founded and served as CEO of Summitas®, an award-winning cloud software company that provides family offices and investment advisors with a secure platform for creating a virtual family portal and an encrypted digital vault. He was awarded multiple patents for interactive advertising and an animated user interface for computer displays.

Stephen also served as the Managing Partner of CCC Alliance, where he helped build America's largest private knowledge network of single family offices, and led CCC Alliance to the "Family Office of the Year" award presented by Institutional Investor's Private Asset Management magazine.

Stephen began his career as an investment advisor with E.F. Hutton (now Morgan Stanley) and later worked with Alex. Brown & Sons (now Deutsche Bank). He received his BS and MBA from Babson College, where he serves on the Board of Overseers, and is a recipient of the college's Snyder Award for Distinguished Service. He lives with his wife and children in suburban Boston.