Managed Account Trading Practices Survey

Best-Execution Requirements Increase SMA "Step-out" Trading Activity

Separately managed accounts (SMAs) represent one of the retail investment industry's fastest-growing products—Financial Research Corporation (FRC) expects SMA assets to grow 16.5% annually over the next five years, reaching $2.2 trillion by 2012. As the industry embarks on its impressive growth trajectory, SMA investment managers continue to face a number of operational challenges, including delivering "best execution" to investors, and addressing the operational and cost issues around the practice of trading away or "stepping-out."

To garner a more complete understanding of the processes and challenges associated with trading-away or step-out trades, Citi's Investment Administration Services recently commissioned FRC to conduct a custom survey of retail SMA managers and their step-out practices. FRC received broad industry participation from investment managers representing nearly a third of the SMA industry's accounts.

Step-out trades are widespread

Stepping-out retail SMA trades is an established practice as 90% of surveyed managers indicated that they perform step-out trades at least some of the time. Among the largest managers (those managing more than 50,000 accounts), step-out trades are most prevalent, with 100% having indicated performing step-out trades for their retail managed accounts.

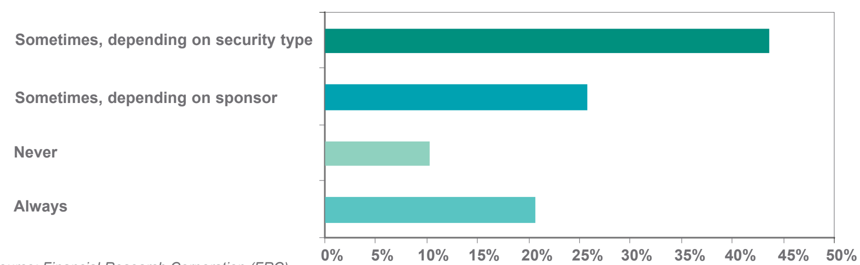
Competing motivations spurn step-outs

Stepping-out or trading-away is primarily motivated by the need to meet best-execution standards and obtain specialized security coverage from institutional brokers. Additionally, nearly 80% of surveyed firms indicated that they manage multiple product lines (i.e., hedge funds, mutual funds, and institutional accounts) and prefer to bundle trade flow across these product lines.

Step-out trading practices

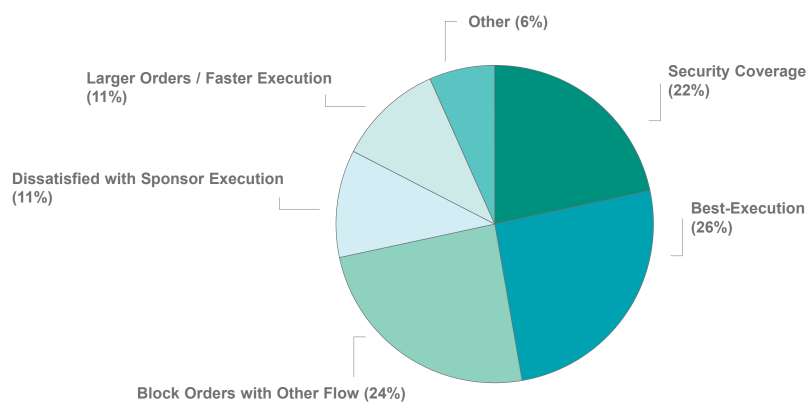
Historically, investment managers have traded with sponsors of managed accounts primarily due to the wrap-fee nature of the managed account business, automation limitations, and to ensure that investors did not incur additional trading costs or commissions. The recent increased focus on best execution and automated trading has caused many investment managers to consider "trading-away" or "stepping-out" managed account trades from sponsor platforms to external brokers.

Prevalence of step-out trading



Source: Financial Research Corporation (FRC)

Primary reasons for step-out trades



Source: Financial Research Corporation (FRC)

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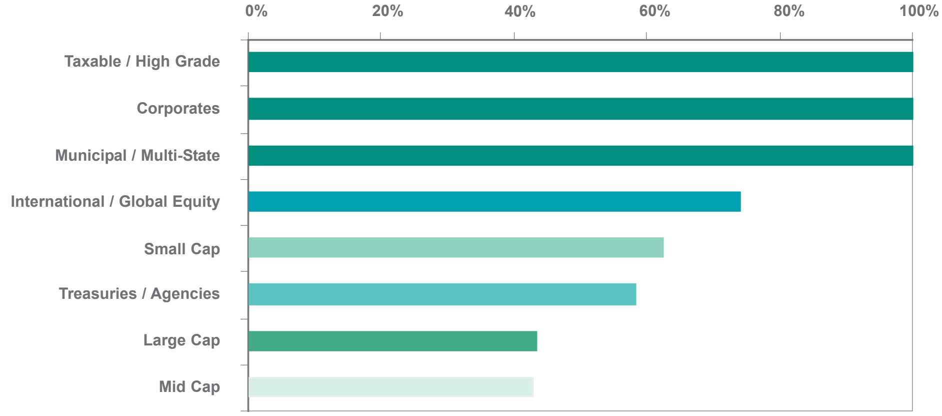
Security types necessitate use of third-party brokers

Step-out trades are largely driven by security type. Often, managers can achieve best execution by trading away in less-efficient markets (small caps, convertibles, and fixed income). They can also receive broader access to international securities, or to take advantage of automation of the purchase of international ordinaries and the automated conversion into ADR's most often used in SMA accounts.

However, despite the prevalence of trading-away in specific markets or illiquid security types, nearly two-thirds of large-cap domestic equity managers indicated they often trade-away when blocking orders with the other product lines they manage, such as institutional accounts or mutual funds.

Security types traded away



Source: Financial Research Corporation (FRC)

Security coverage and best execution propel step-out trades

As best-execution requirements continue to grow and more sophisticated investment strategies enter the retail SMA space, the demand for step-out trades will continue to increase. Nearly half of the surveyed managers reported that approximately a third of their across-the-board volume is traded-away, but managers expect that to grow significantly. Over 75% of managers expect at least a third of their volume will be traded-away in the future. [Additionally, nearly one-half of managers expect that 75% or more of their volume will be traded-away in the future.]

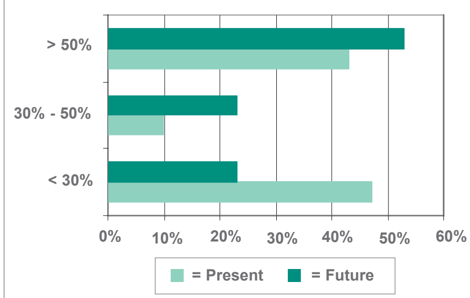
Costs of stepping-out

Costs associated with step-out trades often depend on the size of the investment manager and magnitude of the relationship with brokers of choice for trading-away. While most firms reported that the costs of step-out trades are netted up into the trade, nearly one-quarter of managers indicated that trading on their retail managed accounts was free as part of a broader institutional relationship.

Manual procedures pervade manager step-out trades

Despite the prevalence of step-out trades within the industry and their growing popularity, the process of generating trade-away orders and allocating shares to underlying sponsor accounts is primarily carried out through time-consuming manual processes.

Percentage of model change / across-the-board order volume stepped-out



Source: Financial Research Corporation (FRC)

Step-out trades: Completion of order generation and sponsor allocations

	Order Generation	Sponsor Allocation
Manual Process	63%	69%
Automated Process	27%	28%
Not Catergorized	10%	3%

Source: Financial Research Corporation (FRC)

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Financial Research Corporation
100 Summer Street, 15th Floor
Boston, MA 02110
(888) 491-9788
frcinfo@frcnet.com
www.frcnet.com

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