Separately Managed Accounts: Tailored to Suit You

Mutual funds have been one alternative for many investors seeking professional money management. But when you buy shares of a mutual fund, your assets are pooled with those of other fund shareholders. You gain professional money management, but the fund's manager certainly can't tailor its portfolio to meet your individual requirements.

For investors who want or need a more customized approach--for example, in order to better manage their tax liability or control individual stock holdings--separately managed accounts (SMAs) have become popular. Historically used by institutional investors and high-net-worth individuals, SMAs are now available to a wider group of investors as an alternative to mutual funds, though SMAs typically still require a higher minimum investment than a mutual fund might.

What is an SMA?

An SMA is a personal investment account that is customized and managed for you by one or more professional money managers. In an SMA, your assets are not commingled with those of other investors. With a mutual fund, you buy and sell shares of the fund. Even though each fund share represents a proportionate ownership of individual securities within the fund, your share of each of those securities is tiny. By contrast, you are the sole owner of each security within your separately managed account. You also may be able to place securities you already own in an SMA; with mutual funds, you can't. Typically, the account owner has the ability to customize the account by excluding certain securities or industries, or employing tax-advantages vehicles.

Why is that control important? It increases your ability to coordinate the sale of specific securities with the rest of your overall financial plan.

It was once common for SMA programs to require a minimum of $1 million in investable assets, but today you can find separately managed accounts with minimums as low as $50,000. SMAs' lower minimums, along with a growing appreciation of their unique features, may be reasons for their increasing popularity.

Is an SMA the same thing as a wrap account?

Both wrap accounts and SMAs charge fees based on the size of assets in the account, and the terms sometimes are used interchangeably. However, with a wrap account, your financial professional may serve as the account's money manager, selecting individual securities or mutual funds for your portfolio. With an SMA, your financial professional may rely on a separate money manager (or multiple managers) to handle the day-to-day management of the portfolio or specific components of it. For example, with an SMA, you may be able to have a money manager who specializes in bonds manage that portion of the portfolio, while another manager who specializes in stock handles the equity portion. An SMA must be managed by a registered investment advisor, who may be independent or part of the same firm as your financial professional.

How SMAs trump mutual funds on taxes

Mutual funds have an inherent lack of tax efficiency. When you buy shares of a mutual fund, you automatically get a share of its embedded tax liabilities. By law, mutual funds are required to pay out realized capital gains to all fund holders, regardless of how long you have held its shares.

For example, if you buy shares in a mutual fund right before a distribution date, you may receive a distribution and have to pay capital gains taxes even though you may have held the fund for only a short amount of time. The lack of tax efficiency can be a greater problem for actively managed mutual funds that buy and sell securities frequently than it is for indexed mutual funds.

Also, some fund investors can find themselves owing income tax on their fund investment, even though the fund may have declined in value during the year. If a fund manager sells some of a fund's holdings at a profit but other holdings drop in value, the fund can have a capital gains distribution even though its overall net asset value is lower.

By contrast, each security held in an SMA has an individual cost basis. That allows you to make specific tax-motivated moves. For example, you can generally request that your manager sell a position with an unrealized loss in order to offset capital gains, thus reducing your income tax liability.

Example: *You sold a vacation home at a profit, but do not qualify for any exclusion. As a result, you owe capital gains taxes on that gain. To reduce your tax liability, you instruct your SMA manager to sell part of your position in a stock that has dropped in value. The manager sells enough stock to ensure that the losses on it offset any capital gains taxes you would owe as a result of the real estate sale.*

How SMAs compare with mutual funds on trading costs, fees, and performance

Unlike traditional brokerage accounts, which are commission-based, SMA fee structures are asset-based. They typically cover the investment management fee, trading costs, custody, reporting, and financial planning services.

One thing to consider when comparing mutual fund expenses against SMA fees is the "invisible" trading costs incurred by mutual funds. Mutual fund expense ratios cover fund management fees, administrative costs, and other operating expenses. However, they don't cover trading costs, which include brokerage commissions whenever the fund buys or sells securities. Although these trading costs can vary significantly by mutual fund (depending in large part on their annual turnover rates), estimates of these costs range on average from 0.5% to 1.5% but can be higher.

Also, mutual funds often carry a certain amount of cash as a cushion in case they experience a wave of redemptions from investors. That cash can act as a drag on performance. If a fund has to sell securities to meet redemption demands, that also can affect its results. Though an SMA involves its own risks and doesn't automatically guarantee you'll have better returns, you don't have to worry about the impact of other investors' actions, because an SMA has no other investors.

Because of the different ways in which fees for mutual funds and separately managed accounts are calculated, it can be challenging to compare those fees. Generally speaking, the larger your account, the more likely you are to benefit from an SMA. Before investing, ask your financial professional to do an "apples to apples" comparison between SMAs and mutual funds, including total fees and trading costs, to determine which is the better deal in terms of overall costs.

How SMAs can be customized for your specific situation

Another important feature of SMAs is their ability to allow you to exclude certain securities. You also can set sector guidelines to avoid investing in a sector you might disapprove of (for example, tobacco or casino stocks). This flexibility allows you to better tailor your asset allocation for your own unique circumstances and desires--key considerations for many investors with concentrated stock positions.

Example: *You work for a large company that is a mainstay of most large-cap stock indexes, and you also hold shares in the company as a result of having exercised stock options. You instruct your SMA's manager not to buy your company's stock, to prevent your net worth being too dependent on one company.*

However, don't expect to micromanage every single trade, as you might with a traditional brokerage account. Within the guidelines you set, the money manager typically will have discretion to implement strategies that he or she feels will provide the best returns for you. (After all, if you want to make all the decisions yourself, it probably doesn't make sense to hire a professional money manager.) However, you still have flexibility to integrate those decisions with the rest of your financial concerns. And you'll always be able to track what has been bought and sold on your behalf.

The bottom line

For investors who place a priority on control and tax efficiency, and have the necessary capital, an SMA program may make a lot of sense.