Primer on Separately Managed Accounts

The investment management world is generally divided into retail and institutional investors. Products designed for middle-income individual investors, such as the retail classes of mutual funds, often have modest initial investment requirements. Managed strategies for institutions can have imposing minimum investment requirements that can be as high as $25 million or more. Between these ends of the spectrum, however, is the growing universe of separately managed accounts (SMAs) targeted toward wealthy (but not necessarily ultra-wealthy) individual investors. Whether you refer to them as "individually managed accounts" or "separately managed accounts," managed accounts are a mainstream investment option along with mutual funds. The following is a review of SMAs and what investors—and their financial advisors—should keep in mind when considering such an investment.

INVESTMENT ESSENTIALS

EQUITY STRATEGIES

Defining Separately Managed Accounts

Similar to a mutual fund, an SMA is a portfolio of assets managed by a professional investment firm. In the United States, the vast majority of such firms are called registered investment advisers, and operate under the regulatory auspices of the Investment Advisers Act of 1940 and the purview of the U.S. Securities and Exchange Commission (SEC). One or more portfolio managers are responsible for day-to-day investment decisions, sometimes supported by a team of analysts, operations and administrative staff. **SMAs differ from mutual funds in that each portfolio is unique to a single account (hence the name)**. In other words, if you set up a separate account with money manager X, then manager X has the discretion to make decisions for this account that may be different from decisions made for other accounts. Mutual funds cannot offer, due to their structure as investments shared by a group of investors, the benefit of customized portfolio management. Separate accounts overcome this barrier.

As an example, a manager oversees a diversified core equity strategy including 20 stocks. The manager decides to launch a mutual fund investing in these stocks as well as a separately managed account offering. Assume that at the outset the manager chooses the same investments and the same weights for both the mutual fund and the SMA. From a client's perspective, the beneficial interests in either vehicle seem identical at the outset, but the statements will look different. For the mutual fund client, the position will show up as a single-line entry bearing the mutual fund ticker—most likely a five-letter acronym ending in "X." The value will be the number of fund shares owned multiplied by the net asset value per share at the close of business on the statement's effective date. The SMA investor's statement, however, will list each of the equity positions and values separately, and the total value of the account will be the aggregate value of each of the positions.

From this point, the investments will begin to diverge. Decisions the manager makes for the mutual fund—including the timing for buying and selling shares, dividend reinvestment and distributions—will affect all fund investors in the same way. For SMAs, however, decisions are made at the account level and can, therefore, vary from one investor to another.

Mass Customization

The customization is one of the main selling points for SMAs, particularly when it comes to individual taxable accounts. Portfolio transactions have expense and tax implications. With managed accounts, investors may feel like they have a greater degree of control over these decisions, and that they are more closely attuned to the objectives and constraints set forth in the investment policy statement.

So what is the price of entry for this extra level of customized attention? Given technological advances, money-management firms have been able to significantly reduce their minimum investment requirements to well below the traditional $1 million mark. But there is still no single answer for the several thousand managers that make up the SMA universe. As a general rule of thumb, the price of entry starts at $100,000. SMAs targeted to high-net-worth retail investors tend to set account minimum balances between $100,000 and $5 million. For strategies designed for institutional managers, minimum account sizes may range from $10 million to $100 million.

For style-based investors who seek exposure to several different investment styles (e.g., large-cap value, small-cap growth) the price of entry goes up, as there will typically be a separate SMA, and a separate account minimum, for each style chosen. An investor seeking style-pure exposure in the four corners of the style box—large cap, small cap, value and growth—might need to have at least $400,000 available to implement an SMA-based strategy. Other investors may prefer an all-cap blend (or core) approach that could be accessed through a single manager.

In addition, investors can impose restrictions on how the account is managed. For example, For example, many clients are interested in investing in companies that have strong environmental, social and governance (ESG) records. Separately managed accounts are ultimately designed to provide individual investors with the kind of personalized money management that was formerly reserved for institutions and corporate clients.

Individual Cost Basis

The ability to have individual cost basis on the securities in your portfolio is the key to those benefits. To understand the significance, consider the nature of the mutual fund. In its most basic form, a mutual fund is a company that invests in other companies by purchasing the stocks and bonds issued by those companies. When you purchase shares of a mutual fund, you share ownership of the fund with all of the other investors in the fund. You do not have individual cost basis on the securities owned by the fund. Consider the following example:

ACME Mutual Fund holds shares of two companies: Company 1 and Company 2. You purchase 100 shares of ACME Mutual Fund. While you own those 100 shares of ACME Mutual Fund, you do not own any shares of Company 1 or Company 2. Those shares are owned by the ACME Mutual Fund company. Since you are an investor in the ACME Mutual Fund company, you can buy or sell shares in the ACME Mutual Fund company, but you have no ability to control Acme's decision to buy or sell shares in Company 1 or Company 2. In a separately managed account, you do own those shares. If a separate account portfolio includes shares of Company 1 and Company 2, the money manager purchases shares in each of those companies on your behalf.

To avoid the "mutual" nature of mutual funds, you could choose to purchase individual stocks and bonds to build your own portfolio, but that is a time-consuming proposition and denies you the benefit of professional portfolio management, which is the primary reason most investors put their money in mutual funds. To obtain the benefits of professional portfolio management without the hindrance of mutual ownership of the underlying securities, an increasing number of investors are turning toward SMAs.

Potential Tax Benefits

One of the most significant benefits of separate accounts involves tax gain/loss harvesting, which is a technique for minimizing capital gains tax liability through the selective realization of gains and losses in your SMA. Consider, for example, a separate account portfolio in which two securities have been purchased at similar prices. Over time, one of the securities has doubled in value while the other has fallen by half. By instructing the money manager to sell both securities, the gains generated by the security that has doubled in value are offset by the losses in the other security, eliminating any capital-gains tax liability. The proceeds from the sale can be reinvested, maintaining the balance in your account. In a similar fashion, if you sold some real estate, art or other investments at a gain, but have unrealized losses in your separate account, you could realize the losses and use them to offset the gains from the sale of your other investments.

Another tax benefit of individual cost basis is the lack of embedded capital gains. Again, a comparison to mutual funds demonstrates this issue. Mutual funds must pay out all capital gains once per year. Since mutual funds are "mutual," all investors share the tax liability on the gains. So, for example, if the fund doubled in value from January through November, investors purchasing into the fund in December did not get the benefit of any of those gains, but they do inherit the tax liability because the gains are embedded in the portfolio. Separate account investors, thanks to individual cost basis on the underlying securities, would not be liable for capital gains generated prior to the day they invested in the portfolio.

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The Importance of Due Diligence

Because SMAs do not issue registered prospectuses, investors can often rely on their advisor and their advisor's firm for investigating and evaluating the manager. This is referred to as due diligence. Comprehensive due diligence will elicit sufficiently detailed information regarding all of the following areas:

Performance Data

A manager should be prepared to share performance data (annual and quarterly returns achieved) since inception of the strategy. The information is contained in a composite—a table showing aggregate performance for all fee-paying accounts in that strategy. A good question to ask here is whether the composite complies with the Global Investment Performance Standards (GIPS) set by the CFA Institute and whether a competent third-party auditor has provided a letter affirming compliance with the standards. An advisor would not typically offer the SMA unless it did.

Philosophy and Approach

Each manager has a unique investment philosophy and method of applying that philosophy to an investment approach. You will want to know whether the manager has a more active or passive style, a top-down or bottom-up approach, how he or she manages alpha and beta risk, the strategy's performance benchmark and other similar information.

Investment Process

Find out who makes the decisions and how they are implemented; the roles and responsibilities of portfolio managers, analysts, support staff and others; who comprises the investment committee and how often it meets; and the sell discipline and other key aspects of the process.

Organization and Compensation

How the firm is organized and how it pays its professionals—especially the managers whose reputations and track records are the big draw—are extremely important aspects of the investment. Understand the calculations behind incentive compensation. You and your advisor should ensure that the manager's incentives are aligned with yours.

Compliance History

Red flags include prominent infractions with the SEC or other regulatory bodies, fines or penalties levied and lawsuits or other adverse legal situations. The SEC considers separate account managers to be investment advisers subject to the provisions of the Investment Advisers Act of 1940.

Much of this information can be obtained from the manager's Form ADV Parts 1 and 2 (Part 2 includes more details on strategy approach and fees as well as biographical information on the principal team members). Performance data should be available directly from the manager, either online or through personal contact with a management representative. The representative should also be able to coordinate phone or in-person meetings with key team members, and direct your questions regarding compliance and other issues to the appropriate personnel.

Conclusion

Given the account minimums, separately managed accounts are not for every investor. If you have the means, they can be a useful alternative to mutual funds or other pooled vehicles and more closely align with your own specific return objectives, risk tolerance and special circumstances. To maximize the potential benefits separate accounts offer, most investors work with a professional investment advisor. The advisor assists with asset-allocation decisions and money-manager selection, as well as coordinating portfolio customization and gain/loss harvesting.

Contact your financial advisor to learn more about INVESTMENT ESSENTIALS or please visit amgfunds.com/essentials for more information.

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