Why separately managed accounts are undergoing a rebirth

Customization, transparency, tax efficiency and professional management spurring growth in SMAs

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A class of products that have been around for a long time are undergoing a rebirth: separately managed accounts, or SMAs.

The recent sales figures have been impressive. SMA market assets have bounced back to levels last seen before the financial crisis — more than $762 billion at year-end 2013, according to Cerulli Associates Inc., with one-year growth of 23.1%. Cerulli Associates projects growth rates in separate accounts of 11.3% to 12.2% in each of the next four years.

The success of SMAs lies in their advantages: customization, transparency, tax efficiency and professional management. They can also offer flexibility in fees and a high value perception for clients attracted by the cachet of owning a professionally managed strategy in a more exclusive wrapper.

The concept is easy to explain, one reason that SMAs are gaining traction with clients. They fill the needs of retail investors wealthy enough to invest $100,000, and in some cases as little as $50,000, who want to move beyond pooled vehicles like mutual funds into portfolios with individual security ownership that are actively managed by professional asset managers.

Customization is a key differentiator in the marketplace. SMAs can help financial advisers demonstrate they are listening to the individual needs of their clients. Each SMA can be tailored to meet specific needs and goals. When investing in SMAs, advisers and clients can express preferences or restrictions concerning strategies or individual stocks, which can give them a greater sense of control.

For this reason, they are particularly attractive to clients with specific investment guidelines, and those who require additional hand-holding from their adviser. Increased demand for environmental, social and governance portfolios is fueling momentum in SMA strategies that apply sustainability-focused ESG integration. A shift away from traditional style box investing to outcome-oriented solutions is also fueling the movement to SMAs, as investors express greater desire for products addressing income, longevity and volatility risk.

In the wake of the financial crisis, transparency has become even more important to clients. With SMAs, advisers and clients see their actual holdings. They also receive full details on fees. This level of transparency lets high-quality asset managers prove their worth.

SMAs also provide excellent vehicles to assess and balance tax liabilities. The run-up of the equity markets has created considerable tax implications for many investors. The fiscal condition of public budgets indicates that taxes are likely to increase, not decrease, and many investors are seeking tax advantages mutual funds do not offer. Within an SMA there are no unearned gains and often trades can be balanced to address tax loss and gain harvesting. That can be highly attractive to investors who have large taxable assets and want access to particular portfolio managers or investment strategies. SMAs can also help those who want to create benefits for charitable giving.

Tax management and transparency may not always be top of mind, but these aspects promise to be integral to the dialogue between asset managers, financial advisers and clients for the foreseeable future.

No product is appropriate for all investors. The transparency most see as a key benefit instead can be a liability to those who are driven crazy by the details of their holdings: a 40% increase in one stock may bring great joy, but the 50% decline in another may inspire agita. Likewise seeing the SMA's management fee debited quarterly may dismay those who are accustomed to the less transparent practices of some mutual funds, even if the SMA fees are actually lower. As with all investment products, decisions should be made on a case-by-case, client-by-client basis.

When searching for SMA options for clients, financial advisers should look for asset managers who have deep experience in the area, significant resources devoted to it and strong commitment to servicing their particular needs. Due diligence is crucial. As the area has grown, many firms tout SMA offerings. Financial advisers should exercise care in judging which asset managers have the infrastructure, client service, and track records necessary to serve their clients' needs and meet the adviser's high expectations.

When explaining to clients why they should invest in SMAs, the track record and reputation of the asset manager can help make the sale — if the firm can consistently deliver customization, transparency, professional management and tax acumen. When transparency and customization let clients trust that their money is well invested, advisers can move on to other aspects of running and building their practice … and hopefully allow them to sleep as well as their clients.

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