

Separately Managed Accounts: A Mutual Fund Alternative

By [Katrina Lamb](#)

The investment management world is divided into [retail](#) and [institutional investors](#). On one side are the traditional products designed for middle-income individual investors, like the retail classes of [mutual funds](#); these have modest initial investment requirements. On the other side are managed strategies for institutions, with imposing minimum requirements of \$25 million or more. In between these, however, is the growing universe of [separately managed accounts](#) (SMAs) targeted at wealthy (but not necessarily ultra-wealthy) individual investors. This article will examine the world of SMAs and what investors—or their financial advisors—should keep in mind when considering these investment vehicles.

SEE: [Separately Managed Accounts: A Boon For All](#)

Defining Managed Separate Accounts

A SMA is a portfolio of assets under the management of a professional investment firm. In the United States, the vast majority of such firms are called [registered investment advisors](#), and operate under the regulatory auspices of the [Investment Advisors 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, supported by a team of analysts, operations and administrative staff. SMAs differ from [pooled vehicles](#) like 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.

Say, for example, that a manager operates a diversified core equity strategy including 20 stocks. The manager decides to launch a mutual fund containing these stocks and also a separately managed account offering. Assume that at the outset, the manager invests all portfolios with the same weight—both the mutual fund and the SMAs. From a client's perspective, the beneficial interests in either vehicle are 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 [net asset value](#) from 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 simply be the aggregate value of each of the positions.

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

SEE: [Wrap It Up: The Terms And Benefits Of Managed Money](#)

Mass Customization

The high level of customization is one of the main selling points of SMAs, particularly when it comes to individual taxable accounts. Portfolio transactions have expense and tax implications. With managed accounts, investors can 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? There is 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 especially 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 be a separate SMA, and a separate account minimum, for each style chosen. For example, 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 found through a single manager.

Fee Structures

One of the difficulties inherent in making an apples-to-apples comparison among investment offerings is that fee structures vary. This is even trickier for SMAs than for mutual funds, for reasons we will explain here.

Mutual fund fees are fairly straightforward. The key number is the net [expense ratio](#), including the management fee (for the professional services of the team that runs the fund), miscellaneous ancillary expenses and a distribution charge called a [12\(b\)1 fee](#) for certain eligible funds. Many funds also have different types of sales charges. Funds are required to disclose this information in their [prospectuses](#) and show explicitly how the fund expenses and sales charges would affect hypothetical returns over different holding periods. Investors can easily [obtain these prospectuses from the fund's parent company](#), either online or through the mail.

Separate accounts do not come with prospectuses. Managers list their basic fee structures in a regulatory filing called a [Form ADV Part 2](#). An investor can obtain this document by contacting the manager, but they tend not to be as widely available through unrestricted online downloads as mutual fund prospectuses. Moreover, the published fee schedule in the ADV Part 2 is not necessarily firm - it is subject to negotiation between the investor (or the investor's financial advisor) and the money manager. Often, it is not a single fee but a scale in which the fee (expressed as a percentage of assets under management) decreases as the asset volume (the amount invested) increases.

The Importance of Due Diligence

Because SMAs do not issue registered prospectuses, investors or their advisors need to rely on other sources for investigating and evaluating the

manager. In investor-speak, this is referred to as [due diligence](#). A 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 preferably quarterly returns achieved) since inception of the strategy. The information is contained on 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](#) set by the [CFA Institute](#) and whether a competent third-party auditor has provided a letter affirming compliance with the standards.

Philosophy and Approach

Each manager has a unique investment philosophy and way of going about 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 get carried out; 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.

Operations

Some managers have extensive in-house trading platforms, while others outsource all non-core functions to third-party providers like Schwab or Fidelity. You also need to understand transaction expenses and how they can affect your bottom line. Another useful area of information here is client and account services. Among other things, here you can find out about net client activity—how many new clients did the firm originate and how many left over a defined time period? What were the circumstances surrounding those who left?

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—is an extremely important area to cover. Understand the calculations behind incentive compensation. Are the manager's incentives aligned with those of the investor? This is a must.

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 advisors subject to the provisions of the Investment Advisors Act of 1940.

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

The Bottom Line

By virtue of the account minimums, separately managed accounts are certainly not for everybody. 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.