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Is a separately managed account for you?

A discussion of differences between mutual funds and separately managed accounts

EXECUTIVE SUMMARY Many investors today take mutual funds for granted, but it is important to remember that America's first mutual fund was not established until 1924, and the concept behind the mutual fund was still quite revolutionary not all that many years ago. Even as recently as 1980, fewer than 6% of all U.S. households owned a mutual fund.[1] Mutual funds were unique because they made owning a diversified pool of stocks affordable for everyday investors. They also offered professional management and unprecedented liquidity. But in the late 1970s, another investment vehicle — the separately managed account — made its debut as a way for individual investors to have the same flexibility and high level of personal service enjoyed by institutions that invested large amounts of money.

This piece examines the biggest differences between separately managed accounts and mutual funds, and why an investor might choose the former over the latter, or even combine the two as part of an asset allocation strategy:

1. **ownership** — Separately managed account investors own individual stocks and bonds while mutual fund shareholders own shares in a pool of securities.
2. **flexibility and customization** — Separately managed accounts can provide investors greater flexibility, tax benefits, and the ability to customize holdings.
3. **service and consultation** — Owners of separately managed accounts may enjoy a greater level of service and consultation than mutual fund investors.
4. **fees** — Mutual funds often charge sales loads, management fees, and service fees while separately managed accounts typically charge an all-inclusive "wrap" fee. ■

[1] Source: *2009 Investment Company Fact Book, 49th Edition*

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Separately managed accounts: A potential alternative to mutual funds

A mutual fund lets investors pool money with that of other individuals in order to participate in a portfolio that may be diversified across dozens or even hundreds of securities. With a minimum investment, often as low as $500, a mutual fund enables an investor to have a professional money manager oversee his or her investment, usually paying that manager a fee of about 0.99% per year.[2] And this investment vehicle is so liquid that it can be bought and sold on a daily basis. It seems amazing that although mutual funds were introduced in the Roaring Twenties, they did not truly catch on with the general public until the 1980s.

When the separately managed account was first introduced, the price of entry for individuals was around $5 million. Increased use of technology by a number of investment firms, however, has made it possible to offer separately managed accounts with minimum initial investments as low as $100,000.

Ownership: The key difference

The key difference between a mutual fund and a separately managed account, or managed account, is what an investor actually owns. A mutual fund shareholder owns shares in a pool of securities owned jointly by all shareholders of the fund. Each share of the fund represents a small interest in each and every security the fund owns. In contrast, a managed account client owns individual securities — stocks, bonds, or any other securities in which the account may invest. These are not commingled with securities owned by other individuals who may invest in similar separately managed accounts.

Beyond ownership, however, mutual funds and separately managed accounts share many of the same features and benefits. Both are managed by professional investment firms working toward a stated investment objective. Most adhere to a specified investment style or discipline — large-cap growth stocks, large-cap value stocks, or municipal bonds, for example. However, a separately managed account allows its owner some flexibility in deciding what securities to own, so clients in separately managed accounts handled by the same portfolio manager may each have slightly different holdings. In a mutual fund, on the other hand, the underlying securities are identical for all shareholders.

Diversification is another benefit shared by mutual funds and separately managed accounts.[3] Both may invest in a number of securities in an effort to lessen the impact that poor performance of any individual holding might have on the overall portfolio. The number of holdings in a typical mutual fund can range from dozens to hundreds, while a separately managed account generally invests in a smaller number of securities, typically 35 to 70.

Flexibility and customization

Most of the unique characteristics of a separately managed account stem from its ownership structure. Because an investor in a managed account owns individual securities, those securities can be bought and sold without affecting holders of other managed accounts following the same investment discipline. This allows each account owner some flexibility in restricting ownership of certain securities.

For example, an investor who already owns a sizable position in a certain security might specify that the security not be bought for his managed account. Or if an account owner feels uncomfortable owning a specific company — a cigarette manufacturer, for example — he might exclude that company from his managed account. It should be noted, however, that this kind of restriction can result in an account that differs markedly from the separately managed account's discipline in terms of holdings and, potentially, performance. Excessive customization may thus eliminate some of the value added by the portfolio manager.

[2] Source: *2009 Investment Company Fact Book, 49th Edition*, sales-weighted average of annual fees and expenses and annualized loads for individual stock funds

[3] Diversification does not insure against market loss.

A key attraction of separately managed accounts is the high level of service and consultation, comparable with that enjoyed by institutional clients.

Owning individual securities rather than shares in a fund may also offer tax benefits. Mutual fund shares often include “embedded capital gains” — securities purchased by the fund months or years ago that have since risen in price will generate taxable capital gains when those securities are eventually sold. More recent buyers of fund shares may not receive the full benefit of the securities’ price increases, yet they pay taxes on the full capital gains. In a separately managed account, however, an investor pays taxes only on capital gains incurred while he or she owns the securities — that is, the cost basis for each security is the price at which it was purchased for the individual managed account.

The owner of a separately managed account may also have some flexibility in managing capital gains and thereby limiting tax liability. For example, the owner may request that the portfolio manager harvest some capital losses to offset capital gains or request that holdings not be sold in order to avoid a capital gain. Here again, investors should be aware that overuse of this flexibility may negate some of the benefits of professional management.

Service and consultation

A key attraction of separately managed accounts is the high level of service and consultation, comparable with that enjoyed by institutional clients. Services provided by financial advisors to managed account clients usually include the establishment of personalized investment objectives, creation of an investment plan to work toward those objectives, ongoing due diligence of portfolio managers, and in-depth quarterly performance analysis.

Before opening a separately managed account, a financial advisor generally will spend considerable time with a client establishing financial goals and reviewing all of the client’s assets and holdings. For many investors, separately managed accounts of one or more investment styles may be appropriate as the core of a total investment strategy that may also include mutual funds of complementary styles for diversification. This approach may be particularly useful for clients who want to invest $100,000 or more in their core investment styles but lesser amounts in noncore styles or in market niches such as particular sectors or regions.

Due diligence is another valuable service provided to managed account clients. In general, both the portfolio manager and the investment firm managing a separately managed account must undergo a rigorous due diligence process in order for a separately managed account to be recommended by a financial advisor.

The process typically includes qualitative analysis of a firm’s people, investment process, and investment research, as well as quantitative analysis of the firm’s historical performance. Of course, past performance is no guarantee of future results. After initial approval, due diligence is ongoing. Should events such as manager changes cause a financial advisor to lose confidence in the manager or the investment firm offering a particular separately managed account, a recommendation may be made that clients transfer their money to an alternative investment.

Comprehensive quarterly reports, explaining how and why performance was achieved, are another key benefit of separately managed accounts. Statements generally include attribution analysis showing how various holdings helped or hurt performance. They also may include discussions of particular securities and why the portfolio manager bought or sold them during the period. Performance against one or more benchmarks for the account’s investment discipline is provided, and peer group performance may be shown. Because statements show transactions performed for each individual holding, they can also facilitate tax management by making it relatively easy for clients and their financial advisors to see the tax consequences of trades and potential trades.

Fees

Investors in mutual funds may be subject to two general types of fees. Annual operating expenses are paid to the fund management firm and may include various charges such as management fees and distribution and service (12b-1) fees. Industrywide, the annual total of these fees is about 0.99% of fund assets.[2] These expenses are deducted from the fund's share price, or net asset value (NAV), and are not seen by investors as a line item on their statements.

In addition, investors in funds other than no-load funds may pay a sales charge to their financial advisors. Usually, this takes the form of a "front-end" load calculated into the initial share price (the public offering price, or POP) or a "back-end" load deducted from the account upon redemption and shown as a line item on the shareholder's account statement. Front-end loads may in some cases be subject to a sliding scale for larger accounts.

With a separately managed account, a client pays a single, all-inclusive annual "wrap" fee that covers the complete range of services provided, including portfolio management, trading charges, custody of securities, due diligence, and all consultation with his or her financial advisor (development of investment goals, ongoing monitoring of progress toward those goals, manager selection, and quarterly performance analysis). The annual wrap fee for a separately managed account tends to be in the range of 1% to 3% of assets, with a sliding scale for larger accounts. The fee is usually calculated at the end of each quarter, based on the account balance at the end of the quarter. The fee is paid in advance for the following quarter and is shown as a line item on the account statement.

Considering the options

For individuals or organizations with at least $100,000 available to invest, a separately managed account may be an option worth considering. Many organizations seeking professional money management — but unable to meet the large minimums required by institutional money managers — have found the separately managed account wrap programs offered by their financial advisors to be a viable alternative. Organizations making use of separately managed accounts have included endowments, charitable foundations, associations, corporate retirement plans, and religious groups.

Separately managed accounts have become a popular choice for individuals seeking a high level of service and flexibility and are often combined with mutual funds in an asset allocation strategy. Individuals who have received a substantial amount of money as a lump sum — from a retirement plan distribution, the sale of a business or real estate, or the receipt of an inheritance, for example — have often found separately managed accounts to be a useful investment option. For a more complete discussion of various types of investment vehicles and their application to a specific investment situation, individuals and organizations are urged to contact their financial advisors.

Comparing the features

	Mutual fund	Separately managed account
Ownership	Investor owns shares in pool of securities, commingled with assets of other investors	Investor owns individual securities
Portfolio holdings	Identical for all investors	Based on a stated investment discipline but may be customized to a limited extent (usually by excluding specific holdings)
Minimum investment	Typically ranges from $500 to $2,000 per fund	Typically $100,000 per account
Tax basis	May include embedded capital gains going back months or years before investor bought shares	Begins when individual securities are purchased for the investor
Tax management	Under sole control of portfolio manager	Potential for client and his/her financial advisor to manage taxation of gains
Service level	Varies according to investor’s needs and style of financial advisor	Financial advisor typically draws up investment plan and objectives with client Tends to include a high level of individualized service, consultation, and performance analysis
Due diligence	Generally left to the investor or his/her financial advisor	Conducted on an ongoing basis by the financial advisor’s firm
Quarterly statements	Typically report performance only	Provide comprehensive portrait of account activity and how and why performance was achieved
Fees	Annual operating expenses average about 0.99% industrywide[2] May also carry sales charges	Single annual wrap fee, typically 1% to 3% of assets, covers all management, trading, consultation, and other services

The investment return and principal value of both mutual funds and separately managed account investments will fluctuate, and sale proceeds may be more or less than the amount invested. Past performance is no guarantee of future results.

MFS does not provide legal, tax, or accounting advice. Clients of MFS should obtain their own independent tax and legal advice based on their particular circumstances.

This is not a comprehensive list of the differences between mutual funds and separately managed accounts. The investments you choose should correspond to your financial needs, goals, and risk tolerance. For assistance in determining your financial situation, please consult a financial advisor.

Separately managed accounts are not designed for excessive trading or inactive accounts and may not be suitable for all investors. The costs and the services relating to mutual funds and separately managed accounts may differ, and there is no evidence to support that one may cost less than another.

[2] Source: *2009 Investment Company Fact Book, 49th Edition*, sales-weighted average of annual fees and expenses and annualized loads for individual stock funds

The views expressed in this white paper are those of the author(s) and are subject to change at any time. These views do not necessarily reflect the views of MFS® or others in the MFS organization.

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