

# Are Separately Managed Accounts Right for You Now?

## Introduction

This report describes a route to investing that is gaining increasing attention from affluent investors and their advisors. It's called a Separately Managed Account (SMA).

## I. What is an SMA?

An SMA is a portfolio of investments, in which the investor has direct ownership of each equity (stock) or bond in the portfolio, but delegates authority to make decisions about which securities to buy or sell to a professional money manager. An SMA, therefore, combines the beneficial features of investing directly in the stock market and investing through mutual funds, because the investor owns the stocks directly, but the expertise and research resources of a professional money manager are applied to the investment process and stock selection.

## II. Distinguishing Characteristics

The important features of an SMA are:

- The account is designed to conform to the investor's individual investment requirements
- The cost basis of each stock is set as of the date the security is purchased for the account
- Sell decisions can be orchestrated to minimize the individual's tax liability

These are the defining characteristics of an SMA. They work together to produce some advantages that are important to investors, and that can have a positive effect on after-tax portfolio growth.

### **Individual ownership of stocks.**

Because you own the stocks directly, you can see exactly what companies you own and how many shares of each company. Your money manager can customize the portfolio to your investment requirements. You can also monitor your overall diversification, minimizing the chance of inadvertently over- or under-diversifying your portfolio away from the appropriate level of risk for your investment strategy.

**Customization.** There are many different "styles" of stock investing—some conservative, some moderate and some aggressive. When you select (with the assistance of a financial advisor) a money manager who manages assets in the style appropriate for you, you have already customized your portfolio in terms of the types of stocks you will own. For example, a money manager who manages portfolios in the large-capitalization value style will not buy new issues of companies with small market capitalizations.

In an SMA, you can further customize your portfolio, directing the money manager to seek out or avoid certain stocks or industries that meet or violate your personal standards.

**Cost Basis Control.** When a stock is sold out of any type of investment funded with taxable dollars, there are tax implications. If the stock has appreciated, you must pay taxes on the difference between the price you paid for it (called the cost basis) and the price you sold it for. If the stock has declined in value, you can often use the difference between the purchase price and the sale price (the loss) to offset other investment gains, thus enhancing your after-tax return.

This makes it very valuable to you that, in an SMA, the cost basis of each stock is established on the date you buy the stock. Therefore, your portfolio benefits from 100% of any gain that occurs, and you can establish a basis for using 100% of any loss to offset other gains or other income. This benefit is only possible when you own the stocks directly.

## III. Tax Minimization

In an SMA, you can decide when to sell each stock. This is important because of the tax laws that govern investment gains. If you hold a stock for more than 12 months, any gains you realize when you sell the stock are taxed as long-term capital gains, at 15%. If you sell the stock within 12 months of purchase, gains are considered to be short-term capital gains, and are taxed at your ordinary income tax rates.

If you are in the highest tax bracket, you can reduce your tax bill on gains from 35% to 15% if you hold investments for more than one year, and keep much more of each year's returns on your portfolio. Because, in an SMA, you can control the timing of stock sales, you can protect more of your portfolio's return each year, which will, over time, significantly enhance its growth. This type of control over portfolio returns is independent of market performance—no matter what the market does, you get to keep more of any gains your portfolio earns for you.

#### IV. SMAs and Tax-Deferred Assets

There are times when an SMA is also the appropriate choice for tax-deferred assets such as IRAs and 401(k) plans. Although the tax-minimization characteristics of an SMA don't apply to tax-deferred dollars, the benefits of customization are still important in that environment, enabling you to construct a portfolio that accurately reflects your investment preferences regarding style, risk management and other criteria.

#### V. Costs

Another important consideration when choosing an investment vehicle is cost. If you decide that you want the benefits of professional money management, there are several effective ways to buy them. It is often difficult to calculate the costs of an investment accurately, but if you do, you will often find that the additional customization and control of an SMA is available at a lower total cost than other, less flexible investments.

#### Conclusion

As you consider your investment options, you may believe that an SMA is a good choice for some or all of your investable assets, but wonder whether your portfolio is large enough to qualify for this type of investment. As little as 30 years ago, SMAs were the prerogative of the extremely wealthy. Families with names like Rockefeller, Vanderbilt and Pitcairn founded banks and trust companies to manage the family assets. Institutional investors, like endowment funds, pension plans and foundations, hired profes-

sional money managers who required multi-million dollar investment minimums before they would undertake management of the account. But all that has changed.

Today, through innovative programs developed by forward-thinking investment advisory firms that have harnessed the power of information management technology, this flexible, efficient, customized method of investing is available at minimum investment levels as low as \$50,000 to \$100,000 per account, and at costs that are highly competitive with other investment alternatives. Today, many investors who enjoyed the appreciation of the '90s bull market, either in their taxable investments or in their qualified retirement investments, are in a position to access the further wealth-building capabilities of an SMA. If you are one of these investors, your financial advisor can help you evaluate the benefits of such a choice for you.

## Appendix

### The Difference Your Choices Can Make

Feature	Buying Stocks Yourself	Buying Shares of a Mutual Fund	Investing in a Separately Managed Account
Individual ownership of stocks	✓		✓
Professional money management and research services		✓	✓
Professionally customized to your portfolio specifications	✓		✓
Cost basis for stocks set on purchase date	✓		✓
Timing of capital gains realization planned to minimize your tax liability	✓		✓
Tax-efficient investment approach	✓		✓
Funding the portfolio with low cost basis stock			✓