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Separately Managed and Unified Managed Accounts

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Tailored to suit you

For investors who want or need a relatively customized and tax-efficient approach to creating a diversified investment portfolio, separately managed and unified managed accounts may help them achieve that goal.

What is a separately managed account?

A separately managed account (SMA) is a portfolio of assets that are managed by one or more professional money managers. (SMAs also can be known as individually managed accounts, separate accounts, or privately managed accounts.) In an SMA, your assets are not commingled with those of other investors, as they are with a mutual fund. When you buy shares of a mutual fund, each fund share represents a proportionate ownership of each individual security within the fund, even though your ownership stake in each security is tiny. With a separately managed account, you are the sole owner of each security held within your separately managed account. You also can place securities you already own in your SMA; with mutual funds, you can't.

As a result, you and your financial professional have more control over management of specific investments in an SMA. Why is that important? Because it increases your ability to coordinate the sale of specific securities with the rest of your overall financial plan. However, don't expect to micromanage every single trade, as you might with a traditional brokerage account. An SMA's overall investing strategy and securities selection often is based on a proprietary model developed by the investment management firm that operates it. Within that model and the guidelines you set, the money manager for your SMA typically will have discretion to implement strategies that the manager feels will provide the best returns for you. (After all, if you want to make all the decisions yourself, it probably doesn't make sense to hire a professional money manager.)

An SMA often adheres to a single investing style. For example, you might have a separately managed account that focuses on large-cap U.S. stocks and a different SMA that invests in growth stocks. (However, some SMAs may include multiple styles.) An SMA must be managed by a professional investment management firm, who may be independent or part of the same firm as your financial professional.

Unlike traditional brokerage accounts, which are commission-based, SMA fee structures are asset-based. They typically cover the investment management fee, trading costs, custody, reporting and financial planning services.

Advantages

- You can exclude specific securities or sectors. For example, if you work for a large company that is a mainstay of most large-cap stock indexes, and you also hold shares in the company as a result of having exercised stock options, you might instruct your SMA's manager not to buy your company's stock, to prevent your net worth from being too dependent on one company. Also, if you prefer not to invest in a specific industry--for example, tobacco or casino stocks--you can have them excluded from your SMA.

- You have the flexibility to integrate decisions made within an SMA with the rest of your financial concerns. For example, if you will owe capital gains in another account, you might decide to sell a security within your SMA to recognize a capital loss that can offset those capital gains.

- You can track the purchase, sale and cost basis of individual securities. Your statement will reflect each and every security your SMA holds.

- SMAs offer greater potential for tax efficiency. Each security held in an SMA has an individual cost basis. That allows you to make specific tax-motivated moves. As noted previously, you can generally request that your SMA's manager harvest tax losses in specific securities in order to offset capital gains, thus reducing your income tax liability.

Tradeoffs

- Because of their customization and the fact that they are of most benefit to relatively affluent investors, SMAs often have high minimum balances. Depending on the minimum balance required for a given SMA, the amount needed to invest in multiple asset classes could be substantial.
- An SMA can be challenging to research. Unlike a mutual fund, an SMA is not required to supply potential investors with a prospectus that supplies standardized information about investment objectives, risks, fees, and expenses, which you should consider prior to investing in a mutual fund. As a result, due diligence must be performed to learn about an SMA's performance, investing approach and process, expenses (including the manager's compensation), and transaction costs. Much of this information is available from the Form ADV that SMA managers are required to file with the SEC and the manager's disclosure documents. A financial professional can be extremely useful in doing this level of detailed research.
- Because of the relatively customized management of an SMA, fees may be higher than they would be for a similar mutual fund. It's important to weigh those fees against the tax benefits you expect to derive from an SMA.

Comparing trading costs, fees, and performance of SMAs and mutual funds

Unlike traditional brokerage accounts, which are commission-based, SMA fee structures are asset-based. They typically cover the investment management fee, trading costs, custody, reporting, and financial planning services. Generally speaking, the larger your account, the more likely you are to benefit from an SMA.

One thing to consider when comparing mutual fund expenses against SMA fees is the "invisible" trading costs incurred by mutual funds. Mutual fund expense ratios cover fund management fees, administrative costs, and other operating expenses. However, they don't cover trading costs, which include brokerage commissions whenever the fund buys or sells securities. Although these trading costs can vary significantly by mutual fund (depending in large part on a fund's annual turnover rate), estimates of these costs often range anywhere from 0.5 percent to 1 percent.

Also, mutual funds often carry a certain amount of cash as a cushion in case they experience a wave of redemptions from investors. That cash can act as a drag on performance. If a fund has to sell securities to meet redemption demands, that also can affect its results. Though an SMA involves its own risks and doesn't automatically guarantee you'll have better returns, you don't have to worry about the impact of other investors' actions, because your SMA has no other investors.

What is a unified managed account?

Unified managed accounts (UMAs) are an outgrowth of the separately managed account concept. They offer a more efficient way to manage the asset allocation process and integrate a variety of investment vehicles. A separately managed account typically has a single investment manager (or management firm), and often invests in only one type of asset--equities, for example. A unified managed account allows you (or your financial professional) to aggregate multiple asset managers and investment vehicles within one account, and make investment decisions in the context of a much broader view of your overall finances.

For example, a unified managed account might include a separately managed account, individual securities (including restricted securities), one or more mutual funds or exchange-traded funds, a portfolio managed by an individual advisor, and other registered investment products. (Individual firms may set their own limits on the types of holdings a UMA may include.) This allows the investor to determine an appropriate asset allocation, address tax issues, rebalance a portfolio across all those various holdings. and manage cash flow more strategically across investment products.

The more complex your financial life and the greater your assets, the more benefit you may get from a UMA.

How unified managed accounts work

A UMA may allow investors to select a predetermined asset allocation; the UMA is then managed on an individual basis to maintain that asset allocation. Or it may offer customized modeling of a portfolio and asset allocation that is tailored to a specific individual.

A UMA has several components. At the most fundamental level is the investment management of individual components of the account (sometimes referred to as individual "sleeves"). Those individual components may be combined and transactions executed by another firm (this is sometimes referred to as the "overlay" function). In most cases, the overlay portfolio manager manages the overall strategy and actual execution of cross-investment transactions (for example, tax-loss harvesting) based on models developed by the individual investment managers; in some cases, the portfolio-level investment management decisions are made jointly by the overlay portfolio manager and the sponsoring firm that deals directly with the individual investor.

> **Technical Note:** In some cases, the individual investment manager retains discretion over both the investment model and client accounts. This is the most similar to a separately managed account. However, most UMAs today follow one of the two procedures outlined above.

Advantages

- Enhanced ability to manage taxes. Because a UMA provides a more holistic understanding of your financial assets, it can simplify the process of managing tax loss harvesting across multiple assets.
- Enhanced ability to manage an overall asset allocation across multiple managers and asset classes. Because a variety of different assets can be viewed and considered simultaneously, a UMA produces a more unified view of your finances, and facilitates a more accurate asset allocation strategy. Also, it streamlines the process of rebalancing a portfolio to achieve a given asset allocation. Your financial professional has a greater ability to determine exactly which securities would be most beneficial to adjust, because a UMA gives a broader perspective on your overall assets.
- Greater ability to monitor performance at the portfolio level rather than at the individual investment level.
- Enhanced ability to manage cash balances across multiple "sleeves". For example, a UMA could have a sleeve specifically set up to handle regular cash disbursements, which is replenished automatically by dividends or income from another sleeve.
- Convenience. Because multiple investment vehicles and accounts can be included within a single account, a UMA eliminates the need for multiple statements. Instead of receiving separate statements from a separately managed account, a brokerage account, and two or three various fund companies, you can view all of them in a single document.
- Enhanced ability to monitor tax concerns. A UMA can coordinate transactions in various sleeves so that you don't inadvertently violate tax regulations, such as those governing wash sales.

Tradeoffs

- Unified managed accounts typically are most beneficial for individuals with a relatively high net worth, for whom sophisticated tax management strategies are a key concern.
- The greater the degree of customization, the higher a UMA's fee is likely to be, because the complexity of making investment decisions and trades that involve multiple managers is likely to be greater.

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