Not Just For The Big Boys Anymore
By Sydney LeBlanc

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Advances in technology make separately managed accounts available to smaller investors.

Whoever said that life is fair was probably not a small investor. For years, they have watched the rich get richer, or at least perceived it, as large institutions and high-net-worth individuals participated in investment products that were unavailable to them. Until recently, separately managed accounts (SMAs), for example, had long been reserved for the "rich and famous," and anyone with less than a seven-figure portfolio need not apply. Without access to SMAs, some small investors assumed they were unable to invest with the best-in-breed asset managers, and that they received fewer customization and tax management benefits from their more traditional mutual funds and exchange-traded funds (ETFs).

"To an investor who has only $25,000, that $25,000 is every bit as important to him as the investor with $10 million dollars," says Scott Winters, national sales director for Platmark, an affiliate of Eqis Capital, a managed account platform based in Oakbrook Terrace, Ill. "He deserves the exact same type of options."

And finally they have them, or something close. "The magic lies in technology," says Winters. "There are so many things in this industry that once cost a lot of money from an administrative standpoint. We've built out our technology in a way that we are able to do things more efficiently. In fact, we have ways to customize our smaller accounts. By putting socially responsible screens over the top of an account, we can eliminate individual sectors or individual alcohol or gaming or firearms stocks, for example."

Model Manager Approach

Others agree about the innovation in technology that is helping the smaller investor. "We are now able to provide the same level of asset management expertise—that same privileged access [to SMAs]—to the mainstream investor with a $25,000 account," says Michael Bell, CEO of Curian Capital LLC. "Through technological advancements, we now offer one of the most efficient platforms in the industry, and have streamlined the account opening process that once took at least a week to now being handled in about ten minutes."

Bell adds that new technologies allow managed account platforms to offer fully diversified portfolios with a far lower entry point. His firm has incorporated a model manager approach by contracting with the top asset management firms to receive their portfolio buy/sell recommendations each day. Curian then trades these managed accounts on behalf of investors and handles all of the administrative details.

"This alternative approach allows sponsor firms like Curian to structure and manage diversified portfolios using the same intellectual property of the best-in-breed managers regardless of the account size," Bell says. "The manager no longer has to deal with the administrative aspects of account setup, custody, clearing or trade execution, and is able to cut their fees by a significant degree. Therefore, we can offer their same portfolios to smaller investors at a lower cost."

For investors concerned that trading may suffer using this model approach, Bell explains that the smaller account sizes may actually lend themselves to faster and more efficient execution. "Curian is a self-clearing broker-dealer that trades directly with the Street," Bell says.

Hilary Fiorella, marketing and communications vice president for CheckFree Investment Services, also acknowledges that the model manager approach will allow smaller investors access to the best asset managers. She believes that managed accounts will be opened up to more small investors as brokerage giant Merrill Lynch begins championing this approach through its Consults platform. "Merrill asked their stable of managers to share their models—hand over the secret sauce, so to speak," explains Fiorella. "They [Merrill] actually run the portfolios and pay the managers lower fees since they do not incur the operational obligations."

She adds that Merrill has been instrumental in including more quality managers across various assets classes in its platform, and that she believes the average minimum portfolio size stands at about $100,000. "Today, small investors can get access to the portfolios of good managers with good track records and good diversification," Fiorella explains. "For example, using the models-only approach, the advisor can access the portfolios of four managers and place $25,000 within each. Therefore, somewhere around $100,000 can get them the same quality investment advice as would have once required a $1 million investment."

Fiorella believes that if Merrill Lynch's models-only program proves successful, it will lead to more sponsors following suit and offering similar models-only platforms. "Because sponsors are in charge of distribution, they set the fees," she says. "Other firms will likely come out with models-only programs, if Merrill is successful, that will drive the minimums down and bring more separate accounts to retail investors. However, some managers will not hand over their models and will continue to manage their trades/portfolios. Sponsors drive how the industry goes. It will be interesting to see how the landscape changes over the next few years."

Steve Winks, publisher of Senior Consultant news journal, views the enhanced fiduciary ability of the advisor to act in the client's best interest as a primary benefit of this trend within managed accounts. He believes the model-managed approach helps advisors construct a more favorable value proposition for the client. "The models-based portfolios help reduce the investment minimums, democratize access to professional management, streamline costs structures and allow advisors more direct knowledge and access to all client holdings, something that is not possible with mutual funds," Winks says. "Firms like Merrill may not have acknowledged the fiduciary status of its advisors, but they do see the economic advantages of adopting this technology and approach."

Winks feels today's fee-based focus is very conducive to the use of models. Because advisors incorporate the cost of the investment vehicle into the total cost of their advisory services, significant savings can be passed on to the consumer. Even so, advisors can still enhance their compensation. "Through the models approach, many of the redundant account administration costs can be eliminated. Whereas a mutual fund costs consumers about 150 basis points, not including trade execution costs, they could get managed accounts for less than 50 basis points, models for 25 basis points or less, for pretty much the same thing. In fact, the product is actually superior because it is more style pure," Winks claims. "Now, by buying real-time manager research [model portfolios], advisors and their clients have all the benefits of the intellectual capital of the manager without any of the detriments of being tied to the inefficient operational structure of the manager. Through model portfolios, those manager costs now have been cut in half or more. This creates a far more efficient way to manage money and construct portfolios."

Customization Is Key

Dennis Clark, CEO of Advisor Partners, sees interesting opportunities for smaller investors using managed accounts. He acknowledges that sponsors can implement model portfolios with lower minimums, though with very little tax management and customization. Clark believes that to achieve the true benefits of SMAs, small investors should turn to an indexing approach and hire one portfolio manager (like Advisor Partners) to structure and manage a global portfolio across all style boxes and market capitalizations. "Indexing has become more appealing to not just smaller investors, but to all investors," Clark says. "If you believe that some or all of the markets are efficient, then indexing makes sense."

While Advisor Partners models portfolios to track S&P 1500 and S&P ADR indexes, for example, Clark feels that it is difficult for investors, regardless of their size, to get customization in a packaged product like an ETF or index fund. "We recognize that many investors have substantial customization needs," Clark says. "They may own a collection of stocks with low cost basis and are concerned about tax issues. They may hold a concentrated position or options in one company—-their employer, perhaps—and desire a portfolio that avoids that position and stocks that are highly correlated."

With regard to smaller investors, Clark adds, "We can structure custom portfolios or build them around current holdings, and the benefits can be implemented among accounts as small as $250,000. If that same investor wanted diversification among multiple managers, the pieces of the pie would be cut up pretty small. Plus, it would be highly unlikely they would ever get access to the lead managers."

Curian's Bell points out that small investors can receive the same customization and tax management benefits of SMAs when using the model-manager approach. "It is as easy as checking a box or two when setting up the account to create a custom portfolio." He says that too few investors take advantage of these fundamental characteristics of managed accounts, though Curian promotes them as a way to differentiate itself. "While the adoption rate of these customization features is about 5%, about one in three of our clients customize."

Eqis' Winters agrees that the innovations in technology allow small investors to receive the true benefits of SMAs, including customization. Winters also stresses the cost advantages of the platform Eqis Capital has developed through the latest innovations in technology. "When I say platform fee, I'm talking about custody, clearing, commission, the money manager's cost, reporting, feeing — all those different things that go into a platform. It's generally around $1.40, $1.50," Winters says. "At Eqis Capital, we've actually torn down those barriers once again, and we've broken the dollar, we've broken the buck, we've brought our entry level account down to 95 basis points, all inclusive." Winters continues, "In fact, we built a full working CRM [client relationship management system] for advisors, all within our platform, and we give it to them for free."

A Dissenting View

Not all financial services professionals agree that SMAs are necessarily appropriate for smaller investors. Scott Tiras, a Houston-based advisor who manages the top producing practice at Ameriprise Financial, uses managed accounts for some of his larger clients. However, he believes that investors must have at least $500,000 to $1 million within their portfolios to reap the full benefits. "I understand the advantages of SMAs, but simply don't believe they are that beneficial for most smaller investors," says Tiras. "In some cases, they merely have become a compelling story for the advisors to tell and play off the ego of investors who love participating in institutional-like strategies."

Tiras doesn't believe small investors are able to access the best managers, and most don't have the customization or tax management needs that make SMAs so attractive to high-net-worth investors and larger institutions. He also believes that changing managers can become a logistical nightmare requiring numerous individual transactions and some overlay component. "Many of the best-in-breed managers are still not participating in wrap programs," Tiras claims. "In fact, most of them also manage mutual funds that maintain very similar strategies and underlying portfolios as the separate accounts. Further, while minimum required balances might have declined for large-cap managers, more specialty classes like global bonds, high yield and small cap still require sizable investments that prevent the small investor from participating. Therefore, they are limited in being able to fully diversify."

Regarding the model approach, Tiras sees some merit, but believes that trade execution can prove quite significant in certain less-liquid markets, like specialty fixed income and small cap. "The investor could miss out on performance potential by taking the experienced manager out of the trading equation."

For small investors and many of his large investors as well, Tiras builds portfolios of mutual funds and ETFs. He points out the ease and flexibility involved in buying and selling mutual funds and the numerous good options across the various styles, including the less-liquid asset classes.

"Mutual funds allow the small investor to achieve greater diversification than SMAs for a less significant investment," Tiras adds. "The associated costs have been declining as well. Recently, I read that mutual fund expenses are at an all-time low level. And for those investors who prefer indexing and do not have customization needs, you cannot beat the efficiencies of ETFs."

Like it or not, agree or disagree, SMAs are fast becoming more of an option for the smaller investor. "The growth curve is significant," says Curian's Bell. "The annual growth rate has been in the 30% range over the past five years and is expected to be 15% over the next five." CheckFree's Fiorella adds, "Sponsors drive how the industry goes. It will be interesting to see how the landscape changes over the next few years."

Interesting indeed. But, for now, life in the financial lane has become a little fairer for the small investor.

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