

## SMAs Talk

An advisor turns to a separate accounts manager to help turn a sophisticated prospect with tax-management issues into a client.

**I**magine this: You have been working for months for this appointment. An ultra-high-net-worth investor, a senior executive with a Fortune 500 company, has finally granted you an opportunity to make your pitch.

For the past 10 years, the investor's accounts have been with a large wirehouse that has distributed the investor's money across eight active managers. The incumbent portfolio includes large, low-basis positions in health care stocks that totaled nearly \$1 million in unrealized capital gains. Substantial wealth was also tied up in

identify fees. Check. You've got that covered.

But your smile fades as you read on. The prospect wants to realize no net capital gains from the sale of stocks. The prospect has two additional requirements that will make delivering an indexed solution centered on mutual funds and ETFs problematic: First, he considers himself a socially responsible investor, so his instructions are to avoid stocks in alcohol and tobacco securities. Second, he also wants his portfolio to avoid overexposure to securities related to the company where

for the prospect's core U.S. equity allocation. The SMA would be customized to deliver an industry/capitalization profile matching the S&P Composite 1500 (a combination of the S&P 500 Large Cap, S&P 400 Mid Cap, and S&P 600 Small Cap indices), but without exposure to those stocks in the index that are highly correlated to Big Pharma.

To achieve diversification, the plan would dilute the overweight positions in health care while working towards a U.S. equity exposure based upon the S&P Composite 1500, including index-like exposures to large-, mid-,

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oil leases outside the portfolio.

Dissatisfied, he is ready to hand his \$9 million portfolio to the right investment advisor. You don't want to blow this—you've been in business for 20 years so you know the odds of getting another opportunity as good as this are as low as Gandhi's cholesterol.

The prospect's fax arrives and you smile. The investor actually believes in indexing. He's not one of those investors who pretends to believe you as you pretend you can outperform the market. You immediately contemplate a mutual fund or ETF portfolio that tracks the S&P Composite 1500. So far, so good. The investor also wants to avoid complexity and to receive easy-to-understand statements that clearly summarize performance and

he works. Makes sense. Because the investor receives most of his compensation from Pfizer, he needs to limit his exposure to pharmaceuticals. But buying most mutual fund solutions would be like doubling down on Big Pharma.

### The Solution

Actually, the scenario mentioned above is not hypothetical. In the end, the advisor decided to collaborate with a separate accounts manager in San Francisco named Advisor Partners, which provides model portfolios and managed account services to independent advisors. Together they proposed a solution that would construct and actively tax-manage a single separately managed account

### SINGLE SMAs

**SMAs come in a variety of flavors,** but the main form is the single separate account for the core equity allocation. Tailored to the individual and actively tax managed, it is comprised of individual securities, which can be managed to the level of individual tickers.

High-net-worth investors are particularly suited to a single SMA that replaces mutual funds as the core equity anchor of an investment portfolio. Such accounts minimize the drag on gross performance caused from unintended capital gains taxes, portfolio turnover, commissions and operating expenses. As the core equity product, a single separate account approach allows more customization, personalization and control than funds, ETFs or multi-manager accounts, including the newer Multiple Style Portfolios (MSPs) or Multiple Discipline Product (MDP). It is consistent with advisors who believe in market efficiency, and want to control costs.

and small-capitalization stocks and a 55/45 value/growth weighting. No net capital gains would be realized from the sale of stocks.

The plan wasn't perfect: The no-net-capital-gains restriction would prevent the new portfolio from being closely aligned with the prospective client's own benchmark (in other words the S&P 1500 with diluted concentration of health-care stocks). But ongoing portfolio management would actively work

to dilute the remaining concentrated positions by harvesting tax losses over time.

The alternative—and common—practice of liquidating all existing positions to reconstruct a client portfolio would have left a lot to be desired. If the advisor had recommended a new portfolio comprised of ETFs, for example, the prospect would have been left paying an awful lot of capital gains taxes. That, in turn, would have

reduced the market value of the new ETF portfolio, and, by extension, the future returns from that investment. Plus, the ETF portfolio would not have been able to specifically exclude oil-related industry stocks. (While sector ETFs easily achieve sector strategies, ETFs do not allow customization down to the industry or ticker level.)

The bear market did not spare this particular advisor or prospect, but the investor understood that. He was ultimately persuaded that he would derive a tangible, tax-savings benefit that would dwarf the fees paid to his advisor. That was a big selling point. In addition, the prospect gained a diversified domestic equity portfolio well-positioned for the next market upswing. He liked the proposal and handed his portfolio off to the advisor.

"Investors are seeking to simplify," says Advisor Partners CEO Dennis Clark. "What we'd like investors to know is that simplicity does not necessarily mean you have to forgo tax advantages. The advisor's job is to deliver the benefits without adding complexity. We try to make it easy for them." ●



Dennis Clark, Advisor Partners CEO

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**SMAs VS. ETFs**

The tax advantages of SMAs over ETFs are summarized in this hypothetical example. Starting with portfolios of equal value, the ability of SMAs to harvest tax losses results in a significant difference in account value after five years. The difference in favor of SMAs more than compensates for the increased management fees.

	Separately Managed Account	Exchange-Traded Fund
Ability to incorporate client's existing positions?	Yes	No
Ability to customize to client's unique and specific requirements?	Can re-weight or omit any combination of stocks, industries, sectors, capitalization ranges or value/growth tilts.	Limited to sector allocation or style allocation (not able to exclude specific tickers or industries within sectors).
Initial portfolio value	\$ 847,511	\$ 847,511
Initial unrealized gains	590,000	590,000
Gains realized at transition to new portfolio	333,333	590,000
Tax liability on gains realized during inception	- 50,000	- 88,500
Dollar amount available to invest in new core equity portfolio after commissions and taxes on realized gains	797,511	759,011
Expected amount of loss harvesting to be achieved during the 1st year of management.	47,850	0
Annual cost [commissions, tax cost (savings) and investment management fees] (1)	- 3,191	- 2,610
Hypothetical account value after five years (assumes equal gross return for both vehicles) (2)	\$ 1,144,998	\$ 1,096,364

**DIFFERENCE IN ACCOUNT VALUE AFTER FIVE YEARS: \$48,634**

Notes:

- 1.) Includes commissions, market impact of trading, investment management fees, taxes paid (saved) on realized gains (losses).
- 2.) Assumes gross performance of SMA and ETF average 9 percent per year, less the annual cost of each vehicle.

Source: Advisor Partners

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