Separately Managed Accounts: A Boon For All

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Whether you refer to them as "individually managed accounts" or "separately managed accounts," managed accounts have gone mainstream. To understand why they have such a strong appeal to affluent investors, consider the history of professional money management. Think back to the robber barons. Those industry titans made their money in heavy industry and then hired professional money managers to oversee their wealth. Likewise, large pension plans, endowments and other institutional investors have often entrusted their assets to professional money-management firms. With minimum investment requirements of $1 million, the services of these money managers have historically been well out of reach of the average investor.

See: Wrap It Up: The Vocabulary and Benefits of Managed Money

Over time, investors saw the benefits of professional money management and wanted access to those benefits. The rise of the mutual-fund industry partially met that need, enabling investors to pool their assets and create portfolios large enough to attract professional money-management firms. What mutual funds cannot offer, due to their structure as investments shared by a group of investors, is the benefit of customized portfolio management. Separate accountsovercome this barrier.

Individual Cost Basis

Courtesy of technological advances, money-management firms have been able to significantly reduce their minimum investment requirements to well below the traditional $1 million mark. Instead of pooling their assets with those of other investors, a much larger audience of affluent investors can now access the benefits of customized portfolio management via separate accounts.

The ability to have individual cost basis on the securities in your portfolio is the key to those benefits. To understand its significance, consider the nature of the mutual fund. In its most basic form, a mutual fund is a company that invests in other companies by purchasing the stocks and bonds issued by those companies. When you purchase shares of a mutual fund, you have shared ownership of theunderlying securities with all of the other investors in the fund. You do not have individual cost basis on those securities. Consider the following example:

ACME Mutual Fund holds shares of two companies: Company 1 and Company 2. You purchase 100 shares of ACME Mutual Fund. While you own those 100 shares of ACME Mutual Fund, you do not own any shares of Company 1 or Company 2. Those shares are owned by the ACME Mutual Fund company. Since you are an investor in ACME Mutual Fund company, you can buy or sell shares of ACME Mutual Fund company, but you have no ability to control Acme's decision to buy or sell shares of Company 1 or Company 2.

If this seems a bit confusing, take a look at your personal mutual fund holdings. Pick a fund and find out the name of the largest single holding in your fund. If you call the fund company and tell them that you want to sell that holding, your request will be denied. The fund makes decisions on behalf of all shareholders, not based on the needs of a single investor.

To avoid the "mutual" nature of mutual funds, you could choose to purchase individual stocks and bonds to build your own portfolio, but that is a time-consuming proposition and lacks the benefit of professional portfolio management, which is the primary reason most investors put their money in mutual funds. To obtain the benefits of professional portfolio management without the hindrance of mutual ownership of the underlying securities, an increasing number of investors are turning toward separate accounts. (For more on mutual funds read: *How To Pick A Good Mutual Fund*.)

Putting the "Separate" in Separate Account

Separate accounts are similar to mutual funds in that a money manager develops a model portfolio specializing in a particular aspect of the market (such as large-cap, growth, small-cap or value) and purchases or sells securities in an effort to generate positive returns. The key difference between mutual funds and separate accounts is that, in a separate account, the money manager is purchasing the securities in the portfolio on behalf on the investor, not on behalf of the fund.

In our earlier example, we explained that investors in ACME Mutual Fund do not own any shares of the underlying securities in that fund. In a separate account, the investor does own those shares. If a separate account portfolio model includes shares of Company 1 and shares of Company 2, when you invest in that model portfolio, the money manager purchases shares of each of those companies on your behalf. Your account is "separate" and distinct from that of any other investor in that model, which (unlike mutual funds) gives you the ability to direct the money manager to customize the portfolio based on your personal needs. While it would defeat the purpose of hiring a professional manager if you attempted to micro-manage every buy/sell decision made in the portfolio, there are areas where it can be of significant value to make your voice heard.

The Benefits of Individual Cost Basis
One of the most popular benefits of separate accounts involves tax gain/loss harvesting, which is a technique for minimizing capital gains tax liabilitythrough the selective realization of gains and losses in your separate account portfolio. This can be a significant benefit for affluent investors. Consider, for example, a separate-account portfolio in which two securities have been purchased at similar prices. Over time, one of the securities has doubled in value while the other has fallen by half. By instructing the money manager to sell both securities, the gains generated by the security that has doubled in value are offset by the losses in the other security, eliminating any capital-gains tax liability. The proceeds from the sale can be reinvested, maintaining the balance in your account. In a similar fashion, if you sold some real estate, art or other investments at a gain, but have unrealized losses in your separate account, you can realize the losses and use them to offset the gains from the sale of your other investments. (To learn more read: *A Beginner's Guide To Tax Efficient Investing.)*

Another tax benefit of individual cost basis is the lack of embedded capital gains. Again, a comparison to mutual funds demonstrates this issue. Mutual funds must pay out all capital gains once per year. Since mutual funds are "mutual," all investors share the tax liability on the gains. So, for example, if the fund doubled in value from January through November, investors purchasing into the fund in December did not get the benefit of any of those gains, but they do inherit the tax liability because the gains are embedded in the portfolio. Separate account investors, thanks to individual cost basis on the underlying securities, would not be liable for capital gains generated prior to the day they invested in the portfolio.

Another major advantage of individual cost basis is the ability to customize the portfolio by choosing to avoid investing in certain stocks or certain economic sectors (technology, sin stocks, etc). This is an important option if, for example, you work for a technology firm and your portfolio is already heavy with your employer's stock, or you have strong personal convictions against investing in certain companies (say, gambling, alcohol or land-mine producers).

The Bottom Line

To maximize the benefits separate accounts offer, most investors work with a professional investment advisor. The advisor provides assistance with asset-allocation decisions, money-manager selection, as well as coordination of portfolio customization and gain/loss harvesting. (For more information read*Separately Managed Accounts: An Alternative To Mutual Funds*.)