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NEXT BIG THING

ARE SMAs THE NEW LOOK IN PLATFORMS?

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Maurice O'Shannassy, Merrill Lynch Investment Managers (MLIM) managing director and chief investment officer, and Arthur Naoumidis, Praemium Portfolio Systems managing director, launched potentially the biggest new project in the platform market this year at a press briefing in Sydney on November 7. This was flagged in the last edition of *MasterFunds Quarterly*.

The pair was quietly confident about the self-managed account (SMA) product launched by MLIM using the Praemium software.

MLIM has an exclusive agreement to use Praemium's SMA software in Australia, after Praemium spent the last eight months developing a lot of this system just for MLIM. Praemium will not withdraw its independent services from the market though, as it continues to supply 230 companies with its non-SMA software, including some platforms or wraps.

"The SMA extra, which is restricted to use by MLIM, deals with portfolio rebalancing and execution of the internal broker," Naoumidis says.

Merrill Lynch leads the SMA market in the US where investors have wholeheartedly embraced managed accounts. The total amount in its managed accounts in the US for the fourth quarter of 2004 was US$246.2 billion, according to Cerulli Associates.

"We have looked at the reasons why SMAs have been so successful in the US and we think there is every reason this will be replicated in Australia," O'Shannassy says.

He adds that the two main reasons MLIM sees potential success in this area is that people prefer to own shares in a well-known company than units in a fund, and the tax advantages of SMAs. SMAs allow people to individually own their portfolio of stocks, rather than operating on a unitised structure of managed funds, which results in the fund manager owning the individual stocks.

O'Shannassy does not go so far as to say that SMAs will take over from platforms or wraps, which are the traditional administration system for managed funds. Rather, he says that SMAs will be a strong complement to the existing vehicles of investment.

"I think in the first sense the two systems can be complementary. We just think there is enough of a market out there for this to be successful. I am not interested in making predictions. Platforms could mutate into something completely different to what they are today. They spend millions on development. They are not standing still," O'Shannassy says.

In Australia to date managed accounts and SMAs have barely made a mark. MLIM will be the fifth SMA product on the Australian market, compared to 5,800 types of unit trusts available in the Australian investment market.

O'Shannassy says that SMAs have not taken off in Australia for a number of reasons: they were launched during a bear market, the price has not yet been right for Australians, many financial planners and accountants did not understand the benefits of SMAs, no-one had the systems to do it at the required level of sophistication for brokers to take it on, and SMAs have not yet been available in a white labelling format.

Explorer Group offers two separately managed accounts, DirectPortfolio and ShareInvest II. Explorer Group executive chairman John Aldersley believes the MLIM SMA has the potential to kick-start a revolution in SMAs. Explorer Group's Direct Portfolio SMA now has $180 million in funds under management. It was launched in 1996.

"Brian Bissaker [at Colonial First State's platform FirstChoice] was quoted to say he only thought there was $2 billion in the SMA market but there is already $2 billion in Praemium," Aldersley says.

"From our point of view it is a great thing they have launched. We are just a splash in the puddle of the big guys. Research houses don't rate SMAs in Australia at the moment but I am sure that Merrills will get that altered and they [research houses] will have to rate Merrills against something."

Others in the market, particularly those in the area of platforms, do not agree that SMAs have the potential to grow in Australia in the way they have burgeoned in the US.

"You need to be careful when looking at the US market and Australia," Colonial First State head of platforms Alan Kenny says.

He disputes claims that the SMA can become as popular as wraps.

"Praemium has had a good uptake but still I think it is a niche product," he says.

One of the keys to SMAs is that they are put together by brokers and give the dealer groups more control than the traditional managed fund products.

At the moment, managed funds are largely offered through the platform or wrap structure. The groups that put together the wraps are the ones that choose which managed funds get onto the distribution.

The SMA shifts the balance of power to brokers and dealer groups. For example, the MLIM SMA allows the dealer group to choose exactly which managed funds they want to offer on their SMA platform, instead of being dictated to by the platform. At the same time brokers establish ongoing revenue from the distribution of their product,

Maurice O'Shannassy

as opposed to having to rely on a single brokerage fee for each trade in their position as the distributor of a fund.

WHAT IS AN SMA AND WHAT IS THE MLIM SMA?

Much of the advantage of SMAs over managed funds, according to O'Shannassy, comes from the fact that consumers own their own portfolio of individual stocks. Clients pick their stocks according to model portfolios provided by the dealer group. The portfolios are either created in-house or based on fund managers that have agreed to provide their data.

"You are buying access to fund managers' expertise. SMAs are a more efficient way of getting access to the managed funds expertise," O'Shannassy says.

For example, the Asgard SMA currently offers 12 different portfolios. The Trust IM product has seven portfolios from three different model managers. Investments are made into one or more model portfolios and the appropriate mix of securities is then purchased by the managed account provider, so that the client portfolio reflects the model.

Some SMAs like those run by Explorer Group buy and sell each individual share with each portfolio adjustment. MLIM blends the portfolios together and simply purchases or sells from the net amount of the order.

Aldersley says: "At Merrils, if the client chooses five models they only get one blended portfoio. Our clients get five actual portfolios."

The stocks are all netted into one pool by the broker for trading purposes, and then traded much like an institutional lot.

Portfolios can be also more easily adjusted to make the most of tax positions, Naoumidis says. This is because the stocks are moved around quite simply, without having to buy and sell the more complicated unitised structure.

The other advantage for tax purposes is that this format reduces capital gains tax (CGT) and is much quicker when it comes to reporting on investments. Naoumidis says this model allows tax positions to be calculated on the morning of July 1 each year, including franking, dividends, CGT and income tax.

The MLIM SMA also differs from a number of products on the market to date because it will be available to be placed on different dealer group systems, with their choice of portfolios and allowing them to white label or badge the service with their own brand name.

MLIM also has no minimum limit on investments. The group aims to leave these decisions to the dealer groups or the advisers.

MOVING AWAY FROM UNITISED STRUCTURES

Whether SMAs take over or not, it seems their re-emergence in the form of the MLIM SMA points to the belief of many that direct equities will become a big market for advisers in the near future. It could also be that SMAs are part of a bigger shift away from the unitised structure of managed funds and towards a mandate-type structure as used by Colonial First State platform FirstChoice.

The unit-based structure of managed funds offers a lot of difficulties in reporting, tax and has even attracted the attention of industry regulators.

The Australian Prudential Regulation Authority (APRA) and ASIC have jointly released "Unit Pricing – Guide to good practice for the life insurance, superannuation and funds management industries" as a result of the difficulties a number of fund managers have had in sorting through pricing and capital gains in this structure.

The guide follows findings of incorrect pricing in unit-linked life insurance and managed funds products by Commonwealth Bank-owned Colonial Mutual Life Assurance Society (CMLA), ING and Tower.

APRA also said early in October 2005 that it made directions to CMLA over its pricing errors, requiring it to implement a plan to address deficiencies in its unit pricing processes.

CMLA has also been directed to obtain an independent external review of the implementation of the plan in 12 months.

In addition, CMLA is required to develop additional measures to ensure policyholders affected by its pricing errors are fairly compensated. This is despite CMLA already compensating a significant number of policyholders for unit pricing errors since March.

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>
> *- Arthur Naoumidis, Praemium*

THE FUTURE OF THE ADMINISTRATION OF SHARES

Tribeca Ontrack Continuing Professional Development online training about wrap accounts states of SMAs: "What can be expected is that as volume grows the price and minimum investment levels will fall, while the range of choices – both the number of competing products and the range of features/options within each product – will increase."

Tribeca chief operating officer John Prowse has personally taken a financial stake in Praemium. He says he believes that the SMA is a superior administration vehicle to most managed funds and their platform administration structures.

Michael O'Farrell, independent consult for financial services and author of the article "Are managed accounts the next big thing?" for Tribeca Ontrack Continuing Professional Education, says SMAs could grow with the burgeoning appeal for owning shares among Australians.

"People like having their BHP shares or their Qantas shares or whatever it is they have got, they just do like it better than units in a fund," O'Farrell says.

This is partly why SMAs grew very strongly in the US on the back of broker houses like Smith Barney Citigroup, Merrill Lynch and Schwab. These broker houses initiated the huge flow into US SMAs by creating and selling the products to their client base.

Tribeca says that financial advisers may have the need (and often the desire) to incorporate direct shares and fixed interest into their client solutions.

O'Farrell says there is increasing inflow of new funds into direct investments. He also says that dealer groups are looking for means for financial advisers to offer direct equities without having to pick stocks themselves.

The Tribeca Ontrack article says that while the managed funds industry is massive in Australia, new inflows into managed funds have stalled due to product "fatigue".

"While people are coy about the sources of such information it has been asserted recently that 20 per cent of assets in wrap accounts today are represented by direct equities and that 35 per cent of the new inflow to wrap accounts is for the direct purchase of listed securities," Tribeca Ontrack says.

O'Farrell says, "These are all areas where it is very difficult to get direct quotes, but when I ask them about it most people in the industry will whisper it under their breathe."

The Tribeca Ontrack article encourages advisers to take a look at alternative products to managed funds. It says: "All products have a life cycle. Advisers operating in this market may wish to have alternative products to offer if and when the current product range gets stale."

MARKETING TO ADVISERS

Naoumidis admits that SMAs still face public relations problems that have plagued platforms since their inception. No one understands what these vehicles are.

As Bruce Madden, executive director at BlueChip Communications Group, said in the last edition of *MFQ*, platforms are not understood at all by the consumer market.

"The biggest challenge we have is the lack of understanding of SMAs. Everyone in their own mind has a picture of what they expect it is. It is a non-unitised managed fund," Naoumidis says.

He says the challenge at the moment for SMAs in Australia is that financial planners do not understand the products, let alone any consumers coming close to comprehending what they are.

"Our first task is to get not Joe Smith the ordinary investor to understand SMAs but Joe Smith the ordinary planner. We are working with Tribeca and the FPA to educate people on what an SMA actually is. Many people confuse SMAs with IMAs [individually managed accounts]."

The fact that these products are sold through planners in Australia is one major difference from the US, where SMAs are marketed directly through brokers. Since brokers have a direct benefit from SMAs, they have a lot more incentive to push these products to consumers.

The MLIM SMA is currently being marketed to broker houses, as well as dealer groups and accountants.

O'Shannassy says foundation agreements are in place with key clients, including planning group Epic Adviser Solutions, broker house Lonsdale Financial Group, broker and planning house Tollhurts Noall, stockbroking firm DJ Carmichael and financial planning dealer group PKF Financial Services (WA).

Robert Davies, retail broking development manager at Tolhurst Noall, says the MLIM SMA is a logical extension of the direction of broking both here and overseas.

"Being able to sell SMAs moves us from a non-discretionary environment where we have to rely on clients to make decisions. The decisions on which shares are on the list are made by the adviser, while with managed funds shares are picked at the discretion of the fund manager."

Only time will tell whether there is any fundamental change to the industry as a result of the MLIM take up of SMAs, or whether it will remain a niche product for those who want direct equities with the benefits of managed funds' expertise.

But time may have already caught up with managed funds and the cumbersome unitised structure most of them rest on in today's market.

As Aldersley says: "SMAs are merely a different form of managed fund to unit trusts. The difference is that the average fund manager in unit trusts has no software capability. It is a constant fight to get platforms accurate. That is why I'll be dragged kicking and screaming to unitised funds."