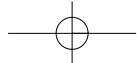
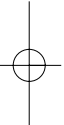
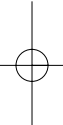


www.financialstandard.com.au
1300 884 434

Financial Standard

VOLUME 4 NUMBER 01
31 JANUARY 2006
FEATURE ARTICLE REPRODUCTION



The rise and rise of managed accounts

Customised investment portfolios were once the privy of the rich and the richer. But 21st century technology is fast changing the rules of the investment game. MICHELLE BALTAZAR reports on the new breed of separately managed accounts (SMAs) and individually managed accounts (IMAs) to hit the market.

Prepare to be dazzled. Coming to a financial planner near you are next generation separately managed accounts (SMAs) and individually managed accounts (IMAs).

These acronym-challenged financial products were referred to by one industry pundit as "managed funds on steroids". And while that is a very loose description, he is not far off the mark in describing how SMAs and IMAs have extra capabilities that allow investors to maximise their tax savings and potential returns.

SMAs and IMAs are two strands of the "managed accounts" sector, which is little known in Australia but is going berserk in the US.

According to Cerulli Associates, a Boston-based consulting firm, the US managed accounts sector was worth more than A\$1.8 trillion in 2005, over a fifth the size of the managed funds sector and growing at four times the rate of the overall market.

SMA firm Financial Engineering Inc, for example, has enjoyed a phenomenal uptake with its SMA under management growing from A\$1.3 billion at the start of 2005 to around A\$4 billion last November.

First, what exactly are they? Put simply, an SMA is like a selection of managed funds, called "equity models", housed under the one account.

Unlike a managed fund, however, the client owns the underlying shares and hence enjoys the benefits and flexibility that is lost once invested in a managed fund.

Through an SMA structure, the client minimises capital gains tax liabilities and is able to buy, sell or hold any of the shares within the portfolio depending on their personal finances and ethical considerations.

But before you start thinking that the two are mutually exclusive, SMA providers build up their SMA portfolio based on the models of top-performing fund managers, paying those fund managers "model portfolio" fees.

To the financial services regulator ASIC's eyes, SMAs are simply a type of managed fund and hence need to comply with similar licensing and compliance requirements.

Meanwhile, individually managed accounts (IMAs) are like souped-up versions of SMAs, where the IMA manager is usually a broker or a former fund manager who will build your portfolio from scratch – not from a ready-made portfolio – based on your personal circumstances, ethical bent and potential "conflicts of interest".

But of course there is no such thing as a free

lunch. While low-frills managed funds can be had for a minimum investment of \$1,000, you need to have at least \$25,000 to invest in an SMA and roughly \$500,000 and upwards for an IMA.

Also, the further up the financial pampering ladder you are, the more you have to look at your fee structure. Low maintenance index funds, for example, can charge as low as 0.2 per cent in fees while SMAs and IMAs could cost anything from 0.5 per cent to the wrong side of 2 per cent.

That said, fees are steadily falling thanks to market competition and new technologies driving costs down.

Technology injects fuel on SMAs

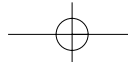
Impractically high fees were once the bugbear of the SMA sector. Merrill Lynch Investment Management (MLIM), the largest SMA player in the US, looked at introducing an Australian SMA several years ago but backed down after its initial research showed that it would be just too expensive.

Worse, the software available then was clunky and had too many moving parts, making the likely product too fragile for high volume use.

But a fortuitous meeting between Maurice O'Shannassy, managing director and co-chief investment officer at Merrill Lynch Investment Management (MLIM), and Arthur Naoumidis, managing director at managed accounts software maker Praemium Portfolio Services, led to



Arthur Naoumidis



last year's launch of MLIM's "Customised Portfolio Service".

Naoumidis did not know at the time he was talking to the head of the country's thundering herd when O'Shannassy enquired about using Praemium's software for his own personal use.

"I remember when he was showing me the system, I was thinking 'this could mutate into an SMA quite easily'," recalls O'Shannassy.

After two years of toing and froing with the New York headquarters, both companies successfully developed the "right" product and put the legalities to bed.

Naoumidis explains, "What we've done, through the technology and the legal structure of Merrill Lynch, is to deliver an SMA at the same price as a wholesale managed fund for the first time.

"So being able to make the legal requirements easy to complete and delivering virtually the same product for the price of a wholesale managed fund makes [choosing an SMA now] a no-brainer," he says.

Financial planners step up their game

With fees on par with managed funds and the technology ripe for mass consumption, financial planners could soon start signing up for their SMA accounts.

Ray Rypma, financial planner, accountant and an SMA convert, said that he had been eyeing SMAs for a while before taking the plunge 18 months ago, and hasn't looked back since.

"I'm now 60 so I've seen over the past 20 years a great deal of ups and downs in the way accounts are run," he says.

"The reason why I like SMAs is both from a transparency aspect and from a taxation aspect."

Rypma adds that in the long run the returns are much better than if a person establishes a self managed super fund (SMSF) and takes charge of their investment strategy.

"I've learnt over the years, preparing hundreds of tax returns, that my clients who sought professional advice have always done better than amateurs, if I can call them that."

Rypma is a client of DirectPortfolio Services, part of Explorer Group, one of the first companies to set up SMAs in the country back in 1996.

Unlike MLIM, which formed an alliance with software group Praemium, DirectPortfolio likes to describe itself as a one-stop shop with their range of SMA products and proprietary software called Ozport.

Like MLIM, DirectPortfolio is also aware that the product, despite its attractions, is still price-sensitive.

With fees on par with managed funds and the technology ripe for mass consumption, financial planners could soon start signing up for their SMA accounts.

"We price our product to compete at the same price as a mutual fund," says Paul Bray, executive director of Explorer Group, DirectPortfolio's parent company.

He adds that they try to keep their ears close to the ground in terms of customer needs and business opportunities.

Later this year, for example, they plan to launch SMA Lite after their clients suggested that their sons and daughters should set up SMAs too. Compared to the current product, SMA Lite requires a smaller investment of \$5,000 and suits the simpler financial profile of young investors.

Bray says another problem is that financial planners don't know much about

SMAs and are quite comfortable with wrap accounts. In response, DirectPortfolio has an SMA account that can sit on a wrap.

He explains, "It is a transition model to get advisers used to the idea. We tell them that, like a managed fund, it will sit on your wrap platform and you can sell it, just like when you do anything."

Bray welcomes MLIM's entry into the market because he believes it would take a big star to push the product for it to gain momentum.

While still in its early stages, Merrill Lynch has successfully signed up several financial dealing groups including Lonsdale Financial Group, Tolhurst Noall and PKF Financial Services.

Praemium's Naoumidis says that they are also in talks with two other major investment houses about launching SMA products.

"I call it the Domino Effect. Once the big players sign up, it would be their successes that will encourage their competitors to follow."

Not surprisingly, Macquarie Investment Management plans to launch their SMA product some time this year.

Financial planners who want to boost their revenues may want to look at the US experience to realise why SMAs are worth exploring. In a 2005 Citigroup Asset Management survey, four of every 10 advisers who sell SMAs said their SMA clients make up half or more of their total revenues.

IMAs: A rich man's financial butler

At the top end of the market, investors with net investable assets of more than \$500,000 can avail themselves of the financial pampering from individually managed accounts, or IMAs.

"SMAs tend to be for the retail client because it is portfolio model driven. IMAs are for wholesale clients where we devise a portfolio unique

PROS AND CONS

Managed accounts

Love 'em or hate 'em, the prospects for the managed accounts sector can only get better.

In the US, it is a A\$1.8 trillion industry growing at a faster rate than managed funds, according to research firm Cerulli Associates.

It is also estimated that from close to US\$470 billion invested in individually managed accounts (IMAs) back in 2003, the figure will reach more than \$2.6 trillion by 2010 with nearly five million households in the US using the product.

At home, while industry debate has focused on how managed accounts differ from other market offerings such as managed funds or investing via wraps and platforms, the bottom line is that they are an added alternative.

At their simplest, SMAs and IMAs are highly flexible products that offer more transparent portfolios and a more effective tax structure.

There are challenges ahead, though, including a lack of education about their extra benefits and the technology in use can still do with some more tinkering to accommodate a wider range of model portfolios (including international equities).

But, judging by how the industry is fast shaping up, the question of whether these investment products will become mainstream is a moot point – it is only a matter of time.


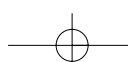


Table 1. SMAs vs IMAs – a case of splitting hairs?

| Separately managed accounts | Individually managed accounts |
|--|---|
| Financial product | Financial service |
| Presented to client as a managed investment scheme subject to full compliance and disclosure requirements of the Corporations Act 2001 | |
| Does not require individual transaction reports – one page summary supplied | Full transaction reports required |
| No ASIC requirement for personal equities advice | Adviser must provide personal equities advice and therefore needs accreditation |
| No ASIC requirement for continuing personal advice | Every 13 months or less, the adviser must confirm that advice remains in the best interest of client (subject to legislative changes) |

Source: DirectPortfolio Services





CASE STUDY

Everett is evergreen with his IMA

Mark Everett, a property developer, married with two children, is a big fan of his IMA through a private Sydney-based broking service.

He says that with an account balance of \$500,000 he was looking for a broker or a fund manager who could manage his money for him. "If you're going to be dealing with fairly large amounts of money, you'd want a professional who is an expert at investing to do that for you," he says.

He chose from a few brokers and fund managers and settled on one that seemed to offer everything he needed.

"He ticked all the boxes so I went for him and it was a very good decision because he saved me close to a million dollars," Everett says.

"After that, if he had told me to jump off a multi-story building, I'd do it."

He says there is danger to doing it yourself. "If you're going to build a house, you're not going to go and get a butcher, are you?"

The key benefit for Everett is that the broker and the IMA take the emotion out of investing.

"Most people, Joe Bloggs like myself and a lot of other people I know, tend to not want to sell something if it's struggling, or wait till it comes good. I would say to him 'Look, you don't really have to ring me and tell me what you're doing. Just do it', because I'm sure if he rang me, and said 'Oh, I'm going to sell this and you're going to rip up \$10 or \$15', I'll be doing my best to talk him out of it."

Was it cheaper for him in the end? "I guess the only way to check whether it's cheaper or dearer is to look at the bottom line, and I've got to tell you, it's a lot better."

to a client's needs," says Richard Nicholas, director at Providence Investment Partners, a Sydney-based IMA firm.

IMAs have been around for decades under the label 'discretionary portfolio services' for high-net worth individuals. Brokers usually offer them as an added value service to their customers.

Dean Thomas, head of products at Asgard Wealth Solutions, argues, however, that the difference between IMAs and SMAs is artificial. DirectPortfolio's Bray points out that their SMA product offers almost 90 per cent of what an IMA product offers.

Admittedly, the difference between the two will blur as technology increases functionalities and, at the same time, drives costs down.

But for now IMA providers are quick to point out the different legal structure, their more personalised stock picking strategy and the client's access to their own personal fund manager (see Table I: SMAs vs IMAs: a case of splitting hairs?).

David Manchee, director at Leyland Private Asset Management, says that a common misconception among investors is that the meter starts ticking as soon as you ring an IMA provider.

"We don't charge for initial enquiries and some clients are surprised to find it's not as expensive as they think it would be to invest in an IMA," he says.

"IMAs provide all the accounting and administration like platforms but don't charge for them."

To simplify the fee structure for clients, Leyland charges a flat fee of 0.5 per cent per quarter of the portfolio value, including broker transaction costs and admin.

Manchee adds that the added advantage of investing in an IMA via a broker is that they are direct equities specialist and therefore have a lot of experience around the foibles of the stockmarket.

The proof in the pudding is Leyland's average return of 30 per cent over the past year plus dividends. "That's excluding the tax benefits as well where we try to time the buy and sell transactions depending on our client's tax situation." See case study: Why Everett remains evergreen with IMAs.

Danger for managed funds?

So will SMAs and IMAs supplant traditional managed funds in the future? Not likely.

Michael Heine, managing director at leading platform provider Netwealth Investments, says that the wrap account they provide to investors already has the extra bells and whistles that managed accounts provide.

"I think they're fine but I don't understand

why there's a distinction between SMAs, IMAs and existing wrap accounts." He argues that the tax impact is minimal, although that is debatable, particularly for large account balances.

Heine concedes, however, that wraps do carry the CGT burden and while 'baby wraps' may suit someone at one stage in their life, they are not a flexible enough vehicle to suit all the stages of their life. By contrast, SMAs and IMAs can accommodate risk profile changes without incurring a lot of fees.

MLIM's O'Shannassy, however, says there is a big difference between what an SMA can provide and what a wrap account can provide.

"Our SMA is very different to a wrap. First, the whole way we do the trading and the blending of portfolios is different, the pricing is very different... it is a different animal."

He continues, "An SMA is a collection of equity models while a wrap is an admin system where you can put in individual shares and managed funds. And, with our SMA, the tax system is as good as it ever gets - you can't get any better."

Perhaps financial planner and accountant Rypma summed it up best when he said it's a case of different strokes for different folks.

"There are three levels here. IMAs are for those who have a very good knowledge and are active participants in their investments... then you have SMAs where you are somewhat participating in the investments but not in the actual decisions."

"Then, when you come to the bottom, the most successful thing that has worked for people with smaller amounts is to move into what I would call Manage the Manager (MTM) funds."

SMA providers are happy to play the waiting game. "These things can take some time to get some traction. We're here for the long haul, we know it's at the right price now so I fully expect that in the next couple of years, we'll be doing some interesting things," says MLIM's O'Shannassy.

Meanwhile, SS&C Technologies (formerly FMC Software) also pins the blame partly on a lack of education.

"As Australia is such a heavily advisor-led market, until investment advisors and financial planners are educated about their benefits, the investor or client will rarely be aware of them," says Nadine Moore, head of sales and marketing at SS&C.

"But once the street hears about the cost savings they can leverage, and realises how much more cost effective the management of their investments could be, we should see a significant jump in assets under IMAs and SMAs," she says. ■

Financial Standard

Reproduced with permission.

Feature article appearing in *Financial Standard*, Volume 4, Number 01 on 30 January 2006.

Opinions expressed in the *Financial Standard* are not necessarily those of Financial Standard or Rainmaker Information.

Level 2, 151 Clarence Street, Sydney NSW 2000

Tel: 02) 8234 7500 Fax: 02) 8234 7599 1300 884 434 info@financialstandard.com.au

Financial Standard is a Rainmaker Information company

ABN 86 095 610 996