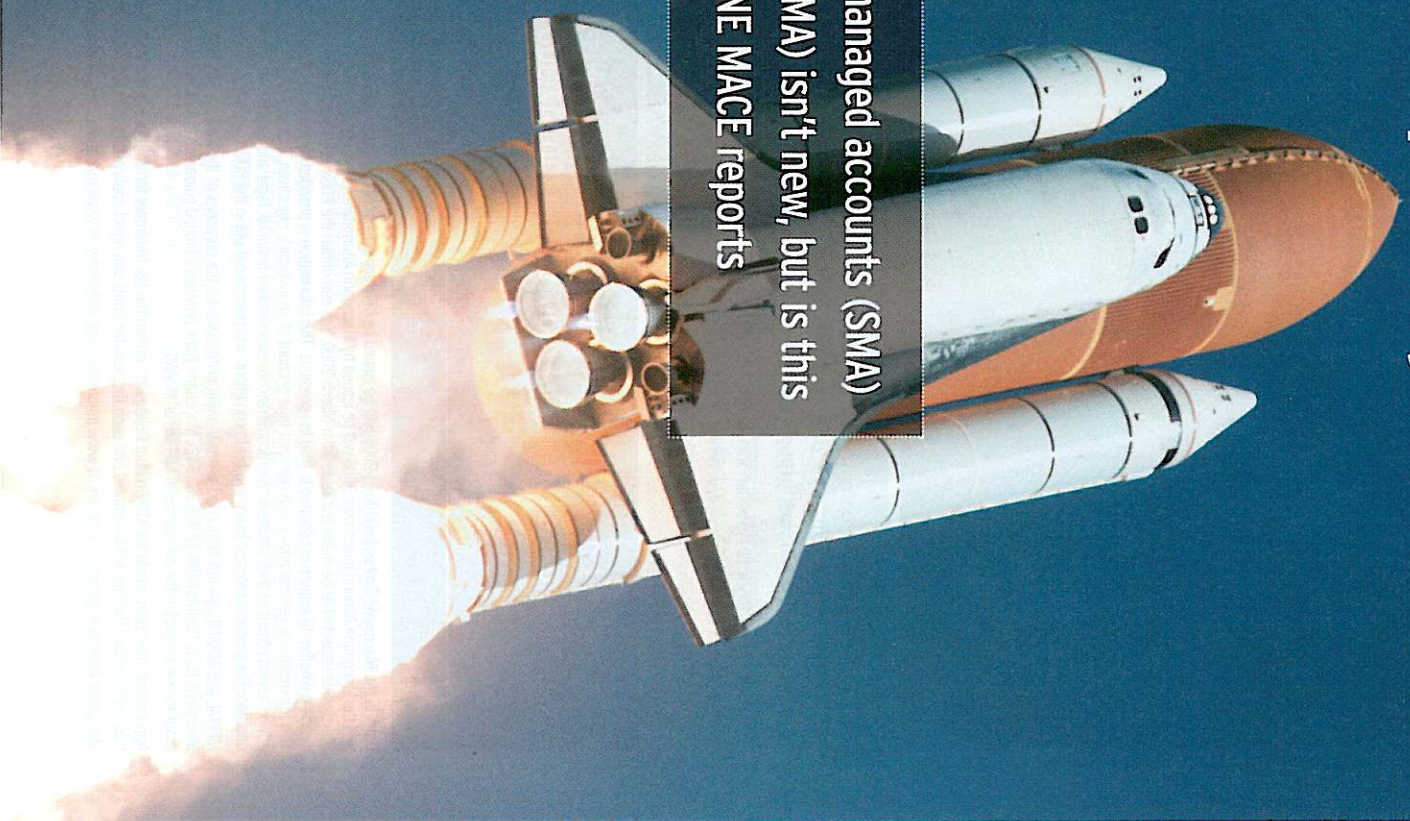


Accounts launch

Is direct investing finally taking off?

Direct investing through separately managed accounts (SMA) and individually managed accounts (IMA) isn't new, but is this the year they finally get going? JANINE MACE reports



Whether it's better management of tax liabilities or a solution to the time and compliance problems of direct shares, these products can supposedly do it all.

But whatever their merits, getting a clear picture of what promoters are talking about can be a little tricky.

Many planners mistakenly view SMAs and IMAs as being the same thing, according to Arthur Naoumidis, managing director of Praemium Portfolio services. He believes there is a clear distinction between the two.

According to Naoumidis, IMAs suit the low volume, high value end of the market and are like traditional discretionary managed portfolios. "They are usually individually managed and designed," he explains. The resulting time demands mean planners can usually only handle about 100 clients, giving a minimum value threshold of \$1 million plus.

SMAs, on the other hand, tend to be low value and high volume, with Naoumidis likening them to an "industrialised portfolio" or an un-united managed fund. "They deploy the portfolio manager's intellectual property on a large-scale basis," he explains.

Direct Portfolio Services (DPS) executive chairman John Aldersley argues SMAs can be targeted at a much broader range of clients. His firm's SMA product, ShareInvest II, can handle portfolios as small as \$25,000.

"There is a tremendous opportunity for scale," Aldersley claims. "It gives the appearance of high-touch without being high-touch."

Legal structures

A key difference between IMAs and SMAs is their "legal envelope". According to Naoumidis, IMAs come under the managed discretionary account (MDA) rules, while SMAs fall under the managed investment scheme (MIS) rules.

Planners using an IMA need to change their business processes and upgrade their licence to meet the MDA rules, a step many dealer groups will not permit. Advice provision is also tied to implementation and Aldersley says this means a statement of advice (SOA) must be reviewed at least every 13 months, with the planner required to sign off that the investment programs remains in the clients' best interests.

"Most people have decided that it is just too difficult," he notes.

Under the MIS rules, this is not required and a normal product disclosure statement (PDS) and application form process can be used. Licences also do not need upgrading.

"The MIS approach makes it easy for any financial planner to use [an SMA]," Naoumidis argues.

While those promoting SMAs are keen to extol their merits, not everyone is certain they are really all that new.

Industry commentator Paul Resnik views SMAs as one development within a larger trend. "They are part of the move within the industry of pulling out costs and ongoing dis-aggregation," he says.

Michael Heine, managing director of Netwealth, sees SMAs as just part of the landscape and "not that different to what we do with our wrap account".

"Whether you are calling it a wrap account or an SMA/IMA doesn't matter," he says. "The concept is fantastic, but it is just a new name."

Heine argues there is a bigger difference between older wraps and newer ones than between modern wraps and an SMA.

"Advisers are looking for a range of investments, pricing, timely and accurate reporting, and software integration. They don't care what you call the product," he says.

A business opportunity?

But promoters of SMAs claim these products represent a new business opportunity for planners, as managed fund inflows slow and interest in directly held shares rises.

Naoumidis and Aldersley cite US figures indicating that US\$1.3 trillion has flowed into managed accounts and last year for the first time their growth rate passed that of managed funds.

According to DPS executive director, Paul Bray, advisers are yet to tap into much of the "hidden" money in Australia held almost invisibly by trustee companies and brokerage firms.

"[SMAs are] a way to tap into that market; a way to get at that iceberg," he says.

Resnik believes one of the appeals of SMAs is similar to the way master trusts allowed advisers to move from being price-takers to price-makers.

"SMAs ... allow them to go from being product-takers to product-makers," he says, with planners able to create their own tailored portfolios, rather than merely taking what is produced by an investment manager.

SMAs also provide a way for advisers to deal with direct shares. Many SMA providers push the "dinner party" argument, claiming planners are increasingly facing clients keen to boast about direct holdings and tangible assets rather than managed fund units.

According to Naoumidis, SMAs can solve this problem. "Investors are pushing more towards direct equities, so these allow planners to exploit that desire," he says.

In addition to offering a time and compliance solution for planners and dealer groups, SMAs also halt the erosion of fee flows caused by direct shareholdings.

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Going direct

But not everyone is convinced there is a demand for direct ownership. Heine argues: "A demand for direct holdings? It's just not there."

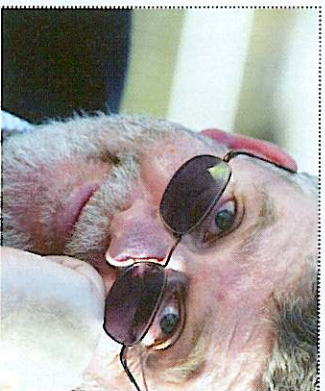
He points to insignificant legal difference between holding assets directly and through a custodial relationship in a wrap. "When a client sees their name at the top of a statement with live prices they don't care about the legal structure," Heine says. "It's like arguing you don't have any cash because the money is held by the bank."

He believes many investors claim they want a hands-on role, but actually doing it is a different thing: "A lot of people want to do it, but then get bored and lose interest".

Figures compiled by Netwealth comparing the structure of adviser-selected portfolios and direct investor portfolios it manages seem to bear this out.

Direct investors have 25 per cent of their portfolio in shares compared to 22 per cent for adviser-selected portfolios, while cash is 14 per cent and 9 per cent respectively. When it comes to managed funds, direct investors have 56 per cent, while adviser-selected portfolios have 59 per cent.

For unlisted investments such as property syndicates, direct investors only have 3 per cent compared to 8 per cent for adviser-selected, a skew Heine feels reflects their lack of



Paul Resnik

knowledge about the availability and advantages of alternative assets.

He believes the statistics indicate that clients with an adviser-selected portfolio are likely to be more active and less conservative than those held directly.

While Resnik is also uncertain about the level of client demand for direct holdings, he believes the desire for control inherent in this idea could be an important trigger for winning clients over.

Highlighting managed fund trust rules that allow redemptions to be stretched in certain circumstances, Resnik argues many clients would be attracted to holding stock directly in an SMA so transactions could be immediate.

"This could be a great driver of SMAs in the future," he says. "It may well trigger interest by planners looking to differentiate themselves. Liquidity – and the fear of not being able to get my money when I want it – is a good selling point with clients."

Adviser benefits

Heine believes demand for SMAs will not come from clients but from advisers seeking to differentiate themselves by offering diverse assets and investment strategies.

SMAs also strengthen an adviser's ability to create a coherent financial plan, argues Aldersley. He cites ShareInvest II's ability to pay dividends as a regular monthly income stream rather than sporadically: "This aligns direct shares into something more like a financial product."

According to Bray, another attraction for advisers is the "stickiness" of SMA money. He points out that US experience shows managed or mutual fund money only averages 2.7 years on an adviser's books, while SMA money tends to stay for almost a decade.

SMAs can be used with both fee-based and commission-based business models and they offer advisers a major business opportunity, Bray says: "For 20 per cent more effort you can double your revenue."

Even so, a major benefit of SMAs is their tax handling capabilities. While managed funds routinely realise and pass on capital gains, SMAs do not and investors can also access capital losses.

"With SMAs, a key benefit is the tax efficiency," Naounitis says.

However, not everyone agrees the tax benefits are unavailable elsewhere. Heine argues

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FEATURES OF MANAGED ACCOUNTS AND MANAGED FUNDS

| MANAGED ACCOUNTS (SMA/IMA) | MANAGED FUND |
|--|---|
| Underlying assets directly held by investor | Assets pooled and owned by the fund with investors owning units |
| Tax benefits from in-specie transfers (no CGT) and matching purchase lots with sell transactions | Redemptions can trigger a CGT liability or lead to forced asset sales at sub-optimal prices |
| Model portfolios offered with different strategies and risk profiles | Various asset allocations offered |
| Able to hold direct shares | Direct holdings not possible |
| Ability to filter in or out individual stocks in model portfolio | No ability to filter holdings |
| Transparent transaction reporting | Opaque transaction reporting |
| SMAs | IMAs |
| Operate under Managed Investment Scheme rules | Operate under Managed Discretionary Account Services rules |
| Scalable; Alternative to managed funds with limited portfolio tailoring | Non-scalable; Offer customised and tailored portfolios |
| Typically low value, high volume | Typically high value, low volume |

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that while tax in managed funds can be a problem, a fully-featured wrap can offer similar tax transparency and parcel management.

"In Netwealth you can buy and sell particular holdings after drilling down and looking at the CGT report," he says.

Aldersley acknowledges that – unlike his firm's product – many SMAs do not offer complete tax handling capabilities.

"In most SMAs, if you transfer in existing shares and they are not in the model portfolio, they get sold. This is not acceptable for sophisticated clients. Our SMAs can transfer in shares and hold them so they are not sold automatically," he says.

Future predictions

While SMAs are currently the flavour of the month, there have been previous attempts to

kick-start the Australian market.

Naoumidis believes these have largely failed due to product providers trying to apply a US pricing structure, which involves selling them at a one-half percentage point premium to managed funds.

But by utilising better technology and improved efficiencies to eliminate a layer of custody, SMAs are now around 0.4 per cent cheaper than a comparable managed fund, he claims. Naoumidis believes this pricing differential makes a "compelling argument" for SMAs.

"Once a planner is aware of the difference in pricing, then on what basis could you possibly argue for managed funds? They are more tax effective and cheaper."

He even goes so far as to speculate that in the future, the Australian Securities and Investments Commission may require planners to justify their decision to invest client funds in a managed fund over an equivalent

SMA structure.

Aldersley, however, argues the key problem with previous SMAs was their business fit: "SMAs must seamlessly fit into the business model of advisers to take off."

But all this is changing, with Naoumidis arguing interest has now reached a 'tipping point'.

"By the end of this year it won't be if SMAs take off, by then they will have demonstrably taken off," he says, and is very confident some major dealer groups are about to get on board.

Aldersley and Resnik both agree this year is likely to see an upsurge in interest and may be a "watershed".

"I think this is the year there will be a move and that's because the preconditions are there," Resnik says. He predicts small boutiques will lead the way, using SMAs as a way of differentiating themselves, with the process mirroring the slow take-up of DIY super funds. ❖