

Understanding Separately Managed Accounts (SMAs)



Overview

A relatively recent addition to the range of investments available to smaller investors, SMAs have a number of distinctive characteristics and advantages.

Investors in SMAs each have a unique portfolio that is apportioned across a number of model portfolios within the SMA. Investors retain beneficial ownership of the underlying stocks in their portfolio – and are therefore eligible for dividends and franking credits. The allocation across model portfolios is done by financial advisers who help their clients select from a range of available investment strategies.

An investor's beneficial ownership of their own discrete portfolio also gives them visibility of the underlying stocks and a range of associated tax advantages.

Visibility: The investor can log on to an online service with a user name and password and view their underlying stocks as a single portfolio – even where stock is invested over more than one model portfolio within the SMA.

Fees and charges: While SMA platforms may vary slightly, investors can generally expect to be able to take advantage of cost savings through wholesale brokerage rates and the netting of transactions across the whole SMA.

Compliance: The legal structure of SMAs will vary, depending on the platform, but compliance requirements for financial advisers may differ very little (if at all) from the compliance requirements for managed funds.

Tax advantages: SMAs can also suggest optimised tax parcels that have resulted from trading throughout the year. The investor's accountant has access to detailed, real-time reporting – thus optimising the taxation process.

Are SMAs an option for all investors?

While SMAs have been available for many years, it is only in recent times that they have started to become more accessible for a wider group of investors.

This change in availability has been brought about by changes in the technology used to deliver the service and by the ability to offer blending – the facility that allows the individual investor to view all their SMA holdings as a single portfolio. These changes have, over time, allowed dealer groups to open up SMAs as an investment option to investors with access to smaller holdings.

With an emphasis on flexibility, SMAs often offer a customisable alternative to managed funds and the unit trust structure.

Minimum entry amounts for investment in SMAs are lower than they have ever been. Decisions about minimum amounts for SMAs are frequently in the hands of advisers – and adviser pricing structures may even include a fee-for-service element that removes the minimum entry requirement completely.

As the entry minimums for SMAs reduce – thereby opening them up as an option to more and more investors – they may become as popular as managed funds and eventually compete with them as an investment vehicle.

As for any investment option, the suitability of an SMA really does depend on the individual's investment objectives and risk constraints.

How do investment model portfolios work with an individual strategy?

An SMA may offer a large number of model portfolios. However, an SMA may also be badged by a dealer group so that it includes a smaller set of model portfolios that complements their other investment offerings.

An individual investor's portfolio may be spread over a number of model portfolios and may also have a cash component. The design and choice of model portfolios for an individual's portfolio generally includes three steps:

1. Model portfolios are created by investment professionals, researchers or fund managers and provided to dealer groups for use in the SMA.

Model providers may be employees of large dealer groups or in some cases they may be external investment specialists who have relationships with one or more dealer groups or a trusted third party fund manager.

2. A range of model portfolios is selected by dealer groups for inclusion in their SMA offering.
3. Financial advisers work with individual investors to select the model portfolios that best match the agreed investment strategy and allocate appropriate weightings.

Who administers the SMA?

While an SMA may be offered as an investment option to individual investors by financial advisers, for those SMAs structured as a managed investment scheme, the custodial and administrative responsibility will be taken care of by a separate responsible entity. For the Merrill Lynch Customised Portfolio Service, for example, the responsible entity is Merrill Lynch Investment Managers.

When a new account is opened, advisers capture investor details on the system and print out an application form for the investor to sign. This form and the Nominated Representative form are then sent to the responsible entity to be kept on file. The Nominated Representative form nominates the person from whom the responsible entity can receive instructions for the portfolio.

What benefits are passed on to individual investors?

There are many benefits to investing in an SMA, often related to transparency, volume benefits and beneficial ownership.

Transparency

In an SMA, there are two aspects to transparency:

- The visibility of the underlying securities.
- Transparency of fees.

Investors retain beneficial ownership of the stock in their SMA account and are able to see their investments displayed as a single portfolio, on line.

When it comes to fees, investors (and their advisers) are able to see what fees are being charged – including transaction fees, in-specie transfer fees and corporate action processing fees.

Volume

In SMAs, even small trades benefit from wholesale execution and brokerage rates. Netting and balancing within an SMA would result in smaller trades overall, and all investors benefit from the reduced brokerage fees that occur as a result of this pooling. Netting is embedded in the platform processes and therefore occurs automatically. The only transactions that attract brokerage fees are trades – and in a blended environment, netting allows these to be further minimised.

Beneficial ownership

Beneficial ownership of stock is a key feature of SMAs, providing investors with significant tax advantages as well as visibility of the stock they own.

Volume benefits, netting and the use of wholesale brokerage services, where available, provide opportunities for cost savings to be passed on to individual investors.

The following sections address individual benefits in more detail.

Can an investor enjoy the benefits associated with investing through a large institution and also retain beneficial ownership?

Yes. An SMA generally holds portfolios for a large number of investors. The system maximises the benefit of volume with netting and wholesale brokerage.

Added to that, if the SMA service is offered by a sizeable and trusted investment institution (as is the case with the Merrill Lynch Customised Portfolio Service) investors continue to enjoy the benefits that a larger institution can offer.

With an established financial institution, investors still have access to the benefits of institutional discounts such as wholesale brokerage. Brokerage rates are already reduced in an SMA because transactions are performed by wholesale execution-only brokers – even when no netting takes place.

As an SMA grows, the opportunity for netting increases – thereby reducing required trades and reducing brokerage fees.

How do netting and blending affect an individual portfolio?

An SMA may be badged by a number of dealer groups and run on a common platform. The cost of trading is potentially reduced because at an SMA level, investments are netted daily, minimising the actual trades required and passing on the benefits to the individual investor.

Many SMAs offer blending – the facility that allows the individual investor to view all their SMA holdings as a single portfolio – across their entire platform, enabling transactions to be netted. The result? A reduction in transaction fees and minimised requirements for actual trades.

Generally, investors would benefit most from an SMA that also offers blending *within* their individual portfolio. Blending within an individual's portfolio means that the cost, if any, of switching from one model to another is minimised and the investor continues to benefit greatly from reduced Capital Gains Tax (CGT) events and maximised flexibility.

That is, for SMAs running on a blended service (such as the Merrill Lynch Customised Portfolio Service) netting occurs across the whole platform *and also* within each investor portfolio.

1. Each day the system checks investment levels in all accounts against latest versions of model portfolios, against investor requirements and then against the actual holdings.
2. Only the differences remaining after netting result in trades. Since it is trades that attract brokerage fees (and in some cases transaction fees) minimising trades passes on a real benefit to investors.

Note: In a non-blended SMA, the benefits are reduced because processing within an individual's portfolio takes place on a model-by-model basis.

Is joining an SMA more cost-effective than investing in other types of funds?

The ability to keep transaction fees to a minimum means that an SMA may be more cost effective than other types of funds, depending of course on the investment size and other factors that would normally affect any type of investment.

Investors and their advisers should take care to familiarise themselves with the fees that might be charged for entry to or exit from an SMA. Does the SMA charge an in-specie transfer fee for entry, exit or switching? What transaction fees are charged? These fees may vary markedly from one SMA to another. The Merrill Lynch Customised Portfolio Service does not charge entry or exit fees.

Because an SMA offers blending and netting, this type of investment can actually result in vastly reduced brokerage costs and favourable CGT implications for the individual investor.

How is a financial adviser reimbursed when they recommend an SMA?

Financial advisers will notice that the process of investing in an SMA is similar to any other investment process they may currently be following. Whatever fee-for-service or other charging structures are in place for an adviser are unlikely to need to change, although many SMAs allow the adviser to select the fee rate rather than qualifying for rebates.

It is true, however, that advisers may need to explain SMAs to investors who are not yet familiar with this type of investment. Flexibility of investment options may also mean more decisions to make. Investors in SMAs are the beneficial owners of individual stocks. Tax benefits may broaden with SMAs but will need to be carefully explained.

Advisers may choose to factor a 'cost of advice' into their fees if they recommend SMAs to their investors, simply because this type of investment can be more complicated and many investors will be unfamiliar with its benefits.

What are the potential tax benefits of using an SMA?

SMAs provide transaction options that can minimise the CGT impact.

With traditional unitised funds, new investors generally inherit the existing tax position when they enter the trust. This is not the case with SMAs.

Most SMAs have a strong focus on recording and managing CGT consequences. In the case of the Merrill Lynch Customised Portfolio Service, tax free, tax deferred and distributed CGT income components are taken into account when calculating CGT positions.

Three major tax advantages of SMAs are:

- No embedded CGT, which minimises tax events.
- Minimised CGT trigger events improve overall performance.
- When realising CGT, investors can choose the most favourable tax parcel(s) – from within the SMA or outside it.

Are there CGT implications to joining or leaving an SMA?

For SMAs that allow in-specie transfers there is no CGT event. Investors retain beneficial ownership of stock that can be applied to their selected model portfolios within the SMA. Thus, CGT obligations only apply to stock that needs to be sold to bring the investor's portfolio in line with the model(s) they'll be investing in. And, if an investor decided to leave the SMA, their ability to transfer stock in-specie will once again result in minimised CGT trigger events.

It is important to take these factors into account when choosing an SMA – for those that do not allow in-specie transfers, the CGT implications will be the same as if the investor were entering or leaving any other type of managed fund.

Investors and their advisers should also be wary of SMAs that charge in-specie fees by tax parcel or by holding, as this could dramatically affect the cost of investing.

Can tax parcel accounting be automated?

Yes. As long as the SMA can link to accountant systems at a *tax parcel level*, there is negligible additional investment required by the adviser, accountant or investor – in terms of time or expense.

SMAs such as the Merrill Lynch Customised Portfolio Service can provide CGT tax parcel reports in a few minutes for any date range – a task that we've estimated could normally take from three to five hours to complete.

Thus, not only is there no increased expense with investment in an SMA, but with the right SMA there can be a significant cost saving for advisers and accountants.

Can SMAs be customised to meet individual investor needs?

The short answer? While advisers will continue to work with investors to ensure that their investment needs are met, SMAs provide different options that may change the way advice is given. Choosing the right balance of model portfolios will be a big part of 'getting investments right'. The choice of model portfolios will be an important way for the adviser to ensure the investor's return and risk needs are being met.

There are constraints of course, but within limits, investors will be able to substitute stock, freeze tax parcels or prohibit holdings of specified individual stocks. Additionally, advisers can act to quickly and easily switch between model portfolios on behalf of the investor – CGT obligations are only affected by the holdings that need to be bought or sold to match the portfolio to the model.

Is there a minimum investment for SMAs?

Minimum investments will be set by the adviser – either at individual level or at the dealer group level. In the past, minimum investments have been high – prohibitively so for some investors. Recent changes to technology and the availability of blending have removed many of the barriers that existed for smaller investors.

The fee structure for SMAs can be quite flexible, depending on the SMA an adviser chooses for their investor. The Merrill Lynch Customised Portfolio Service, for example, attracts no account fees, set-up fees, transaction fees, platform fees or safekeeping fees and allows dealer groups, model providers and financial advisers to set their own fees for model providers, advisers and research. A point to note, however, is that advisers should be wary of recommending those SMAs that have fixed components, fixed transaction costs and minimum fees as part of their fee structure to smaller investors.

Costs associated with investing in a particular SMA may mean there is an effective minimum investment amount.

Further information

For further information about the Merrill Lynch Customised Portfolio Service, visit our website: www.mlimadviser.com.au, speak to your Merrill Lynch Investment Managers Business Development Manager, or contact our Adviser Services Centre on 1300 366 101.



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