Why managed accounts are taking off with investors

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A discussion by Hugh MacNally, Chairman of Private Portfolio Managers

There's been lot of talk around the financial services industry regarding managed accounts and their growing popularity among investors.

> ***"A managed account is one in which the assets (shares, bonds, cash, etc.) are held directly by the client as opposed to the unit trust structure where the client holds a unit in a trust which then in turn owns the assets".***

Essentially it is a portfolio which can be broadly or narrowly defined, managed by a professional management team. Importantly the assets are held directly by the client and not shared by anyone else. "What is driving this shift in investor behaviour?

What is it about the structure of managed accounts that is so appealing?

Holding the underlying assets directly has many advantages over having them indirectly held in a pooled fund.

Transparency – you can see exactly what you hold and the transactions on your account are clearly visible. This is important, as just being presented with the year-end holdings does not tell the whole story. You can see if the manager is actually managing in the way that has been presented (you can see all the mistakes the manager makes laid bare – a humbling experience for the manager I can assure you!). The client can see, by the number of transactions, whether for instance the manager is trading excessively or is taking a lot of short-term bets.

Fees – that are being paid by the client are very clearly visible as all the cash movements in and out of the account are all listed in quarterly reports.

Tax – you are not buying into a fund where there may be a large unrealised capital gains tax liability that may be realised at some time. Additionally, if you want to change strategy or manager you don't have to realise all your investment, pay CGT and re-invest with the new manager; you can simply have your holdings moved to the new manager.

Flexibility – in some arrangements you can bring in any stocks that you already hold and the manager will work around the existing holdings to limit the amount of CGT you have to realise. This is a huge benefit for individuals who hold a portfolio that has large capital gains imbedded. The client may for whatever reason not wish to continue managing the portfolio but is presented with a problem - they don't want to crystalize CGT gains only to re-invest in many of the same stocks inside a unit trust. The managed account lets them transfer the day to day management to a professional without having to realise all the capital gains in order to do so.

To understand the differences between managed funds and managed accounts it's important to break down Australia's principal investment management structures, not just managed funds but Separately Managed Accounts (SMAs), Individually Managed Accounts (IMAs) and the ASX's distribution of managed funds via its mFund system.

> ***"Each investment structure has its advantages and disadvantages but it seems, in our view and that of a growing number of investors, that managed accounts, either IMAs or SMAs, have the most advantages and the least disadvantages".***

All the other structures/managed funds (Listed Investment Companies (LICs), Exchange Traded Funds (ETFs), the new exchange traded products (ETPs), which are generally perceived as active ETFs) are pooled arrangements where the client has a share of a pool with others.

Managed funds are still the most popular structure for delivering investment management services to Australians by a long shot, collectively amounting to approximately $1 trillion in assets. Simply put, a managed fund is an investment vehicle that pools money in order to buy an asset, or a portfolio of assets, which are managed by an external fund manager. The fund owns the underlying

assets, and the investors receive units in the trust proportional to the amount that they contributed. Most of these funds apply a management fee of 0.75 - 1.75 per cent.

Managed funds can provide the investor with exposure to difficult to access asset classes such as property and infrastructure where the size of the individual asset is too large for the individual investor to hold (most individuals can't afford a Grade A building or an airport!). However, shares both international and domestic, bonds and other fixed interest securities are all easily accessed using a managed account. There are also tax consequences for the underlying transactions that occur when a fund manager must rebalance the fund after an investor enters or leaves.

Arguably the greatest issue with LICs is their tendency to trade below Net Asset Value, and in the case of small LICs, the issue of liquidity – being able to get out.

This brings us to ETFs. ETFs are open-ended unit trusts listed on the stock exchange providing exposure to an underlying investment portfolio. As such, ETFs are essentially managed funds that trade like shares.

Purchases and sales are implemented in the same manner as listed shares.

Management fees for ETFs begin at less than 0.30 per cent for Australian equity index products, as low as 0.07 per cent for US equities, and can exceed 1 per cent for other types of offerings. Stock brokerage will apply to ETF transactions.

ETF products tend to offer passive (i.e. index based) strategies in which portfolio turnover is low, reducing tax events such as realised capital gains and losses. Embedded capital gains do not build up to the same extent as in managed funds, but many of the challenges that managed funds experience are shared by ETFs.

It's worth mentioning that the ASX offers access to unlisted managed funds through what they call the mFund Settlement Service. Although mFund units are settled through the ASX, the units are not actually quoted or traded on the ASX and investors buy and sell units to the unit registry of the fund, not each other.

Now we come to managed accounts which are investment portfolios where the investor maintains direct ownership of an investment portfolio, managed in accordance with a set investment strategy. They can be structured in two different forms, Separately Managed Accounts (SMAs) and Individually Managed Accounts (IMAs). Management fees generally range from 1.0 per cent to 1.7 per cent.

The table below provides a comparison of the key features of Australia's primary investment management structures.

	Managed Fund/mFund	LIC	ETF/ETP	SMA	IMA
Tax Efficiency	Poor	Poor	Good	**Very Good**	**Excellent**
Portability	None	None	None	**Good**	**Excellent**
Managed to Particular Tax Outcome	No	Sometimes	No	**No**	**Yes**
Transparency	Poor – Moderate	Moderate	Good	**Excellent**	**Excellent**
Direct Ownership	No	No	No	**Yes**	**Yes**
Embedded Tax Liability	Often	Often	Possible	**No**	**No**
Capital losses can be applied to:	Future gains within structure	Future gains within structure	Future gains within structure	**Any applicable current or future gains**	**Any applicable current or future gains**
Research COVERAGE	Excellent	Good	Good	**Moderate**	**None**
Variety of Investment Options	Excellent	Good	Moderate	**Moderate**	**Moderate**
Portfolio Construction	Manager's Discretion	Manager's Discretion	Manager's Discretion	**Model Portfolio**	**Manager's Discretion**
Tailored Management	No	No	No	**No**	**Yes**
Management Fee Tax Deductibility directly by investor	No	No	No	**Yes**	**Yes**

An SMA manager builds a model portfolio comprising their investment selections and relative weightings, which is provided to an investment administration platform where the individual investor portfolios are implemented and maintained to mirror the model. Any change in the model portfolio will result in corresponding changes in each of the managed account.

On initiation there is no embedded tax liability within managed account structures and investors do not realise tax consequences as others enter or leave the scheme. The assets are not pooled, so the actions of other investors do not affect all investors. Investors may also transfer in an existing portfolio without having to liquidate all positions and potentially incur a capital gains tax.

Investors may terminate the manager and leave the scheme without being forced to liquidate the positions and incur tax events, and the level of transparency in the structure allows assessment of the manager's transactions, holdings, tax efficiency, fees & expenses, and sources of return. Investors can also restrict or exclude holdings in specific securities, with cash being commonly held in lieu of the excluded securities.

Like SMAs, IMAs provide investors with direct ownership of their portfolios but they do not use a model portfolio. Fund managers build and manage an investment portfolio based on the manager's core portfolio of stocks and tailored to the individual objectives and tax positions of each investor. Therefore, the investment portfolio and management decisions will be tailored for each investor.

A key benefit is that IMAs are formally a service offering and the management fees may be tax deductible. For an IMA with $10m in assets (which is not uncommon), tax deductibility can mean a saving of up to a hundred thousand dollars.

Much of the benefits and challenges of an IMA are the same as an SMA, however a key consideration is the minimum investment ranges. While an SMA will require a minimum investment starting at about $25,000. An IMA will require a much higher minimum investment of about $250,000 but can range up to $5 million.

A recent broker report has identified increased regulation in the financial services industry to be the key catalyst for the take up of managed accounts, particularly in regard to dealer groups losing revenue from platform volume rebates on new business. The FoFA reforms in 2013 saw the banning of volume based rebates from platforms to dealer groups which were contributing about 30bps in revenue.

This change in legislation has driven dealer groups to reshape the value chain by focusing on product packaging. They have now recognised the superior value of managed accounts and are transferring clients to these structures.

There is also growing demand for transparency from investors and managed accounts offer beneficial ownership of assets, transparency and tax planning advantages.

Managed accounts are also proving to be relatively cost efficient as much of the back end paperwork is outsourced by the planner to investment professionals backed by an admin platform.

"We are witnessing a revolution in our industry with managed accounts taking off at the expense of managed funds. This shift relates to the structure of these investment vehicles, as trends in wealth management align with the advantages that managed accounts can offer."

Managed accounts hold $28 billion under management today. To put that in perspective, ETFs, which seem to get a lot of airplay, have about $24 billion. At a growth rate of 35 per cent a year, the managed accounts figure is forecast to hit $60 billion under management by 2020.

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