

Separate From What?

There is the bucket, and then there is what is inside the bucket.

Investments are packaged in various “buckets.” One popular bucket is a mutual fund, a diversified portfolio of stocks or bonds of a particular type with a hired investment manager. Another bucket prominently featured by financial services firms these days is a “separate account,” in which your account is directed by a selected investment manager in a “customized” manner.

Of course, the reality is that the bucket is not important, only what is inside of the bucket. There are good and bad brokers, good and bad mutual fund managers, and good and bad “separate account” managers. The primary sales appeal of the new breed of separate accounts marketed to the investment public, however, is the “bucket.” Having a separate account managed by an investment firm has traditionally required an account size with a high minimum, ranging from \$1 million to \$20 million or above. The “new” separate accounts lower this minimum to \$100,000 or even less. Because separate accounts have traditionally been the province of the very wealthy, opening a separate account makes you a “player.”

Many “Separate Accounts” are merely mutual funds in drag.

The new breed of low-minimum separate accounts has morphed from the “wrap account” products brokerage firms have been flogging for years. The marketing of the new separate accounts and wrap products create the pretense that the equivalents of Warren Buffet and Peter Lynch are sitting at a conference table in New York deciding that Fred and Brenda’s account should buy four shares of Starbucks and seven shares of Nordstrom. In fact, many wrap accounts and separate accounts are just mutual funds in drag, with a computer allocating a pooled account so it looks like Fred and Brenda own individual stocks rather than a pro-rata portion of the pool.

There are three rational possible reasons to own a separate account rather than a mutual fund with the same manager: (1) a performance advantage; (2) a cost advantage; and (3) improved tax efficiency. The marketers for the new breed of separate account make vague claims to all three. With respect to the performance advantage, we are not aware of any study demonstrating a performance advantage of the separate account bucket over the mutual fund bucket. From an organizational standpoint, it would be surprising if such an advantage existed. Imagine you are the head of an investment firm managing both mutual funds and separate accounts. Which one will you assign your top people to manage? If you make a mistake in a separate account, you have to explain it to one person. If you have a similar problem in a mutual fund, the media will publicize the mistake.

The larger issue is where all the separate account managers came from? Did they suddenly materialize when Wall Street decided it could sell the concept of a separately managed account to prospects? A manager is either good or bad – putting managers in charge of a separate account “bucket” does not make them better managers; it just adds cachet and mystique.

A cost advantage for separate accounts is possible, but unlikely. The reason mutual funds were invented in the first place was administrative efficiencies that should result in lower costs.

Very few of the new breed of separate accounts offer true customization.

With respect to tax efficiency, one supposed advantage for a separate account results from the account starting anew with each client, avoiding existing capital gains that might be embedded in the shares of a mutual fund. This is not a problem now, however -- according to Morningstar, Inc., the average domestic equity has an embedded capital loss of 24 percent as of June 30 that will offset future gains. On average, this is a current advantage for mutual funds relative to separate accounts.

True, some mutual funds have high-turnover managers that are not very tax-efficient. There are also tax inefficient separate account managers – the key is to pick a tax efficient manager, not focus on the type of account used to access the manager. It is also possible to avoid mutual funds that have heavy retail cash flows in and out that might result in taxable distributions. Another possible source of tax efficiency is true customization to the needs of the investor -- realizing losses to offset gains or harvesting gains to offset losses. While most separate accounts pay lip service to this type of personal attention, Cerrulli Associates has estimated that only 10 to 15 percent of broker-sold separate accounts are customized at setup and only 30 percent provide any year-end tax analysis.

We have no bias against separate accounts. We have used separate accounts for our clients in situations where we believed it was appropriate for the client and where there was a true customized approach. But Wall Street is flogging the “new” separate accounts because they think the "bucket" will appeal to investors, helping them forget the losses they incurred by buying the previous fad sold to them by their "advisers." Much of the pressure to sell separate accounts is driven by marketing rather than any investment rationale.

Beware of the financial products industry's focus on buckets, and instead direct your attention to what is inside the bucket. Select an adviser driven by an investment focus, not someone trying to sell you a "product."