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## FA News

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### SMA's Expand Into Indexing

August 31, 2006

Separately managed accounts, which are usually pitched for their access to top-flight money managers, have expanded into a surprising new niche: indexing.

Benchmark-oriented SMAs are being sold not as a way to beat the market, but to help investors lower their tax bills. SMA managers can tweak individual holdings in response to a client's tax liability.

"Tax efficiency is for wimps; tax management is where we can add value," says money management executive Dennis Clark, touting SMAs' flexibility over tax-efficient mutual funds.

Clark is chief executive of San Francisco investment firm Advisor Partners LLC, which specializes in index SMAs. In the last five years, Advisor Partners has collected about \$200 million in about 200 SMA accounts, Clark says.

Figures for the whole industry are hard to come by. Research firm Morningstar Inc., which tracks SMAs, says it follows 86 index-oriented separate-account strategies, with 29 that are open to retail investors. Those figures also include SMAs that hold exchange-traded funds.

SMAs resemble mutual funds, except that investors' money isn't pooled in funds, it's kept in hundreds of small individual accounts for which investment managers buy and sell stocks directly.

Compared to mutual funds, SMAs can be expensive to operate. However, the vehicle gives investors access to some money managers who don't manage mutual funds. SMAs also allow individuals to customize their portfolios in ways funds don't permit, such as asking for individual stocks to be included or excluded.

With indexing, SMAs are being sold primarily on their customization features, since money management is usually not an issue.

The sales pitch has some advisors skeptical that benefits will outweigh the extra costs, especially with the proliferation of ETFs, which are index-oriented and which charge razor-thin management fees.

Indexed SMAs "are expensive gimmicks for all but the wealthiest investors," wrote Merritt Island, Fla., financial advisor Steven Podnos in an email. "Any small to moderate account is impossible to customize for tax purposes. ...A rip-off most of the time."

James Ross, senior managing director of State Street Global Advisors, which manages index SMAs, acknowledges that customization can be a problem for some SMAs. But he says State Street's index-oriented SMAs keep investment minimums high enough to make individual attention to investors feasible.

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Account minimums for State Street's indexing strategies are "in the millions," as opposed to \$100,000 in some actively managed separate accounts on the market now, he says.

State Street Global Advisors, a unit of State Street Corp., has about \$11.9 billion in what it calls its Tax Efficient Market Capture Strategies SMA program. About \$2.3 billion of that total is in individual investor accounts through financial advisors, Ross says.

### Looking Under Hood

Index SMAs work by "harvesting" investment losses in individual client accounts in order to offset profits from other investments, lowering investors' capital-gains tax bills.

Like index mutual funds, many index-oriented SMAs track well-known benchmarks, such as the Standard & Poor's 500 or the MSCI EAFE index of international stocks.

However, since asset managers generally don't need to buy all the stocks in an index to track its performance, SMA managers can manipulate a client's holdings at any given time, selling losers to offset capital gains recognized in another part of the client's portfolio.

For instance, an S&P 500 account may hold some but not all of the technology stocks in the index.

If Internet companies have taken a hit recently, asset managers may sell the ones they do own to record tax losses and replace them with rival names, which the managers expect to perform similarly, keeping the account on course to replicate the performance of the index.

Ross says State Street's management fees for customized index accounts start at about 20 basis points a year. By contrast, SMA managers typically charge about 40 basis points for actively managed large-cap strategies.

Such figures don't include fees for advisors or brokerage firms. In total, SMA investors can end up paying three to four times the money manager's fee.

Tax benefits for index SMAs vary depending on the amount of risk investors are willing to take, since substitutions do make it more likely the account will deviate from its benchmark.

"It depends on the types of losses you want to generate," Ross says. Some people will accept about one percentage point of tracking error, according to Ross. Others can stomach up to five percentage points.

Steven Schoenfeld, chief investment officer of the quantitative management arm of Northern Trust Global Investments, says tax harvesting can create a return equivalent to boosting the annual performance of the index by about 1%.

Northern Trust, a unit of Northern Trust Corp., has \$7.3 billion in SMAs that track U.S. benchmarks, up from \$5 billion at the beginning of the year. More than half of that total is from individuals, according to Schoenfeld.

Apart from tax harvesting, Northern Trust also customizes indexes for clients. The firm could create, for instance, an S&P 500 index that is light on auto makers for an executive of Ford Motor Co. who already has a big investment in the auto industry.

"We will help clients apply the benefits over other parts of their portfolios," Schoenfeld says, noting that most customers who end up in these accounts often have a relationship with another part of the firm, such as the private banking division.

Northern Trust doesn't market its index SMAs through outside brokerage accounts, but several large brokerage firms do offer the products.

Citigroup Inc.'s Smith Barney, among the largest retail providers of SMAs, offers clients three index funds from Parametric Portfolio Associates, tracking the S&P 500, S&P 100 and the Russell 3000. Smith Barney clients have about \$450 million in the funds, the firm says. Account minimums are \$250,000, compared to about \$100,000 for a typical SMA equity account.

One reason Smith Barney keeps the account minimums high: Even if you don't need to own all the stocks to track an index, there are an awful lot of names in the Russell 3000.



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