

## MANAGED ACCOUNT FIRMS REVIEW CLIENT SUITABILITY

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The issue of client suitability for separately managed accounts (SMAs) is being placed under a microscope as officials are starting to question whether the right clients are investing in SMAs. Instead of accepting all account sizes, SMA managers may be better off persuading advisors to place smaller clients in mutual funds or multiple-style accounts.

Speakers at a managed account compliance forum in July warned that client suitability could become a hot button issue for the industry. The basic point is that not every investor belongs in an SMA and, though advisors may have the final say regarding client suitability, managers have a certain degree of fiduciary responsibility as well.

But there is no easy solution for managers. Some clients investing in SMAs do not have enough assets to diversify properly across a range of styles. Firms could bring the minimum for investment down, which would allow those clients to spread their assets across more investment styles. But that would cut into a manager's profits.

Managers have a couple of options. Firms with both mutual fund and SMA options can offer either to the advisor, depending on the size of client. Or managers can participate in multiple-style account programs.

"An investor with south of \$1 million in assets should be in mutual funds or multi-style accounts," says Dan Seivert, managing director with 3C Financial Partners, a Los Angeles-based investment bank and consulting firm. Multi-style accounts (MSAs) are SMAs that blend different investment styles and managers in one account.

The average number of SMA accounts used per investor is currently around two and a half, according to Seivert. He says that, at the very least, an investor needs four different investment strategies to be properly diversified.

With average minimums in SMAs ranging from \$250,000 to \$300,000, according to Seivert, an investor would need \$1 million in investable assets to invest with proper diversification.

Phoenix Investment Partners has seen a dramatic shift towards mutual funds in its sales over the last couple of years and attributes the shift to an increase in the number of affluent investors on the lower end of the wealth spectrum. Two and a half years ago sales flow at Phoenix was 80% into SMAs and 20% into mutual funds. Now almost the reverse is true, with 75% of sales flowing into mutual funds and 25% into SMAs.

"The SMA business is morphing to match the demographic trends," explains Steve Gresham, executive v.p. "Investors are increasingly younger. We're catching them early in their savings and investment life, which means they don't have as much to invest at this point."

Gresham admits that some of Phoenix's SMA strategies have performed poorly, but says the real issue is to make sure investors are in the investment vehicles best suited for them, whether the vehicle be an SMA or a mutual fund. In the end, it comes down to generating alpha.

Though the minimum for investment in SMAs is largely “out of [the manager’s] control,” he says, referring to the ultimate say advisors have in this regard, “what you may see is the minimum for an effective relationship with sponsors change.”

In order to increase communication with sponsors and advisors, Phoenix is increasing its sales force, which is made up of generalists, in teams of two, with different members of each team focused on internal and external sales. Phoenix currently has 15 teams and is looking to add ten more for a total of 50 sales professionals.

“We will use our historical position as a supplier of products to consult with advisors about this issue,” says Gresham. “But smart advisors are onto it.”

If the minimum for investment in SMAs were to come down, a client with less than \$1 million to invest could still diversify properly across different investment styles. But some industry officials believe that operational costs, portfolio manager time and fees make it economically unviable for managers to run smaller accounts.

SMA managers need to decide where their minimum tolerance is for profitability and determine what account size that corresponds to, explains Seivert. For example, if an SMA manager needs to make a 20% margin, and that does not happen until an account is \$1 million or more, then they should only take accounts of \$1 million or more.

Managers should look to manage either mutual funds or MSAs for anything below their “minimum tolerance,” he adds.

Even though manager fees drop in most cases for MSAs down to 25 basis points compared to 85 or so basis points for mutual funds, costs often drop faster, so a manager can actually get a better margin by managing in an MSA, Seivert says.

“MSAs are an important option,” agrees Gresham. “If they are structured the right way, we’re there in a blink of an eye. But even MSAs can lead to similar problems with diversification.”

There are industry players who say it is still possible to bring minimums down for SMAs and allow lower net worth investors diversification across a number of different styles.

Curian Capital, a Denver-based third party SMA platform launched in 2003, for one, says it has developed technology that makes minimums for SMAs possible at \$25,000. In effect, says Clifford Jack, president, Curian’s technology solves problems of diversification and profitability.

“The only reason I hear from people as to why minimums for SMAs can’t come down is profitability,” says Jack. “But technology solves that problem.”

Curian has an average account size of \$103,929 and \$1.35 billion in assets under management. It has grown from \$1 billion at the end of 2004.

Curian’s technology does the manager’s “heavy lifting,” which includes everything from customization of accounts to operations, he says. “The technology makes it so there is no difference to the manager if Curian’s minimum for investment is \$25,000 or \$25 million.”

But the industry may be moving in a direction where SMA minimums would not have to come down and a client with fewer investable assets could still get diversification through a mix of SMAs, mutual funds and other investment

vehicles such as exchange-traded funds. Combining a variety of investment vehicles into one account creates something the industry calls the unified managed account.

“Unified managed accounts will provide the opportunity to create a solution for investors with SMAs and mutual funds,” says Gresham.

## ABOUT ECHELON PARTNERS

ECHELON Partners (ECHELON) was formed in 2001 to offer investment banking and consulting to a subset of the financial services industry known as “investment product developers and distributors” (IPDADs). Since that time, ECHELON’s professionals have helped hundreds of senior executives envision, initiate, and execute a multitude of complex business strategies and transactions. ECHELON’s business is making companies more valuable through delivering advice and orchestrating transactions. Accordingly, ECHELON measures its success in the enterprise value it creates for its clients. Companies that strive to outperform their peers choose to work with ECHELON because we are as passionate about their results as they are.

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