

## Should you invest using separately managed accounts or mutual funds?

Mutual funds have become tremendously popular over the past two decades. Their efficiency and simplicity have been a boon for investors. Recently, the popularity of separate accounts has seen resurgence. Many articles have been written claiming that separate accounts are superior and anyone with sufficient investment funds to use a separate account should do so. They make this case by comparing separate accounts to the average mutual fund. The average mutual fund is too expensive and not very tax efficient. However, there are many low cost mutual funds that are very tax efficient. These mutual funds compare very favorably with separate accounts.

### What Are Separate Accounts and Mutual Funds?

Separate accounts are portfolios of stocks and bonds managed in a separate account for a specific individual or entity. Mutual funds are portfolios of stocks and bonds managed in a pool for a group of individuals and entities.

A separate account can be customized for a specific investor. These accounts also pass through the specific tax consequences of the activity in that account to the specific investor.

A mutual fund is managed in accordance with a broad objective without regard to circumstances of individual investors. Tax consequences of the fund are passed through to all investors as of a particular date on a pro-rata basis without regard to their individual results.

### Separate Account Myths

- ?? Separate accounts are less expensive than mutual funds. This is not true. Mutual funds benefit from tremendous economies of scale that allow them to be managed less expensively and to make trades more cost effectively.
- ?? Most mutual funds underperform the market. This is absolutely true, but so do most separate accounts. This is not due to characteristics of mutual funds; this is due to characteristics of active management.
- ?? Separate accounts can be customized. This is true, but it has limited value. There are enough mutual funds to build a portfolio to meet any conventional objective.
- ?? Separate accounts benefit from the best investment ideas. This is not true. The largest accounts benefit from the best investment ideas. In most cases, mutual funds are far and away the largest accounts.
- ?? Separate accounts receive more personal attention. The personal attention received by separate accounts is much more appearance than substance. These accounts are usually managed on a broad systematic basis. A manager may be responsible for hundreds or even thousands of accounts and cannot review each one individually. Instead, trades applicable to a broad array of accounts will be entered globally to be spread among the separate accounts based on an automated system.

?? Individuals invested in mutual funds can suffer investment losses because of departing shareholders. This is not true. The claim is that departing shareholders can force sales at inopportune times and force existing shareholders to realize losses due to selling at a bad time. This does not happen. Departing shareholders' shares are redeemed at the then depressed net asset value. Remaining shareholders recover to the same extent they would in a separate account. Existing shareholders cannot be forced out of their positions unless the mutual fund completely folds.

?? Individuals invested in mutual funds can be forced to realize capital gains to redeem the shares of departing shareholders. This can happen but it is unlikely to have meaningful impact. There is usually enough new money to be able to raise cash without a significant tax cost. If redemptions exceed new money, it would likely be due to a market decline and there would be ample opportunity to raise cash at a low tax cost. In addition, many mutual funds have the ability to pay off departing shareholders "in kind" with securities rather than in cash.

?? Mutual fund shareholders pay more tax than separately managed account holders. This is often true of the average actively managed retail mutual fund. However, actively managed separate accounts also distribute significant gains. The same activity yields the identical tax consequence in a mutual fund and a separate account.

The difference is not that mutual fund investors pay more tax. The difference is that the tax is allocated differently between new investors and old investors. If a fund realizes a big gain on a position it has held for twenty years, the gain is allocated equally to those who have been invested for twenty years and those who have been invested for one year. In the short-term, it is possible to buy a mutual fund, lose money and pay tax.

It is obvious that paying tax on a gain you did not enjoy is bad. However, it is a timing issue. Over the life of the investment, each investor pays only their share of tax. In the beginning new investors will pay tax that should be paid by old investors. But it is a zero-sum game. If one investor pays too much tax, another pays too little. Long-term investors will eventually be the ones who are paying too little tax! The short-term tax advantage for separately managed accounts becomes a long-term tax advantage for mutual funds.

### Mutual Fund Advantages

?? Mutual funds are less expensive

?? Mutual funds provide much greater diversification

?? Money flow allows funds to take advantage of new investment opportunities without selling anything

?? Money flow provides continuous new tax basis to allow ongoing tax management

?? The largest accounts receive the most attention

?? Accounts can be fully invested or completely liquidated in one day

## *Mutual Funds Enjoy Subtle Advantages that Become Significant Over Time*

*There are many low cost, low turnover mutual funds that compare very favorably with separate accounts by bringing the economies of scale of an institutional investor to the individual investor.*

*Many investors with portfolios large enough to hire separate account managers will fare better with mutual funds. The belief, held by many, that wealthy investors are better off with individually managed accounts is based on the attributes of typical actively managed retail mutual funds. Low cost, low turnover mutual funds stackup very well against separate accounts.*

*The advantages of separate accounts are often short-term or realized only sporadically. The consistent efficiency of mutual funds compounds over time to more than offset the occasional advantages of separate accounts.*