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Don't outsmart yourself

MarketWatch via NewsEdge Corporation :

BOSTON (MarketWatch) -- Any time someone says you can "invest like the super rich," they're missing the point. It's more important to be super smart about the way you invest.

That difference may sound semantic, but it's a key issue in one of the hottest debates in the investment world, the value of using "separately managed accounts" in place of mutual funds.

The rhetoric on the topic heats up this weekend, with the fan-the-flames release of "Stop Wasting Your Wealth in Mutual Funds" by Don F. Wilkinson, one of the first mainstream books to look at the fund-versus-separate-account decision.

Unfortunately, a better title for the book would be "Stop Wasting Your Time and Money on This Book," as it holds to a bunch of old arguments and outmoded thinking, and has too much "invest like the super rich" instead of "be super smart."

To understand why that is, you must first understand what a separately managed account, or SMA, is.

Separately managed accounts are a way for an investor to own individual securities -- stocks and/or bonds -- managed directly by a pro. Functionally, they amount to a personal mutual fund, where the investor (or the investor's financial adviser) handpicks a manager to handle the money, rather than picking fund pros to do the same kind of job.

It's a bit like having a tailor make a custom suit rather than buying off the rack. Custom has "status," which is where the attitude of "invest like the super rich comes in."

Separate accounts have three supposed advantages over funds: customization, better tax management and efficiency, and that special cachet.

These days, however, you don't need to be super rich to get an SMA; they can be had for as little as \$50,000.

Wilkinson contends that SMAs are simply a better investment than funds, from a structure, cost and results standpoint. "My whole goal is to make people aware that there is a choice now that they didn't have three years ago," Wilkinson said in an interview. "Now that they can get in for as little as \$50,000,

they have a real choice, and I think when they look at what they can get for their money, the choice becomes obvious."

It's obvious only when the data behind it is skewed Wilkinson's way to lead you to that conclusion.

Wilkinson wrote that 90% of all mutual funds lagged the stock market the last five years (not only is that number erroneously high, but the broad market is an inappropriate benchmark for most funds), and discussed how mutual funds are more expensive to own (data based on ridiculously flawed assumptions made about a decade ago by SMA proponents, and which ignores far more reputable studies done by firms like Morningstar Inc., which now tracks SMAs as well as funds and stocks).

He ignored the considerable question of whether separate accounts live up to the tax hype. A recent study by Cerulli Associates, a Boston research and consulting firm, concluded that just 30% of taxable separate accounts actually get special tax treatment.

That means most investors kiss off the tax benefits; for many others, the bottom-line differences from active tax management can be pretty small.

Perhaps most important, the SMA world is not populated entirely by angels. Those who aren't super rich may be hiring a star manager's junior assistant, who applies a black-box formula to all customers. In almost all cases, there is limited information on track records; most SMA databases are proprietary, costly and incomplete.

If it's hard to pick a good mutual fund with readily available records and ratings to guide you, it must be tougher to choose a personal stock picker in the dark. (Wilkinson does suggest that investors hire advisers to make that choice.)

"Who would want less scrutiny over what they do, the good managers or the bad ones," asks Don Phillips, managing director at Morningstar. "If the argument is that SMAs offer superior money management, there is no proof of that."

None of this means that SMAs are a bad investment. They are a different choice from funds, and can have very real benefits; the SMA industry needs to prove itself broadly, rather than simply ripping on the fund set.

Until that happens, the super rich may have the ability to get the most from these accounts, but the rest of us probably won't.

"If you are getting the name manager, and you believe that the manager has an edge and will outperform, and will watch your taxes and you have enough money and can identify enough managers to build a diversified portfolio, then SMAs are the way to go," says Steve Savage, a partner in Litman/Gregory, a Larkspur, Calif.-based investment-management firm.

"But most people aren't going to find that, so it's clear that separately managed accounts aren't for everyone, at least not yet."

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