



PHILO CAPITAL ADVISERS

With legal input and review from
Vianne Consulting

ON BALANCE... UNDERSTANDING & SELECTING MANAGED ACCOUNT SERVICES PART A

On Balance... is the name given to the White Papers that Philo produces from time to time. Our goal in producing these White Papers is to stimulate industry discussion on matters to do with portfolio construction and management.

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About the Philo “On Balance” white paper series

This is the second white paper from Philo in the On Balance series. In our first edition we looked at a key commercial question facing many non-aligned financial planning firms – whether to vertically integrate their business and the merits of the different vertical integration models existing in the market. That paper can still be obtained on the blog section of the Philo website.

In this edition, which we have split into parts A, B and C, we explore the world of managed accounts, including managed discretionary accounts (MDAs) and separately managed accounts (SMAs). Our experience is that there is great interest in managed accounts in the financial services industry, but also some confusion as to what they are, how they are regulated and what the issues are for selecting the right managed account for a particular business. Our goal therefore is to help people to understand these issues and to feel they can make more informed and confident decisions.

Part A of this paper is focussed on helping people to understand what managed accounts are, their key characteristics and what the benefits of them can be. We also seek to dispel some myths around managed accounts. Part A can be downloaded by anyone who would like to have a copy from Philo’s website (www.philocapital.com.au).

Part B examines the legislative framework around different forms of managed accounts in a bit more detail and looks at the regulatory outlook for managed accounts. We also consider the best use of managed accounts and identify the circumstances where it is more appropriate, in our view, to use a unit trust. Part B also includes a list of questions a planning business might ask of itself in the lead up to selecting a managed account service. Part B will be released via Philo’s website in due course.

Part C provides a more detailed examination of the different roles involved in operation of a managed account and the different business models that exist in the managed accounts market. We critically analyse each model and score each model on a range of assessment criteria. Part C is a private document that Philo uses in strategic planning with organisations that have an ongoing commercial relationship with Philo.

In preparing this paper we draw on years of experience in developing, implementing and operating managed accounts, in addition to our experience as an investment manager to managed accounts. Given the evolving nature of the managed accounts market we may update this paper if we see new innovations in the market worth including. More information on Philo’s services is available at the end of this paper.

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Purpose of this Paper

Managed Accounts have been accelerating in popularity in the past few years with FUM estimated at over \$15 billion and there is much industry anticipation that their rate of growth will accelerate further.

Despite this increasing popularity and anticipation, general industry knowledge levels around managed accounts are relatively low. One of the reasons for this is that the business models around managed accounts offered in the market are quite diverse – resulting in a situation where there is no definitive picture in the collective consciousness as to what a managed account is.

The purpose of this paper is to provide a plain English explanation of managed accounts – what their essential characteristics are, the different forms of managed accounts available and what issues financial planning businesses may care to think about in determining their managed account strategy.

We welcome questions and feedback arising from your reading of this paper. Our contact details are on the back of this paper.

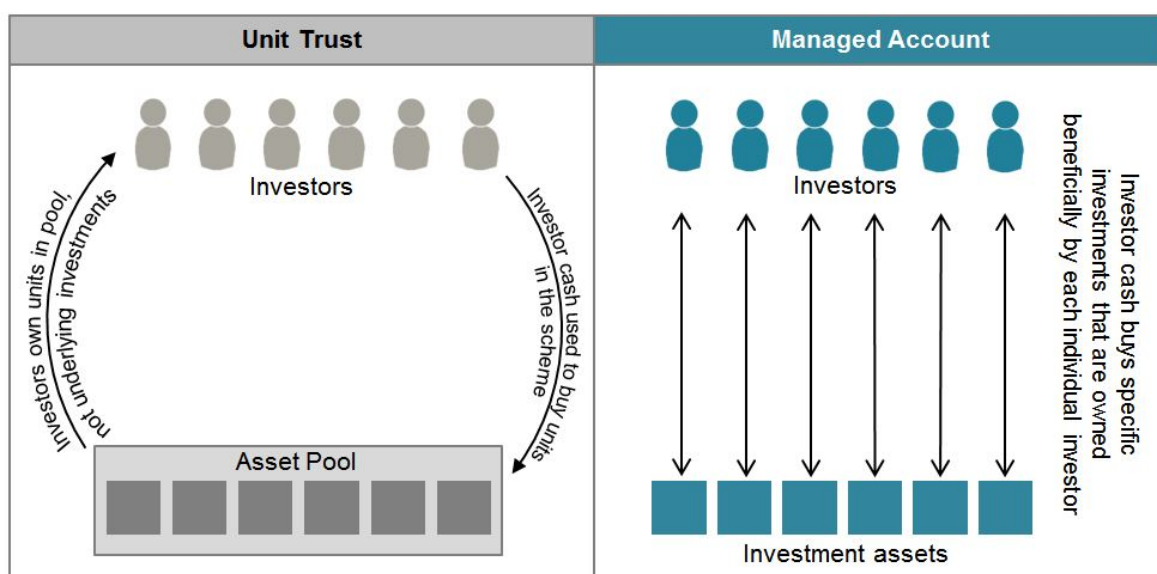
What exactly is a managed account?

The term “managed account” refers to a particular subset of the discretionary portfolio management services universe that includes managed discretionary accounts (MDAs) and separately managed accounts (SMAs) offered via a product disclosure statement (PDS).

The defining characteristics of Managed Accounts are:

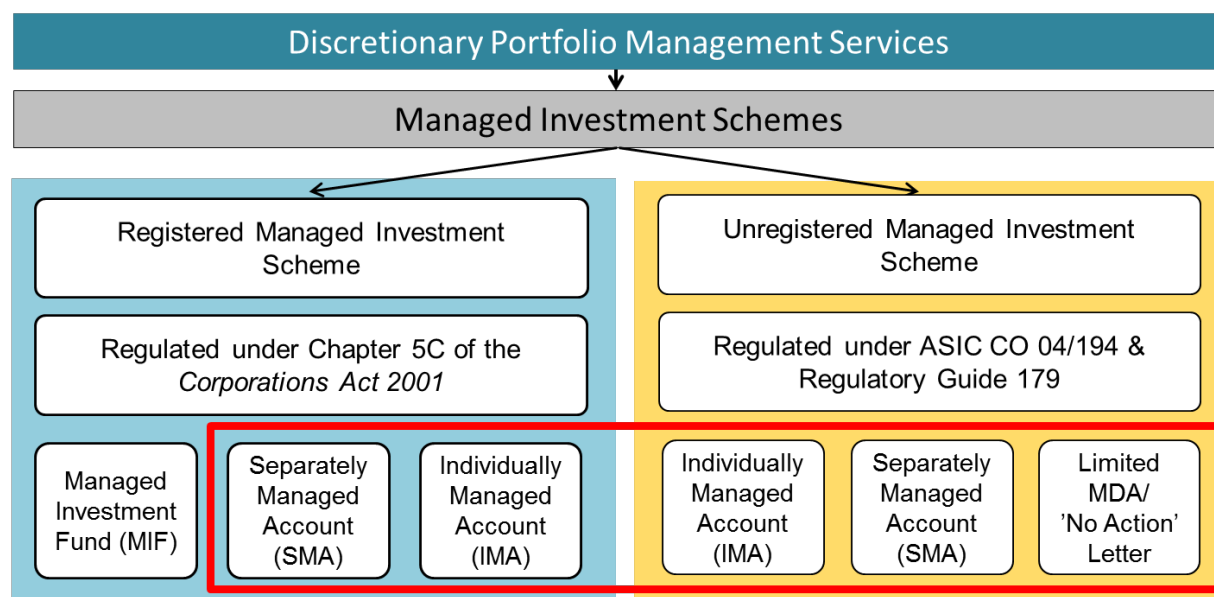
1. *The investor grants discretion* to a third party to manage the portfolio on their behalf, without recourse to the investor when making and implementing investment decisions; **and**
2. each investor has direct or beneficial ownership of the individual underlying investments in their portfolio rather than taking a share of a *pool* of assets via issued units. The investor therefore enjoys the tax advantages that direct ownership offers relative to the unit trust structure¹.

The most common underlying investments held in managed accounts are direct securities, managed funds and bank deposits. The difference between unitised structures used in managed funds and non-unitised structures used in managed accounts is shown conceptually in the diagram below.



¹ When an investor buys units in a trust the unit price generally contains components of accumulated income and realised capital gains. This turns part of the new investor's capital into taxable income and gains. ON an ongoing basis, where the unit trust manager sells investments to fund redemptions, this can also generate taxable gains for the investor that is not leaving the unit trust.

Where managed accounts fit in the universe of discretionary portfolio management services, and the types of managed accounts that exist in the Australian context, is shown in the diagram below.



- = Registered Managed Investment Scheme (includes unit trust and 'Managed Accounts' offered under a PDS).
- = Managed Discretionary Account (MDA) per CO 04/194 & 'No Action' Letter.
- = Services described by Philo as a 'Managed Account'. Includes discretionary portfolio services offered as a registered scheme or as an MDA (unregistered scheme) but does not include unitised investment offerings.

Within this paper when we use the term 'managed accounts' we are referring to the structures encapsulated within the solid red line above, unless specifically stated otherwise.

Clarifying managed account terminology

Part of the confusion around managed discretionary accounts is the different terminology that is used, some of which does not have a universally understood meaning. Using the chart above as a reference point, let's run through a few of the terms that cause confusion.

A **managed account** is a discretionary portfolio management service that is non-unitised and that provides investors with the tax advantages of beneficial ownership of each individual asset in the portfolio. Managed accounts can be either registered or unregistered schemes.

Managed accounts operated as **registered schemes** must meet the regulatory requirements of chapter 5C of the Corporations Act, which includes the obligation to issue a PDS.

Managed investment funds (conventional unit trusts) are not managed accounts because they involve unitisation, but we do consider them a form of discretionary portfolio management service as the investor authorises the investment manager to manage the portfolios within a mandate.

Separately Managed Accounts (SMAs) and **Individually Managed Accounts (IMAs)** can be offered as either registered or unregistered schemes. There are no accepted industry definitions of Separately Managed Account (SMA) and Individually Managed Account (IMA) and the services the terms are applied to can be quite different in nature.

When people refer to a SMA this *tends to mean* a service that:

- Has little or no customisation ability i.e. generally, everyone owns the same investments in the same proportions
- Is more likely to be, but is not necessarily, a single asset class portfolio
- Is more likely to be a registered scheme under a product disclosure statement (PDS).

At one end of the scale an SMA can look a lot like an Australian equity trust run by a single manager - but with no unit pricing and the stocks held beneficially for the end investor. At the other end of the scale, an SMA could be a multi asset class service where a range of fund managers / managed funds are used to access the different asset classes.

When people refer to an IMA this *tends to mean* a service that:

- Is generally customised for the individual investor
- Is more likely to be a multi asset class portfolio service
- Is more likely to be offered as a MDA (i.e. no PDS is required)
- Is likely to be more expensive than an SMA from the same provider

The sort of customisation capability an IMA might make available includes:

- Excluding a particular stock or asset class
- Substituting one stock or fund for another
- Holding minimum levels of cash
- Not selling a particular investment without express permission of the client
- Being tax aware in investment decisions

The term “**Managed Discretionary Account**” (**MDA**) is only found in Class Order 04/194 and Regulatory Guide 179 which refers to unregistered schemes. The term is not found in the Chapter 5C of the Corporations Act and so we reserve the term Managed Discretionary Account for schemes governed by the class order and use the term **Managed Account** as a more general term covering registered and unregistered schemes.

Limited MDAs or **No Action MDAs** are unregistered schemes offered under the relief granted by ASIC in a no action letter issued in 2004. These MDAs are limited to operation on a regulated platform in conjunction with a limited power of attorney. They are typically used to rebalance multi asset class portfolios using the model portfolio functionality on the chosen platform. Please see the later section in part B of this paper on MDAs offered under the no action letter for more information.

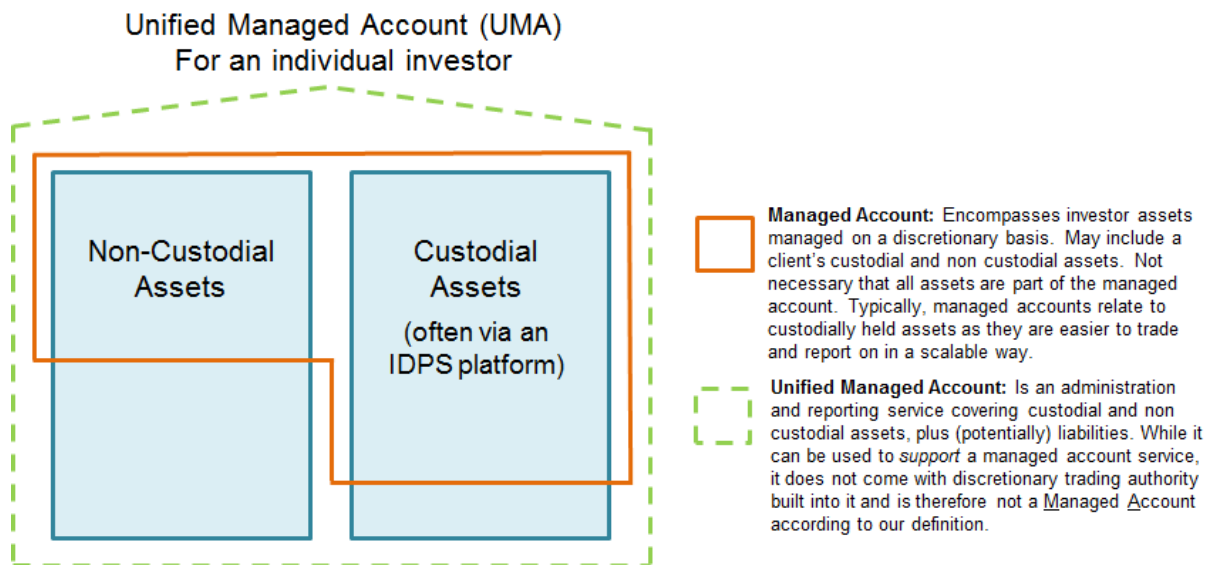
MDA regulation applies in the retail market only. i.e. when providing discretionary portfolio management services to wholesale investors Class Order 04 / 194 and Regulatory Guide 179 do not apply.

When people refer to a **Unified Managed Account (UMA)** this tends to mean a service that:

- Can provide transaction, administration and reporting services in relation to assets that are held both custodially and non custodially. Non custodial assets can include such investments as direct property, over the counter investments, structured products, shares in private companies, options etc (whereby valuations and transactions in relation to those investments may be downloaded into the system or may be entered manually) .
- Is not a *discretionary* management service in and of itself. A UMA may be used by a MDA as supporting infrastructure to initiate a transaction or value off platform assets, but the UMAs we are aware of do not allow investment discretion as part of the service. They simply provide a form of portfolio administration utility and if they are used as part of a discretionary portfolio management service the legal authority to

exercise discretion for investors is sourced elsewhere. They are not regulated products in the same way managed accounts are regulated under the law and they fall outside our definition of managed accounts, i.e. they do not offer both ownership of underlying assets (without pooling or unitisation) and investment discretion. Accordingly, the term Unified Managed Account is quite confusing. Replacing it with a term such as Unified Portfolio Administration Service would help to remove this confusion.

- The following diagram shows that a UMA can report on custodial and non custodial assets, without presuming that all assets are covered in the service. The lack of full coverage, where it occurs, may result from lack of access to data with some non custodial assets or from an investor preference to not include some assets because they will not contribute to a particular investment goal.



Why managed accounts are attractive

While there are a variety of managed account business models available in the market that have quite different features, we set out some general benefits of managed accounts below before we review the various managed account models later in this paper.

The main benefits to investors are:

1. Having investment discretion supports more frequent review of investor portfolios

An adviser with 200 clients and operating under a “traditional model” would require at least 3 months of intensive effort to review all client portfolios, meet with clients, frame appropriate recommendations, obtain client consent and execute necessary changes. There is a real prospect when it takes that long to implement change that market conditions change before the last client is seen and those clients at the end of change program are disadvantaged.

The administratively intensive nature of the traditional model means that most advisers review portfolios annually or semi-annually. Smaller portfolios may even be managed on an “as requested” basis only. The administrative overhead of traditional portfolio review methods is thus hostile to the interests of investors.

Conversely, where a robust managed account service is in place, thousands of investor portfolios can be reweighted quickly and efficiently – generally within between 3 days and 4 weeks, depending on the underlying investments. The limiting factor is usually the settlement period on the investments that are sold as part of portfolio reweighting. Having access to this more efficient framework for portfolio review means that portfolios can be reviewed and reweighted quarterly, rather than annually or semi-annually. This more frequent full portfolio reweighting is in addition to the fine tuning of underlying investment exposures that occurs where an MDA portfolio manager changes their view on an individual stock or fund.

2. More frequent reviews can lead to better investment outcomes

Philo Capital Advisers has modelled the impact that more frequent portfolio review can have on net investment returns for investors. In our modelling exercise² the performance benefit from actively adjusting portfolios on a quarterly basis as opposed to active adjustment on an annual basis was 0.80 per cent per annum, net of transaction costs and taxes. It should be noted that the quantum of this benefit is highly dependent on the nature of the client portfolio and how active the investment service provided is. What the exercise illustrates to us is that more frequent review can lead to material performance gains and that these gains can only be provided on a sustainable basis if the investment service is executed in a timely and cost effective way - otherwise there can be “implementation leakage” that arises when execution of investment decisions is delayed. Without a managed account the performance gains are eroded by the cost of labour required to execute the change and by implementation leakage. Based on this analysis a managed account can more than pay for itself.

Of course the managed account structure alone will not lead to better investment outcomes. High quality investment management is required for the managed account service to deliver the outcomes that clients seek. If poor investment decisions are being made, a managed account will make execution of those decisions more efficient, but it won't turn them into good decisions.

Further, our experience is that “oils ain't oils” when it comes to managed account investment management. This is a very important point that should not be dismissed or glossed over. The magnitude of difference for the sort of investment “engine” required for a managed account, relative to a unit trust is as large as the difference between say a tractor and racing car. Both may be very sophisticated, involve similar concepts and similar raw materials, but the issues that each must address; the designs, the application and the output are very different.

² For a cash / equity portfolio taxed at 15%. Full details are available on formal review of Philo MDA services.

3. Better tax outcomes for investors

Investors holding investments via a managed account enjoy the same taxation benefits that exist if they held the investment in their own name. This makes managed accounts an attractive way to hold direct securities in particular as it allows for the tax efficiency of direct ownership, access to professional investment management and the execution efficiency of managed accounts. In this sense, a managed account provides a combination of the best features of direct investment and managed funds.

4. Managed account portfolios are easier for investors to own

Relative to the conventional statement of advice process, administering a portfolio via a managed account is a less demanding experience for investors. There is far less paperwork to review, fewer decisions to make and there is the comfort of knowing that your portfolio is being actively and professionally managed. Investors who like to travel can enjoy their holiday without investment issues intruding or missing out on sensible portfolio changes.

5. Transaction costs can reduce

This application of specialist expertise also opens up the opportunity of accessing brokerage on listed security trades at institutional rates which can generate further worthwhile savings.

The main benefits to advisers and licensees are:

1. Combined with a suitable investment value proposition, a revenue stream can be created

A managed account is an excellent foundation for an investment proposition that can provide meaningful benefits to investors. Provided the planning firm is properly organised to communicate and deliver these benefits reliably it is entirely reasonable to charge a fee for the provision of portfolio management services that is distinct from fees earned for provision of strategic advice on issues such as superannuation strategies, estate planning and insurance.

2. Operational costs will fall

The overhead associated with the production of statements of advice and implication of transactions is material. Managed accounts can greatly reduce that cost – whilst providing a superior portfolio management service. Further, managed accounts are usually implemented with a centralised portfolio management capability (either internal or external) that removes much of the burden of portfolio management from advisers. This means that professional investment managers make decisions about how to structure and trade portfolios rather than having advisers carrying out this function as a part time activity.

3. The efficiency dividend can be deployed in a variety of ways

Managers of financial planning businesses can utilise the savings that managed accounts provide in a variety of ways:

Provide better client service – staff time can be redeployed to more meaningful services for clients such as achieving a better understanding of client goals, providing more comprehensive investor education, more detailed analysis of whether clients will achieve their goals etc.

Increased adviser time for client acquisition and retention – advisers can devote more time to generating new revenue through conducting seminars and other revenue raising initiatives.

Improved margins – more efficient service delivery can also enable a higher client to adviser ratio and improved profit margins to the firm

Reduce fees – Where required, the efficiency dividend can be shared with clients to reduce overall cost of service provision.

4. Advice, investment management, and portfolio administration can be done by separate expert teams, as part of one cohesive process

Today's consumers of professional services are seeking the comfort of providers offering deep expertise, whether the service is medical, legal or financial. The era of the generalist is fast fading if not over. Investors are looking for their planning firm to demonstrate that they can assemble first rate providers in each discipline, rather than expecting that their financial planner can realistically claim to be an expert in each field. Managed accounts provide a useful "backbone" for the delivery of multi disciplinary service that is cohesive for the client and the expert teams involved.

5. Better management of operational risks can be achieved

A properly executed managed account will bring specialised systems, additional expertise and increased focus to a range of activities that carry elevated levels of operational risk. The sorts of risks that a managed account can reduce include:

- Failure to review portfolios in accordance with agreed service levels
- Failure to implement a portfolio in a timely way after receiving permission to proceed
- Purchase or sale of the wrong investments
- Loss of client paperwork requiring approval processes to be repeated / causing client annoyance

For many financial planning businesses the cost of making good on problems such as these can be material. Use of managed accounts can greatly reduce such costs.

6. Investors are happier and more loyal

More frequent portfolio review, better investment outcomes, tax benefits of direct ownership and (ideally) a clearer nexus between fees paid and value delivered should make for happier investors. (That is certainly the feedback Philo has received.)

7. Business valuation will rise

Managed accounts provide an outstanding opportunity to improve business valuation. Valuation improvements come from:

- Increasing portfolio management revenues (without necessarily having to become the portfolio manager)
- Revenue being more sustainable and attracting higher valuation multiples
- Reduction in operating costs
- Reduction in operating risks and associated costs
- Enabling higher client to adviser ratios

It is notable from the above that managed accounts offer benefits to end investors, advisers and financial planning business owners. In our experience that win / win / win aspect of managed accounts is a rare circumstance and a key attraction.

There are other benefits of managed accounts that are significant, but are specific to particular managed account providers. These should be explored with any managed account provider that planning businesses engage with.

Myths surrounding MDAs

Another consequence of there being a relatively low understanding of managed accounts and MDAs in particular in the general market is that certain myths take hold that to the uninitiated may appear to have the weight of fact. In this section we identify some common myths surrounding MDAs and examine the merits of them.

Myth: Portfolios have to be reasonably large to justify use of an MDA service (\$500k plus is a commonly mentioned number).

The MDA structure itself does not bring any size limitation with it per se. However, some managed accounts are built to be scalable and some are not.

Generally, all SMA services are scalable. They offer automated rebalancing, bulk trading and limited or no customisation. SMAs are suitable for most client types and can work for very small portfolios when the SMA is offered via a registered scheme.

For IMA portfolios the situation can be somewhat different. Some IMA services are based on the idea of using template portfolios that can then be tailored extensively to meet the needs of the client. This type of IMA tends to be very scalable whilst still offering thousands of portfolio combinations.

Other IMA services are based on the notion of each portfolio being absolutely bespoke. This type of IMA service tends to focus heavily on tax outcomes for investors and building a unique portfolio for each investor. Portfolio review and trade initiation is a manual process that is managed client by client. This makes the service very expensive. At best the service might be able to bulk trade but that still leaves a lot of client by client workload in place. In practice many providers who start out with this approach find they start to template portfolios to make their task easier and because the range of investors' needs does not justify the effort required to build a unique portfolio for each client.

For the scalable form of IMAs, offered under MDA regulation, the main driver of minimum portfolios size is the time and cost required to know the client and produce an annual recommendation regarding the ongoing suitability of the MDA service. Without being too definitive about cut off points, a client with \$20,000 to invest would likely find the cost of this annual recommendation process prohibitive, whereas a client with \$100,000 to invest may consider the cost reasonable. Accordingly, minimum portfolio sizes are a matter for adviser and client to discuss relative to the annual costs of the required client service.

One "wrinkle" to be aware of regarding portfolio minimums relates to transaction charges that can be incurred with some managed accounts – particularly limited MDAs that utilise model portfolio functionality on platform. If there is a minimum transaction fee on share trades it can become prohibitively expensive for a small investor to own a portfolio of direct stocks. This factor is often overlooked when considering managed account services. We have seen transaction pricing on platform services that with reasonable assumptions on portfolio size and turnover will generate additional portfolio costs per annum of 1 per cent or higher. Bear in mind also if there is a minimum trade fee, this fee is likely to exist for non managed account clients as well – and may in fact be higher- so this issue is about the pricing of listed security execution on the platform, not the managed account structure itself.

Myth: Investors are generally not comfortable with granting discretion over their portfolios.

While some investors are not comfortable with granting trading discretion, our experience is that 75 to 85 per cent of investors are comfortable with a managed account service and readily appreciate the benefits that managed accounts deliver. In particular investors like the fact that managed account portfolios are easier to own (less administration required on their behalf) and the fact that portfolios can be more actively managed.

Myth: Managed accounts are riskier than the conventional process of investing via statements of advice

The logic of this thinking is hard to fathom unless there is an assumption that the managed account is not professionally operated or that its introduction coincides with a decrease in investment discipline. In our experience the implementation of a managed account greatly reduces both operational risk and advice risk within a financial planning business. In fact we are aware of a financial planning business receiving a reduction in its professional indemnity insurance costs after providing its insurer with a comprehensive briefing on the workings of its MDA service and the risk management benefits the service provides. This reduction in risk through using managed accounts happens at a number of levels:

1. Portfolio administration is more systematised – more of the disciplines of portfolio administration are scheduled and managed by systems than before
2. There is a generally clearer policy framework
3. The staff managing the portfolios are more focussed on portfolio administration, have better resources to do the job and are more skilled at managing portfolios in volume
4. Investors are treated more equally as their transactions tend to be managed at the same time as each other
5. There are fewer “erratic” stock picks by advisers
6. Overall, there are far lower claims for failure to act errors and therefore lower financial risk
7. Subject to the managed account model adopted – accountability for much of the administration can move to an external organisation
8. Introduction of managed accounts also tends to coincide with centralised portfolio management and more overt process around portfolio management
9. Managing portfolios using scalable systems results in lower error rates and incidences of investors being “forgotten”
10. The interaction between portfolio management staff and those involved in transaction execution is closer and results in smoother execution with lower transaction costs and error rates. This is particularly so where portfolio administration and portfolio management staff are co-located.

Of course there is the potential if a mistake is made using a managed account service that the mistake could be replicated over many client accounts. Whilst this risk cannot be denied, use of structured managed account systems and processes allows this risk to be greatly mitigated. Further that risk does not sit with the planning firm unless they are the MDA operator and administrator themselves. Where they outsource the function the risk is managed and borne by the outsourced service provider. The specialist providers who take on that risk insure for it and then manage their business to reduce the risk to the minimum.

Myth: Managed accounts are riskier because they involve granting investment discretion

While investors are right to be careful about whom they grant investment discretion to, some perspective on the issue is worth bearing in mind. The sort of investment discretion that a managed account manager has is generally quite similar to that granted to a multi sector fund manager – for example the sort of manager responsible for the superannuation funds of most working Australians. One of the key differences with a managed account however is that the contents of the portfolio and the trading pattern associated with the portfolio are far more transparent. Managed account investors can and do query specific trades and this provides a useful opportunity to explain the decisions and processes that drive portfolio trading. That level of discussion does not occur between unit trust managers and end investors.

Investors that use sector funds recommended by their adviser with portfolio adjustments justified via statements of advice have a different current experience to judge managed accounts against. For investors that enjoy this

type of control it is perfectly reasonable for them to want to continue on this path. However, there are issues with this model that are worth considering before they make such a decision. In our experience the main issues are:

- The burden of producing statements of advice means that the level of portfolio trading is lower than it should be, resulting in lower returns to investors
- Producing statements of advice is expensive and the implementation process around this model is very inefficient. Ultimately this leads to higher costs within a planning practice which are ultimately borne by investors (whether directly or indirectly).
- Relatively speaking, a greater proportion of investment decision making sits with advisers under the “SOA model” than with the typical MDA implementation. Whilst this can greatly benefit portfolio customisation, it can also mean that people who are not investment specialists are required to make portfolio management decisions. Without intending any disrespect, the vast majority of financial planners do not have portfolio management expertise, just as the vast majority of specialist portfolio managers do not have the skills of a financial planner that allow them to:
 - Help investors distil their needs
 - Recommend entity structuring
 - Develop superannuation strategies
 - Maximise Centrelink and other benefit entitlements
 - Identify and resolve issues in estate planning, insurance, aged care etc.

Investors do benefit from having experts attending to each specialist area of need and having their trusted adviser coordinate the delivery of these services as well as contributing their own expertise.

Myth: MDAs need to be a premium priced service

In our experience investors do receive a higher level of service and are more satisfied when using a MDA service. Arguably then, that is justification for higher fees.

However, our experience is that MDAs are more efficient and can assist planning firms to take cost out of their businesses.

There is no *need* for MDAs to be a premium priced service – it is a choice the planning firm needs to make based on how they wish to position the service.

Myth: Managed Accounts are all about tax management

It is true that managed accounts are supportive of better taxation outcomes. However, managed accounts are about far more than tax management. Other aspects of managed accounts that are similarly important include the ability to reweight portfolios more frequently, reductions in operational and advice risk, lower operating costs, the potential for superior performance, happier investors and improved business valuation. See the section of this paper entitled “Why managed accounts are attractive” for more detail on the benefits of managed accounts.

Key “thinking traps” to avoid

There are a number of thinking traps that we have identified that impact on the ability of planning firms to achieve the optimal managed account solution.

1. **A managed account is a product.**

Our observation is that managed accounts can be seen and utilised like an investment product, but this perspective dramatically under appreciates and under utilises the power of managed accounts. Rather than viewing them as a product that is passively utilised, consider them a service that can be incorporated into a broader service offering of your design.

2. **The managed account service I decide on will provide me with a new investment value proposition.**

Realistically it won't. For you to have a new investment value proposition, you need to integrate it into your other services. Logically, your other services will need to adjust to reflect the use of the managed account. It is the combination of the managed account and your updated and amended services that creates the new value proposition. It is important to ensure that your value proposition is based on a sound investment philosophy that can be defended in all environments.

3. **My firm needs to be the investment manager if we are to charge portfolio construction and management fees.**

Whilst this sounds logical, the fact is that most firms will have more success charging portfolio construction and management fees if they are NOT the investment manager. In a world of increasing specialisation it is no longer credible or necessary for most planning firms to claim the investment expertise required to properly manage the portfolios of Australian investors. Investors will reward firms that assemble the relevant experts across the necessary disciplines to deliver a well run service. Investors rely on their chosen financial planning business to:

- Assemble the right providers
- Ensure direct contracts are on fair terms
- Provide initial and ongoing advice on how to best utilise MDA services and tailor delivery to their needs
- Review the recommendations of MDA investment managers
- Monitor providers of MDA services
- Provide customer support and communication
- Identify the right asset allocation for them and to customise the portfolio to suit them
- Deal with their changing circumstances and needs

Investors will pay for the right value proposition delivered by a team of bona fide experts, with a credible process coordinated by their financial planning firm.

4. **My clients are used to paying transaction fees and are not sensitive to them.**

That is certainly not our experience of the managed accounts world. The transparency of managed accounts makes investors highly sensitive to transaction fees and encourages them to seek explanation for every trade. It is therefore critical that there is a clear reason for each trade and that financial planning firms carefully consider total cost to client issues when selecting their providers and structuring and pricing their managed account services.

5. **I can improve client satisfaction and my business valuation by utilising innovative new services – without having to change myself.**

As alluded to earlier in this paper, investors and advisers are generally strong at sensing whether a service is soundly based, has an investor driven reason for existence and whether there is genuine conviction from

those promoting it. It is inconceivable to us that a financial planning firm can successfully introduce a managed account service (where success is defined by take up levels across the business) without material change in the services that the planning firm itself provides. It is critical that internally generated advice, third party services, internal client service functions and shared infrastructure such as regulated platforms all work together in a seamless fashion. The bottom line is that firms wanting to achieve material benefits from managed accounts need to expend material effort to achieve this prize. Some managed account providers can provide excellent consulting and support on these issues, while others cannot. Spend as much time understanding the support they can provide as you do looking at the managed account service itself. The quality of support will have as much or more significance to your final outcome as the portfolio administration elements.

6. I looked at SMAs / IMAs / MDAs before and they are not for me.

The trap here is that people sometimes assume that managed accounts are homogenous. We hope and trust that the analysis of different managed account configurations presented in this paper (parts B & C) will dispel that myth forever. If you have reviewed a particular type of managed account in the past and found it to fall short of your needs, don't despair. There are a range of providers in the market and others may suit your needs.

Why the success of (some) managed accounts is taking off

Suppliers to the financial planning industry first introduced managed accounts to the market over 10 years ago. The market penetration of managed accounts was modest until the last 2 to 3 years, despite the enormous advantages of managed accounts over competing solutions. Why is this so? In our recent paper entitled “Maximising the Vertical Integration Opportunity” we provided a few potential explanations of what slowed the development of the managed account market which we have repeated and added to here:

- Lack of understanding in the market around what managed accounts are and how they are regulated.
- Lack of clarity as to how managed account regulation would evolve.
- Industry participants seeing managed accounts as products rather than services
- Few providers have offered a true multi asset class service (most have focussed on direct Australian shares) thus limiting their attractiveness and utility in “whole of portfolio” advice.
- Lack of breadth in the portfolio management capability that has come with managed accounts.
- The variety of ways that managed accounts can be constructed and implemented has led to confusion and people managing financial planning firms are often “time poor” – making it hard for them to get to the bottom of the issues. (A key motivation for producing this paper was to assist people with this need)
- Adviser firms have not had the incentive to move away from platform rebates and existing business models – until now.
- Compliance departments have not understood managed accounts, considering them an increased compliance risk when in fact the opposite is true.
- Large institutions have only made token attempts to develop managed account functionality in the past as they see a risk that managed accounts will cannibalise their funds management businesses and because of the sophisticated technology development required.
- There have been few working models of successful and sustainable managed account implementation with a financial planning business to observe and learn from.
- Managed account pricing has been unenlightened to say the least. Often managed accounts have been priced significantly above that of competing unit trusts to protect the related funds management businesses of those offering the managed account.
- Expensive trade execution on listed security trading.

These barriers to success have been resolved or are rapidly breaking down in such a way that we appear to have reached a tipping point concerning managed accounts in Australia. A number of pioneers in the industry have embraced managed accounts in recent years and they have shown that the managed account model can be outstandingly successful. While there is no definitive data available, the authors of this paper are aware of well over \$10 billion being run on retail managed accounts in Australia and we estimate total market size over \$15 billion. More importantly, the practitioners using managed accounts are confirming increased client satisfaction and greatly improved profitability. Advisers who have taken up managed accounts are vocal advocates and in many cases service over 90 per cent of their client bases this way. Compliance departments and professional indemnity insurers are realising that managed accounts materially reduce regulatory and operating risk. This practical vindication of managed accounts as an outstanding and rare opportunity for financial planning firms to simultaneously delight clients, advisers and shareholders is becoming a powerful force for change.

The managed account opportunity has been recognised by the industry and we understand that ASIC has been receiving large volumes of applications for MDA operator authorisation / MDA adviser authorisation relative to historical levels. In our view the firms that will ultimately be successful with managed account implementation will be those that take a considered approach and we hope this paper will make a contribution to that endeavour.

Conclusion

Managed accounts offer a rare opportunity to advance the interests of investors, advisers and business owners at the one time. The range of needs that managed accounts can meet is broader than most people realise and the variations between managed account providers are significant. Learning more about managed accounts in general and taking time to properly understand the variations between different providers is a very worthwhile undertaking for any financial planning firm contemplating use of managed accounts. We trust this paper has made a useful contribution to your knowledge concerning managed accounts and welcome any questions you may have.

In **Part B** of this paper we examine the legislative framework around different forms of managed accounts (including limited MDAs) in a bit more detail and look at the regulatory outlook for managed accounts. We also consider the best use of managed accounts and identify the circumstances where it is more appropriate, in our view, to use a unit trust. Part B also includes a list of questions a planning business might ask of itself in the lead up to selecting a managed account service. Part B will be released via Philo's website in due course.

More information on Philo's services is available at the end of this paper.

About the authors



Brett Sanders is joint CEO of Philo Capital Advisers and has overall responsibility for the design and management of Philo's managed discretionary account services.



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Disclosure of Interest

Philo Capital Advisers is a provider of a range of portfolio construction and management services, including managed accounts. It is only fair to acknowledge that the analysis contained in this paper is influenced by Philo's business philosophy, perspective and experience in relation to managed accounts. Philo stands to benefit from the growth in use of managed accounts and in particular managed accounts offered in the service configurations that Philo favours.

We established Philo Capital Advisers with a keen desire to provide leading investment management services to the market and began with a clean sheet of paper. The choice of managed accounts as the primary means by which portfolios would be administered was a choice made after consideration of competing alternatives and with first hand experience operating managed accounts and seeing them applied to financial planning relationships. The *form* of managed account Philo offers was determined by careful evaluation of the managed account models in the market place carried out before a material investment in service development was undertaken. That service development is continuing. In that sense we have "put our money where our mouth is" and in this paper we are sharing some of the thinking that led us to making our own decisions.

Philo Overview

At the time of writing Philo administers and provides portfolio management for over \$2.9 billion in managed account funds in addition to managing \$1.1 billion of non-managed account money. To our knowledge we have been Australia's fastest growing provider of managed account services in the past 2 years. Our investment approach has been running with live portfolios for over 3 years and performance has been excellent.

Philo's role in achieving these successes extends beyond investment management functions such as asset allocation, portfolio management and managed account administration to a range of implementation and support services. These have included training, policy creation, client communications and much more.

We have also had the great fortune to work with committed management and advisers at our foundation client and we thank them sincerely for their support and patronage.

Philo Services

Our core services include:

- Dynamic asset allocation
- Listed portfolio management for shares, property and income securities
- Unlisted investment evaluation and blending
- Investor communications
- Practice management consulting and training around the customisation and implementation of managed accounts
- Managed account administration
- Separately Managed Accounts (SMAs)
- Individually Managed Accounts (IMAs)
- Limited MDAs

Philo can act as the managed account administrator or also provide services as an MDA operator under Philo's AFSL.

We have significant intellectual property around all of the above aspects of service provision that client firms can benefit from. Our experience in successful managed account development and delivery can greatly improve speed to market and reduce execution risk.

Our services extend well beyond investment management and portfolio administration and can be used to greatly enhance the investment value proposition of any business. In our opinion the services Philo clients can deliver represent best practice in Australian financial services.

We are available to assist financial planning firms that would like to scope out the issues surrounding implementation of managed accounts in their business.

Philo welcomes enquiries from any organisation wishing to investigate the potential for integrated managed account services to help grow their business and drive their profitability.

$\sigma_p = \sqrt{(w_A^2 \sigma_A^2 + w_B^2 \sigma_B^2 + w_C^2 \sigma_C^2 + 2w_A w_B \text{Cov}_{AB} + 2w_A w_C \text{Cov}_{AC} + 2w_B w_C \text{Cov}_{BC})}$
 $(E(r_M) - r_f) \beta_i = \rho_{i,M} f(x_i) = e^{-((x_i - \mu)/\sigma)^2} \frac{1}{\sigma \sqrt{2\pi}} \sum_{n_i=1}^{\infty} (x_i - \mu)^2 (n_i - 1) \sigma$
CAPM: $E(r_i) = r_f + \beta_i (E(r_M) - r_f)$



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