

# The Benefits of a Tax-managed Separate Account

September 2011

As the close of fiscal third quarter draws near, many investment firms and do-it-yourself investors are shifting their focus toward the taxable impact of their investments. For most investors, this involves selling specific holdings to realize cash and sitting out the rest of the year to satisfy the wash-sale rule and reflect on the year gone by. At Mercer Advisors, this time is used not only for year-end tax planning for our investment clients, but also to implement proactive strategies designed to reduce our client's tax liabilities through smarter investing over the years to come. These strategies are derived from thorough research and testing conducted on the multitude of investment vehicles available. We also measure the benefits associated with each instrument in order to determine which best serves the unique needs of each client.

There are essentially three managed account investment options available, each offering slightly different features and benefits. These vehicles include mutual funds, exchange-traded funds and tax-managed separate accounts. For the purposes of our illustration, the investor will be presented with the option of investing in an actively managed open-end mutual fund (ticker: FUNDX), an exchange-traded fund (ticker: ETF) or a tax-managed separate account (company: SMA, Inc.). The investment holdings, weightings and performance of each option at time of purchase will be identical. However, the tax implications for each of these "identical" investment vehicles will vary greatly. This article will outline the different performance outcomes potentially realized through each of the investment instruments. It will also dispel the myths surrounding separately managed accounts and explain the ways in which Mercer Advisors utilizes these various investment options for the benefit of our clients.

## **USING INVESTMENT VEHICLES TO MANAGE TAXES**

Let's assume the following scenario: an investor is interested in placing \$400,000 of non-qualified assets into a U.S. large-cap stock portfolio and wishes to purchase on September 1st. The investor would like to learn more about the potential return and tax ramifications related to each of the options before making a decision.

Each of the three options consists of equal weightings of the following stocks: Microsoft (MSFT), Johnson & Johnson (JNJ), Chevron (CVX), Apple Inc. (AAPL), Altria Group (MO), Coca-Cola (KO), Amgen (AMGN), Pfizer (PFE), Wal-Mart (WMT) and Bank of America (BAC).

Now, let's fast forward 100 days to December 10th. The current value of all three investment options has remained flat for a 0.00% return (assume no dividends were paid during this period). This 0.00% return represents total return — as the stocks within each instrument either gained or lost 10.00% over the 100-day period:

Up 10.00%	Down 10.00%
Microsoft (MSFT)	Johnson & Johnson (JNJ)
Chevron (CVX)	Apple Inc. (AAPL)
Altria Group (MO)	Coca-Cola (KO)
Amgen (AMGN)	Pfizer (PFE)
Wal-Mart (WMT)	Bank of America (BAC)

Is it safe to assume that this investor's after-tax net return would be 0.00% for this period? No. In fact, depending on the tax treatment of the investment option selected, the investor could owe additional taxes, break even or realize an increased return. Let's take a closer look at how each of the three options work...

#### **Mutual Fund (FUNDX):**

Many investors are aware that mutual funds are required to distribute net capital gains and fund income earned to their shareholders on an annual basis, at minimum. However, the shareholder at the time of distribution may not be the same person who profited from the fund's gains. By buying into the mutual fund in September, this investor would inherit the cost basis of each stock within the mutual fund. If this mutual fund were to sell its Apple holdings in 2011 at \$400/share (purchased at \$70/share in 2006) — the person owning the fund AT TIME OF DISTRIBUTION would be responsible for any tax liabilities associated with the distributed gains! If the mutual fund distributed long-term capital gains of 5.00% of net asset value (NAV), this investor would be responsible for a \$3,000 tax bill<sup>1</sup> without benefiting from any of the growth.

It is important that clients are made aware of the fact that an actively-managed mutual fund manager is not required to mirror any given index or to customize fund holdings as a means of benefiting an investor's personal tax preferences. In essence, the actively-managed mutual fund investor has no say in the allocation or management of the mutual fund. Rather, the fund manager is paid only to make investment decisions based upon past performance of the holdings within the fund.

#### **Exchange-Traded Fund (ETF):**

Like a stock, an ETF investment is traded inter-daily over an exchange. Gains and losses are realized on the value of the ETF, relative to the difference between an investor's purchase and sale dates. Within our scenario, assume a purchase of ABC ETF for \$100/share. The unrealized gains (or realized if the investor opts to sell) on this ETF would be 0.00%. In this scenario, no taxes would be owed.

<sup>1</sup> \$3,000 tax liability is comprised of a 15% long-term capital gain. No state income tax for capital gains assumed in this scenario. Source: [www.irs.gov/taxtopics](http://www.irs.gov/taxtopics).

Through the internal workings of an exchange-traded fund, the ETF option can create a more tax-neutral holding for the shareholder than that of its mutual fund cousin. If the ETF were to rebalance all holdings in December in order to maintain an equal weighting, the gains would offset the losses for a net capital gain of \$0.00.

#### **Tax-managed Separate Account (SMA, Inc.):**

Per our scenario, the investor has a \$40,000 cost basis in each of the ten stocks within the separately managed account. As year-end approaches, the investor is able to take advantage of personal tax-loss harvesting, based upon personal needs as well as each stock's gains/losses since the SMA's inception.

Let's assume that SMA, Inc. used a proactive tax planning strategy and that all holdings incurred short-term losses of 10%. In order to capture these short-term losses, SMA, Inc. sells Bank of America, Pfizer and Coca-Cola. Rather than sitting in cash, SMA, Inc. then replaces these stocks with identical holdings, such as JP Morgan, Merck and Pepsi, in order to avoid wash-sale restrictions and maintain the integrity of the portfolio. This investor would be able to realize \$20,000 in losses and choose to realize \$17,000 in gains while deducting the remaining \$3,000 against taxable income. Given a 33% federal income tax rate, the investor would see a \$1,000 reduction in tax liability. This represents a **0.25% annual increase** in return for the identical investment!

### **SEPARATELY MANAGED ACCOUNTS — NOT AS EXPENSIVE AS MANY ARE LED TO BELIEVE**

Separately managed accounts were introduced as a private mutual fund for high-net-worth investors within the brokerage community. Such accounts were reserved generally for investors able to commit more than \$500,000 to a single strategy. These accounts were sold as an instrument for gaining private access to the latest ideas from renowned mutual fund managers.

As these vehicles became more accessible to the mass affluent (those able to invest \$100,000 in a single strategy), separately managed accounts were abused and sold as one-stop options for investment advisors seeking the simplest solution for their clients. This approach was essentially analogous to investing all of a client's assets in one mutual fund based solely on its last year performance. In addition to paying up to 1.50% in management fees for the SMA, the client would also be responsible for paying an investment advisor fee upwards of an additional 1.50%. This second fee became nothing more than a 'finder's fee' for placing the client into this managed account.

In alignment with Mercer Advisors' investment philosophy and principles, we firmly believe that the proper asset allocation of stocks, bonds, alternative investments and cash will outperform even the best fund managers over time. We use passively managed SMAs only to mirror asset class performance and control costs, not to outperform an asset class.

Mercer Advisors offers a variety of separately managed accounts which mirror the performances of several different indices for an annual fee of between 0.35%-0.40%. In addition, there is a flat 0.15% annual charge for all trades placed within the account, creating a total annual expense ratio of 0.50%-0.55%. When compared to the costs of all U.S. Large Blend mutual funds and ETFs offered on the Fidelity platform, the cost of a Russell 1000 separately managed account ranks quite favorably:

When compared to mutual funds, passive **SMA**s ranked **37 out of 745 mutual funds (95th percentile)**<sup>2</sup>

When compared to ETFs, passive **SMA**s ranked **41 out of 73 ETFs (43rd percentile)**<sup>3</sup>

As the numbers illustrate, a passively managed SMA can be comparable to the low-cost structure of an ETF and can be much less expensive than the vast majority of mutual funds.

## HOW MERCER ADVISORS USES TAX-MANAGED SEPARATE ACCOUNTS

Mercer Advisors believes that passively managed accounts play a significant role in client portfolios holding broad-based, highly liquid asset classes such as U.S. Large Cap stocks and International Large Cap stocks. In order to maximize the tax benefits associated with a tax-managed separate account, we recommend holding them in a non-qualified account. Further, in order to realize the full benefit of an SMA, we recommend this strategy to our clients who are able to invest at least \$250,000 in a specific asset class.

Tax-managed separate accounts are useful tools for clients with complicated or sensitive tax situations or those interested in maintaining a tax-efficient portfolio. These accounts allow the investor to maximize tax efficiencies while minimizing costs. More importantly, this focus on tax and fee containment can lead to vastly improved portfolio performance without any additional risk.

## TAX-MANAGED SEPARATE ACCOUNTS ARE NOT APPROPRIATE FOR UNIVERSAL APPLICATION

While the tax advantages of these separate accounts certainly are appealing, it would be unwise to use them for all investments. There are certain asset classes for which we have found institutional mutual funds to be the more cost-effective investment option. Following are some examples to this effect:

- **Economies of Scale:** Assume a \$1,000,000 client portfolio with a 1.00% weighting in emerging market small-cap companies. It would be counter-productive to spread the \$10,000 allocation over numerous companies within various foreign markets — the bid-ask spreads and trading costs would be astronomical! However, by pooling the client's \$1M with identical funds from another thousand investors — investing a sum total of \$10M in a single asset class — the expense per investor drops considerably.

<sup>2</sup> Data from Fidelity mutual fund screener; large blend category, open to new investors ([www.fidelity.com](http://www.fidelity.com))

<sup>3</sup> Data from Fidelity ETF screener; large blend category ([www.fidelity.com](http://www.fidelity.com))

- **Tax Treatment of Underlying Investment:** It is more advantageous to hold certain asset classes in tax-deferred accounts than others, such as Momentum strategies and/or real estate investment trusts (REITs). Further, the benefit of controlled cost basis afforded by a tax-managed separate account becomes moot when placed in a tax-deferred account like an IRA. In this instance, a low-cost mutual fund or highly liquid ETF can become equally viable solutions.

## OUR POSITION

Our focus with each client is to understand personal financial goals, to track the progress made toward achieving these goals and to develop a strategy that maximizes return while incurring the least amount of risk, taxes and fees possible. As with any other investment vehicle, a tax-managed separate account is one of many options available to meet a client's financial and life goals. It is vitally important to consider fully the costs, benefits, drawbacks and purpose of any investment instrument when evaluating its potential for enhancing a client's investment strategy.

At Mercer Advisors, our intent is neither to find products with spectacular past performance histories, nor is it to predict whether a certain investment will outperform in the future. Rather, we look to academically validated investment science, time-tested investment theories, the unique circumstances and goals of each client and the most cost effective methods for producing maximized returns to guide our fiduciary advice and actions on behalf of our clientele.