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Exchange-traded fund SMAs worth consideration

Separately Managed Accounts with a twist

Investors have been enjoying the benefits of separately managed accounts (SMAs) for many years. Originally introduced in the 1970s, they were developed as an alternative to mutual funds but have since risen in popularity and are now available at most financial institutions.

SMAs are discretionary accounts offering diversified portfolios of individual stocks and bonds, managed by institutional-caliber managers who deal with the investing and ongoing rebalancing. They are designed for investors who want greater control in setting the strategy for managing their wealth, but lack the time or expertise to make the day-to-day decisions.

A recent trend in the SMA industry has been the addition of exchange-traded fund SMAs. These are discretionary managed portfolios comprised of various ETFs, as opposed to individual securities. The idea is to take an ETF, which is generally a passive investment, and make it a more tactical tool through active management.

Similar to regular SMAs, exchange-traded fund SMAs provide diversification by way of the number of holdings, asset types and sectors, geography and market capitalization. Enhanced diversification is reinforced by the liquidity of ETFs, which facilitates fast and cost-effective repositioning.

SMAs also add the ability to diversify by ETF manager, providing the advantage of informed focus. For example, the growing proliferation of ETFs means an investor can face dozens of choices in an asset class, with correct selection becoming a real challenge. However, a knowledgeable ETF manager, knowing the investor's risk tolerance and investment objectives, can sort through the myriad of choices to make decisions appropriate for the profile and goals.

The broad access of ETFs to industries or sectors allows the investor with a smaller portfolio to have better diversification than would be possible by purchasing individual securities. In a $300,000 portfolio, for example, a 10% allocation to a particular sector will be broader with well-chosen ETFs than with individual securities.

Added to these advantages are those that ETFs inherently have, such as tax efficiency. Due to the structure of ETFs, investors are not affected by the taxable actions of other shareholders. The passive nature of most ETFs leads to lower turnover, resulting in minimized distributions.

Additionally, ETFs are extremely transparent investment vehicles because they are required to disclose their holdings on a daily basis. This is vastly different from a mutual fund, which is only required to disclose its top ten holdings once a month.

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ETFs are generally more cost efficient than other diversified products. Although exchange-traded fund SMAs are subject to management fees and MERs, they tend to be a good deal less than regular SMAs or mutual funds; often much less than 2% combined.

Exchange-traded fund SMAs are relatively new and there isn't much in the way of history to review. However managers do have track records and the investor should be diligent when making that decision, looking to the manager's performance with previous portfolios as a gauge of competence. It's important to know how active or passive a manager is and how they manage risk. The investment process should be scrutinized and fees should be reasonable.

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