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Comparing the advantages of SMAs

Many tax benefits not available in mutual funds, but side by side against ETFs, they are lacking

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A multitude of papers extol the tax virtues of investing through separately managed accounts. Most have compared them with mutual funds and have concluded that SMAs can produce better after-tax returns than funds for those able to take advantage of managing individual lots of securities.

But what about SMAs in comparison with exchange-traded funds or with a broker-directed account?

The tax benefit of an SMA most often cited is the ability to harvest losses. Harvesting losses has been measured to add about 80 basis points of after-tax return annually to an indexed portfolio. More tax alpha is produced in the early years, with little harvesting to do in later years once the portfolio has become one of mostly unrealized gains.

An SMA can pass losses through to its owner; mutual funds cannot. Although a fund can harvest losses, those losses can be used only to lower the amount of gain that the fund would have to make to remain an untaxed regulated investment company.

If an SMA portfolio is held until death so that the step-up in basis of gains forgives the gains tax, totally efficient after-tax savings will have been achieved. If the portfolio holds its value and is sold before death, then any losses harvested will come back as gains, triggering a tax. Thus loss harvesting can become only a deferral vehicle. Those now-realized gains may be taxed at a higher or lower rate than the tax rate that was in effect when the losses were harvested.

The second benefit ascribed to SMAs is that in a mutual fund, other investors can cause portfolio transactions that generate taxable distributable income. These shareholder redemptions can cause taxable distributions to holders even if the investor's holding hasn't changed. Alternatively, changes made to an SMA portfolio will create taxable events only for the investor.

Because of these two issues, SMAs are perceived as more tax-efficient than mutual funds. But what about a comparison with ETFs?

ETFs also are RICs that must pass through other people's gains. But ETFs have a redemption-in-kind mechanism that allows them to distribute their big winners to redeeming holders, ridding the portfolio of unrealized gains. This mechanism should allow a passive portfolio to distribute few, if any, gains. If the ETF makes no distributions during the investor's holding period, and he or she holds it until death, no capital gains tax is ever paid. Of course, if the ETF holder sells, they will crystalize a gain or loss, versus their cost basis.

It should be noted that an investor in an SMA pays the management fee directly to the manager. A management fee expense is a miscellaneous itemized deduction that is useless to many taxpayers. This is not a problem in either form of RIC — ETFs or mutual funds — because they are allowed to net their expenses against their income when calculating how much income they have earned. Thus, in an SMA, the investor pays tax on phantom income that in a mutual fund or RIC they would not.

The control of the portfolio's pieces is what gives an SMA its favorable tax attributes. Not only can an SMA holder harvest losses but he can also pick which lot of shares are to be delivered when selling.

SMA holders also can give low-cost-basis shares as gifts, a benefit not available when the portfolio is taxed as one. If taxpayers give stock to charity, they can deduct from their taxes the current market value of the shares. If the shares had unrealized gains, the gains tax is forgiven.

A broker-directed account can have many of the same favorable tax attributes as an SMA; it is all about having control of the portfolio's parts. Loss harvesting, specific lot identification and giving of low basis shares are all available in both types of individual account.

In a RIC or an SMA, investors join in while the game already is in play. Investors may be buying into a position that's already been run up, but the manager is waiting for the position to go long-term. In a broker-directed account, the positions will be scaled into as the broker advises.

SMAs can have definite tax advantages over mutual funds for those investors with sizable holdings. Even then, those who cannot take itemized deductions should take a hard look at the total tax effect of having such an account. The comparison of SMAs with ETFs is not quite as favorable and would need to be analyzed on a case-by-case basis.

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