

Article reproduced from the **Sydney Morning Herald**, November 12, 2005

Singing in tune with the big funds

Customised share portfolios could be to investing what iPods are to online music, writes Simon Hoyle.

If Maurice O'Shannassy has his way, he'll become to the Australian funds management industry what Apple Computer's Steve Jobs is to the music industry.

Merrill Lynch Investment Managers, where O'Shannassy is managing director, last week released a new service called a separately managed account, or SMA.

An SMA is a customised share portfolio where the shares are owned by individual investors. They receive advice on which shares to buy and sell (and when) from professional fund managers and have their portfolios administered professionally.

Although the concept of SMAs isn't new, O'Shannassy says the improvements that Merrill Lynch has been able to build into its SMA structure makes it the iTunes of the funds management world.

Apple revolutionised the music industry by developing the iTunes Music Store and iPod music player, which changed how music is bought. But it could not have happened without significant steps forward in technology and a willingness (some might say a compulsion) to challenge conventional thinking.

O'Shannassy sees parallels between iTunes and the SMA. He says Merrill Lynch decided to think differently about how an SMA should work. The aim is to put access to fund managers' services in the hands of consumers in a way that gives unprecedented choice and flexibility.



Thinking differently... it's about putting fund managers' services into consumers' hands, says Maurice O'Shannassy.

Photo: Erin Jonasson

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Think of fund managers as musicians and the SMA as the Music Store.

Under Merrill Lynch's model, you can either buy a predetermined model portfolio (an album, if you will), but you can also pick individual stocks (tracks from an album). You can also add your own stocks (tracks from your favourite CDs). It is delivered online cheaply and quickly. There is no theoretical minimum amount you need to get started. However, you might need a certain minimum because of the need to buy

a minimum parcel of each stock.

There's no limit to how many fund managers can put their services on the SMA or how many model portfolios they offer.

Model portfolios will be offered initially by Merrill Lynch and Aegis, and others are expected to follow.

"Because we are the responsible entity, they have to go through our due diligence process to get on [the menu]," O'Shannassy says. "There's a whole process around what they have to

do to demonstrate that they have the capacity to manage money."

The entities that offer model portfolios might, in some instances, be called fund managers. In reality they will be more like advisers, issuing buy and sell orders. The SMA will execute transactions on behalf of the owners of the shares.

This 'open architecture' is expected to be attractive to financial planning dealer groups, which often construct model share portfolios for their advisers to recommend to investors.

Under Merrill Lynch's structure, a dealer group can put its model portfolio onto the SMA, and its advisers can use it to track, administer and report on the portfolio.

Investors can add their existing share portfolios to the service without incurring capital gains tax. They can pick from (and modify) a range of model share portfolios constructed by professional managers.

O'Shannassy says an SMA is a cheaper and more tax-efficient way than a managed fund for investors to get professional management of their share portfolios. Under an SMA structure, investors buy and own the shares directly. In a managed fund investors buy units, which entitle them to part of an underlying pool of shares.

"You can customise an SMA portfolio to meet your needs – including placing 'screens' on what you want to invest in (eg screening out companies that cause pollution or are involved in gambling, and so on)."

"It's very different to a unit trust," O'Shannassy says. "There are different tax consequences, but also differences in terms of how the investor feels."

If an investor wants to invest in Australian shares, "I can buy units in an Australian share fund, or I can buy this, where I see what the stocks are, and I see what they are buying and selling", he says.

"When people ask why we are doing it, I say it's because I believe we are able to deliver our investment expertise in a better way."

There's no doubt the most tax-effective way to invest in shares is to do it yourself. You can decide what shares you want to buy and sell and when, maximising the tax efficiency of your transactions.

You can customise a portfolio to meet your needs – including placing 'screens' on what you invest in (for example, screening out companies that cause pollution or are involved in gambling or alcohol, and so on).

The starting philosophy for Merrill Lynch's SMA was that it had to provide investors with all benefits of investing in a managed fund and had to be relatively cheap, so investors with relatively small sums could use it.

O'Shannassy says the open architecture of the SMA and its low cost are two features that set it apart from existing SMAs and similar individually managed accounts (IMAs). Generally, IMAs and existing SMAs are set up for "high-net-worth" investors with significant sums to invest.

He says Merrill Lynch wanted to 'unbundle' the intellectual property aspects of funds management – stock selection and portfolio construction – from the more commoditised aspects such as account-keeping and tax-reporting.

Merrill Lynch teamed with Przemium Portfolio Services, a leader in producing systems to track stock portfolios and provide account-keeping and tax-reporting. Przemium's systems have been carefully refined over several years. The company's managing director, Arthur Naoumidis, says O'Shannassy drove the company hard to make sure the SMA can do everything that Merrill Lynch wants.

"Merrill Lynch has structured its service as a managed investment scheme. This means that a financial planner may use it without having to change the licence under which they operate."

The SMA keeps track of each investor's account. This means transactions – whether determined by investors or changes to a model portfolio made by a fund manager – are executed to make them as tax-efficient as possible.

For example, imagine you have some National Australia Bank shares that you've owned for five years, and you transfer them into an SMA. At the same time you complement your NAB holding with a model portfolio that contains NAB shares. The SMA administration system would adjust the model portfolio for the NAB shares that you own, so your holding of NAB shares would stay in line with the model.

After a few months, the manager of the model portfolio might sell some NAB shares. The SMA will automatically work out which parcel of NAB shares should be sold. Your shares have been held for five years, so you would probably have a lower capital gains tax bill than if you sold some of the NAB shares bought just a few months ago.

For another investor, say one whose only NAB shares are those he or she bought when selecting a model portfolio, the situation is different. The point is, the SMA system will work it out for each investor, individually.

It gets even better: if you have investors and model portfolio providers buying and selling stocks at different times, you often get a situation where one investor is selling, say NAB shares again, when another is buying. If you have two model portfolios within your own account, these transactions will be netted.

Say model portfolio A decides to sell 1500 NAB shares at the same time model portfolio B decides to buy 2000 NAB shares. The net effect on your account will be the purchase of 500 shares – so you only pay transaction costs on buying 500 shares, instead of those from selling 1500 and buying 2000.

Transactions can be netted across separate investors' accounts within the SMA. While the net effect on your account might be to buy 500 NAB shares – elsewhere within the SMA, another investor's net transaction might be to sell 500 NAB shares – so you cancel out each others' transactions and minimise transaction costs.

As you own shares directly when investing through an SMA, an investor has greater control over the timing of his or her transactions, and consequently over the realisation of capital gains.

Even if a model portfolio provider advises that the shares should be sold, the transaction can be structured to minimise capital gains tax liability.

This contrasts with a managed fund, where an investor might buy units in the fund just before the manager realises and distributes a substantial capital gain. Just a few weeks or months after making your initial investment, you could face a capital gains tax bill.

The SMA isn't an idea that O'Shannassy expects to catch on quickly. He says it will take time for the benefits to dawn on investors and advisers. As the concept is new, it will be available initially

only through financial planners who can work closely with investors to ensure they understand how the service works.

O'Shannassy says Merrill Lynch launched the SMA because it had long-term potential. "We would like to think of ourselves as the largest SMA operator in the world, which is mainly the US," O'Shannassy says. "We've studied what happened offshore and looked at the reasons they have been successful in the US, in particular. We think there's every reason that's going to replicate itself in Australia."

"We [first] had a look at this a couple of years ago. We set up a taskforce to look at it. We abandoned it after about six to nine months. In essence, we didn't have the complete confidence that it could be the product we wanted it to be."

One of the reasons that O'Shannassy gives for the anticipated success is that Merrill Lynch has structured its service as a managed investment scheme. This means that a financial planner may use it without having to change the licence under which they operate.

Otherwise, an adviser might have to adjust their business systems and vary the terms of their licence. Many simply don't believe the extra cost and effort justifies the potential business gains. Unfortunately, that attitude puts the adviser's interest ahead of the investor's. By removing that impediment, O'Shannassy says a greater number of advisers will use the service for their investors.

Further information

For further information about the Merrill Lynch Customised Portfolio Service, visit our website: www.mlmadviser.com.au, speak to your Merrill Lynch Investment Managers BDM, or contact our Adviser Services Centre on 1300 366 101.