

Customization for Tomorrow

*The Value of Implementing
Separate Accounts*



TABLE OF CONTENTS

Introduction	3
Households with Advisor Interaction: Desired Account Features by Investable Assets, 1Q 2022	
Structural Advantages to SMAs	5
Households with Advisor Interaction: Desired Account Features by Investable Assets, 1Q 2022	
Algorithmic, Not <i>Ad Hoc</i>	7
Wealth Managers: Opportunity for Direct Indexing, 2022	
Direct Indexing	9
Wealth Managers' Plans for Customization, 2022	
Not Just a HNW Solution Anymore	11
Wealth Managers: Opportunity for Customization by Investable Assets, 2022	

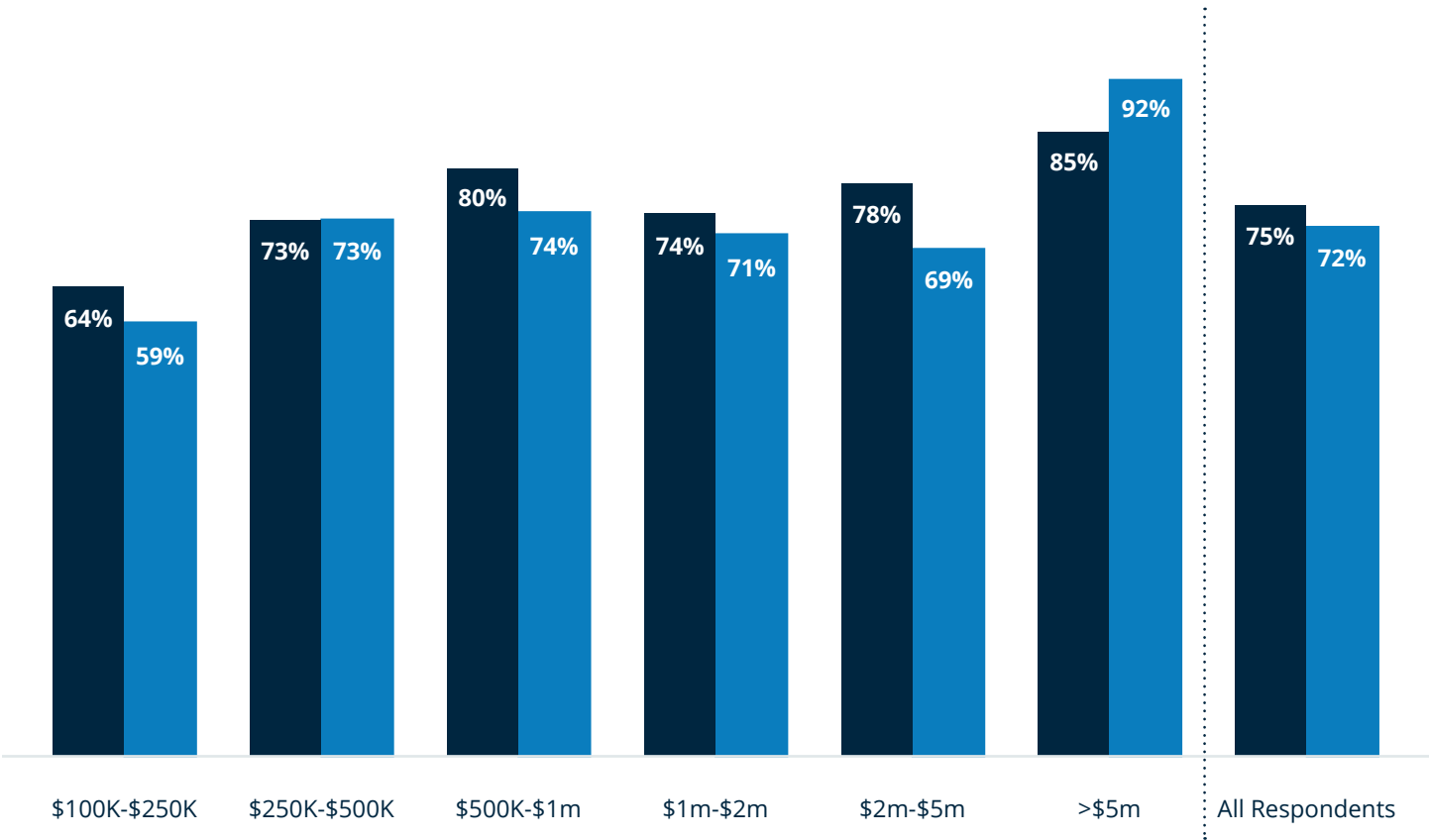
Introduction

The increase in the personalization of products and services has been a significant trend that shows no signs of slowing down. Whether it be uniquely curated playlists from Spotify, Amazon’s focused product recommendations, or the boom in targeted advertising, personalization has had a profound impact on the way companies think about product development.

While true personalization has yet to diffuse through the wealth management industry, there is an existing account structure that offers clients the ability to personalize and tailor investments to meet one’s needs. Separately managed accounts offer the customization and flexibility to tailor a client’s portfolio to match their preferences and meet their goals.

Households with Advisor Interaction: Desired Account Features by Investable Assets, 1Q 2022

- Access to a financial advisor to help develop a plan for achieving my goals
- My account is personalized to my situation and designed specifically around my financial goals



Sources: Phoenix MarketCast, Cerulli Associates
Analyst Note: Respondents were asked, “If you were to open a new financial account today, how appealing would each of the following account characteristics be?”



01 | Tactical Tip

Proactive advisors are thinking about how to deliver greater customization and personalization to enhance the financial planning services that they offer to clients.

Structural Advantages to SMAs

Unlike a pooled investment vehicle, such as an exchange-traded fund (ETF) or a mutual fund, in a separately managed account, the investor owns the underlying securities. This allows for a higher degree of customization and control over the portfolio, granting clients the option to exclude certain securities or sectors they do not want to invest in. However, perhaps the largest advantage lies in taxes. Owning the underlying securities can be a critical tax advantage allowing for the opportunity to harvest losses in the portfolio to offset capital gains. In down years when investors are already seeing their account values decrease, such as in 2022, SMAs can help minimize unpleasant tax surprises that might occur in a mutual fund.

Separately managed accounts are becoming more accessible to investors. Historically an obstacle to SMA adoption, account minimums and fees continue to decrease, with the average fee for a manager-traded single-contract equity portfolio ranging from 32 to 42 basis points.

SMAs can also be used as a business development tool for financial advisors. With only 42% of advisors currently using SMAs in their practice, this can be a key point of differentiation. Additionally, for those advisors seeking to attract younger clientele or take advantage of the massive generational wealth transfer in the coming years,

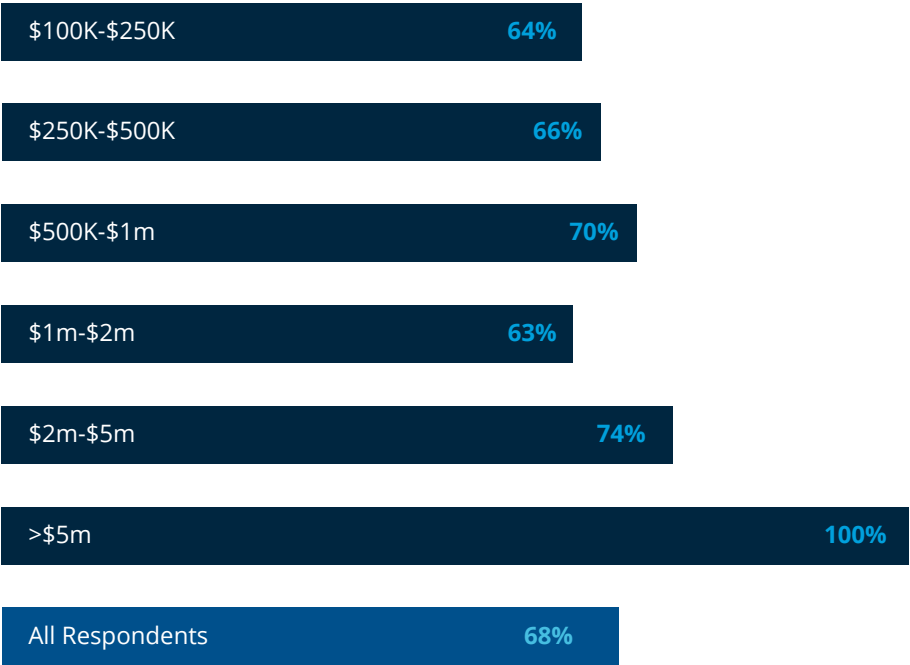
the interest in personalization through environmental, social, and governance (ESG) skews heavily toward younger generations, and SMAs can deliver this personalization.

Overall, 75% of retail investors under the age of 40 would rather invest in companies that have a positive social or environmental impact compared to 40%

or less for investors over the age of 50. Advisors who can successfully communicate and implement personalized ESG solutions into client portfolios will have an edge over the competition. While SMAs are currently a great way to stand out, advisors must act quickly as this advantage will not last for long.

Households with Advisor Interaction: Desired Account Features by Investable Assets, 1Q 2022

The account minimizes my tax bill by using tax-efficient investments strategies.



Sources: Phoenix MarketCast, Cerulli Associates
Analyst Note: Respondents were asked, "If you were to open a new financial account today, how appealing would each of the following account characteristics be?"





02 | Tactical Tip

Think about tax and ESG preferences among clients. Are these being met by current vehicle allocations? How can owning underlying securities help produce a better after-tax return and better align a client's portfolio with their values?

Algorithmic, Not *Ad Hoc*

There is tremendous opportunity to improve tax management through the use of SMAs. Based on Cerulli survey data, more than two-thirds of wealth managers are managing taxes in an *ad hoc* manner, either through asset location or occasionally harvesting losses. Just 29% of wealth management firms are using some form of automated tax management, with 18% of those firms using an algorithm or overlay portfolio manager to perform ongoing tax-loss harvesting.

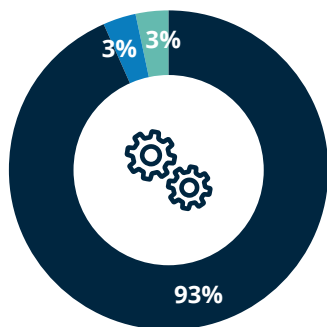
An algorithmic tax management system is far more likely to provide superior outcomes for clients rather than an advisor who occasionally harvests losses in the portfolio. It also takes the burden off the advisor, giving them more time to spend on other areas of their business. With relatively few wealth managers currently using algorithmic tax solutions, advisors who can adequately implement these strategies in their practice and communicate the benefits to their clients have a surefire way to attract and retain clients. With so many wealth and asset managers either building out the technology or acquiring firms capable of it, now is the time for advisors to use this to their benefit before it no longer provides a competitive advantage.



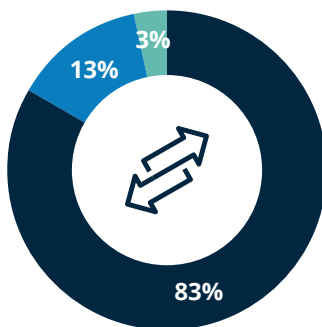
Wealth Managers: Opportunity for Direct Indexing, 2022

■ Significant opportunity ■ Modest opportunity ■ Little opportunity

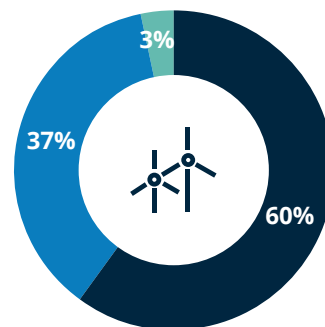
Ongoing tax optimization
(Algorithmic)



Tax-managed transitions



ESG factors



Source: Cerulli Associates

Analyst Note: Wealth Managers were asked to rate the opportunity for each type of direct indexing. Data points may not total to 100% due to rounding.



03 | Tactical Tip

Consider how implementing systemic, algorithmic solutions such as tax-loss harvesting can improve client outcomes and free up time to focus on other aspects of your business.

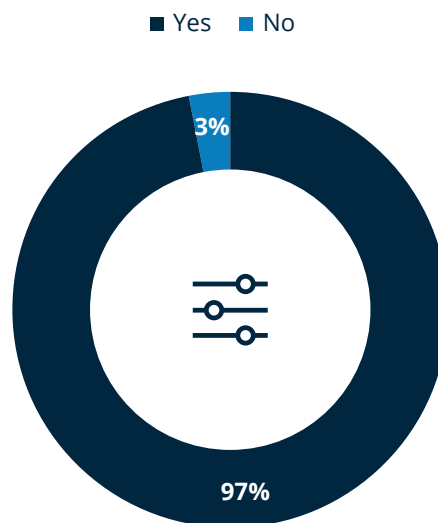
Direct Indexing

Interest in direct indexing has skyrocketed over the past few years and has been a huge point of discussion in the wealth and asset management space. Direct index SMAs are manager-traded separate accounts that focus on the tracking of an index (e.g., S&P 500), producing passive returns with additional customizations that can be personalized to match a client's preferences. Technology is the key to this personalization, using algorithmic processes to minimize portfolio tracking error as well as optimizing for taxes and customizing to meet investor preferences (e.g., ESG).

Although personalization for taxes and ESG are the top priorities for wealth managers and clients using direct indexing strategies, there are more applications that have flown under the radar.

Wealth Managers' Plans for Customization, 2022

Plans to offer greater direct indexing or customized SMA



Source: Cerulli Associates

Analyst Note: Respondents were asked, "Do you have plans to offer greater direct indexing or customized SMA options to advisors and clients using your managed account platforms in 2022?"



Highly Appreciated Stock Positions

A common issue for advisors is trying to unwind a highly appreciated stock position. Whether it was inherited when the client-advisor relationship began or simply due to capital appreciation, these positions pose a risk to the portfolio in terms of overweighting and potential tax implications. The flexibility of direct indexing allows for advisors to trim the concentrated position while also harvesting losses in the portfolio, diversifying exposure while simultaneously lessening capital gains tax.



Customized Fixed-Income Ladders

It is possible to deliver customized fixed-income solutions using bond ladders. While differing from an equity direct index strategy because there is no tracking of an index, bond ladders can produce predictable returns and substantial tax benefits, all while customizing based on maturity ranges, credit quality, and ESG factors.



Planned Charitable Giving

Direct indexing can be used to lessen the tax burden for clients planning on donating to charity. This is done through the donation of a highly appreciated position that would have realized a capital gain to a charity directly, or through a donor-advised fund. The portfolio is then replenished with the cash that would have been donated to charity, which can then spin off future losses. Advisors who are willing to have this conversation with their clients will stand out from the pack, as currently only 7% of affluent investors report that their financial provider assists them with charitable giving.



04 | Tactical Tip

Consider how a loss-harvesting engine at the core of advisor portfolios can help offset gains in other areas. Have conversations with clients around what other ways they would like to customize.

Not Just a HNW Solution Anymore

In the past, access to separately managed accounts was limited by high investment minimums and trading costs. With the advent of commission-free trading and investment minimums on the decline, this vehicle is becoming very accessible to mass market investors, particularly with direct index SMAs. Almost two-thirds of wealth managers (62%) are seeing opportunity for customization with as little as \$100,000 in investable assets.

In early 2022, Fidelity began offering direct index SMAs for minimums as low as \$5,000 and Altruist shortly followed suit by introducing strategies with a minimum of \$2,000. Increased adoption of fractional shares has opened the door for these offerings because indexes

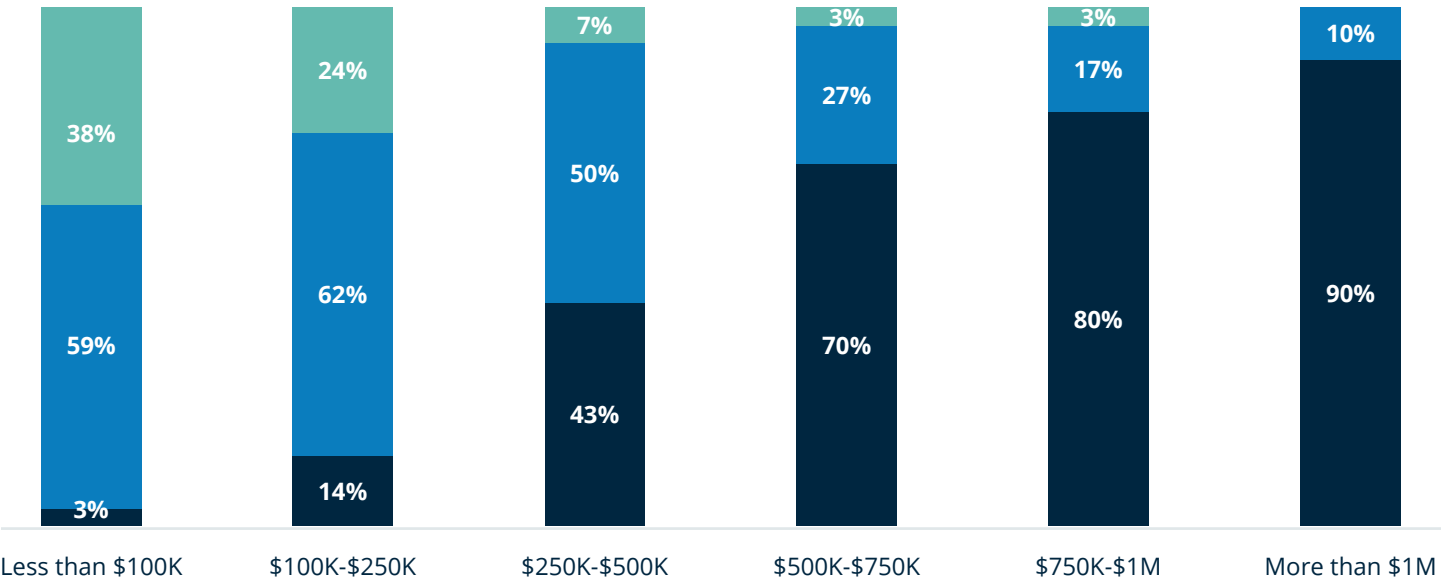
can be replicated without having to own full shares of all the underlying securities, further helping push these solutions downmarket.

An important difference in the pricing of SMAs compared to a pooled vehicle is that they incur an explicit cost as opposed to the implicit cost in an ETF or mutual fund. Advisors need to be able to discuss that the SMA fee will come from the client's account rather than deducted from the fund's expense ratio, making it more visible to the client overall. While this may deter many advisors from using SMAs, advisors who can clearly demonstrate the benefits and explain the after-tax value to their clients will find success using this vehicle.



Wealth Managers: Opportunity for Customization by Investable Assets, 2022

■ Significant opportunity ■ Modest opportunity ■ Little opportunity



Source: Cerulli Associates
Analyst Note: Respondents were asked, "At what asset levels do you see an opportunity for customization for clients?"



05 | Tactical Tip

Be prepared to intelligently discuss the explicit pricing of separately managed accounts. If handled correctly, this can deepen relationships with clients as they see the benefits and can provide a differentiator for advisors and their practices.



Advisor Research Collaborative

Cerulli's Advisor Research Collaborative (ARC) is the largest financial advisor research network in the U.S. For over 30 years, it has served as the foundation for Cerulli's strategic intelligence on the U.S. wealth management marketplace. More than 2,000 financial advisors regularly participate in the Collaborative to benefit from shared insights and recommendations.



CERULLI
ASSOCIATES

www.cerulli.com | 699 Boylston Street, Boston, MA 02116 | +1 617-841-1011