Next-generation SMAs are changing the investment landscape

Five strategies to help investment firms prepare for the future

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SMA innovations that are changing the industry's future

Innovations in Separately Managed Accounts (SMAs) are poised to change the future of the financial services industry. They will also be instrumental as financial advisors (FAs), wealth firms, and asset managers seek to offer precisely customized portfolios to retail investors.

Today, the "fifth generation of SMAs" can accommodate the dramatic shift toward "personalization" of products and services. This trend has been propelled, in large part, by the giant strides in technology and intelligent automation (IA) the industry has made over the past several years.

Thanks to their structure and features, these fifth-generation SMAs will be able reach—and benefit—new customer segments and also grow wealth management firm and FA assets under management (AUM). First- and fast- adopter SMA firms are already piloting these new innovations and preparing to roll them out on a massive scale.

Financial firms that haven't already jumped in with both feet may find themselves at a disadvantage in terms of staying competitive, capturing new customer segments, growing existing client wallet share, and attracting and retaining their productive FAs. Every week, the media reports news of billion-dollar advisor teams lifting and shifting to another firm that offers a better set of products and advisor tools.

This report drills down and explores SMA innovations—their advantages and limitations, how they work, and the steps you need to take to add them to your product and service mix.

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Skyrocketing growth of SMAs

SMAs are a type of investment account (brokerage, private bank, or trust account) that first came on the scene in the 1970s. From the outset, they have offered a three-fold benefit:

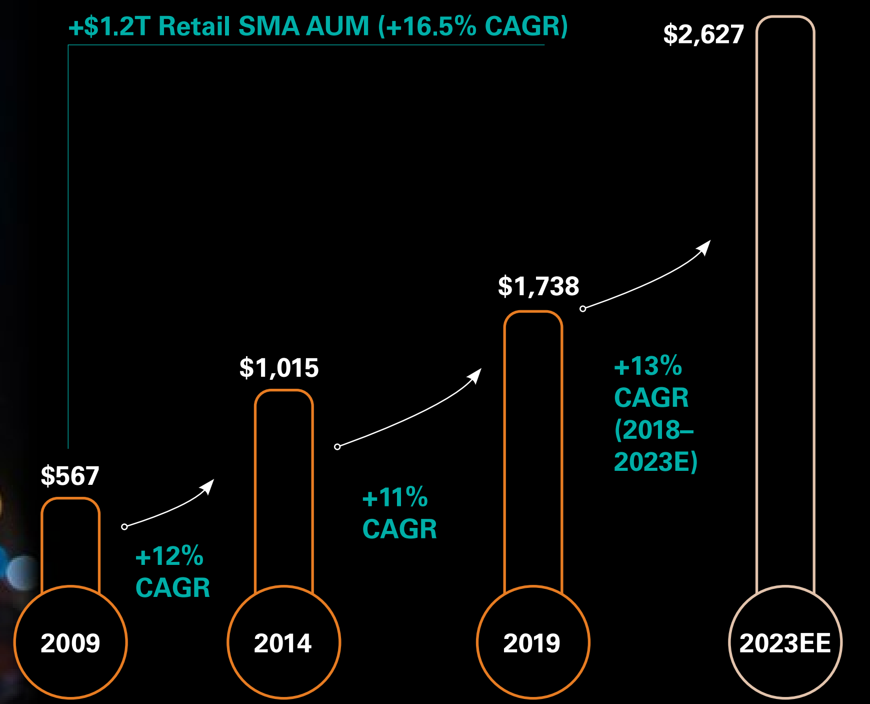
Individual retail investors gained access to the industry's best money managers (i.e., institutional quality portfolio managers). In addition, unlike mutual funds or exchange traded funds (ETFs), SMAs offered investors some control over tax outcomes as well as the ability to customize portfolios by, for example, restricting the purchase of certain securities.

SMA managers—both active and passive—gained the ability to grow AUM by offering their investment strategies to millions of individual investors rather than being limited to funds and institutions.

FAs were able to increase their books of business. Daily duties for portfolio monitoring and trading were essentially outsourced to SMA managers, so FAs were able to spend more time growing their client base.

AUM in retail SMA vehicles[1]

Cumulative annual growth (CAGR) of SMA manager assets in retail SMA & UMA sponsor programs ($billion)



[1] Cerulli Associates US Managed Accounts 2020

Due to this win-win-win proposition, the SMA industry skyrocketed. Retail SMAs **grew 450 percent** between 2009 and 2019, and now represent around **$1.7 trillion of the $7 trillion U.S. retail managed money industry**. SMAs have grown by nearly 12 percent CAGR since 2009[2] and are expected to grow even faster over the next five years thanks to the new innovations in personalization solutions and emerging technology.

We also anticipate that there will be new entrants to the SMA space, for instance, active fund managers, ETF firms, and hedge fund managers who haven't yet dipped their toes into the SMA waters, paving the way for even stronger growth.

SMAs and UMAs combined, represent around $3 trillion AUM and are expected to grow by 30 percent in 2021.[2]

The history of SMA innovations

1974: Gen 1

E.F. Hutton offers the *first retail SMA accounts*, providing retail investors with access to institutional portfolio managers.

1997: Gen 2

Multiple Discipline Accounts (MDA) are offered, allowing multiple SMAs to coexist in one account.

2003: Gen 3

2003: *Unified Managed Accounts (UMAs)* come to market. These products acted as "virtual portfolio sleeves," allowing FAs to combine SMAs, mutual funds, ETFs, and tradable options into a single UMA account.

2010: Gen 4

"Model only" SMAs, which supported greater agility and lower cost for investors, were introduced. SMA managers packaged their investment strategies into a turnkey model, which was sent to wealth firms that implemented all manager models at once.

2020: Gen 5

2020: *Direct indexing*, ESG SMAs, and Robo Equity baskets are introduced. A new range of SMA innovations are laying the foundation for expanding SMAs into new client segments.

[2] Cerulli Associates US Managed Accounts 2020

Five key SMA innovations

Here are five of the most important innovations impacting the SMA industry that are now being implemented by wealth management firms:

Five key SMA innovations

- **Direct indexing** with automated assembly of a customized ETF-like portfolio for individual investors
- **Passively managed SMAs** that can work together with actively managed SMAs
- **SMAs that are personalized** with environmental, social, and governance (ESG), socially responsible investing (SRI), and other filters, factors, and restrictions
- **The digitalization of SMAs** by both traditional wealth managers and Robo Advisors
- **Automation of tax-aware and retirement income generating** capabilities that can benefit targeted SMA client segments

SMA firms can offer one or all of these innovations. The main barrier is whether or not the firm has the technological ability to design the appropriate algorithms and implement an effective operations and distribution infrastructure.

Direct indexing, combined with other innovations, represents the pinnacle of personalized portfolios for individual investors. The ability to mass produce these products for thousands of individual investors is a tremendous, but achievable, challenge through enhancements in technology, operations, and data management.

— ***Jim Penman***, *Advisory Director, Financial Services Solutions, KPMG*

Now let's take a closer look at these SMA innovations.

Direct indexing

Direct indexing is perhaps the most dramatic innovation with respect to fifth-generation SMAs. As the wealth management industry strives for greater personalization of investment services, direct indexing represents the pinnacle of personalized portfolios for individual investors.

For example, an SMA owner might want a portfolio of stocks that replicate the S&P 500 index, but it may not be practical to hold all 500 securities in the SMA. So, filters or factors can be applied to a portfolio algorithm to reduce the number of securities in the SMA so that it aligns with the account size.

Account size	Appropriate number of securities for account size
S&P 500 full index	**500**
500k account	30 from S&P 500
$1M account	40 from S&P 500
$2M account	80 from S&P 500

SMA basics

SMAs are set up and serviced by a custodian. Unlike pooled investments such as mutual funds and ETFs, the SMA is owned by individual retail investors or institutional clients.

FAs help select an SMA manager and the investment strategy, which is driven by the manager's portfolio model(s).

The models, which contain a target list of securities to buy, feature an auto-rebalancing trading process that's executed by either the SMA manager or wealth firm.

First steps for direct indexing for SMA firms: For starters, SMA firms that want offer direct indexing will likely need to invest in modifying and upgrading their technology, data, and operations since the product requires a different process than traditional SMAs. Traditional SMA models come from SMA managers. Direct indexing starts with an industry or a manager's custom index. For example, since the source of the portfolios typically will be one of the standard indexes, SMA firms may need to **license usage of these indexes** in investors' accounts (even if they're modified).

In addition, SMA firms will want to start marketing these types of SMAs to young and emerging investors through Robo Advisors, as well offering them to ultra-high-net-worth (UHNW) investors, family offices and private banks.

Opening the door to hedge funds, PE funds and liquid alt firms: Alternative managers historically haven't been part of the SMA market. However, direct indexing enables them to enter the SMA/ Unified Managed Account (UMA)[3] space by providing active and passive investment strategies focused on, for example, real estate, space, cannabis, specific countries and currencies, and other micro-sectors. The number of potential new asset classes is limited only by the ability of SMA firms to guide investors and trade on securities in the models.

These SMA innovations have an opportunity to further democratize wealth management by helping advisors personalize portfolios for potentially millions of individual investors. But in order to offer them, it's paramount to have a well-designed tech architecture and risk controls framework in place to adopt these innovations.

*— **Sean McKee**, National Practice Leader, Public Investment Management, KPMG*

[3] A UMA is essentially a single account which contains multiple SMA models as "virtual portfolio sleeves." Rather than opening a separate new account when an investor needs an additional asset class, SMA firms can simply add another virtual sleeve to the same UMA account. UMA technology lowers the costs and complexity of offering multiple SMA models to investors. Throughout this report, every reference to SMAs applies equally to UMAs.

Passively managed SMAs

Traditional SMAs generally have been actively managed. Direct indexing introduces passive strategies into SMAs in addition to supporting active management. This flexibility addresses the needs of investors who want to allocate part of their assets to passive strategies such as the standard industry indexes.

SMA firms that intend to offer both active and passive SMA models to investors will need to make several changes in their operations, particularly in the way they blend, package and market their investment strategy to an investor. For instance, they'll need to modify the systems that support financial planning, research, proposals, and model management so they take into consideration the impact of passive SMA models. In addition, it will be necessary to upgrade their performance reporting systems to support more complicated benchmarking and composite requirements.

Just as the ETF industry is now witnessing the rapid expansion of new types of investment strategies and asset classes, SMAs are about to experience a similar increase in new strategies, including passive SMA models. The growing range of investment strategies is helping investors improve diversification and lower investment costs. We anticipate that both active and passive SMA models will be combined within single UMA accounts in the near future.

Direct Indexing SMAs currently hold approximately **$150 billion in AUM**; this figure is expected to **grow by 50 percent in 2021** alone.

Source: Cerulli Associates US Managed Accounts 2020

Personalized SMAs, including ESG/SRI filters and factors

Investors are interested in the new generation of SMAs primarily because they can be customized to accommodate their preferences and restrictions. Historically, SMAs were part of very defined and focused investment strategies (e.g., large-cap growth, large-cap value, mid-cap, small-cap, munis) and didn't support mass customization.

But fifth-generation SMAs allow FAs to construct and customize portfolios that meet individual investors' needs and requirements using powerful IA technology and D&A capabilities. These portfolio customizations can reflect an investor's desire to avoid concentration in a particular industry or sector or investing in certain countries or companies with unfavorable ESG/SRI ratings.

FAs need to work closely with investors to understand all their requirements, preferences, and restrictions. And IA- and D&A-based algorithms allow SMA models to be continually updated to meet investors' personal requirements. This is important as ESG/SRI scores and other securities' ratings change frequently.

For example, a scandal at a particular company can immediately change its ESG/SRI score. Or a firm can instantly grow from mid-cap to large-cap through a merger or acquisition. The new technology allows SMA firms to refilter, rescore, and adjust investors' individual SMA models on a daily or weekly basis to ensure they're in lock step with changes in customer preferences and external factors.

Restrictions and filters used in SMA customization

Here are some of the more common customizations, restrictions, and filters requested by investors:

Restrictions

Executives in a firm may be restricted from owning company stock due to legal or contractual provisions or company policy. This may further prevent the executives from buying many ETFs and mutual funds. However, now SMAs can be customized so that investors own the stock comprising the ETF minus the company's stock.

Filters

Filters can reduce the number of securities in the SMA so that it aligns with the size of the investor's portfolio. Examples of filter criteria may include profitability, dividend yield, industry sector, risk ratings, credit rating, and much more.

Customizations

An index can be customized to change the weight and focus of the securities in an index in order to reduce a risk or exposure. For example, if an investor generally likes the Russell 2000 index but feels that it's weighted too heavily toward tech stocks, the "tilt" can be lowered in the final SMA portfolio.

ESG/SRI

ESG and SRI are important trends across the entire financial services industry. Increasingly, investors want to reflect their values and beliefs in their investment decisions. This may include eliminating securities from companies with a specified percentage of revenue attributable to alcohol or tobacco products or with poor ESG/SRI scores.

The digitalization of SMAs for wealth managers and robo-advisors

Today, most robo "digital" advisors offer ETFs and some offer mutual funds. But they generally don't offer ordinary securities because of the increased cost and complexity of equity trading.

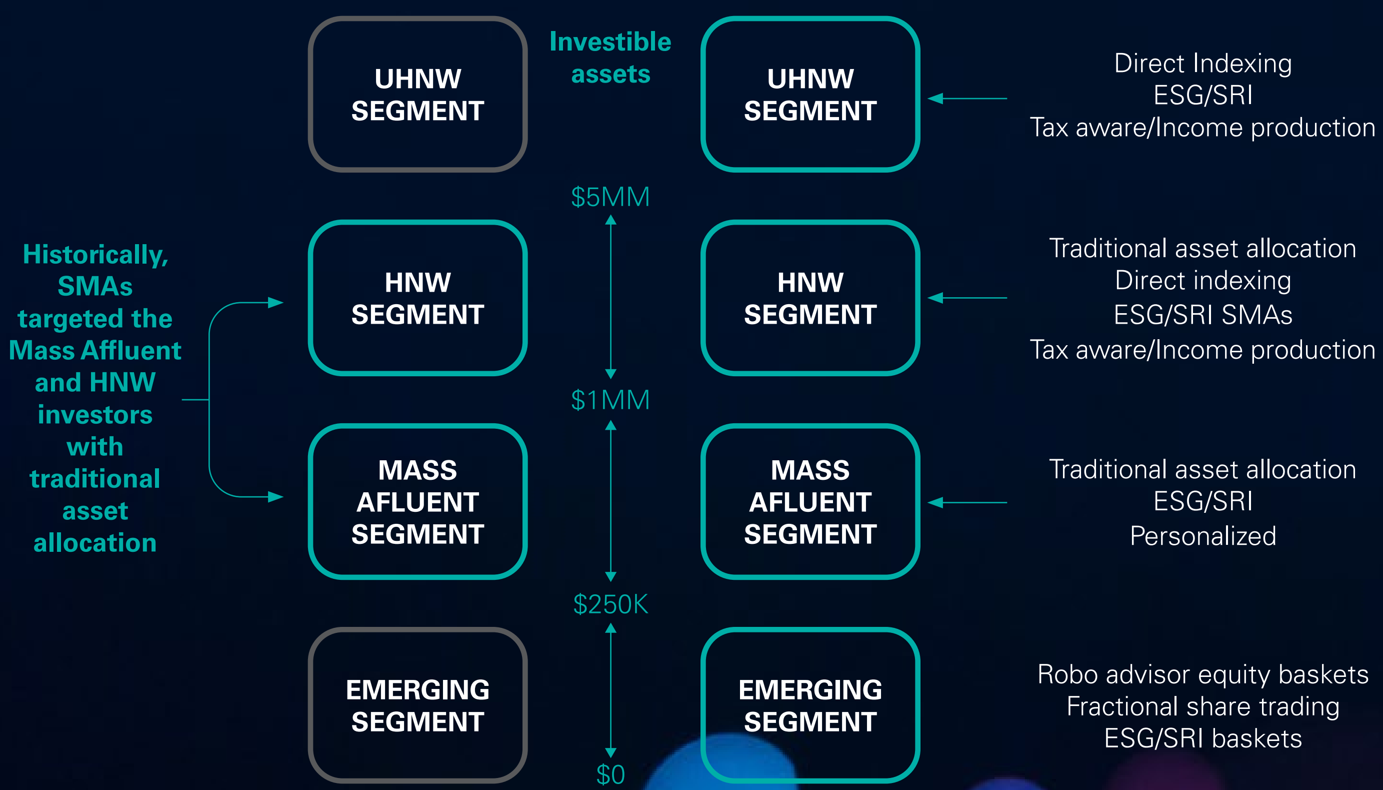
This inability to offer equity securities to investors places a cap on robo-advisors' business growth potential. Although younger investors may currently be less affluent than some more experienced investors, they are digitally savvy and interested in investing in equity securities.

Thanks to SMAs. robo-advisors now have a prime opportunity to cultivate this base of younger clients, who will only increase their wealth—and their investments—in the future.

As a result of emerging technology that makes conducting equity transactions more cost effective, we're beginning to see equity trading at many robo-advisors and digital brokerages through equity baskets with fractional share trading. So, for example, young investors with $100 can buy a basket of 10 securities and own a fractional share of each one.

Over time, robo-advisors and digital brokerages can grow relationships as young clients eventually become 40-year-old investors with $500,000 in investable assets who may then evolve into 60-year old HNW clients needing more sophisticated investment advice and services—**while staying digital**. In the near future, digitally oriented clients can still remain with the robo-advisors throughout their lifetimes, and apply their own filters, factors, and ESG/SRI criteria to create their own personalized SMA models.

The SMA innovations enable firms to target all investor segments



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Automation of tax-aware and retirement income generating features

SMAs that offer tax-aware trading or generate optimized retirement income are also becoming available to all investor segments, thanks in large part to the strides made in IA and D&A. While both of these strategies present a number of challenges and complexities to SMA firms considering offering them, they may well be worth the effort in terms of providing welcome solutions to investors and an effective way to grow the business.

Tax-aware SMAs: Controlling tax outcomes, for example through tax harvesting,[4] has long been a value-added service for SMAs. However, technology innovations that allow for continuous tax-optimized trading and auto-rebalancing have made this feature even more effective and simple to execute.

Investors typically would wait until November or December to harvest tax losses or tax gains through their SMAs. But a bad trade executed in January often could not be fixed in December. On the other hand, continuous goals-based tax-aware trading provides a better outcome than tax harvesting alone.

As investors' tax goals may change from year to year due to a variety of economic, regulatory, or personal factors, continuous tax and income optimization makes a lot of sense. For example, during the course of any year, an investor's tax objective might switch between producing tax losses and tax gains, or to remaining tax neutral. The continuous tax-aware trading/rebalancing capability makes it much easier to control investors' tax positions throughout the year.

Income optimization SMAs for retirees: As people are living longer, the traditional asset allocation of 70–80 percent bonds/20–30 percent equities is no longer working for many retirees. The solution: The new "income optimized" SMA whose goal is to modestly preserve capital while generating income. This strategy is also referred to as "self-annuitization."

SMA firms will likely need to upgrade their technology infrastructure if they want to offer optimized income trading methodologies. The portfolio management techniques for self-annuitization are complex and typically require very sophisticated analytics to account for all sources of retirement income, including social security income, as well as investors' federal and state income tax brackets.

As noted above, tax-aware trading and optimized income production are complicated activities and must factor in the ability to quickly change and optimize algorithms whenever new tax regulations are enacted. Some SMA firms are working on incorporating machine learning, robotic processing automation (RPA), and IA into trading processes, as they realize that the ability to support these features effectively will be a key differentiator between SMA competitors.

Asset managers will need to invest in modernizing their SMA infrastructure and platforms to support and drive growth. The focus should be on process optimization, digitization, workflow automation, and the use of data and analytics to support new product offerings that differentiate them from the pack.

— ***Agnel Kagoo***,
Advisory, Capital Markets Leader, KPMG

[4] Tax harvesting is the process of selling securities to help maximize an investor's tax situation. It typically occurs only at year end.

It's time to get on board

This report highlights some of the more significant and exciting innovations in the SMA arena. These developments hold the promise of benefiting all parties involved: wealth management firms, financial advisors, RIAs and, of course, investors.

SMA managers who have provided active strategies for years may face significant disruption from passive SMA models, but the benefits to investors of direct indexing are too strong to ignore. First movers will have an opportunity to capture a new market space by producing personalized SMA models that incorporate investors' specific requirements, ESG/SRI values, and restrictions.

We have already seen explosive growth in the SMA space, and the potential for further growth is unlimited. There's no question that SMA firms will need to step up their game to support these and other emerging innovations as well as the anticipated continued rapid growth of SMA/UMA accounts.

This means making significant upgrades in technology, and in IA- and D&A-programming. It also means enhancing the efficiency and effectiveness of their data management, product management, distribution and risk management practices, upskilling overlay management and operations personnel, and entering into smart partnerships with appropriate industry players.

How KPMG can help you

KPMG offers a full spectrum of products and services to help asset managers establish managed account programs or help optimize their current offerings. We understand that the wealth management industry is a multidimensional one, and you may need to address a variety of issues and challenges, often simultaneously, including:

— Designing and implementing operating models

— Shaping and reacting to customer experience

— Understanding future markets and investors

— Staying ahead of the curve in technology and data management

— Choosing the right vendors to partner with.

Our approach is to holistically address all of these dimensions, and work with you to design and implement solutions that are uniquely suited to your needs, regardless of where you are on the maturity curve. We possess extensive experience in these and many other areas of the wealth management business, including:

— Platform automation

— Platform scalability

— Controls and risk-minimization processes

— Platform audits

— Data & analytics

— Performance reporting

— Fee billing

— Tax-aware investment services

About the authors

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Agnel is Capital Markets leader in the KPMG Advisory group. Agnel has more than 20 years of experience in helping clients transform their processes and technology to address complex business challenges. His technology background, combined with his business integration experience, helps him bridge the gap between technology and business teams. Agnel has been a key contributor in developing KPMG methodologies, accelerators, and thought leadership. He also has led global system implementation and technology integration initiatives and coordinated enterprise transformation programs across diverse industries.

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Contact us

For more information on how we can help you in the design, structure, implementation, operation, and distribution of SMEs and other financial products, please contact us.

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