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Wall Street Is Selling Custom-Made Portfolios to the Masses

Once reserved for the very rich, separately managed accounts hold out the promise of tax savings. Are they worth the extra cost and complexity?

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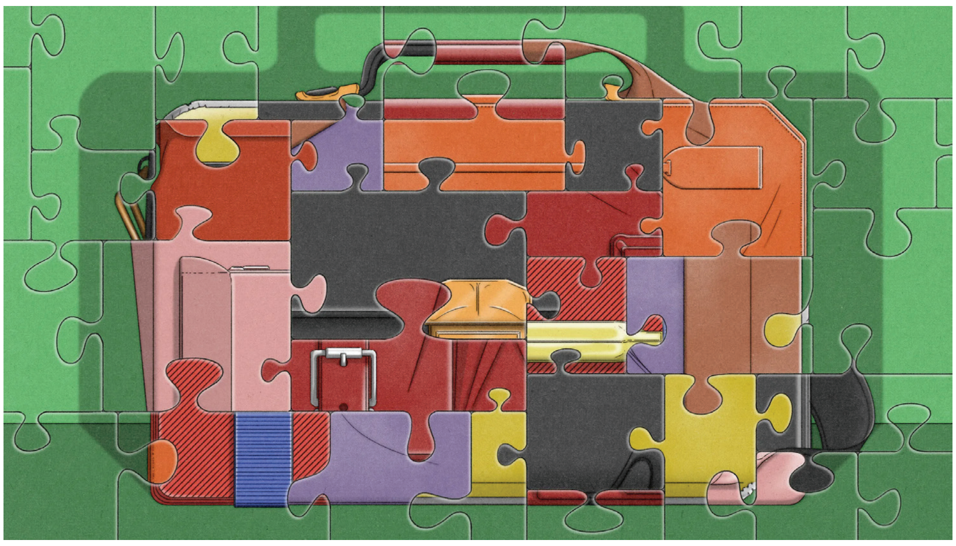
When Gregory Greene retired from his job as chief administrative officer of a Miami-based transportation and logistics company, he realized he didn't want to manage his retirement money on his own. "I do not want to or have an interest in spending too much time watching my finances," says the 64-year-old, who lives in Hollywood, Florida. "I outsource that." That might make him a prime customer for mutual funds or exchange-traded funds. But Team Hewins LLC, the financial-planning firm he hired in Florida after an introduction from a friend, had an alternative suggestion: a separately managed account.



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Like a mutual fund, an SMA is a portfolio run by a professional money manager. The difference: Each client owns the securities in the portfolio directly instead of in a pool with other investors. This feature means an SMA can be more closely tailored to an investor's taxes, estate plans and other investment preferences. Dimensional Fund Advisors LP, a fund and ETF company in Austin with about $790 billion under management, runs some SMAs for Team Hewins clients. Greene says he put two-thirds of his portfolio into an SMA.

SMAs were once reserved for institutions and America's wealthiest. But the barriers are dropping quickly. In 2021, Dimensional reduced its account minimum from $20 million to $500,000. Fidelity Investments Inc. has introduced a digital retail version of SMA portfolios—which allow users to customize but don't come with personal advice—with a minimum of only $5,000. Overall, separately managed accounts have collected almost $3 trillion in assets, a sum that's expected to swell to $5 trillion by the end of 2027, according to industry consultant Cerulli Associates.

Tech that makes it easier for money managers to design and monitor multiple accounts has been a big part of the shift. "With customization comes complexity," says Thomas Lee, co-president and chief investment officer at Parametric, the direct-indexing arm of Morgan Stanley Investment Management. Parametric in June brought down some of their minimums to$100,000 from $500,000 in the past. "You can't manage hundreds of thousands of SMAs without technology," Lee says.

Advisers pitch SMAs as a way to save on taxes, in particular from a technique called tax-loss harvesting. Managers can sell unprofitable investments at a loss to minimize tax bills while replacing those investments with similar ones to keep their strategy intact. Greene, who sits on university and foundation boards, says he also wants to make charitable giving part of his tax planning. An SMA allows him to donate stocks directly without selling them. Investors might also use SMAs to exclude investments that clash with their values or to trim or beef up their exposure to certain companies or industries.

As with other tools Wall Street has hailed for democratizing investing, however, experts worry about added fees and complexity that may be unnecessary for most retail investors. After all, they tend to have much of their nest eggs in retirement accounts, which are tax-deferred or tax-free, so loss harvesting isn't so useful. Customers in many cases need an adviser to access SMAs. Average fees for them, on an asset-weighted basis, add up to about 0.64% of assets per year overall, according to researcher Morningstar Inc. And that's not including a typical financial adviser fee of around 1%. By contrast, average fees for passive ETFs, which are also very tax-efficient, are about 0.13%.

Rick Ferri used to be in the business of selling SMAs to clients. He has a different model now. Ferri, the founder of advisory firm Ferri Investment Solutions, charges by the hour and typically advises clients that they'd be better off putting their money in an ETF tracking a total stock market index while paying fees as low as 0.03%. "Most products that are being sold by advisers and asset management companies tend to be oversold to people who don't need them," he says. "There are much simpler ways of managing people's money."

Loss harvesting has its limits, especially after a long bull market. "At some point you don't have any more tax-loss harvesting to do," says Wes Gray, chief executive officer of asset manager Alpha Architect LLC in Havertown, Pennsylvania. A 2023 paper by AQR Capital Management LLC finds that in portfolios that can't also go short—that is, bet against some stocks—the benefits of tax-loss harvesting tapers off after the first five years. But Larry Paterson, head of Fidelity's managed account investment product, says tax-loss harvesting usually saves enough to offset a 0.4% asset management fee.

The more customized an SMA, the less it will resemble a broad market benchmark such as the S&P 500. That approach may have concrete advantages for some investors—for example, a longtime tech company employee with wealth tied up in stock options might want to dial down exposure to that industry elsewhere. But personalization can often become another form of active management. And history shows most stock pickers fail to beat index funds. Similarly, a study by S&P Dow Jones Indices found that more than 9 in 10 equity and fixed-income SMAs have underperformed their benchmarks over 10 years when accounting for fees. "Active management is a fool's errand," says William Bernstein, a veteran investment adviser and author of the book The Four Pillars of Investing. "It doesn't matter whether you're trying to sell actively managed mutual funds or whether they're SMAs."

Even so, it's likely that technology will continue to blur the line between the markets for off-the-shelf fund products and tailored SMAs. Artificial intelligence is already entering the picture. Brooklyn Investment Group LLC in New York uses AI to quickly build and help watch over custom portfolios for the clients of financial advisers who use its platform. "Ultimately asset management is a fiduciary business, and you've got to have a human at the end of the funnel," says Erkko Etula, Brooklyn's CEO and co-founder. "With our technology, each one of those human portfolio managers is able to massively scale the number of accounts they can manage while improving the quality of portfolio management."