Investment Research

# Six Advantages of Separately Managed Accounts

## Over Ultra-short Bond Funds

Strategy

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**Abstract**

*Important regulatory changes to institutional prime money market funds are forcing institutional cash managers to look elsewhere. While ultra-short bond funds hold promises, they exhibit many of the same drawbacks of commingled vehicles. A well-researched and well-structured separately managed account may overcome these drawbacks while delivering comparable or better benefits.*

*Commingled vehicles and separate accounts need not be mutually exclusive. A stratified portfolio with government money market funds insured deposits SMAs and other alternative vehicles may gain popularity.*

*Six Advantages of Separately Managed Accounts:*

1. *Tailored Risk Management*
2. *Reduced Shared Liquidity Risk**
3. *Transparency*
4. *Low Portfolio Turnover and Simple Tax Considerations*
5. *Income and Capital Gains Management*
6. *Versatile Reporting*

### Introduction

The implementation of floating net asset values (NAVs) and redemption fees and gates on institutional prime money market funds represents a paradigm shift for most cash management professionals in liquidity vehicle selections. Over the one-year period ending October 31, 2016, institutional prime assets went from $1.02 trillion to a measly $122 billion, representing a loss of 92%[1]. While some service providers are hopeful that eventual wider yield spreads between prime and government funds will win back some former shareholders, a new battleground has opened among alternative vehicles such as structured insured deposits, private liquidity funds, ultra-short bond funds (USBFs), exchange traded funds (ETFs), and separately managed accounts (SMAs).

Since we published the original paper of the same title in November 2007, we have made several revisions articulating the inherent shortcomings of pooled liquidity vehicles, including money market funds, as exposed by the 2007-2008 financial crisis. Despite the appearance of safety and liquidity, these vehicles are susceptible to lapses in investor confidence that may lead to runs. We think USBFs are not immune to this risk.

[1] iMoneyNet Domestic Market Shares as of October 31, 2015 and October31, 2016.

## The Ultra-short Bond Fund vs. Separately Management Account Debate

Several recent industry surveys suggest that interest in SMA solutions has flourished among some institutional cash managers as money fund alternatives in the post-reform era. Besides higher yield potential and the absence of fees and gates, cash investors are attracted to customization, transparency and risk control features offered by SMAs.

One may argue that an USBF may offer many of the same benefits of an SMA, such as no redemption fees and gates and higher yield potential than prime funds, but avoids the need to construct a separate portfolio and conduct related operational tasks.

We will devote the rest of this paper to this question and articulate that many of the same SMA advantages over money market funds also apply to USBFs.

## Separate Account Management Basics

Investors of SMAs own their investments directly, often in a custodial investment account registered under the investor's name. This is in contrast to investors owning shares of a mutual fund or other commingled vehicles that in turn own individual securities, such as stocks, bonds and/or derivatives. In both cases, investors use professional investment managers to make discretionary investment decisions. Typical SMA investors include educational endowments, charitable foundations, corporations, pension plans and private wealth trusts.

In the area of corporate cash management, the use of separate account management has a long tradition, but with a limited following. According to the latest liquidity survey by the Association for Financial Professionals as of May 2016, about 3% of U.S. corporations' short-term portfolios, on average, were in separately managed accounts. This compares to 55% in bank deposits, 9% in prime money market funds and 7% in government money market funds. However, in response to the regulatory changes in prime money funds, SMAs were the most-preferred alternative among survey respondents at 44%.

## Introducing Ultra-short Bond Funds

The term is a relatively new phenomenon that lacks a standard definition. According to US News and World Report's mutual fund ranking service, USBFs are mutual funds that "invest primarily in investment-grade U.S. fixed-income issues and have durations of less than one year (or, if duration is unavailable, average effective maturities of less than one year). This category can include corporate or government ultrashort bond portfolios, but it excludes international, convertible, multisector, and high yield bond portfolios. Due to their focus on bonds with very short durations, these portfolios offer minimal interest-rate sensitivity and therefore low risk and total return potential.[2]"

USBFs as retail products have been around for several decades, seeking income returns higher than money markets but price volatility less than short-term bond funds. Like all bond mutual funds, they are subject to the Invesment Company Act of 1940 which is enforced and regulated by the Securities and Exchange Commssion (SEC). Money market funds, by contrast, are a special class of mutual funds subject to the Rule 2a-7 exemption of the Investment Company Act.

USBFs in the institutional cash management space are specifically designed with former institutional prime money market fund shareholders in mind. They generally replicate the "old Rule 2a-7" product, for example, targeting portfolio weighted average maturity (WAM) between three and six months, abiding by the 5% issuer concentration limit, keeping maximum issuer maturity under one-year, and refraining from using below investment grade credits. We should caution that these are not required features by the Investment Company Act and USBFs may deviate from them by wide margins.

[2] Refer to U.S. News & World Report classification http://money.usnews.com/funds/mutual-funds/rankings/ultrashort-bond

In recent months, several large money fund sponsors announced the launch or the registration of USBFs. By our estimation, however, only a handful of funds exist that invest in mostly (80%) investment grade securities with portfolio duration less than 0.5 year. Excluding government funds, only three funds have balances greater than $1 billion.

For practical considerations, therefore, USBFs as institutional liquidity vehicles are more of a proof of concept than an investible option at this time.

## Advantages of SMAs over USBFs

Many of the potential and obvious advantages of SMAs over USBFs reflect their trait of individuality. Because assets and investment preferences are not commingled with those of others, investors are able to work with their investment managers to customize investment strategies and construct portfolios catered to their own risk tolerance, return expectations and specific cash needs. They are also free from the "hot money" issue prevalent among institutional prime money market funds.

1. Tailored Risk Management: Every investor faces unique circumstances that impact income, growth, safety and liquidity considerations. Understandably, a commingled vehicle rarely satisfies the preferences of all investors in the fund. For example, most institutional cash investors do not allow below investment grade credits, but few USBFs stay away from such credits. Some institutional investors prohibit mortgage-backed securities (MBS), asset-backed securities (ABS) and derivative contracts, but USBFs routinely use these asset types to improve yield potential while introducing liquidity risk.

In an SMA relationship, an investor may set guidelines on some of the key risk control metrics such as maximum maturities, concentration limits, ratings and liquidity requirements. Another effective risk control mechanism may be a list of prohibited transactions including the use of financial leverage, derivatives and/or specific security types to be excluded.

Figure 1: Sample Restrictions in Investment Guidelines

| Item | Limits |
|---|---|
| Maximum Issuer Maturity | 24 months |
| Maximum Portfolio Maturity | 12 months |
| Minimum Credit Ratings | A3/A- (A-1/P-1) |
| Issuer Concentration | 5% |
| Industry Diversification | 20% |
| Overnight Liquidity | 10% |
| Benchmark Selection | 3-month T-bill |
| Prohibited Transactions | Leverage, derivatives, MBS, CMO, home equity ABS, etc. |

2. Free from Shared Liquidity Risk: Pooled investments are subject to investor sentiment because of mismatched maturities between their assets (greater than one-day) and liabilities (one-day). When the credit quality and liquidity of fund assets (for example, US government securities) are not in question, shareholders generally do not bother with liquidity concerns. When market-based or idiosyncratic credit concerns flare up, however, shareholders may resort to their flight instinct by selling shares. Many pooled vehicles are not designed to satisfy redemptions with liquidation of existing holdings. Rather, managers typically keep some portion of the fund in securities of very short maturities for normal and unexpected redemptions. Understandably, this shared liquidity cushion is on a first-come-first-serve basis. We call it the shared liquidity risk.

In 2007, several "yield-plus" and "enhanced-cash" funds exposed to sub-prime or otherwise illiquid assets stopped taking sell orders. A few state-owned local government investment pools (LGIPs) froze redemptions due to investments in troubled structured investment vehicles (SIVs). The Lehman Brothers bankruptcy in 2008 forced the $64 billion Reserve Primary Fund to "break the buck," the second such instance in the history of money market funds.

While most mutual funds experience principal fluctuations on a daily basis that do not lead to runs, the unique shareholder base of funds labeled "liquidity" or "cash" accentuates the shared liquidity risk in such vehicles. The latest money fund rule revision makes this risk more pronounced as institutional shareholders are now separated from retail investors.

On the other hand, separate account investing is not affected by cash flows from other investors. SMA investors can, and often do, work with managers in response to upcoming cash flow changes weeks or months ahead of time. Such information becomes a valuable tool in helping to improve the account's investment performance.

3. Transparency: Another risk control related advantage of SMAs is the level of disclosure of investment activities. In addition to periodic statements and reports, an investor is entitled to all relevant portfolio information on demand. Equipped with the right data, the investor can address and deal with credit issues in a relatively timely fashion.

SMAs are investment accounts held at custodian banks in the name of the clients. Portfolio transparency is only limited by a bank's speed of information delivery and the manager's investment accounting and reporting capabilities.

USBFs and other mutual funds, on the other hand, are required by the SEC to file holdings data on a quarterly schedule with a 60-day filing period, making data potentially stale by more than 150 days. This lack of transparency pales even with money market funds, which must provide monthly holdings data with a five-day lag. USBF shareholders also generally receive less information on their funds than money market funds due to the absence of Rule 2a-7 protection.

4. Lower Portfolio Turnover and Simpler Tax Considerations: Institutional cash managers generally look to cash management vehicles for consistent income returns. The buy-and-hold investment approach in money market funds and many institutional cash SMAs seek to accomplish this objective by minimizing active trading. USBFs, on the other hand, seek total return from both principal and income sources, and are often engaged in active trading.

Money market funds and USBFs, as open-ended investment vehicles, need to satisfy daily shareholder subscriptions and redemptions. Money funds are required to set aside a minimum of 30% in weekly liquid assets for redemptions. USFB portfolios, on the other hand, have no such requirement. They may be without sufficient cash buffers and sell assets to satisfy redemptions. This contributes to higher portfolio turnover which leads to higher transactional costs. The single-shareholder nature of SMAs makes liquidity-based trading more manageable and less frequent.

A cumbersome feature of frequent mutual fund trading is the complex two-level tax recognition. Post-reform prime funds received IRS relief in recognizing gains and losses by essentially ignoring intra-period NAV fluctuations. USBF shareholders must record tax information on each share transaction. The funds must also distribute substantially all of the gains and losses from fund level activities to shareholders at the end of each year. Complex tax treatment is one of the reasons institutional investors prefer bonds to bond mutual funds in fixed income investing. By contrast, gain or loss recognition in an SMA, if any, is associated with specific securities and is more easily identified and manageable.

5. Income & Capital Gains Management: A related trading advantage for SMAs is the flexibility for cash investors to retain control in setting book yield targets, income recognition and capital gain/loss management. This is especially true for some publicly traded companies where investment income is a meaningful contributor to a firm's bottom-line. SMAs afford investors betting income forecasting capabilities, selective capital gains recognition and loss-harvesting for tax purposes. These are valuable tools not available in USBFs.

6. Versatile Reporting: In addition to risk and return considerations, SMAs allow investors to receive customized and more comprehensive reporting unavailable from commingled vehicles. For investors concerned with specific credit, industry and country exposure, performance measurement, corporate governance, audit oversight and operational efficiency, the number and details of reports are limited only by the investor's preferences and the manager's technological capabilities. Compliance reports that detail all portfolio activities and current holdings on demand may be included among these reports.

## Conclusion

Important regulatory changes to institutional prime money market funds are forcing institutional cash managers to take a closer look at other liquidity vehicles. While ultra-short bond funds hold promise as potential yield enhancing total return tools, they exhibit many of the same drawbacks of commingled vehicles. A well-researched and well-structured separately managed account may overcome these drawbacks while delivering benefits comparable to, or better than, ultra-short bond funds.

The process required to establish a separate account relationship may take more steps than a mere mouse click on a fund portal, but investments in time and research may bring just rewards during times of uncertainty. There is no question that an advisory relationship should be a long-term partnership that requires considerable trust and scrutiny.

Separate account relationships are not without their drawbacks. Less public and comprehensive information is available on the SMA universe. The customized nature of institutional cash SMAs results in the lack of uniformed benchmarks. Risk and return characteristics may not be directly comparable among managers. As a result, investors may benefit by starting with shorter duration and more conservative SMA strategies before moving onto more sophisticated account structures.

These six potential advantages of separate account management are not meant to be exhaustive, but are intended to stimulate discussions. Commingled vehicles and separate accounts need not be mutually exclusive. A stratified portfolio with government money market funds, insured deposits, SMAs and other alternative cash vehicles may gain popularity among many former prime fund shareholders.

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Drawing upon almost a quarter of a century of experience through varied interest rate cycles, the firm has built its reputation upon deep, research-driven investment strategies and solutions for its clientele.

Capital Advisors Group manages customized separate accounts that seek to protect principal and maximize risk adjusted returns within the context of each client's investment guidelines and specific liquidity needs. Capital Advisors Group also provides FundIQ® money market fund research, CounterpartyIQ® aggregation and credit analysis of counterparty exposures, risk assessment on short-term fixed income securities and portfolios, and independent debt financing consulting services.

Headquartered in metropolitan Boston, Capital Advisors Group maintains multiple U.S. regional offices.

### Disclosure Information

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