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THE "INTIALS" OF INVESTING
The Who, What, When, Why, and How's of MF's, ETF's, or SMA's

More is Better…

What used to be simply "stocks and bonds" has been transformed in a wide array of investment offerings that provides financial advisors today far more options and greater flexibility in serving the diverse needs of their clients.

For advisors with a traditional retail or even "mass affluent" investor base, a *mutual funds* platform allows them access to hundreds of fund families with the tremendous liquidity and diversification benefits of these products.

Exchange traded funds (ETFs) have grown in popularity as many investors seek out portfolios with consistent market returns that can be managed in a cost effective manner.

High net worth investors appreciate the chance to invest alongside major institutional accounts with *separate account managers* whose customized portfolios are rarely available for retail.

However, the extensive nature of these comprehensive investment offerings may result in confusion and can even be overwhelming in the portfolio selection process.

But Is More *Always* Better?

The following Q&A is designed to help advisors best determine the "who, what, when, where, why, and how" of structuring the most appropriate portfolios for their diverse investors.

Q: With so many offerings, how do I get started in selecting the best allocations?

A: Before even considering the various platforms or analyzing the different models, the first rule of thumb must always be "Know Thy Client." No two investors are exactly alike. Even with similar assets and income levels, the 30-year old father of two who is concerned about educating his kids may have different goals than the 30-year old single guy willing to take significant risk in his portfolio. One 60-year old retiree may be interested in conservatively living on interest and dividends and leaving principal to children, while another may want to spend every last dollar during her lifetime.

Before making even investment decision one…take the time to get to know your client, their goals and objectives, their dreams and aspirations, their hopes and prayers, their financial plans for today, tomorrow, retirement and beyond. Understand their tolerances for risk and their abilities to sleep at night during potentially negative periods in the markets. Learn about their prior investment experiences with the various security types

and just how comfortable they are with each. Only after you have gathered a comprehensive profile can you begin to structure an appropriate portfolio.

Q: What are the appropriate levels of experience for the various investment platforms?

A: Understanding your clients' comfort levels with the markets is a crucial component in structuring appropriate portfolios. And a comfort level only grows with years of investment experience. Relatively new investors with just a year or two in the markets should be directed to ETF or mutual fund investments. Both provide excellent diversification opportunities and have relative ease of trading (liquidity).

Since ETFs are structured to track indexes, the new investor can gain comfort (and experience) by achieving returns that resemble the markets. As they become more familiar, investors may choose to structure mutual fund portfolios which attempt to outperform the markets on a relative basis, but are often associated with greater (than market) risk in the process. The more experienced investors can be guided to separately managed accounts and all their perceived benefits; but, only those with enough investable dollars to create appropriately diversified portfolios (see below) should participate. As for alternative investments (hedge funds), these are appropriate for only the most sophisticated, experienced (accredited) investors.

Q: How do investable dollars play into these decisions?

A: The concept of diversification should be one of the cornerstones of all investment allocation decisions. The more dollars one has to invest, the greater the diversified portfolio that can be created. Therefore, for individuals just getting started, ETFs allow them to structure market-related portfolios for relatively few dollars. They can start with an ETF tracking the S&P 500 to model the benchmark equity index and then add complementary funds that track small-cap, fixed income, or perhaps international markets to enhance diversification. The more experienced investors with similar assets to invest may choose to gravitate to mutual funds. The minimum required balances are typically small and liquidity is rarely an issue with those actively traded funds.

Separately managed accounts often require substantial minimum investments. Typically, the more experienced (and successful) the manager, the higher the minimums. While an individual may be able to participate with a manager for as low as a $50,000 investment, anything less than $250,000 will not allow them to invest with multiple managers and achieve anything close to the most desired diversification. Additionally, managers who accept investors with $50,000 may not be among the most talented or experienced. While sophisticated investors with $500,000 may choose to structure SMA portfolios, generally $1,000,000 to $2,000,000 of investable dollars should be the minimum needed before considering these products. This would allow multiple asset classes (at least five) to be included in the portfolio. Some managers maintain minimums that start at $1,000,000. While many of the associated benefits (top managers, customized portfolios, tax efficiencies, etc.) may be desirable, they should never outweigh the significant advantages of diversification.

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Bear in mind, MSPs (multiple style portfolios) can be traded using the strategies and investment allocations of certain separate account managers (without the direct investment), often for far less than the minimum required investments. Even so, the experience level and diversification ability of the investor should always be taken into account.

Q: How should an investor's risk tolerance be considered?

A: When determining an investors' financial goals and objectives, risk should be among the most important considerations. Just what keeps these folks up at night? Are they most comfortable hiding their hard earned dollars under the mattresses or placing it all on "red" at the roulette table? Ask questions that can help determine priorities. While everyone will state that earning an attractive return is a key goal, are they willing to experience a potentially substantial loss should the gains not materialize? Do they view pullbacks in the market as reasons to sell and stay in cash or do they consider them aggressive buying opportunities? Even investors with significant experience and investable assets may be relatively risk averse and should have portfolios structured accordingly.

With regard to the security type, there are risky and non-risky elements to all of the products. ETFs are structured to track the markets; however, certain markets like small-cap, emerging markets, and various themes (commodities, real estate) can prove risky when not structured within a well-diversified portfolio. Similarly, separate accounts may be perceived as more risky because of the higher minimum balance requirements; however, a properly allocated and well-diversified portfolio of multiple managers could prove safer than one created using just a few ETFs or mutual funds. Again, diversification is the key to reducing the overall risk of a portfolio. In general, risk averse investors with fewer dollars and limited experiences should stick with the ETFs.

Q: What about those fee conscious investors?

A: First of all, fees should never be considered on a stand-alone basis. Investors should be educated to measure fees in conjunction with performance by looking at "returns net of fees and expenses." Many individuals may be willing to pay more for a brand name detergent if it cleans and smells better than a generic or choose a more expensive restaurant for superior food and service. Similarly, the whole package should be considered when choosing investments. The best separate account manager may have significant fees as compared to other products, but the performance may far exceed them.

With that said, ETF are relatively cost effective and often maintain far lower fee structures than mutual funds or SMAs. Mutual funds and SMAs often have "breakpoints" that initiate fee reductions at various levels of investments. In order words, the more dollars invested in a certain fund/manager, the lower the associated fee. Be careful not to forgo diversification merely to achieve a certain breakpoint or fee reduction.

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Q: What about those tax conscious investors?

Separately managed accounts often offer significant tax efficiencies as portfolios can be customized to meet the specific needs of the investors. Trades can be timed to limit taxes, assuming the manager's overall philosophy is not impacted. Unfortunately, not every investor has the resources to participate with these managers. ETFs are often considered tax efficient as the make-up of the various indexes does not change very often and such products can be used for a long-term 'buy and hold" strategy.

Mutual funds may, in fact, be the least tax efficient of these products, though certain funds are managed with taxes in mind. The primary issue with mutual funds relates to existing capital gains/losses that are "unrealized" at the time new participants invest in the fund. For example, a longer-term holding that is targeted for sale in the near future may have appreciated in value since purchased by the fund manager. An individual (or institution) who invests right before the sale will incur "realized" capital gains taxes, though they never reaped the appreciation benefit.

Actively managed portfolios (of any product type) can also lead to greater tax liabilities. Some investors choose to rebalance and reallocate portfolios on a timely (quarterly) basis and attempt to earn maximum return for a given level of risk. While tax implications may be given some consideration in the trading of these portfolios, the very nature of multiple trades may translate into additional liability. Tax conscious investors may wish to consider rebalancing and reallocating (annually) far less often. These "buy and hold" portfolios do not attempt to actively manage or time the markets and often result in greater tax efficiencies.

Q: Can multiple investment strategies ever be appropriate for the same investor?

Sure. In fact, many investors have various pools of assets that are designed to accomplish different goals and should be invested according to diverse strategies. For example, people often have retirement dollars that might not be needed for years down the road. Depending on the timeframe until retirement, these 401(k) or IRA dollars can be invested more aggressively and allowed to grow over time. On the other hand, parents who have set aside dollars for their children's education (529's, UTMAs, Educational IRAs) may choose to invest more conservatively to ensure that college tuition and related expenses will be covered. Both retirement and education accounts carry certain tax advantages which should be considered when allocating those dollars.

Some individuals choose to maintain a more speculative investment account and invest in a more aggressive manner. While these "play money" accounts can be fun to monitor and discuss at cocktail parties, these folks should understand the risks involved in such strategies and never invest more dollars than they can truly afford to lose.

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Q: Can an advisor be expected to master the nuances of all products?

No, an advisor should never attempt to be all things to all people. Unfortunately, those who try often become mediocre at everything. While it never hurts for advisors to maintain a basic understanding of the various products offered, developing a specialty can create far greater expertise and lend additional credibility in the eyes of their clients. There are simply too many ETFs, mutual funds, and SMAs to know everything about each of them. While certain external resources are available to help educate, inform, and suggest the most appropriate asset allocations, advisors are best served developing an expertise and sticking to it.

Often the nature of the client base can help dictate the product strategy. A high net worth clientele may lead to greater knowledge of separate account managers and even hedge fund alternatives. Granted, plenty of high net worth folks still invest in mutual funds as well. Similarly, an advisor who targets young investors or even the mass affluent (middle to upper-middle America) should spend more time learning the nuances of ETFs and mutual funds. Most of these investors simply do not have the assets required to participate with those managers so the advisor would be doing a disservice spending significant time learning about such products. Bear in mind, while many advisors desire a high net worth clientele, there are substantially more "normal folks" to target and grow an attractive practice. Again, it all comes back to "Know Thy Client."

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