

ADVANCING *Issues*

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Managed Accounts – No Longer the Domain of the Ultra Rich

By David Vicic, Senior Vice President, Technical Services, Corporate Planning Associates

What do the Rockefellers, the Thompsons and an investor with as little as \$100,000¹ have in common? Well, if you read the title of this piece, you probably already know. It is very likely that all three use managed accounts for all or part of their investment portfolio. Yes, the managed account is no longer the domain of the ultra rich and is available to those with far less available for investment.

You may be familiar with some of the generic names of managed accounts programs – Individually Managed Accounts, Separately Managed Accounts, Unified Management Accounts, Segregated Wrap Accounts to name but a few. No matter what the name used, the underlying principles are the same. The program consists of segregated investment accounts that are professionally managed according to the guidelines established by the investor (with the aid of their financial

advisor). The investments held in these accounts are owned directly by the individual investor and can be tailored to meet the specific requests and circumstances of the investor.

In short, the program seeks to combine the benefits of professional money management with the flexibility, control and potential tax advantages of owning individual stocks/securities. When you add in the potential cost savings of using managed accounts as compared to using another managed asset – mutual funds, the separately managed account program becomes a very attractive alternative in the right circumstances.

There are a number of benefits to using separately managed account (SMA) programs. We will attempt to outline some of these now.

Money Management Advantage

As noted earlier, SMAs allow investors to customize portfolio holdings and investment strategies to match their

needs and objectives. This customization begins with the completion of a comprehensive questionnaire by the client (with the help of their advisor) to create the client's profile. This profile is then used to create an appropriate asset allocation/mix. Money managers are then chosen to manage certain mandates with an eye to provide exposure to various investment styles, disciplines and strategies, all the while keeping in mind the client's profile.

Once the managers have been chosen, it is important to be able to judge how well they are doing. In order to accomplish this, performance benchmarks are established to match the particular investment objectives. If a manager consistently fails to measure up, he/she can be fired and replaced with a new manager without the need to replace the other managers in the portfolio.

With an investment manager universe that numbers well into the thousands, an individual investor who

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wishes to use a managed account has a daunting task ahead of them. How do you choose which managers to use? By using an SMA program, the selection of the managers is delegated to consulting firms who have the experience and capability to select the appropriate managers. This process, investment manager due diligence, includes the initial screening of managers but just as importantly, it includes the on-going monitoring of the managers to ensure that they are managing the money according to the mandate for which they were chosen.

The ability to tailor the investments in a managed account is another big advantage, especially for those investors who are considered corporate “insiders”. For example, a request can be made to avoid investing in specific companies and/or sectors. As a result, if you have substantial holdings in your employer’s stock or stock options, you can request that the money managers buy no more of that particular stock.

Enhanced reporting is another key benefit to using SMA programs. Quarterly reports are issued that include personalized portfolio performance reporting that includes not only how the portfolio has done since inception (and other time periods) but how it has done in comparison to an appropriately chosen benchmark.

Tax Advantage

Another key advantage to using separately managed accounts is that the investments are managed for tax efficiency. That is, the investment manager will structure the portfolio and time transactions to lessen the tax impact while maximizing performance in line with the investor’s goals and objectives.

One of the benefits of owning the securities outright is that there is a measure of control over the realization of gains and/or losses since each security in the account has its own separate cost base.

The benefit of having a security with its own separate tax base is that no accrued tax liability exists when the investor initially invests in a separate account. This can be a problem in mutual funds where large, embedded gains exist – an investor could end up paying tax on the gains that have benefited others and not himself/herself.

When accounts are set up for non-registered assets, all or part of the fees paid as part of the SMA program could be tax deductible. However, there is no tax deductibility of fees paid on account of registered funds.

Fee Advantage

In an SMA program, the fees charged are asset-based rather than commission-based and it is in everyone’s best interest – client, advisor, portfolio manager – that the

portfolio grows in value. One transparent fee, based on the size of the portfolio and usually paid quarterly, covers the following:

- Portfolio management
- Brokerage fees
- Performance measurement
- Ongoing account administration

The costs generated by an SMA program can be competitive with mutual fund MERs for amounts under \$1,000,000 but substantial savings can be achieved as amounts invested increase.

Until now, we have focused on the positive aspects of separately managed accounts. However, there are some disadvantages to using these types of programs.

Disadvantages

Because an investor is directly holding securities, there is a potential U.S. estate tax exposure. Without getting into too much detail regarding the calculation of U.S. estate tax, assets that are deemed to be U.S. situs (that is, located in the U.S.) are included in this calculation. Securities of companies headquartered in the U.S. are deemed to be U.S. situs. As a result, this tax could be significant if proper planning is not carried out.

Another consequence of owning the securities personally is that every “sell” will be considered a taxable disposition of one sort or another. Keeping track of and reporting on

all the transactions, both “buys” and “sells”, can become problematic if the SMA program does not have the right technology in place.

Is a separately managed account program right for everyone? The obvious answer is “no”. However, when stacked up against mutual funds with MERs that seem to be increasing to ever-higher levels, an SMA program may be the way to go. In fact, T. Neil Bathon,

President of Financial Research Corporation (FRC), a Boston-based financial services consulting firm, states that “Managed accounts are perhaps the single biggest threat to mutual fund assets because of their well-chronicled advantages.” Managed accounts allow investors to invest in a range of diverse investments beyond mutual funds, all the while maintaining a diversified portfolio.

We may not be as wealthy as the Rockefellers or the Thompsons. However, if managed accounts are good for them, then they may be good for you.

¹ All managed accounts and managed account programs are subject to minimum investment amounts. Although you may be able to invest as little as \$100,000 into a managed account, we would suggest that the minimum amount invested in a managed account program be \$1,000,000.

Tax & Estate Matters

Tax Treatment of Escalator Term Deposits “Leveling” the interest rates over their term

By *Jamie Golombek*

This past June, the Ontario government introduced its 2004 series of Ontario Savings Bonds (OSB). Among the different OSBs offered was a five-year step-up OSB paying 1.7 per cent in year 1, three per cent in year 2, 3.5 per cent in year 3, 4.5 per cent in year 4, and six per cent in year 5.

This resulted in a competitive, blended yield of 3.73 per cent over the five-year holding period. A recent technical interpretation (2004-0068021E5) released on April 5, 2004, specifically deals with the tax treatment of interest on an “escalating” term deposit.

Prescribed debt obligations

The Income Tax Act Regulations define four types of debt obligations that are considered to be “prescribed debt obligations.” Each of these obligations has rules that govern how interest earned on the investments is to be calculated. The four types are:

Debt obligations on which no interest is ever paid. These would include “deep discount bonds” that have no stipulated interest but are issued for a price that is significantly less than the value on maturity. Debt obligations where more than one investor holds an interest in that obligation and payments of principal and interest do not flow in equal proportions to each investor. The most common example is a strip bond where the coupons have been removed and sold separately from the principal. Debt obligations that have increasing yearly interest payments, such as the step-up OSB described above. Debt obligations where the interest varies according to a contingency that is not known until after the end of the year. An example would be an index-linked GIC, where the interest payable depends on the level of a stock market index at the maturity of the GIC.

Under the specific rules for prescribed debt obligations that have increasing yearly interest payments, the deemed accrued interest that must be reported is essentially the interest calculated on a “yield to maturity basis” and not the amount actually paid on the contract basis.

Example

Let’s take an investor who purchased a five-year step-up OSB for \$10,000. The first year, she would only receive \$170 of interest although she would be required to include \$373 of interest income on her return for the year. As long as the step-up OSB is held to maturity, the total interest actually paid to the investor on the bond and the total interest reported for income tax purposes will be the same. If the OSB is not held to maturity or if the investor dies before maturity of the OSB, it is possible that interest income reported for

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CPA's Marketing Update

By P. Lee Fisher, President and Chief Executive Officer, Corporate Planning Associates

With the end of the year fast approaching, we are not only looking back at what has been but also looking forward to what will be.

In the third quarter of 2004, thirteen new clients began working with us. Eight of them are executives from corporations that already work with us; two represent corporations that are just beginning to work with us, and three are individuals. You might be interested to know that 80% of our clients are Senior Executives of major Canadian corporations (current or retired), 8% are entrepreneurs and 12% are individuals.

Looking ahead, you will have read earlier in this Newsletter about Managed Accounts. Our Gold Leaf investment platform will broaden

the investment options available to our clients. CPA has long prided ourselves on our key differentiators as Financial Planners. This new investment platform will extend that uniqueness and give our clients the first class investment opportunities you expect and deserve.

If you haven't already seen our ads, they have most recently been run in the National Post's CEO of the Year magazine and in Canadian Art, Fall 2004 edition.

Thank you to all of you who have referred clients to us in the past and we sincerely hope that you will continue to be inspired to do so in the future. We are all working very hard to ensure that CPA is the Financial Planner of choice to individuals requiring sophisticated planning and implementation.

Tax & Estate Matters

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income tax purposes will be greater than the interest income actually paid. In these cases, the tax rules permit the excess cumulative interest income reported for tax purposes to be deducted in the year of sale or death.

Tax policy rationale

From a tax policy perspective, the rules governing prescribed debt obligations provide taxpayers with certainty with respect to the amount of accrued interest that must be reported in circumstances where, because of the nature of the obligation, it would be otherwise quite difficult or unclear on how to report the income. According to the Canada Revenue Agency, "the rule can be considered a 'leveling' of the interest rates over the term of the instrument."

Note that it makes no difference whether or not the interest on the step-up OSB is paid annually or paid at maturity – the yield to maturity basis must be used to calculate the annual amount required to be reported by the investor and will be reported as such on the T5 slip from the issuer.

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