



PHILO CAPITAL ADVISERS

With legal input and review from  
Vianne Consulting

# ON BALANCE... UNDERSTANDING & SELECTING MANAGED ACCOUNT SERVICES PART B

**On Balance...** is the name given to the White Papers that Philo produces from time to time. Our goal in producing these White Papers is to stimulate industry discussion on matters to do with portfolio construction and management.

**November 2014**

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## About the Philo “On Balance” white paper series

This is the second white paper from Philo in the On Balance series. In our first edition we looked at a key commercial question facing many non-aligned financial planning firms – whether to vertically integrate their business and the merits of the different vertical integration models existing in the market. That paper can still be obtained on the blog section of the Philo website.

In this edition, which we have split into parts A, B and C, we explore the world of managed accounts, including managed discretionary accounts (MDAs) and separately managed accounts (SMAs). Our experience is that there is great interest in managed accounts in the financial services industry, but also some confusion as to what they are, how they are regulated and what the issues are for selecting the right managed account for a particular business. Our goal therefore is to help people to understand these issues and to feel they can make more informed and confident decisions.

**Part A** of this paper is focussed on helping people to understand what managed accounts are, their key characteristics and what the benefits of them can be. We also seek to dispel some myths around managed accounts. Part A can be downloaded by anyone who would like to have a copy from Philo’s website ([www.philocapital.com.au](http://www.philocapital.com.au)).

**Part B** examines the legislative framework around different forms of managed accounts in a bit more detail and looks at the regulatory outlook for managed accounts. We also consider the best use of managed accounts and identify the circumstances where it is more appropriate, in our view, to use a unit trust. Part B also includes a list of questions a planning business might ask of itself in the lead up to selecting a managed account service. Part B is also available on the blog section of Philo’s website.

**Part C** provides a more detailed examination of the different roles involved in operation of a managed account and the different business models that exist in the managed accounts market. We critically analyse each model and score each model on a range of assessment criteria. Part C is a private document that Philo uses in strategic planning with organisations that have an ongoing commercial relationship with Philo.

In preparing this paper we draw on years of experience in developing, implementing and operating managed accounts, in addition to our experience as an investment manager to managed accounts. Given the evolving nature of the managed accounts market we may update this paper if we see new innovations in the market worth including. More information on Philo’s services is available at the end of this paper.

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## Purpose of this Paper

Managed Accounts have been accelerating in popularity in the past few years with FUM estimated at over \$15 billion and there is much industry anticipation that their rate of growth will accelerate further.

Despite this increasing popularity and anticipation, general industry knowledge levels around managed accounts are relatively low. One of the reasons for this is that the business models around managed accounts offered in the market are quite diverse – resulting in a situation where there is no definitive picture in the collective consciousness as to what a managed account is.

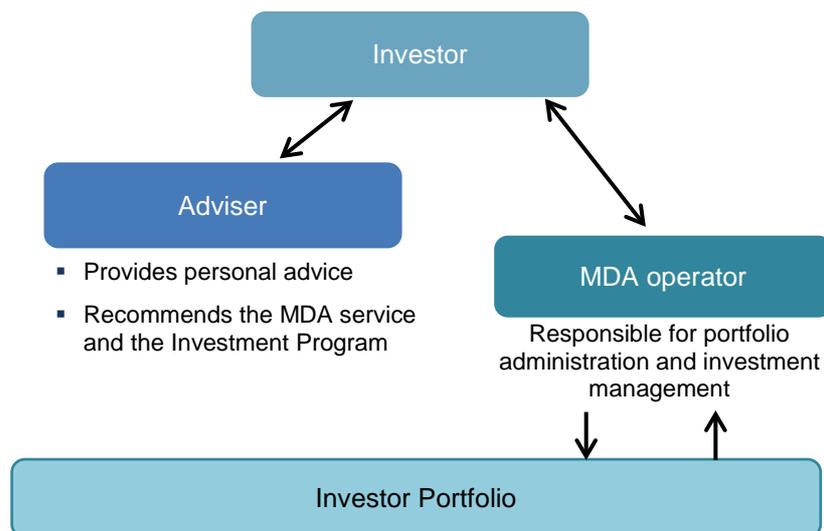
The purpose of this paper is to provide a plain English explanation of managed accounts – what their essential characteristics are, the different forms of managed accounts available and what issues financial planning businesses may care to think about in determining their managed account strategy.

We welcome questions and feedback arising from your reading of this paper. Our contact details are on the back of this paper.

## Key structural and regulatory variations between managed accounts

Having identified the main branches of discretionary portfolio management in Part A of this paper (available on the Philo website), it is worth understanding some of the key structural and regulatory variations between each branch. We focus here on managed discretionary accounts (MDAs) offered as unregistered schemes under Class Order 04 / 194 and separately managed accounts (SMAs) offered via a registered scheme. We also examine limited MDAs offered under the no action letter.

### Key characteristics of a MDA



In simple terms the essential elements of a MDA are:

1. The MDA must meet the requirements of Class Order 04 / 194 and Regulatory Guide 179<sup>1</sup> (RG 179), both issued by ASIC along with a number of other incidental requirements set out in other regulatory guides. Under the class order the issuer of the MDA is granted relief from certain disclosure obligations such as having to provide a product disclosure statement.
2. An investor grants discretion to a “MDA operator” to manage their portfolio for them via a formal contract.
3. The MDA contract must have a clearly identifiable section or document headed “Investment Program. The Investment Program agreed between the investor and the MDA operator governs the scope of the investment discretion (generally there are a range of template investment programs that the adviser and investor can choose between and further customise). The Investment Program is a regulatory requirement and the essential elements of the Investment Program are set out in the Class Order 04 / 194.
4. Before entering into an MDA contract to provide MDA services to a retail client the MDA operator must give to the client a compliant Financial Services Guide (FSG). In addition to the requirements set out in the Corporations Act, there are explicit content requirements for a FSG issued by a MDA operator. Again, these are set out in Class Order 04 / 194.
5. The investor’s portfolio assets are not pooled with those of any other investor so that the investor always retains the beneficial interest to all of their assets.
6. Whereas MDAs of the past tended to be arrangements to manage a direct portfolio of stocks, many MDAs in use today are multi asset class portfolios that offer both direct and unlisted investments.

<sup>1</sup> At the time of writing, limited MDAs operating under the no action letter are relieved from some, but not all, requirements of the Class Order

7. The MDA operator can execute changes to the investor's portfolio within the discretion granted - without the need to create formal advice documents for each change and is not required to obtain investor authorisation for each change.
8. To the extent that the MDA investor invests in managed schemes, it is not necessary for the underlying Product Disclosure Statements (PDSs) to be given to the investor.
9. Reporting must be provided to the investor setting out the transactions on their account on a quarterly basis at a minimum. This obligation can be met through providing hard copy reports or by granting online access to the investors with an internet connection.
10. For retail investors personal advice is still required for the provision of a MDA, namely;
  - a. An initial recommendation must be made that sets out how the MDA is appropriate for the investor
  - b. Annual advice (at least every 13 months) is required confirming that the MDA investment program remains appropriate for the investor (or making such recommendations for change so that the service being provided to the investor remains appropriate).

For wholesale investors these obligations do not apply.

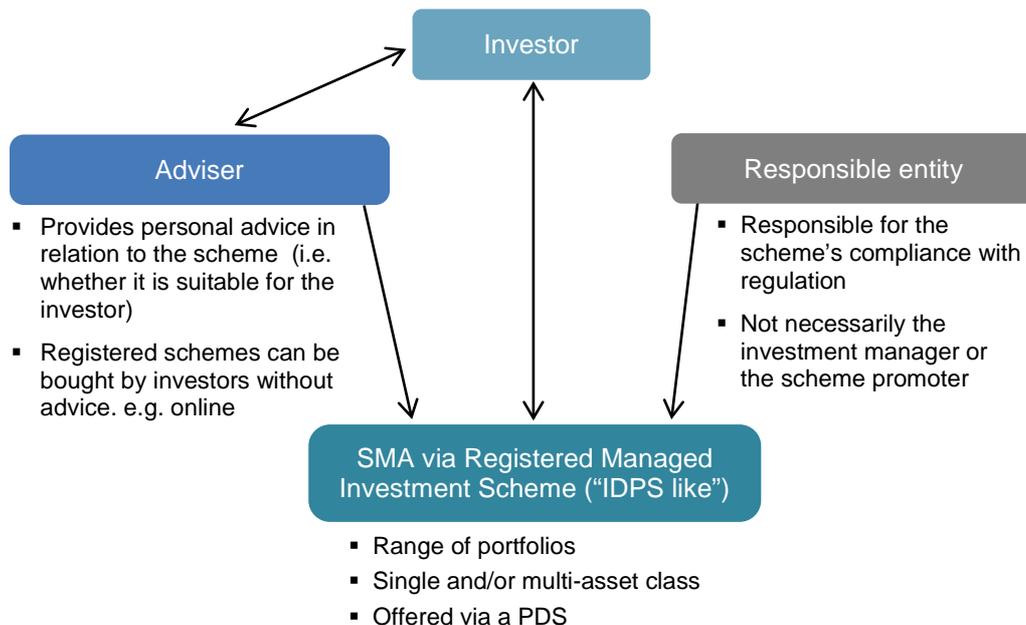
11. The MDA operator and the party providing the personal advice must be expressly authorised to provide the respective services under their Australian Financial Services Licence/s (AFSL). It is not necessary that the party providing the personal advice is also the MDA operator.
12. As we explore in greater detail in a later section of this paper, the operator of a MDA is responsible for both portfolio administration and investment management regarding the MDA they operate, but it is not unusual for MDA operators to appoint other parties to provide day to day investment management services. In some instances the MDA operator appoints investment management specialists whilst in other instances they appoint the planning firm that also provides the personal advice. In other circumstances the MDA operator is also the provider of investment management services to the MDA. There are pros and cons associated with the different MDA configurations offered in the market and we comment on these later in this paper.
13. Administratively, it is important to have access to specialist systems to manage MDA portfolios if the service is to scale and if administrative risks are to be managed effectively. There are specialist providers of MDA software in the market that provide this technology as a subscription service. These providers allow the MDA operator to develop a centralised MDA administration service that can manage assets across multiple external platforms. More recently we are seeing more platforms providing managed account functionality as part of their overall platform functionality. The choice between specialist systems and using embedded platform functionality is an important one with significant strategic and operational implications. We explore the different ways to access MDA software in part C of this paper.
14. Regulatory relief for MDA operators that extends beyond that provided in Class Order 04 / 194 is available to advice firms in certain circumstances under a temporary no action position. There are two no action positions we are aware of that are relevant in this context. The first is set out by ASIC in correspondence to the Financial Services Council (previously known as Investment and Financial Services Association or IFSA) dated 5 November 2004. It relates to the ability to transfer funds between investments on a regulated platform under a limited power of attorney (the "no action letter"). The second no action position is set out by ASIC in a letter to SDIA (now the Stockbrokers Association of Australia) dated 8 December 2004 and stated that,

"ASIC does not intend to take enforcement action for failure to comply with the provisions from which relief is given under the MDA policy or have appropriate licence authorisations against a licensee. This applies only where the non-compliance is merely because the licensee's representatives provide discretionary trading services to their immediate family members."

This second no action letter is therefore more limited in scope and the commercial implications are far narrower.

When we refer to the no action letter or the no action position in this paper, we are referring to limited MDA arrangements set out by ASIC in its letter to IFSA unless explicitly stated otherwise. A copy of the no action letter to IFSA is provided as attachment 1 of this paper. More details on the no action letter and its implications for planning firms can be found in later sections of this paper.

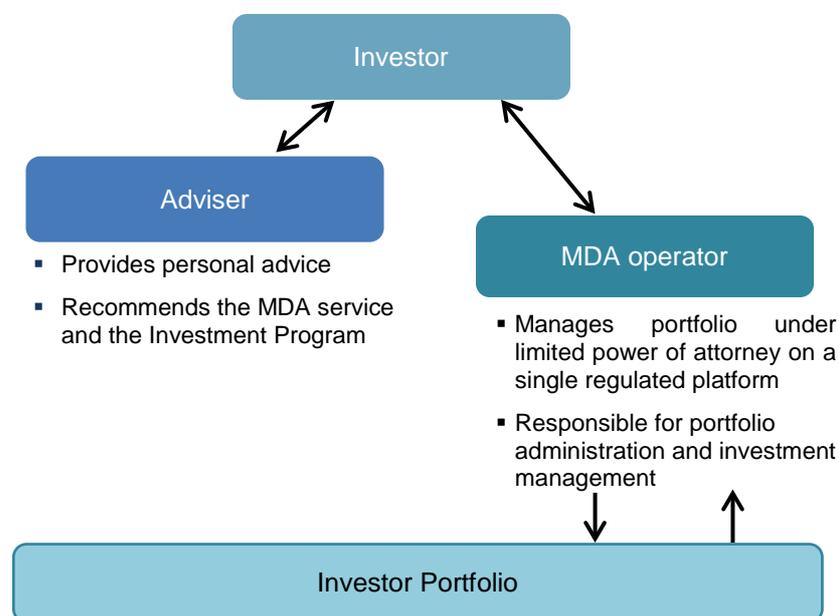
### Key characteristics of a SMA offered via a Registered Scheme



1. A registered scheme must be offered under a product disclosure statement (PDS) that accords with the Corporations Act. The PDS requirements are the same as those that apply to a registered retail unit trust.
2. The SMA would be classified as an "IDPS (Investor Directed Portfolio Service) like" structure, similar to a wrap account. While an "IDPS like" structure must be issued under a PDS, it is not necessary for the PDS of any underlying investment to be provided to the end investor.
3. The SMA can offer a range of portfolios – both multi asset class and potentially single asset class portfolios that investors can select from.
4. Investors retain beneficial ownership of the underlying investments. The custodian to the scheme may hold investments in an omnibus account but the scheme maintains records of each investor's entitlement to those underlying investments.
5. As with conventional managed funds there must be a Responsible Entity associated with the scheme that can meet minimum regulatory capital requirements and ensure general regulatory compliance. The obligations of the responsible entity are quite onerous. It is reasonably common for the promoter of a fund to outsource the responsible entity role.
6. Given the presence of a PDS, there is no legal requirement for personal advice to be given to investors before accessing the underlying investments and no legal obligation for advisers to confirm the appropriateness of the investment at regular intervals (contrast this to an MDA where appropriateness must be confirmed at least every 13 months). Where an adviser is recommending the SMA, the adviser is still subject to normal best interest obligations.

7. Where a planner does provide personal advice in relation to a registered SMA offered, all the regulatory obligations relating to personal advice apply – just as it would with recommending a wrap platform or unit trust.
8. A planner recommending the investment must be appropriately licenced to do so. The AFSL holder responsible for the personal advice must have appropriate authorisations in respect of ‘advising’ and ‘dealing’ in managed investment schemes including IDPS. For the sake of clarity, there is no requirement on either the provider of advice or a Responsible Entity to have an MDA operator authorisation when using SMAs offered via a registered scheme.
9. Some SMAs offered in the market today provide access to a menu of investment managers while others are offered by a single investment manager to provide a range of portfolios.

### Limited MDAs offered under the no action letter



Readers of this paper may have heard of “limited MDAs” offered under the relief granted by a “no action letter” from ASIC and may be wondering where no action letters fit in terms of regulation and business strategy.

The Australian Securities and Investments Commission (ASIC) defines a no action letter thus:

*“A no-action letter is a letter in which we state to a particular person that we do not intend to take regulatory action over a particular state of affairs or particular conduct. It is an expression of our regulatory intent at the time the letter is given that we do not anticipate taking other regulatory action in relation to conduct regulated by the Corporations Act 2001 (Corporations Act), the Australian Securities and Investments Commission Act 2001 (ASIC Act), the National Consumer Credit Protection Act 2009 (National Credit Act), the National Consumer Credit Protection (Transitional and Consequential Provisions) Act 2009 (Transitional Act) or any other legislation that ASIC administers.”<sup>2</sup>*

ASIC goes on to describe the purpose of no action letters and some general limitations:

*“A no-action letter is used to provide comfort and some level of certainty to an applicant on the basis that we do not currently foresee that we will take other regulatory action in relation to the conduct. It is not, however, a guarantee that ASIC will not take action in the future, nor is it intended to affect the rights of*

<sup>2</sup> ASIC Regulatory Guide 108, December 2009, page 4.

*third parties to take action in relation to any contravention. It is not legal advice and may be withdrawn at any time.*<sup>3</sup>

In the MDA context, the no action letter refers to a letter from ASIC to the Investment and Financial Services Association (now the Financial Services Council) in November 2004 that granted relief to MDA operators operating under limited power of attorney (we will call them 'Limited MDA operators') to provide services that are offered only within a single regulated platform. In general terms, relief is granted from the obligation to hold a financial services licence covering the provision of MDA services, to register the MDA service and to supply relevant disclosure documents. The no action letter makes it plain that the relief is temporary. It implies that the period of relief will be short.

A copy of the no action letter is provided as Attachment 1 to this paper. Please also see the table below that sets out our understanding of the obligation of Limited MDA operators working under the no action position relative to those who operate under a full MDA operator's authorisation on their AFSL.

**Please note:** this or anything else in this paper, should not be taken as legal advice and readers should obtain their own legal advice before taking any action in relation to developing or offering managed account services. Please refer to the disclaimers on page 2 of this document.

Over 9 years after its issue, the no action position has not been withdrawn and many financial planning businesses have relied upon it to provide MDA services. Our perception is that when ASIC commenced its review of MDA regulation in early 2012, they were surprised at the extent of reliance on the no action position. ASIC has provided a strong indication in Consultation Paper 200 that the no action position will be withdrawn when amendments to MDA regulation are finally announced and that those relying on the no action letter will need to:

- a. Become fully licensed as an MDA operator themselves; or
- b. Identify a third party MDA operator that can provide that service to their clients as part of an integrated service delivery; or
- c. Cease providing MDA services; or
- d. Offer managed account services via a registered scheme in compliance with all the obligations of that regime

within whatever transition period/s are prescribed by ASIC.

In the "no action" MDA model, financial planning firms typically use model portfolio functionality on their platform to adjust client portfolios under a limited power of attorney. Clients are often assigned to a particular model portfolio and are updated en masse when the planning firm determines that a change in the model portfolio is required or a rebalance is due. Under the relief granted the planning firm does not require MDA operator authorisation under its AFSL and is not required to comply with all elements of the relevant class order (CO 04/194). Using limited MDAs in this way avoids the need for time consuming statements of advice (SoAs) when rebalancing portfolios of investments already on a regulated platform. SOAs are still required to recommend funds moving on or off a regulated platform.

Public submissions made to ASIC post the release of Consultation Paper 200 as part of the industry engagement process would indicate that there are some influential organisations that are keen to preserve the no action position. It is difficult to speculate whether these submissions and any subsequent lobby efforts will be successful. Our current view is that while it is likely that the no action position will be withdrawn, it is by no means certain.

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<sup>3</sup> Ibid

**Table 1: MDA Conditions / Obligations when operating under the no action letter.**

MDA Condition / Obligation	Full MDA licence	"No Action" Letter <sup>1</sup>
Qualified relief from Chapter 5C (MIS provisions), Chapter 6D (fundraising provisions) Part 7.3 (PDS requirements) of the Corporations Act	✓	✓
AFS Licence required	✓	✓
Specific AFS Licence Authorisations (MDA)	✓	✗
Additional disclosure in Financial Services Guide (FSG)	✓	✓
MDA contract required	✓	✓
Investment Program required	✓	✓
Annual review of Investment Program	✓	✓
Portfolio assets must be managed as a discrete portfolio	✓	✓
Required to give a PDS for a product acquired under the MDA to the investor	✗	✗
Obligations to report non-compliance with CO 04/194 to ASIC	✓	✗ <sup>4</sup>
Quarterly and annual reporting obligations	✓	✗ <sup>3</sup>
Able to invest in unregistered scheme	✗	✗
Professional indemnity insurance requirements	✓	✗ <sup>4</sup>
MDA Audit required	✓	✗
Must be administered/executed on a "Regulated Platform" <sup>2</sup>	✗	✓
Limited Power of Attorney required	✗	✓
Invest in investments not available through platform/IDPS	✓	✗
Contribute and withdraw funds from platform without SoA	✓	✗

(1) Copy of 'No Action' letter provided as attachment 1 of this document

(2) Regulated Platforms are described as IDPS, IDPS-like schemes, Super wraps & Master Trusts. CP 200 proposes the definition of 'Regulated Platform' be an IDPS, IDPS-like scheme or superannuation entity.

(3) No specific requirement under 'No Action' letter but reports provided through Regulated Platform.

(4) No specific requirements under the "No Action" letter to comply with relevant requirements under CO 04/194 but general obligations included as AFSL conditions.

### Access methods for SMA, IMA and unitised funds

The table below sets out the service features that are typically available via SMA, IMA and unitised funds.

Service Features	Type of Discretionary Portfolio Management Services		
	SMA	IMA	Unitised Managed Fund
Available as unregistered Managed investment scheme under CO 04/194 i.e. a MDA	✓	✓	✗
Available as registered managed investment scheme under Ch. 5C of <i>Corps Act 2001</i> i.e. a MIS	✓	✓	✓
Direct asset ownership	✓	✓	✗
Transparency on investment management	✓	✓	✗
Flexible Tax Management i.e. ability to nominate tax lots when selling	✓	✓	✗
Extensive investment level customisation available	✗	✓	✗

## The regulatory outlook for managed accounts

The regulatory framework for managed accounts offered via registered managed investment schemes is well established and reasonably stable. We make no particular comment on it here other than to say it is just as onerous, if not more so, as the regulation around MDAs.

The regulatory framework for MDAs has been the subject of recent review and is likely to see some change as ASIC more formally recognises the role of MDAs in the mainstream of investment management solutions. This section focuses on the regulatory outlook for MDAs.

Since 2011 there has been a significant increase in the number of applications for MDA authorisations, reflecting the increasing use of MDAs by the planning industry. This growing popularity is partly driven by a better understanding of the efficiencies that MDAs can bring to an adviser's business, particularly in the context of the new Future of Financial Advice (FoFA) regulations. As with any licensed activity, the MDA operator must be able to demonstrate to ASIC that it has the relevant resources and experience to undertake MDA activities, noting that running MDA operations requires specialised experience and skills, beyond determining whether an MDA service is suited to an investor's needs<sup>4</sup>.

Anecdotally, ASIC has tightened up considerably on the granting of MDA operator authorisations and many applications have been denied. Applicants that have been unsuccessful in obtaining a MDA operator authorisation for their AFSL have the option to commence / continue relying on the no action letter for the time being or they can utilise third parties that provide access to MDA operator authorisation, usually in conjunction with MDA administration services.

A detailed description of the roles of different parties surrounding MDAs is included later in this paper along with more information about the different MDA configurations that exist in the Australian market.

As applications for MDA licensing have increased, attention has been drawn to the regulatory regime around these activities, prompting a review by ASIC of its guidance and regulation with the release in March 2013 of its Consultation Paper 200 – *Managed discretionary accounts: Updates to RG 179*. This was the first substantive review by ASIC of MDAs in a decade since RG 179 was originally implemented in 2004.

Amongst ASIC's key proposals in its Consultation Paper are:

- Revoking the no action letters<sup>5</sup> with a two year transition period, and incorporating these issues into ASIC's main guidance and relief.
- Imposing higher financial requirements for MDA operators – operators must hold NTA that is the greater of \$150,000 or 0.5% of assets held in the MDA service (up to a maximum of \$5M) or 10% of revenue earned from the MDA service. NTA requirements increase if the MDA operator also acts as the custodian.
- Improving disclosure for MDA investors, with greater clarity in the MDA contract, investment program, fees, outsourcing arrangements and terminating the MDA service.
- Changes to operations of MDAs involving leveraged or derivative products, where recourse is not limited.
- Clarifying and updating ASIC guidance, particularly in relation to conflicts of interest and alignment with the implementation of broader FoFA changes.

Industry stakeholders provided robust submissions regarding ASIC's proposals, particularly in relation to the potential consequences of removing the no action letters and increasing capital requirements. From these public submissions, it appears that a substantial number of advisers offer their services in reliance on the no action

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<sup>4</sup> Under RG 179 ASIC contemplates a client service model where an adviser (being the External MDA Adviser) provides personal advice to retail clients recommending use of an MDA service, which is provided by a MDA operator. An External MDA Adviser must be licensed to advise on MDAs.

<sup>5</sup> These were issued as temporary positions by ASIC in a letter to IFSA (now Financial Services Council) dated 5 November 2004 and a letter to SDIA (now the Stockbrokers Association of Australia) dated 8 December 2004. See attachment 1 for a copy of the no action letter to IFSA.

letter. The exact number of AFSL holders relying on the no action letter cannot be determined as there is no formal application or designation required. This in itself provides support to ASIC's proposal that these issues be formally incorporated into its regulatory guidance and any class order relief.

ASIC's revised release date of April 2014 for updated MDA regulatory guidance has again been deferred pending the outcome of the Financial System Inquiry and any amendments to the FoFA reforms. Without a revised timetable, the status quo remains, with MDAs continuing to operate as previously. However, revision of the MDA regulatory regime is clearly in ASIC's sights and there is recognition of the growing popularity of the specialised service offering of MDAs. Further, ASIC has made it clear that there is effectively a 2016 sunset date on Class Order 04 / 194, failing any other intervention on ASIC's behalf. Therefore it would appear that ASIC's goal is to issue a replacement Class Order before 2016.

The big question we see is whether the new regulatory guidelines will help clarify the ambiguity regarding some of the MDA operator's obligations, particularly in light of new FoFA requirements, and achieve ASIC's aim of promoting regulatory consistency in comparable financial products and improving confidence in consumers and investors.

## When to use a unit trust with / instead of a managed account

In our view, managed accounts are a vastly superior vehicle to unit trusts for meeting the needs of investors, advisers and financial planning business owners – whether they are being compared to stand-alone unit trusts or unit trusts accessed via a platform.

However, managed accounts are not the perfect vehicle for meeting all portfolio administration needs of retail investors. There are some needs that unit trusts are better suited to and so it is worth understanding when to use unit trusts as part of a managed account service and when to use a unit trust on its own.

Many managed account services will use unit trust investments as part of the range of investments on offer. This often means that managed account investors can have access to directly held securities or managed investments or some combination of the two. How to best use unit trusts in a managed account structure is a topic worthy of your consideration.

### Best use of unit trusts within a managed account

Best Use	Description	Commentary
Access professional management	The range of professional investment strategies and skills that can be accessed via direct investment is still relatively narrow.	While there is a strong move to passive investment management globally, there are still high quality active managers available that outperform relevant indexes with quantifiable skill.
Access offshore markets	Trading offshore markets directly is cumbersome and expensive	The ability to directly trade offshore markets from Australia is improving and this is a positive development. However, it is still cumbersome relative to local trading. One should not lose sight of the research resources required to invest well offshore. Offshore fund managers can be expensive, but the right ones provide excellent value for money.
Currency hedging or other derivative based strategies	Obtaining affordable and appropriate access to currency hedging for retail investors is still best done through a unit trust.	Many managers we research subtract value through their currency hedging activities and we favour strategies where currency hedging is managed by specialists, separate from the underlying asset class management, but still as part of a trust structure. We know of no practical method for providing currency hedging for thousands of individual investors via a managed account if it is not provided within a unit trust structure.
“Wrapping” attractive wholesale products	A PDS must generally be in place for an investment to be available to retail investors.	Often the easiest and most conservative way to make an attractive wholesale investment available to retail investors is to put it in a unit trust. The costs are substantial however and the compliance burden is high – so scale is required.

### When to use unit trusts or an SMA via a registered scheme instead of a MDA

Best Use	Description	Commentary
Very small portfolios	The cost of “knowing the client” and providing annual reviews required by MDA regulation may be too high for small portfolios to bear	MDA regulation requires that the adviser confirm the appropriateness of the investor’s investment program at least annually. The cost of this review will be too high for smaller portfolios – say for \$100k or less – and a multi asset class unit trust with active asset allocation or an SMA via a registered scheme may be the best option. Whether a unit trust or an SMA is the right choice is likely to be a function of the underlying assets.

## Choosing the right managed account for your business

The managed account solution you ultimately select for your business should support your business strategy.

For most businesses, their strategy regarding the investment value proposition they would like to offer their clients, and how they would like to charge for that, is still evolving. Some key questions that might assist planning firms to clarify their strategic objectives as a precursor to evaluating the merit of differing managed account service providers include:

- 1. How well is your business scaling? Are you becoming increasingly profitable as you grow or are costs growing in line with revenue? How motivated are you to explore ways to enhance profitability? Are you willing to make changes to your business in pursuit of higher profitability and improved client service?**

Many financial planning businesses are not achieving growth or are experiencing “profitless growth” where the majority of revenue growth is consumed by expenses that also grow in a linear fashion. Managed accounts can assist by reducing the ratio of support staff to advisers, helping advisers to be more productive and reducing the growth in staff and associated costs that exists with more traditional approaches to advising clients. All this can be achieved while improving client servicing and satisfaction levels. **However**, it does require a commitment to change and not all financial planning businesses are willing to make changes of this magnitude. Firms like Philo Capital can assist business owners and principals to drive this type of change through their business, but the leaders of the business have to commit and lead the change.

- 2. What business are you (the financial planning business) in? What is the key value add your business offers its clients today and on what basis do you wish to compete in the future?**

Relating that to the managed account decision, do you want to compete on advice and service or investment – or something else entirely? Do you have particular advice or investment niches you would like to pursue? If you want to compete on investment, are you best to partner with specialists or develop internal capability. If you wish to go internal, how realistic is it to compete with specialist providers in this discipline? Do your organisational competencies and resources align with the areas that you wish to hang your competitive hat on or if you are planning to hire this expertise, do you have a clear idea of the number and cost of expert resources required? Can you get more “bang for your buck” by deploying capital to build from scratch or by adapting and extending existing services?

- 3. How do you think your clients would rate your firm on investment capability? Are you retaining clients by innovating and surprising them on the upside, or are you relying on relationships and investor inertia?**

Many planning firms were fearful of the opt in provisions that were proposed as part of the FoFA regime. Some practitioners went so far as to comment in the public domain that they were not confident in their value proposition regarding investment. Any business that has trouble articulating its investment value proposition or is not confident it can survive scrutiny should be looking at rectifying that situation with some urgency. Do you feel a need to be more proactive in locking in existing clients?

- 4. If you found yourself competing for a prospect with another firm with a very strong value proposition around investment management, would you be confident in winning the prospect?**

This is another way of asking if you are prepared for an increasingly competitive market. Investment capability is ultimately the most enduring need of investors. While strategic advice needs periodic review, it is in essence a “point in time” service whereas investment is a never ending 24 x 7 issue. If your investment services are not outstanding, your firm is vulnerable.

- 5. How clear is the investment philosophy of your business? Are you in a position to provide clients with clear messages in this regard that you can live and die by? Do you need assistance with clarifying / distilling your beliefs and aligning your investment activities to them?**

Whilst it is undeniably important to choose the managed account configuration that best suits your business, that issue borders on being inconsequential relative to the issue of getting your investment philosophy clear and your investment activities aligned with that philosophy. Clarity of investment belief creates conviction and purpose in your business and supports decision making, service development and marketing. Unfortunately many financial planning firms either do not have clearly articulated beliefs or have made statements that they cannot support and have no real conviction in. Your managed account service should reflect your investment philosophy being applied in practice.

**6. What scope of investment services do you wish to offer? For example some financial planning practices in the United States no longer use active fund managers. Would you do this in your business? Alternatively, some practices have a strong preference to be able to offer direct security portfolios. Is that important to you?**

Seeing peer firms implement differing strategies can add to the confusion as to what is the right thing to do, particularly in an industry where myth often masquerades as fact. If you do not believe in active management, your managed account service should be constructed to reflect that. Similarly if you do believe in active management your portfolios should be supported by strong research and skills of the managers you have chosen. If you see use of direct investments as the way of the future, then your managed account service should include strong capability in this regard. If you are not sure what you believe in (and many planning groups are genuinely unclear on some of these issues) it is far better to not try and “bluff” your way through. Rather, engage parties that can assist you to work through the issues and then put your stake in the ground. It is important to ensure that your investment beliefs are grounded in facts that can be drawn on when the philosophy needs to be justified or explained.

**7. Does your business aim to have reasonable consistency in client service and advice or are you comfortable that each adviser should be the main decision maker and influence on what the client experience will be?**

Historically, the experience that investors have when being serviced by non-aligned planning groups in particular, has varied enormously depending on the adviser allocated to the client. Is that the way you wish your business to operate? Is that a conscious decision or just an outcome that has occurred because it has not been clear how a more consistent approach could be practically achieved? By using managed accounts it is possible to deliver more consistent servicing of clients, without diminishing the opportunity for advisers to bring their own personality and skills to the role. The best managed account providers understand the dynamics of this and can consult to your business on how to achieve increased service consistency and higher client and adviser satisfaction levels.

**8. How often would you like client portfolios to be reviewed and adjusted in an ideal world?**

Most planning firms like the idea that client portfolios can be reviewed and adjusted more frequently, as clients like to see the nexus between their portfolio settings and what is happening (and expected to happen) in financial markets. In your ideal world, how often should client portfolios be reviewed? Managed accounts can make it easier and more affordable for portfolios to be reviewed more often.

**9. What level of portfolio customisation would your clients require?**

Is yours a client base that likes to feel they are getting a highly tailored service? Or are your clients relatively unengaged on investment issues and simply seeking simplicity or lower cost? The ability of different managed accounts to support customisation of client accounts in a manner that is scalable across a client base varies remarkably. Some functionality supporting limited MDAs, SMAs and IMAs is a long way behind the more scalable service offerings in the market. Just how much that matters to you will have a bearing on the ability of those providers to meet your current needs. We advocate that you identify examples of the ways that you would like to customise and test these needs on the managed account

provider. Once you understand what can be customised, it is important to then understand how scalable the solution is and how efficient the portfolio reweighting process is.

**10. What proportion of your client base is below say \$100k in size?**

This will have a bearing on the extent to which you need a SMA via a registered scheme or a unit trust to support an MDA service.

**11. Does your business currently pursue or is it planning to pursue, objectives based planning?**

The more important it is to you to engage your clients on probability of investment outcome, risk management, transparent expectation setting etc., the more likely you are to need a managed account service with an investment framework that incorporates strong asset allocation and investor engagement capability.

**12. Is your firm or your dealer (where applicable) likely to obtain MDA operator authorisation on your AFSL?**

If the answer is “no” then you probably need to engage a managed account provider that can act as the MDA operator or use a managed account offered via registered managed investments scheme.

**13. How good is your fee structure at aligning interests with your clients? Do you have particular goals regarding strength of alignment? Have you considered your fee structure options and which ones will be most acceptable to your clients?**

Do you have a strong alignment with client interest via your current pricing model, or do you feel that can be improved? Most managed accounts will provide a revenue model for planning firms that can enable a revenue stream to be generated by the planning firm. The transparency and sustainability of those revenue streams vary materially. It is worthwhile thinking about what fee models you are happy to work with and defend.

**14. Do you need assistance with creating a new revenue stream for portfolio management at the time you introduce managed accounts to your clients? Do you need assistance with structuring your future pricing?**

The ability of managed accounts to assist with this task is highly variable. While most will have a theoretical solution, the number that have achieved material commercial success and can offer genuine insight is more limited.

**15. How far do you want these alignment principles to extend to your managed account and platform providers? i.e. how do you feel about platforms clipping the ticket on trades, only offering related party broking services, collecting fees on IPO's accessible through them etc? Can you tolerate these practises or are all / some of them a show stopper?**

If the practises described above are unacceptable to you, a number of providers will not be compatible with your requirements or will need to change their business model to become eligible providers.

**16. How much operational risk are you willing to bear in your business?**

The answer to this question may impact whether you even seek to become an MDA operator or whether you outsource the functions associated with regulatory and commercial accountability for the managed account service to a third party.

**17. How much retail superannuation business do you do / intend to do?**

If retail super is a significant part of your business then some managed account solutions look significantly less appealing as they do not cover this type of investor.

The best managed account providers, like Philo Capital Advisers, can provide you with significant assistance to address these sorts of questions.

## Conclusion

Managed accounts offer a rare opportunity to advance the interests of investors, advisers and business owners at the one time. The range of needs that managed accounts can meet is broader than most people realise and the variations between managed account providers are significant. Learning more about managed accounts in general and taking time to properly understand the variations between different providers is a very worthwhile undertaking for any financial planning firm contemplating use of managed accounts. We trust this paper has made a useful contribution to your knowledge concerning managed accounts and welcome any questions you may have.

In **Part C** of this paper we provide a more detailed examination of the different roles involved in operation of a managed account and the different business models that exist in the managed accounts market. We critically analyse each model and score each model on a range of assessment criteria. Part C is a private document that Philo uses in strategic planning with organisations that have an ongoing commercial relationship with Philo.

More information on Philo's services is available at the end of this paper.

## Attachment 1 – Copy of “No Action Letter”



11 NOV 2004

**ASIC**

Australian Securities &amp; Investments Commission

5 November 2004

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 GPO Box 9827 Melbourne VIC 3001  
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Dear Philip

**Managed Discretionary Accounts:  
 Limited powers of attorney and regulated platforms**

I refer to your letter dated 18 October 2004.

We note that IFSA is seeking relief for MDA operators who hold a limited power of attorney valid only within a "regulated platform", such as an investor discretionary portfolio service, superannuation wraps and master trusts. In this letter, a reference to a limited power of attorney is to a power of attorney that authorises these operators to transfer funds between investments offered via a regulated platform, but not to contribute or withdraw funds.

ASIC is prepared to consider whether certain relief going beyond current ASIC Class Order [CO 04/194] may be appropriate for these operators, both to facilitate the use of limited powers of attorney and to avoid any duplication of reporting requirements already imposed upon the providers of the regulated platform. We will in the next few months make a decision on the matters raised by you and, if necessary, modify our policy.

In the meantime, and on the conditions set out below, ASIC will take no action against MDA operators holding limited powers of attorney for any failure to:

- a) hold a financial services licence covering the provision of the MDA service (under Part 7.6 of the Act);
- b) register the MDA service as a managed investment scheme (under section 601ED of the Corporations Act);
- c) give a product disclosure statement for the financial product which is the MDA service (under Part 7.9 of the Act); or
- d) give a product disclosure statement for a financial product acquired by a client, or a prospectus for securities offered to the client, as part of the MDA service (under Chapter 6D or Part 7.9 of the Act).

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We have adopted this position on condition that the MDA operator complies with:

- a) subject to the exceptions in this paragraph, the requirements set out in paragraphs 1.11 to 1.18 (inclusive), 1.20, 1.21, 1.24 and 1.25 of ASIC Class Order [CO 04/194], as if the class order applied to the person or entity holding the attorney, as an MDA operator. However, we will not require compliance with paragraphs 1.11(g) and 1.12(e)(i) of the class order;
- b) any other applicable requirements of the *Corporations Act 2001* with respect to the MDA service (including any provisions dealing with Financial Services Guides and Statements of Advice for investment programs); and
- c) if applicable, any AFS license conditions relating to discretionary portfolio services.

Amongst other things, these requirements will enhance the disclosure given in the Financial Services Guide and Statement of Advice, implementing paragraphs PS179.36-179.43 and PS179.50 of ASIC Policy Statement 179 "Managed discretionary account services".

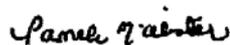
Please note that ASIC's general policy with respect to no action positions is set out in Policy Statement 108. We will revoke our no action position after further considering the issues you have raised and finalising any necessary changes to our policy. Of course, before revocation we will allow a period for those people relying on it to transition to any modified policy.

You should not assume from this letter that ASIC is inclined to exempt MDA operators holding limited powers of attorney from the requirement to hold an Australian financial services licence authorising them to operate the MDA service. As a practical matter ASIC accepts that licence conditions cannot be finalised until the content of the regulatory regime for such participants is determined, including resolution of any duplicated requirements. Accordingly, ASIC has agreed to take a short term no action position for failure to obtain an Australian financial services licence on the conditions set out in this letter.

I note that IFSA supports the relief application made by Trustee Corporations Association of Australia (TCA) in relation to the provision of services to clients who are *non compos mentis*, for the reasons set out in paragraphs 38 to 43 of your letter. We are presently considering this issue and will keep you informed of any developments.

If you have any questions or wish to discuss this matter further, in the first instance please contact John Price on (03) 9280 3639.

Yours sincerely



Pamela McAlister  
**Deputy Executive Director**  
**Financial Services Regulation**

c.c. Kerrie Kelly - FPA

## About the authors



Brett Sanders is joint CEO of Philo Capital Advisers and has overall responsibility for the design and management of Philo's managed discretionary account services.



Mathew Birch is head of consulting and implementation at Philo Capital Advisers. Mathew has extensive experience in the implementation of MDAs in financial planning businesses.



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## Acknowledgement

We would like to acknowledge the contribution of those that reviewed this paper and suggested amendments that both aided clarity and delivered additional insights. Thank you so much.

## Disclosure of Interest

Philo Capital Advisers is a provider of a range of portfolio construction and management services, including managed accounts. It is only fair to acknowledge that the analysis contained in this paper is influenced by Philo's business philosophy, perspective and experience in relation to managed accounts. Philo stands to benefit from the growth in use of managed accounts and in particular managed accounts offered in the service configurations that Philo favours.

We established Philo Capital Advisers with a keen desire to provide leading investment management services to the market and began with a clean sheet of paper. The choice of managed accounts as the primary means by which portfolios would be administered was a choice made after consideration of competing alternatives and with first hand experience operating managed accounts and seeing them applied to financial planning relationships. The *form* of managed account Philo offers was determined by careful evaluation of the managed account models in the market place carried out before a material investment in service development was undertaken. That service development is continuing. In that sense we have "put our money where our mouth is" and in this paper we are sharing some of the thinking that led us to making our own decisions.

## Philo Overview

At the time of writing Philo administers and provides portfolio management for over \$2.9 billion in managed account funds in addition to managing \$1.1 billion of non-managed account money. To our knowledge we have been Australia's fastest growing provider of managed account services in the past 2 years. Our investment approach has been running with live portfolios for over 3 years and performance has been excellent.

Philo's role in achieving these successes extends beyond investment management functions such as asset allocation, portfolio management and managed account administration to a range of implementation and support services. These have included training, policy creation, client communications and much more.

We have also had the great fortune to work with committed management and advisers at our foundation client and we thank them sincerely for their support and patronage.

## Philo Services

Our core services include:

- Dynamic asset allocation
- Listed portfolio management for shares, property and income securities
- Unlisted investment evaluation and blending
- Investor communications
- Practice management consulting and training around the customisation and implementation of managed accounts
- Managed account administration
- Separately Managed Accounts (SMAs)
- Individually Managed Accounts (IMAs)
- Limited MDAs

Philo can act as the managed account administrator or also provide services as an MDA operator under Philo's AFSL.

We have significant intellectual property around all of the above aspects of service provision that client firms can benefit from. Our experience in successful managed account development and delivery can greatly improve speed to market and reduce execution risk.

Our services extend well beyond investment management and portfolio administration and can be used to greatly enhance the investment value proposition of any business. In our opinion the services Philo clients can deliver represent best practice in Australian financial services.

We are available to assist financial planning firms that would like to scope out the issues surrounding implementation of managed accounts in their business.

Philo welcomes enquiries from any organisation wishing to investigate the potential for integrated managed account services to help grow their business and drive their profitability.

$$\sigma_p = \sqrt{(w_A^2 \sigma_A^2 + w_B^2 \sigma_B^2 + w_C^2 \sigma_C^2 + 2w_A w_B \text{Cov}_{AB} + 2w_A w_C \text{Cov}_{AC} + 2w_B w_C \text{Cov}_{BC})}$$
$$(E(r_M) - r_f) \beta_i = \rho_{i,M} f(x_i) = e - \frac{((x_i - \mu)/\sigma)^2}{2} \frac{1}{\sigma \sqrt{2\pi}} \sum_{n_i=1}^{\infty} \dots$$
$$\text{CAPM: } E(r_i) = r_f + \beta_i (E(r_M) - r_f)$$
$$\sigma_p = \sqrt{\frac{1}{n-1} \sum_{n_i=1}^n (x_i - \mu)^2}$$



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