Fixed Income Mutual Funds, ETFs, and SMAs In Perspective

Charting a course through the confusion

There are a wide variety of investment vehicles to consider when building a portfolio. To the average investor, the selection process can be confusing and overwhelming. Investments are often known by their acronyms rather than by their names, and, have disclosure requirements, fees, and other information that can be challenging to understand. In short, constructing a portfolio that best suits individual risk profiles and preferences can be a complicated and time-consuming activity.

With that in mind, we are offering the following synopsis as a primer on the key differences between three of the more popular vehicles offered in the fixed income marketplace: mutual funds, exchange-traded funds (ETFs), and separately managed accounts (SMAs). It is our intent to have the information provide a better level of clarity and understanding, so that it can be used as a guide to help navigate an often complex fixed income marketplace.

	SMAs	ETFs	Mutual Funds
Liquidity	Good	Better	Better
Diversification	Moderately Diverse	More Diverse	More Diverse
Customization	Yes	No	No
Investor Tax Efficiency	High	Moderate	Moderate
Holdings Portability	Available	Limited Availability[1]	Limited Availability[1]
Holdings Disclosure	Daily	Daily[2]	Quarterly[3]
Minimums	High	Very low	Low
Fees	Variable	Low	Low to moderate

[1] Mutual funds and ETFs may permit in-kind contributions and redemptions in certain circumstances.
[2] Certain ETFs disclose holdings less frequently than daily.
[3] Many mutual funds disclose portfolio holding more frequently on their public websites.

Fixed Income Mutual Funds and ETFs: Diversification, Liquidity, and Affordability

Fixed income mutual funds and ETFs are pooled vehicles in which investors buy shares in the vehicle's ownership. The underlying assets are owned by the mutual fund or ETF and are commensurate with the vehicle's stated investment style. Typically, mutual funds and ETFs are designed to provide diversification within an asset class or sector for investors. This broad mix of holdings seeks to mitigate the performance risk of defaults and downgrades within a portfolio.

The two vehicles have other similarities and potential benefits. Mutual funds and ETFs are highly liquid, with proceeds from share liquidation typically available to the investor within one business day. Both vehicles' minimum investments are more attainable than other options. The minimum investment in mutual funds and ETFs are often \$500 or less—and investment options are plentiful. For example, many mutual funds and ETFs can invest in bank loans, the high yield market, and less liquid debt instruments. Income generated by both mutual funds and ETFs is typically distributed on a monthly basis.

Mutual funds and ETFs also have their differences. For example, they have different ways of setting their buy and sell prices. Mutual funds determine their share price—their net asset value (NAV)—at the end of the day, based on the value of the underlying assets. ETFs trade like equities, with buy and sell prices fluctuating throughout the trading day based upon price changes in the underlying assets, as well as supply and demand for the ETF.

Another difference between mutual funds and ETFs is their disclosure of underlying holdings. Mutual funds are required to disclose their holdings on a quarterly basis, and the majority of ETFs tend to post their holdings daily. Therefore, investors looking for greater transparency may want to select an ETF over a mutual fund.

One more detail to evaluate in deciding whether a mutual fund or an ETF is right for you, is cost. Both mutual funds and ETFs have various types of fees. Their expense ratio is comprised of a management fee and other operating costs. Mutual funds can also have sales fees, known as front- and/or back-end loads. ETFs are generally considered to be less expensive than mutual funds; however, ETFs have implicit and explicit costs, potentially including commissions.

SMAs: Individual Ownership, Customization, and Tax Efficiency

Another popular investment vehicle that may be invested in fixed-income securities is the SMA. SMAs are accounts in which individuals own the underlying securities instead of being in a pooled vehicle with other investors. These investment vehicles also tend to focus on the more liquid, investment grade portion of the fixed income markets, although they do not invest in this segment exclusively.

The fixed income industry has seen significant growth in SMAs over the past decade, with increasing investor interest stemming from the distinctive structure of the accounts, the ability to customize, and their capacity for tax efficiency. SMAs may also have the benefit of mitigating downside risk during volatile markets, in that their tailored structures may provide some insulation against other investors selling into weak markets. Investors in SMAs can choose when and how they access liquidity, and this may enhance performance over time and/or reduce trading costs.

Two key elements that make SMAs appealing are the ability to customize an investment strategy and the ability to harvest gains or losses for tax purposes. Many SMAs that invest in fixed income securities allow customization in the area of duration, credit quality, and for municipal bond strategies, state of preference in order to own securities that are not subject to state income taxes. Additionally, an SMA investor can choose to harvest gains or losses on specific securities, irrespective of whether the portfolio as a whole is in an unrealized gain or loss position. This is a distinctive benefit.

Another benefit to SMAs is that investors can see the specific bonds they own, as well as all transactions in those bonds, as they are posted to their account. Lastly, investors' needs may change over time. Fortunately, an SMA provides the flexibility to transfer specific securities to new advisors and custodians when changes occur in relationships and financial plans, representing another benefit, and one that mutual funds and ETFs are not able to offer.

As with any investment vehicle, however, there are trade-offs. SMAs tend to require larger minimum account sizes, making them less attainable than mutual funds or ETFs. In most cases, the minimum account size for a fixed income SMA is $250,000 or more. SMAs also typically hold fewer positions than a mutual fund or ETF, which is a potential drawback for investors seeking broad diversification.

Summary

All investment vehicles have benefits and trade-offs, and we believe that knowing and understanding them is important for building investment portfolios. Factors for investors to consider may include, but are not be limited to, the size of allocation, fees, investment strategy, and liquidity needs. As always, please consult with your financial advisor or fixed income specialist to understand these options in greater detail.

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