A popular question that often arises in conversations with advisors around fund structures and investment vehicles is:

*What is the difference between a separately managed account (SMA), a mutual fund, and an exchange-traded fund (ETF)?*

There are subtle nuances between each structure, but the answers are not as complicated as they may seem. In short, it boils down to structure.

With mutual funds and ETFs, investors have an ownership interest in a fund, and the fund owns the underlying securities. With an SMA, however, the investor directly purchases and owns individual securities.

### Exhibit 1: Pros and Cons of Different Investment Wrappers

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Index Mutual Fund</th>
<th>Index ETF</th>
<th>Direct Indexing (SMA)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tracks an Index</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Ownership of underlying securities</td>
<td>×</td>
<td>×</td>
<td>✓</td>
</tr>
<tr>
<td>Portfolio Personalization</td>
<td>×</td>
<td>×</td>
<td>✓</td>
</tr>
<tr>
<td>Tax-loss Harvesting at individual tax lot level</td>
<td>×</td>
<td>×</td>
<td>✓</td>
</tr>
<tr>
<td>Low Investment Minimums</td>
<td>✓</td>
<td>✓</td>
<td>×</td>
</tr>
</tbody>
</table>

Source: Morningstar Wealth.

When it comes to personalization, there is likely no greater tool than an SMA for investors.

If you don’t want to hold an individual security (or multiple securities), for example, that’s no problem at all. Whatever securities you don’t want to own would simply be excluded from the account.

For example, say a client wants exposure to U.S. stocks but would like to exclude tobacco companies, that can be accomplished with direct indexing. And tobacco is only a single example — many other exclusions can be implemented as well.
By comparison, it may not be easy, or even possible, to find a mutual fund or ETF with the same exclusions you desire.

But what about tax personalization?

Here again, an SMA is best practice for investors. Mutual funds and ETFs are able to realize losses, but those losses can only be used to offset gains realized within the fund. Mutual funds and ETFs are prohibited from distributing losses to investors. If there are more realized losses than gains at a fund, those losses can be carried forward into the future.

The best case scenario for funds is that they avoid distributing a capital gain to shareholders.

But even in years like 2022 where most financial assets fell in value, that can be difficult. We saw this reflected in mutual funds last year: despite the average large cap mutual fund falling nearly 18%, the average capital gain these funds distributed was nearly 8%.

Exhibit 2: Large Cap Performance (2022)

-17.8%
Average Large Cap Mutual Fund Performance 2022

7.9%
Average Capital Gain 2022

Source: Morningstar Direct. All institutional share class large cap mutual funds. As of 12/31/2022.

But with SMAs, any losses realized in the portfolio belong to the end client and can potentially turn a tax drag into a tax benefit.

This isn’t to say that SMAs are better than mutual funds and ETFs—people have been forecasting the end of these popular investment vehicles for years, and yet they have survived.

Instead, where personalization is desired, at both the investment and tax levels, SMAs may be a wise choice for investors to consider.

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