The ‘tailored’ approach

The advantages of separately managed accounts in today’s market

by Payson Newman

Working with a separately managed account (SMA) is like tailoring custom clothing rather than purchasing it off the rack, but without the cost premium that usually comes with it. Every element is constructed around the client’s specific needs, resulting in a better fit, more appropriate function and a more efficient use of resources. Similarly, SMAs allow institutional investors to construct real estate portfolios precisely tailored to fit their specific risk and investment objectives, rather than adapting to a standardized commingled fund structure.

SMAs, in their simplest form, are investment structures in which a single investor owns and controls a dedicated portfolio of real estate assets. It is important to briefly recognize the difference between an SMA and a joint venture, as the latter includes co-investment from the manager. For the purposes of this piece, the term SMA is often used to refer to either structure, despite their distinct legal differences. Unlike commingled funds, which serve multiple investors with potentially different goals and objectives, an SMA is formed to meet the specific objectives and preferences of a single client. Most SMAs are structured as “evergreen” vehicles, which have no fixed end date and allow capital to be invested and reinvested over time, further enhancing flexibility and long-term alignment. Just as a tailor takes exact measurements to ensure the item fits the individual perfectly, an SMA is structured to meet the client’s specific requirements for property type, geography, risk profile, return targets and hold periods.

This customization extends beyond initial portfolio construction. Much like tailored clothing can be adjusted over time to maintain a perfect fit, an SMA allows an investor to engage actively throughout the life of the investment vehicle, while having the added benefit of allowing the client to get “closer to the properties” by actively participating, if they desire, in key leasing, capital, financing and sales decisions. This can result in higher degrees of control for the client, which is especially important when market conditions shift. In a commingled fund, individual investor goals can diverge quickly, and agreements on what is best for the investment vehicle and underlying properties can differ based on each investor’s needs. In contrast, in an SMA, a client can negotiate varying levels of inputs, for example, discretion, on a number of portfolio or property-level decisions. Additionally, this allows SMA clients to form real-time understandings of the transaction markets, along with a deeper knowledge of geographic markets and submarkets, not otherwise available in the traditional commingled fund model.

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Adjustable threads

SMAs enable investors to concentrate capital on high-conviction opportunities — and still manage diversification effectively. *Diversification: Friend or Foe?,* a 2017 white paper by Aviva Investors, analyzed more than 1,000 properties and found that portfolios with just 15–20 assets achieved nearly all the diversification benefits of much larger portfolios. This challenges the assumption that large, broad-ranging commingled funds are required to reduce both market- and property-specific risk. The study also showed that concentrated portfolios outperformed peers that were more

closely aligned with benchmark indices, since managers were able to focus on their best ideas through fewer, targeted assets. SMA structures are uniquely suited for this kind of focused, high-conviction strategy.

SMAs also provide a flexible framework for risk management. Clients can construct portfolios to meet their specific needs regarding diversification, leverage, lease maturity schedules, concentration and liquidity. Just as a tailor chooses construction techniques and materials based on how an item will be used — durability for travel, lightness for summer, formality for events — SMAs allow clients to shape portfolio risk precisely to match their evolving goals and objectives. The ability to manage these factors directly with the manager ensures the risk profile remains aligned with the client's overall strategy. Additionally, SMAs eliminate the inherent counterparty risk that can come with commingled fund structures.

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The SMA model supports cost efficiency. SMAs are not burdened by the elevated formation costs associated with having multiple investors as well as multiple fund closings. The lower up-front administrative expenses for an SMA can allow the client and manager to avoid the misaligned economic incentives many fund managers require to recoup these up-front costs, which may include transaction-based fees or, more often, a fee on unfunded commitments in closed-end funds. Much like working directly with a tailor avoids unnecessary retail markups, SMA clients generally have transparency into line-item fee details and can specifically limit allowable fee pass-throughs for the partnership, thus further aligning the fee structure to meet their portfolio objectives. Further, the level of manager co-investment, performance fees and base management fees can be structured to maximize the alignment between the client and manager and to meet the specific investment objectives of the SMA.

Stitch by stitch

Importantly, SMAs provide five important features for a client's portfolio construction.

- **Patient capital deployment:** With an SMA, the manager is not incentivized to deploy capital in a predefined period but can instead construct a portfolio based upon underlying market opportunities without the need to adhere to a specific investment period. In addition, fundraising for follow-on closed-end funds typically commences once a fund gets to a certain amount of capital deployed, over which the investor has no control. Just as a tailor waits for the precise measurements before cutting, SMA investors can wait for the right opportunities, investing only when the fit is right.
- **Disposition flexibility:** Disposition flexibility is another distinguishing feature of evergreen SMAs. Funds with fixed expiration dates can create pressure to sell assets, even in unfavorable market conditions, to close the fund. In contrast, SMA investors can control the timing of dispositions based on portfolio strategy, like replacing a suit when it no longer fits your needs, not because a date on the calendar says it must be done. In addition, when a manager is already "in the promote," they may be incentivized to avoid riskier investments or those with longer hold periods to protect their promotion, even when those decisions are not aligned with the client's objectives. With an evergreen structure, which is the most common SMA structure, the investor can choose when to exit based on long-term portfolio strategy rather than commingled fund-driven timelines.
- **Minimized time "out of the market":** This is an area often overlooked by the institutional investment community, with real estate portfolios heavily invested in closed-end fund structures. Fund investors have very limited, if any, control rights for liquidation and capital pacing. As a result, capital can be committed, but not invested, for extended periods, including during fundraising cycles. If an investor does not have the capital or is not able to make the closing requirements for committing to the next fundraise, they may have to wait until the subsequent fund is brought to market — usually a few years away — before they can reinvest in the same strategy with the same manager. However, the determination to provide new capital for an SMA rests solely with the investor.

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- **Scalability:** Similar to other open-end structures, SMAs afford the investor the optionality to redeploy capital from distributions, whether it is return on or return of capital, to enable the SMA to scale over time. If a tiered fee structure is in place, this has the benefit of lowering management fees while also creating a more efficient investment process for many investors.
- **Governance:** Due to the lack of counterparties as well as improved termination rights provided to the client, an SMA structure has a clear advantage over commingled funds. SMAs typically include short-term termination provisions, giving the investor the ability to make changes if performance or alignment falters. This reinforces accountability and requires the manager to continually earn the client's trust. There is no need to wait for a fund's life to expire or to navigate complex investor governance before changing course. The client remains in control of their capital and timing. While open-end funds do have quarterly redemption and commitment allowances, the ability to effectively pace the capital is determined by the volume of other investors with the same intent. As evidenced in every market cycle, open-end fund managers are required to protect the value of the investments for all shareholders before meeting redemption requests, which can result in a significant backlog of investor redemptions that, ultimately, may never be met. The opposite holds true with deposit queues, which delay the deployment of capital in a rising market. In contrast, SMA termination rights can include a transfer of the assets as well as liquidation requirements.

Inside the lining

Transparency is a core benefit of SMAs. Reporting can be standardized or customized, and communication is often more frequent and direct than in other structures. Clients can request special reports, receive ad hoc analysis, and adjust reporting cadence as needed. Just as a client can work directly with a tailor to adjust or refine their clothing over time, SMA clients maintain an active, relationship-driven dialogue with managers to optimize reporting and investment transparency at all times. This creates a structure where the client always knows where things stand.

Just as a client can choose every stitch or simply trust the tailor's expertise, SMAs allow flexibility in how actively the client engages. They can be structured to give full discretion to the manager or allow for a more hands-on client role, depending on what the client desires. In an SMA, it's the client, not the structure, which defines the relationship.

The collaborative engagement model developed between a client and manager within SMA can ease the staffing constraints of most investors by allowing the manager to act as an extension of the client's staff, providing relationship-level support and freeing internal resources to focus on other portfolio needs. A typical misperception is that SMAs require additional resources for an investor. Experience has shown the inverse to be true. Rather than travels dictated by the manager for two-day investor meetings, the SMA investor can determine their own travel schedules while simultaneously gaining a deeper understanding of their manager and portfolio. That said, responsiveness to portfolio communications that is commensurate with the level of decision authority a client desires is a necessary trait for a successful SMA partnership.

Final fitting

Lastly, the unique nature of an SMA being a highly tailored investment structure means that it can have greater flexibility and creativity in investment scope, fee arrangements, risk tolerances and investment guidelines. A case in point is the allowance for the transfer of stabilized properties from a value-added SMA structure into a core SMA vehicle. This unique attribute allows the client to define what value-added investment risks may be employed, but with the added advantage of then retaining these core properties at a lower fee basis and avoiding the need to repurchase similar assets in a competitive market. If structured properly, the investor benefits by eliminating the frictional trading costs typically incurred from buying and selling, and eliminating information asymmetry.

As institutional investors continue to face evolving market pressures, the enhanced efficiency, flexibility and alignment built into the SMA structure make it an attractive option. It is a model that emphasizes collaborative partnership engagement, transparency and optimized strategic control rights. While not suitable for every institution or investment profile, SMAs allow for greater oversight and long-term alignment with managers in today's rapidly changing environment. ❖

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