

Is a separately managed account for you?

A discussion of differences between
mutual funds and separately managed accounts

By Barry Lewis

MFS Investment Management® (MFS®) invented the mutual fund over 75 years ago; today, it provides a variety of money management products for individuals, institutions, corporations, and governments around the globe. We hope you find this discussion helpful in deciding which investment vehicles may be appropriate for you.

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MFS: a diversified global money manager

More than 75 years ago, MFS invented the mutual fund with the creation of Massachusetts Investors Trust in 1924. Several years later, we established one of the first in-house research departments in the financial services industry. In the ensuing decades, quality research has become the distinguishing characteristic of our firm. More than anything else, we believe our firsthand, bottom-up MFS Original Research® process has enabled us to deliver a level of performance over time that we feel is exemplary in our industry.

Today, we believe we have an investment team distinguished for its unique blend of talent, continuity, and cohesiveness — a product of our company culture of both teamwork and commitment to quality research. That culture was a key factor in our recognition by *Fortune* magazine as one of the “100 Best Companies to Work For” in America for the past four years.¹ As befits a great team, our people tend to stick around — the average MFS tenure of our portfolio managers is 10 years, with approximately 17 years (as of 12/31/02) in the investment industry. Contributing to this continuity is our policy that all equity portfolio managers are promoted from within the company. And because many of the senior executives who are now managing portfolios or managing the company itself have been working together for well over a decade, we have a cohesiveness, a shared philosophy of investing, and a unity of purpose that we believe bodes well for the future of the company.

With offices in Boston, London, Singapore, and Tokyo, MFS today is a diversified global money manager. As of December 31, 2002, our assets under management exceeded \$112 billion. Working through investment professionals in firms around the world, we manage money in many types of investment vehicles for individuals, institutions, corporations, and governments. For more information on our performance record and on the various investment options that MFS provides, we urge that you consult with your investment professional.

¹ Source: *Fortune* magazine, (January 10, 2000; January 22, 2001; February 4, 2002; and January 20, 2003 issues).

(the public offering price, or POP), or a “back-end” load deducted from the account upon redemption and shown as a line item on the shareholder’s account statement. Front-end loads may in some cases be subject to a sliding scale for larger accounts.

With a separately managed account, a client pays a single, all-inclusive “wrap” fee that covers the complete range of services provided, including portfolio management, trading charges, custody of securities, due diligence, and all consultation with his or her investment professional (development of investment goals, ongoing monitoring of progress toward those goals, manager selection, and quarterly performance analysis). The annual wrap fee for a separately managed account tends to be in the range of 1% to 3% of assets, with a sliding scale for larger accounts. The fee usually is calculated at the end of each quarter, based on the account balance at the end of the quarter. The fee is paid in advance for the following quarter and is shown as a line item on the account statement.

Considering the options

For individuals or organizations with at least \$100,000 available to invest, a separately managed account may be an option worth considering. Many organizations seeking professional money management — but unable to meet the large minimums required by

institutional money managers — have found the separately managed account wrap programs offered by their investment professionals to be a viable alternative. Organizations making use of separately managed accounts have included endowments, charitable foundations, associations, corporate retirement plans, and religious groups.

Separately managed accounts have also become a popular choice for individuals seeking a high level of service and flexibility and are often combined with mutual funds in an asset allocation strategy. Individuals who have received a substantial amount of money as a lump sum — from a retirement plan distribution, the sale of a business or real estate, or the receipt of an inheritance, for example — have often found separately managed accounts to be a useful investment option. For a more complete discussion of various types of investment vehicles and their application to a specific investment situation, individuals and organizations are urged to contact their investment professionals.

Although most of us now take mutual funds for granted, the concept behind them once seemed quite revolutionary. By pooling money with that of other individuals, an investor can participate in a portfolio that is diversified across dozens or even hundreds of securities. With a minimum investment, often as low as \$500, a mutual fund enables an investor to have a professional money manager oversee his or her investment — and usually pay that manager a fee of less than 2% per year.¹ And this investment vehicle is so liquid that it can be bought and sold on a daily basis. It seems amazing that although mutual funds were introduced in the Roaring Twenties, they didn't truly catch fire with the general public until the 1980s.

In the late 1970s, another investment vehicle — the separately managed account — made its debut as a method of offering individual investors the same investment flexibility and high level of personal service enjoyed by institutions that invested large amounts of money. Initially, the price of entry for individuals was around \$5 million. Increased use of technology by a number of investment firms, however, has made it possible to offer separately managed accounts with minimum initial investments as low as \$100,000.

Ownership: the key difference

The key difference between a mutual fund and a separately managed account, or managed account, is what an investor actually owns. A mutual fund shareholder owns shares in a pool of securities owned jointly by all shareholders of the fund. Each share of the fund represents a small interest in each and every security the fund owns. In contrast, a managed account client owns individual securities — stocks, bonds, or any other securities in which the account may invest. These are not commingled with securities owned by other individuals who may invest in similar separately managed accounts.

Beyond ownership, however, mutual funds and separately managed accounts share many of the same features and benefits. Both are managed by professional investment firms, following a stated investment objective. Most adhere to a specified investment style or discipline — large-cap growth stocks, large-cap value stocks, or municipal bonds, for example. However, a separately managed account allows its owner some flexibility in deciding what securities to own, so clients in separately managed accounts handled by the same portfolio manager may each have slightly different holdings. In a mutual fund, on the other hand, the underlying securities are identical for all shareholders.

Diversification is another benefit shared by mutual funds and separately managed accounts. Both invest in a number of securities in an effort to lessen the impact that poor performance of any individual

holding might have on the overall portfolio. The number of holdings in a typical mutual fund can range from dozens to hundreds, while a separately managed account generally invests in a smaller number of securities, typically 35 to 70.

Flexibility and customization

Most of the unique characteristics of a separately managed account stem from its ownership structure. Because an investor in a managed account owns individual securities, those securities can be bought and sold without affecting holders of other managed accounts following the same investment discipline. This allows each account owner some flexibility in restricting ownership of certain securities.

For example, a client who already owns a sizable position in a certain security might specify that the security not be bought for his managed account. Or if an account owner feels uncomfortable owning a specific company — a cigarette manufacturer, for example — he might exclude that company from his managed account. It should be noted, however, that this kind of restriction can result in an account that differs markedly from the separately managed account's discipline in terms of holdings and, potentially, performance. Excessive customization may thus eliminate some of the value added by the portfolio manager.

Owning individual securities rather than shares in a fund may also offer tax benefits. Mutual fund shares

¹Source: Lipper Inc. As of 12/31/02, the average expense ratio of the 17,054 mutual funds tracked by Lipper was 1.36%.

often include “embedded capital gains” — securities purchased by the fund months or years ago that have since risen in price will generate taxable capital gains when those securities are eventually sold. More recent buyers of fund shares may not receive the full benefit of the securities’ price increases, yet they pay taxes on the full capital gains. In a separately managed account, however, a client pays taxes only on capital gains incurred while he or she owns the securities — that is, the cost basis for each security is the price at which it was purchased for the individual managed account.

The owner of a separately managed account may also have some flexibility to manage capital gains and thereby limit tax liability. For example, the owner may request that the portfolio manager harvest some capital losses to offset capital gains or request that holdings not be sold in order to avoid a capital gain. Here again, investors should be aware that overuse of this flexibility may negate some of the benefits of professional management.

Service

A key attraction of separately managed accounts is a high level of service and consultation, comparable to that enjoyed by institutional clients. Services provided by investment professionals to managed account clients usually include establishment of personalized investment objectives, creation of an investment plan to work toward those objectives, ongoing due diligence of portfolio managers, and in-depth quarterly performance analysis.

Before opening a separately managed account, an investment professional will generally spend considerable time with a client establishing financial goals and reviewing all of the client’s assets and holdings. For many investors, separately managed accounts of one or more investment styles may be appropriate as the core of a total investment strategy that may also include mutual funds of complementary styles for diversification. This approach may be particularly useful for clients who want to invest \$100,000 or more in their core investment styles but lesser amounts in noncore styles or in market niches such as particular sectors or regions.

Due diligence is another valuable service provided to

managed account clients. In general, both the portfolio manager(s) and the investment firm managing a separately managed account must undergo a rigorous due diligence process in order to “make the cut” as an account offered by an investment professional.

The process typically includes qualitative analysis of a firm’s people, investment process, and investment research, as well as quantitative analysis of the firm’s historical performance. After initial approval, due diligence is ongoing. Should events such as manager changes cause an investment professional to lose confidence in the manager or the investment firm offering a particular separately managed account, a recommendation may be made that clients transfer their money to an alternative investment.

Comprehensive quarterly reports, explaining how and why performance was achieved, are another key benefit of separately managed accounts. Statements generally include attribution analysis showing how various holdings helped or hurt performance. They may also include discussions of particular securities and why the portfolio manager bought or sold them during the period. Performance against one or more benchmarks for the account’s investment discipline is provided, and peer group performance may also be shown. Because statements show transactions performed for each individual holding, they can also facilitate tax management by making it relatively easy for clients and their investment professionals to see the tax consequences of trades and potential trades.

Fees

Investors in mutual funds may be subject to two general types of fees. Annual operating expenses are paid to the fund management firm and may include various charges such as management fees and distribution and service (12b-1) fees. Industrywide, the annual total of these fees is about 1.4% of fund assets.¹ These expenses are deducted from the fund’s share price, or net asset value (NAV), and are not seen by investors as a line item on their statements.

In addition, investors in funds other than no-load funds may also pay a sales charge to their investment professionals. Usually this takes the form of a “front-end” load calculated into the initial share price

Comparing the features: mutual funds and separately managed accounts

	mutual fund	separately managed account
ownership	Investor owns shares in pool of securities, commingled with assets of other investors	Investor owns individual securities
portfolio holdings	Identical for all investors	Based on a stated investment discipline but may be customized to a limited extent (usually by excluding specific holdings)
minimum investment	Typically ranges from \$500 to \$2,000 per fund	Typically \$100,000 per account
tax basis	May include embedded capital gains going back months or years before investor bought shares	Begins when individual securities are purchased for the investor
tax management	Under sole control of portfolio manager	Potential for client and his/her investment professional to manage taxation of gains
service level	Varies according to investor's needs and style of investment professional	<ul style="list-style-type: none"> • Investment professional typically draws up investment plan and objectives with client • Tends to include a high level of individualized service, consultation, and performance analysis
due diligence	Generally left to the investor or his/her investment professional	Conducted on an ongoing basis by the investment professional's firm
quarterly statements	Typically report performance only	Provide comprehensive portrait of account activity and how and why performance was achieved
fees	<ul style="list-style-type: none"> • Annual operating expenses average about 1.4% industrywide¹ • May also carry sales charges 	Single annual wrap fee, typically 1% to 3% of assets, covers all management, trading, consultation, and other services

Investment return and principal value of both mutual funds and separately managed account investments will fluctuate, and sale proceeds may be more or less than the amount invested. Past performance is no guarantee of future results.



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