Alley Company Commentary
Back to Basics

In the recent era of Wall Street innovation, investors have been lured away from basic investing. Complexity, leverage, and high fees have been commonplace in newly manufactured and marketed products. The addition of 24/7 media coverage of the financial markets has left many investors with the challenge of sifting through the noise.

Investors should look beyond this era by focusing on the basic principles of investing. These principles include: *understanding what you own*, *maintaining appropriate levels of diversification,* and *ensuring* that an investment management program is inherently structured to serve the *unique and changing* needs of the investor.

Separate Account Management vs. Pooled Investments

No two investors have exactly the same investment objectives, risk profiles, or personal preferences. Thus, it only stands to reason that pooled investment products – or one-size-fits-all investment management programs – typically fall short in placing the *unique* needs of the investor first and foremost.

Investors should demand a *customized* investment management program – one that continually maintains flexibility while also delivering high-touch personalized service. This level of customization is best achieved through the utilization of **separate account management (SAM)**.

SAM, unlike pooled investments such as mutual funds, private equity funds, or hedge funds, *segregates* each investor's portfolio in its own separate account rather than *commingling* the assets with other investors that may or may not have like objectives. Under SAM, assets can be managed according to the investor's unique and changing needs.

While both SAM and pooled investments can achieve broad portfolio diversification or specific asset class exposure, important technical and practical differences exist that favor SAM. These differences are depicted in the following table:

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Factor	**Separate Account Management (SAM)**	**Pooled Investments**
Ownership Structure	Direct ownership of underlying securities with all the rights and privileges that accompany direct ownership	Assets pooled with other investors; investors own an interest in a fund, not in the underlying securities/investments; investor results can be impacted by the behavior of other investors
Portfolio Management Structure	Portfolio customization mandates can be achieved; benefit of direct contact with the portfolio manager	Limited, if any, customization opportunity; limited direct contact with the portfolio manager
Tax Efficiency	Custom tax management can be achieved; low basis securities can be gifted; tax-loss harvesting opportunities	Unable to provide custom tax management; investors potentially inherit tax liabilities of a fund; underlying securities are not directly owned and thus cannot be gifted
Transparency	Positions, trading activity, and trading costs are fully transparent on a daily basis	Limited transparency of positions, trading activity, and trading costs; lack of transparency inhibits understanding what you own
Liquidity	Direct ownership of underlying securities, thus highly liquid	Traditional mutual funds are typically liquid; private equity funds and hedge funds can be illiquid

Beware of the "Middleman"

Due to the benefits of SAM, it grew at a rapid rate over the past several years. This growth, however, was accompanied by the proliferation of programs manufactured by third parties. These programs – often labeled "wrap" or "managed account" programs – preserve some of the benefits of separate account management, but they also introduce a *"middleman"* between the investor and the portfolio manager. Programs with a middleman compromise SAM in two important ways: first, complexity escalates because control over the portfolio management function is outsourced to a third-party manager; and second, investment management fees escalate because of the multi-layer fee arrangement (i.e., both the middleman and the outsourced portfolio manager charge fees).

The Private Money Management Solution

The *solution* for investors is a *direct* relationship with a firm that has both the internal expertise and business platform to provide separate account management services in house (i.e., without the need to outsource the portfolio management function). This direct relationship with the portfolio managers/decision makers is what we think of as **private money management**.

Private money management allows the investor's unique objectives and personal preferences to continually be served in a separate account management format. In addition to the benefits depicted in the table, important core and customized services in a private money management relationship include the following:

- equity portfolio management
- fixed income portfolio management
- dividend income portfolio management
- asset allocation advice and implementation
- management of concentrated stock positions
- management of covered call writing programs
- other customized services

Conclusion

The recent turmoil in the financial markets has exposed the flaws of many newly manufactured and marketed products. In many cases, complex structured products, opaque hedge funds, auction rate securities, and multi-layer wrap programs have not served the best interests of investors. In getting back to basics, investors should focus on the basic principles of a long-term investment management program. The best way to achieve this is through a private money management relationship.

Alley Company is an independent investment advisory firm that serves a limited number of select clients. Our investment philosophy is grounded in the basic principles of a long-term investment management program. As a private money management firm, we are able to offer dispassionate advice with our only bias being toward our clients' investment needs and goals.

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