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Winged Keel Group Insights

The Popularization of the Separately Managed Account: How Financial Advisors and Fund Managers Are Investing for Their Clients Inside Private Placement Life Insurance Vehicles

Winged Keel Group Insights is a publication designed to create education and awareness around life insurance topics and solutions that may address certain needs of your clients and their multidisciplinary goals.

By Aaron Abrahms and Eric Naison-Phillips

In today's tax climate, high net worth individuals (and their advisors) are keenly aware of the tax burden that falls upon their investment portfolios. Depending on the mix of short-term capital gains, long-term capital gains, dividends, etc. it is not uncommon for investment returns to be cut nearly in half by the impact of income taxes.

As the investment landscape continues to expand, and a greater number of providers compete for the same dollars, financial advisors and investment managers are looking for ways to differentiate themselves. Gross returns alone are no longer sufficient to win investment dollars. High net worth families are increasingly focused on returns net of fees and taxes. Many in the advisory space are familiar with the tax advantages of Private Placement Life Insurance ("PPLI") but are uncertain of how to utilize the structure in the context of their clients' specific planning objectives.

Many have concerns in raising the idea of PPLI. What happens if the client likes the idea, but the financial advisor or fund cannot manage the money themselves inside of PPLI? How will the advisor get paid? Does this open the door for a competitor to meet the client?

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For much of the history of the PPLI industry, financial advisors and investment managers who managed money for their clients inside of the insurance vehicle had to set up co-mingled investment offerings known as "Insurance-Dedicated Funds" ("IDFs"). Because of the nature of co-mingled investment offerings, the minimum size to make the IDF structure viable is between \$25MM and \$50MM. Once the IDF finds seed capital and is launched, the vehicles are very leveraging given the stickiness of assets in PPLI and the ability to aggregate assets across multiple clients. So while the IDF structure provides many advantages for managers, the need for a meaningful seed investor makes it challenging for

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many financial advisors and investment managers to secure the critical mass to launch.

Recently, however, an increasing number of insurance companies in the PPLI space have begun allowing for financial advisors to manage customized discretionary mandates through Separately Managed Accounts ("SMAs"). Generally, these can be launched at much smaller deposit sizes than IDFs (as low as $5MM cumulative deposit). Because the SMA is attached to only one policy and insurance company, the administration and pass-through costs are de minimis (usually under 10 basis points per year).

SMAs allow financial advisors and investment managers to customize (within limits) the investments for each client based on their risk profile and investment goals (subject to the same governance and controls as IDFs). Imagine a financial advisor with two clients—one whose core wealth is in real estate and the other in a single stock position tied to the software sector. The financial advisor may structure the SMA for the real estate family with less correlation to real estate and more technology stocks, and vice versa for the software investor. In addition, financial advisors can use SMAs to allocate client assets inside of PPLI to funds that do not have IDFs themselves.

Just as with IDFs, SMAs must follow the three guiding regulatory and IRS rules. The SMA must be a separate legal vehicle which only accepts money from an insurance company limited partnership. The SMA must be broadly diversified (under Section 817(h) of the Internal Revenue Code) with no more than any one investment or fund greater than 55% of the assets in the vehicle. Lastly, the SMA advisor needs to follow the Investor Control guidelines which prohibit the policy owners from directing the underlying selection of funds or securities in the SMA (essentially, the policy holder needs to be comfortable giving investment discretion to the manager of the SMA).

As more insurance companies utilize SMAs as a solution set within PPLI, this additional channel is expected to lead to further growth in an already rapidly growing industry. PPLI can be a powerful tax-efficient solution for high net worth individuals, and this attractive entry point provides an ideal pathway for financial advisors and investment managers to explore PPLI with their clients.

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