Do Investors Really Need the New "Wrap" Accounts?

By James B. Cloonan

The "wrap account" (my term), also known as the "fee-based account" or the "money management account," is a program that provides investment advisory services and commission costs for a single fee, based on a percent of the funds managed. The accounts I have heard about charge 3% and are organized by brokerage firms. In most cases, the brokerage firm works with a separate adviser, but in some cases the brokerage firm also serves as the adviser. I suspect that if such plans grow, the brokerage firms will tend toward using an internal manager to increase their profit.

The question that immediately comes to mind is: Do individual investors need wrap accounts?

The major advantage of a wrap account is that the brokerage firm's incentive is to minimize commissions and increase the asset value of the portfolio. These, of course, are the same objectives as the investor's. Of course, reducing commissions also means reducing other trading costs, such as the bid/asked spread.

The disadvantages are cost—at least with those that are charging 3%—and the danger that if the investment portfolio is controlled by the brokerage firm, the portfolio may be used for distributing investment banking products or other brokerage firm inventory. The latter problem is easily overcome. If you go into a wrap account, do so only where the adviser is a separate entity, and make sure you prohibit trades where the broker is a principal as opposed to an agent. You should also have account objectives and limitations in a written agreement.

The former disadvantage—cost—is more difficult to analyze. The cost of investing has several components: administrative costs, management fees, transactions costs, and the bid/asked spread. Let's look at these costs as they apply to three alternatives to the wrap account: managing your own account, using an investment adviser, and using a mutual fund. Of course, it should be remembered that in this analysis I am using average costs; any changes in the assumptions would affect the total costs.

Administrative costs are low or ignored when you manage your own account, but are significant for mutual funds and will be combined with the management fees in our analysis. The bid/asked spread is a real cost when buying or selling stocks, but since the cost tends to be the same regardless of how orders are placed, I will ignore it. You should remember, however, that high turnover strategies will incur more spread costs.

That leaves two major costs to consider: transaction costs and management fees (including expenses). Transaction costs are strongly affected by portfolio turnover—the amount of buying and selling of individual securities within a portfolio; an annual turnover rate of 100% implies a complete portfolio turnover in one year. Transaction costs are also, of course, affected by brokerage commissions. Let's take a look at how these two factors affect the cost of managing money. Table 1 indicates three different turnover ratios: 40%, which would result from a longer-term strategy; 100%, which would be the average of stock mutual funds; and 160%, which would be the level of a not-too-aggressive trader or timer. The table also breaks down round-trip commissions (a purchase *and* a sale) for: a typical listed full-service brokerage firm's rate of 5%; a typical negotiated or discount firm rate of 2.8%; a deep discount rate of 1.5%; and a typical rate for an institution (such as a mutual fund) of 1%. These estimates are based on a $100,000 account.

Table 1 also indicates the typical management fee

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Table 1.
Annualized Costs: Commissions and Management Fees*

	Annual Portfolio Turnover Rate		
	40%	100%	160%
Commissions (Round-Trip)*:			
Typical Full-Service Broker	2.00%	5.00%	8.00%
Typical Discount Broker	1.12%	2.80%	4.48%
Deep Discount Commission	0.60%	1.50%	2.40%
Institutional Commission	0.40%	1.00%	1.60%
Management Fee Including Expenses*:			
Self-Managed			0%
Investment Adviser			1%
No-Load Mutual Fund			1%
Total Cost Range (Commissions plus Management Fees):			
Self-Managed			0.60% to 8.00%
Investment Adviser			1.60% to 3.40%
No-Load Mutual Fund			1.40% to 2.60%

*As a percentage of the investment, based on a $100,000 portfolio.

(including administrative expenses) for the three alternatives: 0% for a self-managed account, 1% for the typical investment adviser and 1% for the typical no-load mutual fund.

The total cost to an investor would be a combination of the transaction costs and the management fee. From the table, you can see that using a typical stock mutual fund the total cost to the portfolio (using the institutional rate) would range from 1.4% to 2.6%, depending on how aggressively it is traded.

On the other hand, individuals can manage their own accounts for as little as 0.6% (if they search hard enough for a deep discount rate), or as much as 8% if they are active traders and pay full commissions. Active traders, however, should never pay full commissions. That puts the top cost for individuals at about 5%. However, I simply don't believe that anyone, except by temporary luck, can outperform the market enough to overcome a 5% cost. Better by far to buy two-year Treasury notes direct, have no costs, and virtually no risk; the current yield on two-year notes is 8.5%.

Using an investment adviser who negotiates deep discount commissions would run from 1.6% for a long-term strategist to 3.4% for a trader or timer.

The least expensive strategy—either doing it yourself or using an index mutual fund (whose management fee is significantly lower than the average stock mutual fund), would be about 0.6%. But this doesn't appeal to many individuals because they either want help or want a portfolio more structured to their needs. Thus, the lowest possible cost is more realistically above 1%.

If 1% is the lowest possible total cost, and 5% is impossible to overcome, how much can you pay and make active stock investing worthwhile? The less the better, of course.

And how does the wrap account compare in terms of cost? If you like managers who are short-term traders, you would be better with a wrap account of 3% than with a separate manager and separate commissions (with a total cost of 3.4%). But I doubt you will find a wrap account managed by a short-term trader.

The wrap account would seem appealing at a cost of 2% compared to mutual fund costs or the combined costs of separate brokerage and management. It would also be profitable to brokerage firms at that price unless sales costs got out of hand. On the other hand, 3% seems too high—and no matter what you are told, the extra cost will not go toward a better adviser.