

Why managed accounts are a win-win for investors

Managed accounts are the answer to investors' calls for increased transparency, says **Patrick Merville**.

Separately-managed hedge fund accounts (managed accounts or MACs for short) have been around since the late 1980s. Managed accounts have stood the test of time, as they offer quite a few interesting tools for professional investor groups that meet their increased demands. Now more than ever, hedge fund investors are placing great emphasis on asset control, portfolio transparency and liquidity. MACs are capable of meeting these demands, so they will play a key part in the hedge fund industry going forward.

After the financial turmoil in 2008 that caused several hedge funds to postpone redemptions by gating, suspending or side-pocketing the assets, the investment environment in the traditional as well as the alternative market has changed dramatically. Transparency and control over the assets have become key criteria for institutional investors. In the last year, falling asset prices have led to a downward spiral that manifested itself in higher volatility in the market, as well as hedge fund managers being confronted with higher margin calls. Dysfunctional credit markets and scarce liquidity forced investors to sell assets to raise capital. In this environment, even positive performance was no protection

against redemptions, and the steady outflow of capital hurt returns and obligated many hedge funds to impose limits on how and when investors could access their money.

Hedge funds did record significantly smaller losses than the broader market, underpinning the diversification potential of the asset class. Nevertheless, negative performance coupled with redemption limits are likely to be the catalyst for significant change as investors take a far more critical look at how their money is being managed. Managed accounts offer the solution.

What is a managed account?

A managed account is an investment structure that is owned or controlled by an investor, but mirrors the strategy of an existing hedge fund. It is a completely segregated account on which the hedge fund manager can replicate his strategy. A robust MAC will typically include an independent board of directors and a network of contractual relationships between the MAC and its trading counterparties and service providers. MACs can be simple stand-alone master funds, or can grow to include several special purpose vehicles and feeders to accommodate bespoke trading and tax issues in various jurisdictions.

Historically, managed accounts were simply dedicated investor accounts opened at a prime broker in the name of the investor, with trading authority delegated to the manager, while the investor retained control over cash and the assets.

Benefits of managed accounts

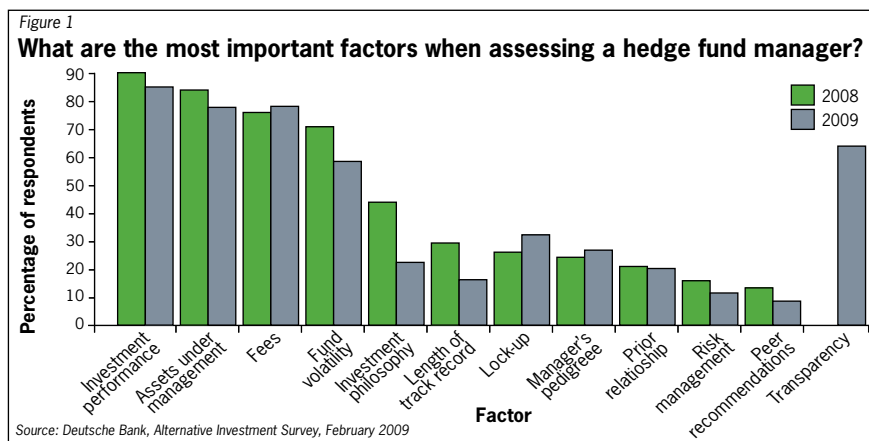
There are numerous benefits when investing through a managed accounts platform. While MAC structures may differ from investor to investor, the central premise remains the same: investors can benefit from additional control and transparency.

As Figure 2 shows, the investment manager agrees to commercial and legal terms with the managed account. Managers are responsible for trading the strategy within the agreed terms. This provides investors with important tools through which they can optimise their risk, yield and the dynamics of their investment decisions. They further contribute to the decrease of operational risks.

The key MAC benefits to investors are: tailor-made investment and risk profiles, transparency, liquidity and asset control.

Investment and risk profiles

Investment and risk guidelines can be fully tailor-made to the individual needs of investors as long as these are within the agreed strategy of the hedge fund manager. The manager has the possibility to customise the investment programme for the specific requirements within his overall investment strategy. The terms of the relationship between the manager and the managed account are set in an investment management or investment advisory agreement and may include preferential liquidity terms, fee adjustments, authority limits, control and notifications and special termination events, as well as changes to



leverage tolerances and cash efficiency, blended strategies, limited exposure to certain instruments and/or markets, disclosure, the use of manager information “upstream” and access to new trading ideas and opportunities.

Transparency

Managed accounts provide investors with a position-level transparency available on a daily, weekly or monthly basis. This is particularly important to institutions looking to manage their exposure across multiple portfolios. This allows for a detailed analysis of the investment and risk profiles of a hedge fund manager’s strategy. Especially when comparing the initially agreed upon investment goals and risk exposures with the actual implementation in the market, the MAC platform permits investors to monitor concentration risk, as well as early detection of style drifts.

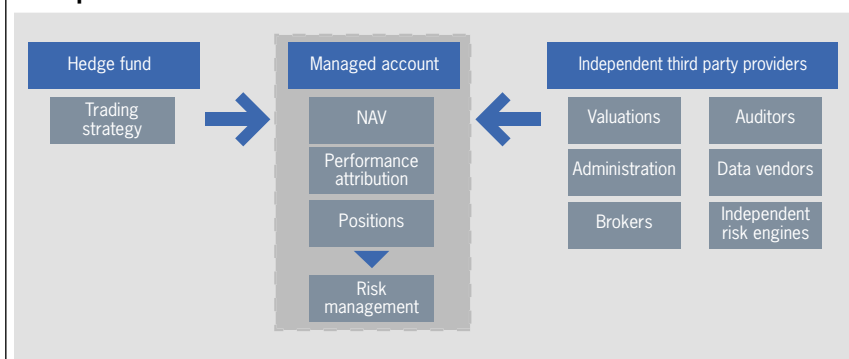
Transparency from managed accounts is of high importance in particular for institutional investors as they monitor and coordinate their risks and exposures of their overall investment portfolios on a constant basis. It is critical that the portfolio and position transparency is provided independently of the hedge fund manager’s own data sets. There is a consistent need for investment by the platform in its own internal capabilities to track performance on a strategy level, ensure that the portfolio construction process can run smoothly and factor in differentials when monitoring slippage.

Liquidity

Since managed accounts remain in the ownership of the investor (respectively the managed accounts provider), there are no formal liquidity limitations such as redemption notice periods or deadlines, gates or fund suspensions. In order to ensure an orderly liquidation of a certain investment, the hedge fund manager and the investor will periodically agree upon a liquidation period and a general time plan in which, under normal circumstances, an investment in a MAC can be reduced or liquidated.

However, the investor is at liberty to liquidate the assets in a faster (or slower) way either through the hedge fund manager,

Figure 2
A simple MAC structure



Source: Internal Man Investments diagram

a third party or on his own. Nonetheless, the speed of liquidating certain assets may come at significantly higher costs, depending on the market conditions with regards to liquidity and depth.

Asset control

As already mentioned, all assets stay in the control and ownership of the investor (respectively the MAC provider) in whose name they are being managed, valued and administrated. This requires a close collaboration between administrators, valuation service providers, prime brokers and auditors. The selection and monitoring of managed account service providers is done entirely independently from the underlying manager and is controlled by the managed account vehicle.

Among the many service provider relationships, an independent valuation is a key attribute of any managed account. It is critical to select a suitable administrator who can provide the necessary level of oversight and independence in the valuation process. It is advisable for a platform provider to seek out a valuation agent that has the technology that is a good fit with the platform’s transparency requirements, typically daily independent price, cash and position reconciliation to the street if reasonable. It may be the case for complicated strategies such as credit, distressed or new alternatives. Pricing complicated instruments requires a detailed knowledge of those instruments and the ability to question and push back on assumptions. Investors and managers rely on the information provided by all service providers, and if this proves to be inaccurate

and unreliable, the entire risk monitoring process will break down.

Limits of managed accounts

In spite of all the benefits, MACs do have some challenges and limitations when compared to traditional hedge fund investments. A MAC structure can add between 50 to 100 basis points to the cost of investing in hedge funds, as they may demand increased services to manage daily data. This charge is typically netted from performance.

Managed accounts can also present operational and relationship challenges with the hedge fund managers. Extra resources and effort required by a manager to integrate properly with a potentially new service provider can be demanding. The working relationship between some managers and service providers can be complex, as ultimate ownership of the relationship with these service providers rests with the managed account rather than the manager.

MACs are powerful instruments of active management, giving professional investors the tools to upgrade their control of risk, returns and the dynamics of allocation, as well as providing important mechanisms to monitor and mitigate operational risk. They may not be for everybody, or useful for all strategies, but for users with the resources and know-how to keep pace with the changes and who can read and understand the powerful data streams they furnish, MACs provide an alternative and powerful route to access the expertise of hedge fund managers.

The writer is the CEO of Man Investments Middle East.