



Managed Accounts

The long term structure for hedge fund investment or another tool in the kit?

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Managed accounts were once caught in the backwaters of the hedge fund industry but the recent turmoil in financial markets has launched them firmly into the mainstream. Regarded as a specialist area in the past, managed accounts' offer of enhanced transparency and control appears to be providing reassurance to investors rocked by the Madoff scandal and gating of certain hedge funds. Some believe the use of managed accounts will be the dominant driver of asset flows in the coming years and may even be necessary to retain current assets under management (AUM). However, there are also naysayers who believe the sudden interest in managed accounts is a transient enthusiasm that will pass as market confidence returns.

Where one sits in this debate is generally driven by a number of factors such as philosophical outlook, business position, fiduciary responsibility and commercial goals. The reality is that managed accounts are unlikely to prove either a miracle or a misadventure for the hedge fund industry as a whole. In the right circumstances, they can be a powerful way not only to increase investor confidence but also to take a distinctly different approach to portfolio construction and product design. Equally, in certain cases they can give an expensive veneer of security but offer little real benefit over a fund-based investment.

Managed-accounts: the rise in popularity

Part of the rush of interest in managed accounts is in response to the negative events which have hit the hedge fund industry over the last year including the Madoff scandal, the failure of Lehman Brothers and the extreme market conditions of the last two years. These events have brought certain issues to the forefront of both investors' and managers' minds:

1. **Transparency:** A perceived lack of transparency has been an issue for the hedge fund industry for over a decade but concerns in this area have moved higher up the agenda due, in large part, to the Madoff affair.
2. **Fund redemptions and gating:** Some investors are deeply uncomfortable that a number of funds have utilised "gating" clauses over the last year in response to extreme market conditions. Certain commentators have argued this behaviour has severely diminished the trust between investors and the hedge fund industry.
3. **Counterparty risk:** The failure of Lehman was a nightmare scenario for many areas of the capital markets including those funds where Lehman was a prime broker.
4. **Severe negative performance:** The hedge fund

industry, as a whole, had a very poor 2008 with some managers posting performances that were significantly worse than expected by many investors.

These concerns have driven a change of mindset amongst many market participants. This could be broadly described as a shift of primary focus from "what is the return on capital" to simply ensuring "return of capital". The debate on managed accounts is part of this with investor preference for security and return of capital (ie. risk management and investment structure) taking an increasing weighting relative to return on capital (ie. performance and cost). It is highly likely this trend will run for the foreseeable future.

Managed accounts: the basics

The term managed account is used to describe an array of differing approaches and structures. Broadly speaking, a managed account is a segregated portfolio that is managed by a fund manager where a third party (eg. an investment manager or administrator) has overall control of the account. The fund manager's role is typically limited to security selection, portfolio construction and trade execution. The third party is responsible for all the other activities (custody arrangements, portfolio valuation, margining etc) and will retain title to the assets and overall control of the portfolio. This is clearly a different set up to a manager's own fund where they will have some degree of control or responsibility for many of these activities. In the managed account set-up, clearly the possibility of another Madoff scenario is significantly reduced.

There are essentially two types of managed account set up:

1. **Managed account platforms (MAP):** Managed account platforms operate by offering multiple external investors direct access to the managed accounts. The platform provider (eg. Lyxor) creates each managed account as an investment vehicle (invariably a fund or special purpose vehicle) and then appoints a hedge fund manager to "advise" on the assets in that vehicle. However, the managed account platform provider retains responsibility for much of the operation, valuation and control of the vehicle. This means an investor in this vehicle needs to gain confidence in the platform provider as the underlying manager's role is limited to trade selection and execution. The platform provider will retain overall control of the asset pool.
2. **Proprietary managed accounts (PMA):** To create a PMA an investor allocates a mandate to a hedge fund manager to manage a portfolio containing only their assets. Again, it is likely a fund or SPV will be used. The investor or overall manager of the account will be able to tailor the arrangements

with the underlying manager. Essentially, these arrangements are whatever can be negotiated subject to all relevant regulation and fiduciary responsibilities. As with option 1, the manager of the account retains overall control and the duties of the underlying fund manager are limited to building and managing the portfolio.

Both approaches offer benefits and drawbacks when compared to direct fund investment although the mix may not be identical. The devil is in the detail when using managed accounts. If a MAP/PMA is not designed and operated carefully it can suffer from all of the drawbacks and achieve none of the benefits of a managed account but with increased costs and inconvenience relative to a direct fund investment.

Managed accounts: benefits and drawbacks

An appropriately constructed managed account should be able to offer an investor:

- Position-level transparency (most likely lagged by one day)
- Control over all cash and collateral flows
- Ability to verify all portfolio valuations
- Negotiated liquidity terms with the manager
- Customised investment mandate
- Ability to take control of the underlying portfolio if required and instruct the prime broker directly to either liquidate or appoint another manager
- Management of counterparty risk
- Ability to appoint approved service suppliers to the account (administrator, auditor etc.)

However appealing these advantages may seem they need to be tempered with an awareness of some of the complexities and drawbacks of using managed accounts. The exact mix of issues will vary between MAPs and PMAs and according to the specifics of each set up.

Firstly, cost and complexity are likely to be increased by the mirrored structure of a managed account when compared to a fund-based investment (eg. the managed account will require similar levels of checks, balances and reconciliations to those that the manager is already carrying out on their own fund). However, this cost can vary depending on the specific set-up of the managed account and may be offset by efficiencies generated through the use of a managed account structure. There is no doubt that managed accounts are a scale business and there is a minimum efficient size at both the single account level and at the aggregated level. Under the MAP set up, this scale is achieved through an aggregation of multiple investors into a single account. Under PMA, the individual investor has to provide this scale, ideally offering assets significantly in excess of \$1 billion. At a minimum, each account will almost certainly need to be in excess of \$25 million and the

overall group of accounts over \$500 million. Scale is necessary to cover fixed costs such as fixed fee drag and set up of infrastructure but also to make the account sufficiently attractive to the managers, amongst other reasons. However, when scale is achieved it is debatable whether cost is an issue once other efficiencies specific to managed accounts are factored in such as possible improvements on treasury arrangements, brokerage or other support services.

Accessing the best managers has always been a driver for many hedge fund allocators. Certainly in the past, a number of top managers have either refused to run managed accounts or have been very selective in this area. This has led to some commentators suggesting that a managed account portfolio will be populated with second and third rate managers. Reasons for manager refusal have included operational complexity, business simplicity and position secrecy. However, some of these concerns can be addressed by the investor:

- **Confidentiality:** The manager must be confident their data is secure and no attempt will be made to reverse engineer their process or to trade against them.
- **Scale and duration of the investment:** A manager will be more interested in a long term partnership. There is a big difference between a \$10 million investment for six months and a \$300 million investment with a five year horizon.
- **Clear communication of the process driving the investment level in the managed account:** If the manager understands the investment process of the allocator they can understand how the account size may vary through time and when it may be de-leveraged for risk management purposes.
- **Control of assets in the managed account:** The manager will prefer to be in dialogue with the asset owner so they are not subject to sizeable, unexpected asset flows. Clearly, when dealing with a MAP the manager can only be given reduced visibility on asset flows as these are dictated by third parties, especially if the accounts are used for any structured or non-linear products.

One of the most frequently mentioned benefits of managed accounts is the transparency afforded to the investor. Whilst it is true that full position-level transparency may be available the more important question is how this data can be transformed into useful knowledge. The situation can be compared to receiving an update on every item sold by Tesco in real time (or close to it) by store location when trying to understand the UK grocery market - great data depth and granularity but if you can't process

Table 1. *Source: Tomlinson Investment Consulting*

PMA TYPE	DESCRIPTION	BENEFITS AND WEAKNESSES
Basic	<ul style="list-style-type: none"> • Set up in similar manner to a MAP • All investments fully funded (ie. to get \$1 of exposure to the fund \$1 of capital is required) • Standardised administration platform with investor receiving standardised reporting directly from the platform • May have enhanced liquidity relative to the reference funds, possibly weekly 	<ul style="list-style-type: none"> • Delivers the standard managed account benefits of transparency, control and governance • A more controlled way to access a hedge fund portfolio compared to fund investments but fundamentally the investment characteristics will be little altered • The simplest type of PMA and likely lowest cost • Excess cash held within each underlying managed account giving inefficient cash utilisation
2nd Generation funding efficiencies and collateral security	<ul style="list-style-type: none"> • Utilises the "closed asset pool" nature of a PMA to make efficient use of funding and capital • Investment partially funded by using margin trading at broker (ie. to get \$5 of exposure to the fund collateral of say \$1 may be required) • PMA manager will need to perform increased administration relative to Basic 	<ul style="list-style-type: none"> • Improved counterparty risk profile as only minimum collateral to support trading activity needs to be in managed account. Excess capital can be held higher up the structure in risk free assets of used for yield enhancement. • Provides efficient leverage if required or efficient un-leveraged exposure • Asset flows in and out of portfolio do not need to lead to trading in underlying portfolio as exposure can be allowed to fluctuate
3rd Generation layering on dynamic risk management, hedging and alpha strategies	<ul style="list-style-type: none"> • As per 2nd generation but moving into active management of portfolio • Using the financing and treasury advantages of the managed accounts coupled with the improved transparency to create an enhanced portfolio management process • Process may be for risk management, hedging or an alpha process 	<ul style="list-style-type: none"> • Same as for 2nd generation • For example, could run a portfolio with a derivatives overlay seeking to offset certain risk factors. Risk factor analysis run on weekly basis on position-level data then portfolio management decisions and overlay based on this • No need to get into complicated swap or other financing issues as portfolio has excess collateral to support overlay activity

it appropriately it will be of little use. Having said this, the result of developing a thorough process for managing the information can lead to very powerful insights.

Lastly a significant amount of intellectual capital is required to build and manage a PMA.

Fully utilising a PMA

When running a PMA, it is possible to develop a number of additional features which can enhance the actual investment process and not simply offer an alternative way to access the respective hedge fund. It can also allow the development of products that can be distributed into new investor groups. For example, a fund of fund manager could create a product that would fit on to a daily dealing fund platform for distribution to retail investors. Other advantages may include utilising the funding benefits of an advanced PMA to deliver leveraged portfolios without the need for a bank credit facility or freeing up capital to be deployed elsewhere

whilst maintaining economic exposure to the underlying hedge funds. Table 1 highlights some of the different set-ups and possibilities.

Where will managed accounts add value?

As with most debates, there are no simple black and white distinctions when discussing the benefits of managed accounts against a direct fund investment.

For some investors the construction and operation of a PMA makes a lot of sense, for others it will be costly and of little benefit. Table 2 gives some examples of where a PMA may or may not be most effective.

Final thoughts

The use of managed accounts is likely to be a key part of the hedge fund industry moving forward as there are clear advantages to certain investors, intermediaries and fund managers. However, that is not to say that all assets will migrate to managed accounts. There are strong reasons, both

Table 2.

Source: Tomlinson Investment Consulting

INVESTOR	PORTFOLIO OBJECTIVES & SET UP	MANAGED ACCOUNT SUITABILITY & COMMENTS
Large, sophisticated institutional investor with a diversified hedge fund allocation in excess of \$5 billion within a global, multi-asset portfolio	<ul style="list-style-type: none"> Investment objectives defined at overall portfolio level with a keen eye on overall risk levels covering all appropriate risk factors including non-investment risk Investment process seeks to integrate all risk/return characteristics of total portfolio Hedge fund investments cover most forms of hedge fund strategy with all fund investments over \$50 million 	<ul style="list-style-type: none"> Highly likely a PMA structure could yield significant benefits Investor has sufficient scale both in aggregate assets and minimum fund investments Has sufficient expertise and infrastructure to utilise many of the basic and higher order benefits of a PMA Likely that within portfolio some strategies are not suitable for a managed account so should remain as fund investments
\$500 million fund of funds focussed on tactical allocation between strategies and managers	<ul style="list-style-type: none"> Targets high return by taking focused bets on strategies and managers Sometimes will be in and out of a manager in a six month window 	<ul style="list-style-type: none"> Highly unlikely that a PMA is suitable Lack of scale so uneconomic Some of the allocations may not work well in a managed account Lead times for each managed account set-up may hinder the investment process
Smaller institutional investor with a \$1 billion hedge fund portfolio invested through several fund of funds	<ul style="list-style-type: none"> Allocation to hedge funds as part of overall portfolio diversification strategy Want uncorrelated asset with moderate medium-term performance expectation Conservative mandate, trustees concerned about transparency and governance of hedge fund portfolio 	<ul style="list-style-type: none"> PMA may be a possibility but would need a detailed study to confirm May be economic but this is not certain If trustee concerns cannot be satisfied by the fund of fund managers (who may themselves be running assets through managed accounts) then likely best option is to look at allocating to a MAP
Global fund of funds with AUM in excess of \$10 billion	<ul style="list-style-type: none"> Running a series of multi-strategy and specialist fund products Assets raised from a combination of HNW and institutions 	<ul style="list-style-type: none"> Comments as per first row

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commercial and investment, for certain investor groups and managers to remain faithful to fund-based investments. A key challenge in the near term for the industry is one of education and the development of a common understanding of the benefits and drawbacks of managed accounts. It is in everyone’s interest for all participants to be clear on likely outcomes before the investment of substantial time and resource in developing a managed account set-up. There is nothing more frustrating for any business than to start a project based on incorrect assumptions of the likely benefits and then to have to spend significant resources on re-engineering when the project struggles.

The establishment of managed accounts for some investors and managers, at present, appears to be at risk of falling into this scenario. Like most evolving technologies and business processes the use of managed accounts will mature and settle down into steady state but for the time being it is all about testing out the possibilities. **THFJ**

ABOUT THE AUTHOR

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Richard Tomlinson is the Managing Director of Tomlinson Investment Consulting and has over seven years experience of developing and managing hedge fund assets through proprietary managed accounts. Richard was formerly the Head of Multi Strategy Products at Old Mutual Asset Managers (UK).

ABOUT THE COMPANY

Tomlinson Investment Consulting is a provider of consultancy services to the investment management industry with a specialisation in the use of managed accounts for hedge fund investment.