New investor needs prompt innovation among managed account providers

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The surge of demand among fund of funds managers and other institutional investors to invest in hedge funds through managed accounts is bringing a surge in new business to established platform providers and attracting a wave of new players into the market. It is also prompting innovation among providers as they seek to offer new facilities and tools to their clients, and examine ways to mitigate the extra cost of using a managed account platform.

The rebound in business as institutional capital starts to flow back into the hedge fund industry is a welcome change for managed account platform providers, which suffered last year for one of the key benefits they offer to investors – liquidity. “Being the liquidity provider to the market was painful,” says Martin Gagnon, co-chief executive of platform provider Innocap Investment Management, which is owned by National Bank of Canada and BNP Paribas.

The run on hedge fund investments – especially liquid ones where there was no danger of gating or suspension of redemptions – coupled with the industry-wide negative performance saw Innocap’s assets under management shrink from USD3.6bn to USD1.8bn, but the figure is now climbing back. What Innocap and other platforms demonstrated, however painfully, was the reliability of their liquidity promise. “We paid back USD1.2bn in six weeks last autumn, but we didn’t miss a beat – everyone got their money at T+3,” Gagnon says.

It was the same for Lyxor Asset Management, which runs the world’s biggest managed account platform. “Last year we were used as an ATM and we honoured all redemptions; we delivered on our objective to provide liquidity and security,” says managing director and head of managed accounts development Nathanaël Benzaken.

From a peak of USD13bn assets under management fell back to USD7bn but are now climbing again; Lyxor reported a USD3bn increase in assets on the platform over the first three quarters of 2009. “We are benefiting as investors are transitioning more and more from direct hedge fund investment to managed accounts,” Benzaken adds.

Another longstanding managed accounts platform, run by HFR Asset Management (like Innocap and Lyxor, it dates back to the 1990s) is also benefiting from the resurgence in investor interest. “The world’s largest hedge fund allocators are all either considering setting up their own managed account platform and building it internally or looking to use providers like HFR to scale off the infrastructure we’ve already built,” says managing director Marc Denogent.

“Approximately 50 per cent of hedge fund assets are run by the largest 150 managers, and you have the same kind of concentration levels among the largest hedge fund allocators. If you’re one of the world’s largest allocators, you’re going to ask yourself: ‘All things being equal, would I rather have a vehicle where I have full control and full transparency, or something that’s opaque;”

As an alternative to the established platforms, some fund of hedge funds managers are building their own structures. “We found that in many cases these managed account platforms had been designed for purposes that were not in line with our objectives,” says Gabriel Bousbib, chief executive of Gottex Solutions Services, established by the USD8bn fund of funds manager earlier this year after it rejected the option of using an existing provider.

“A lot of these platforms have been built to help banks develop structured products business, using managed accounts to invest in hedge funds in a way that would offer much more liquidity and flexibility in moving capital in and out of those investments. That was not our goal, which was to address the issues of fraud, pricing and not least governance.”

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In this environment, opportunities are rife for firms such as Managed Accounts & Governance Consultancy, which advises fund of hedge funds managers and other investors on building their own platform. In the past, says managing director Richard Day says, the cost and difficulty of building a managed account platform put off many institutions that might have considered it.

“Two years and USD10m is not a bad estimate for the various platforms we [Day and MAG Consultancy managing partners John Godden and Simon Hookway] have been involved in, for groups ranging from independent asset managers to large investment banks. One of the areas where MAG can help people is to reduce that cost and time, by saving them from having to reinvent the wheel. We know where mistakes are made, where costs can run out of control, and we’ve already made some of the difficult decisions, so working out solutions doesn’t take so long.”

However, do-it-yourself managed accounts are not a wise option for the inexperienced, he cautions. “First and foremost you need a legal structure that ensures that control sits with the intended fiduciary,” Day says. “If the allocator wants control, they have to ensure that the legal structure provides that. In addition, if you’re running a series of managed accounts you need to ensure that each managed account sub-cell is correctly segregated from each other so that one cell can’t blow up all of them.”

Sonya Van de Graaff, a bankruptcy and finance partners with law firm Brown Rudnick in London, adds: “The contractual agreements create the legal obligations. The terms of the investment management agreement are critical, and from that will flow the fiduciary relationship and obligations, and the specific concerns of the investor in terms of investment limits and portfolio requirements, risk limits and volatility appetite.”

Crucial to the success of the structure is the quality of service providers such as administrators. “You need service providers of high calibre and with a high level of independence,” Day says. “At the roots of the Madoff scandal were service providers that were controlled or influenced by Madoff entities. If you’re not using best of breed service providers such as the prime broker or administrator all the way through, you have a weakness in your managed account structure.”

Administrators are themselves seeing the shift toward managed accounts, although it does not necessarily involve a significant change in the functions they are being called on to perform. “From our point of view, there’s a little less to do when you’re administering a managed account in areas such as shareholder services and corporate secretarial functions,” says Dermot Butler, chairman of Custom House Global Fund Services.

Custom House, which merged with Equity Fund Services last year, services a number of individual managed accounts as well as the Malta-domiciled Innocap managed account platform. “Investors feel safer with the transparency, flexibility and liquidity of a managed account, but to gain the benefits of full transparency you really have to understand what the investment manager is doing,” Butler says.

“If you don’t understand the strategy, you won’t understand exactly why a particular instrument is in the portfolio, or how to value it, and you’re probably in a worse state than if you were blind, because you’re effectively transferring some of the risk from the investment manager to yourself.”

Akshaya Bhargava, chief executive of hedge fund administrator Butterfield Fulcrum, is also seeing increased interest in managed account servicing. “It’s latent demand in the sense that investors want to know more about it,” he says. “There is interest from family offices, from funds of funds and from other large institutional investors, but a lot of people don’t know how to go about it.”

He believes that the trend reflects the growing institutionalisation of the hedge fund industry that was already clearly underway before the financial market turbulence erupted in 2007. “The industry has changed, and in some ways the change is permanent. The more institutionalisation progresses, the more we will see use of managed accounts. We won’t be going back to the situation of two years ago.”

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Like other players in the market, Bhargava acknowledges the concerns of investors about the added costs inherent in the use of managed accounts, but believes that these reflect the benefits they confer. “It could be costly in some – but not all – scenarios, but you have to balance it against what you are getting: much greater transparency, greater control over the assets, and a liquidity benefit that is worth a lot more than a couple of years ago, when people didn’t really care about it.”

In any case, administrators can help mitigate those costs, according to Mike Leahy, a managing director at SEI Investment Manager Services. “Partnering with SEI or another third-party provider that has the scalable infrastructure and technology resources is an area in which costs can be mitigated,” he says. “We can provide those types of service and infrastructure in a cost-efficient way.”

His colleague Jim Cass notes that another advantage of the managed account model for fund of hedge funds managers can be an improved reporting cycle. “You don’t have to wait around for a particular hedge fund that normally finishes up valuations with their administrator around the 22nd day of the month,” he says. “When everything is placed with an administrator like SEI, you can complete valuations and report to your investors with a much quicker turnaround. Improved timing of investor reporting shouldn’t be overlooked when talking about added value in the managed account model.”

Adds Leahy: “Managed accounts are helping to drive the industry toward a daily reporting model. For a fund of funds manager or large institutional investor, the added transparency is only useful if it is timely. Fund of fund managers are looking for daily access to the data set. Transparency on the NAV is not sufficient.”

Platform providers are also working actively to reduce the cost burden by negotiating lower fees with both managers and service providers. “It is very important that our clients should not be overcharged, so we make sure that the management fee of about 2 per cent charged on our managed accounts covers the compensation of both the hedge fund manager and CASAM,” says François-Régis Bocqueraz, head of fund relations and selection at Crédit Agricole Structured Asset Management.

“At the same time we seek to minimise the overall cost attached to our funds’ operational architecture – the expenses relating to the right administrator, valuation agent, directors and other quality service providers can become quite significant when you add them all up. Most managed account platforms have been quite good at minimising these costs because of their scale as well as long-standing privileged relationships with premier service providers.

“The independent valuation, risk management and reporting and the segregation of assets come on a single platform at a charge not materially different from that of a direct investment in a hedge fund. At CASAM, we believe a managed account’s cost should be approximately equal to that of the hedge fund it seeks to replicate.”

Bocqueraz adds: “All in all, the cost of structural risk management is not particularly high in our view. In CASAM managed accounts, savvy investors benefit from the mitigation of operational failure and fraud risk at a minimal cost. In addition, we think change is part of the game even for managed account service providers, and we continuously looking for improvements on the cost front and on the structural front to reduce risk and to optimise costs.”

Denogent argues that the perception that managed accounts were more expensive than direct hedge fund investment is not necessarily based on accurate like-for-like comparison. “It depends on how you measure the true cost of a managed account versus the cost of a flagship fund,” he says. “People concentrate on the management and performance fees, but there are other expenses inherent in funds that can vary from 50 to 600 basis points. The problem is that very few people have done a proper cost analysis of investing in a flagship fund and through a managed account.

“To set up managed accounts you need a certain level of scale to be cost-effective, but that’s just about the direct costs. What about the indirect costs such as fraud? Various fund of hedge funds managers that have been affected by scandals such as Madoff are now switching to investment

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through managed accounts. You have to factor in not only the direct cost of frauds and blow-ups to their portfolios but the reputational cost. How do you quantify that?"

The Gottex managed account platform incorporates a feature known as NetFunding that aims to provide leverage to managers who need it and provide higher returns to those with excess cash, and which reduces the overall cost of the platform to users. Says Bousbib: "NetFunding aims to enable a managed account that has excess cash to lend it to managed accounts on the same platform through the use of tri-party repurchase arrangements.

"Normally when a hedge fund has excess cash, it leaves it at the prime broker or sweeps it into some kind of money-market product, which at the moment earns almost zero return, while those that need cash to leverage their positions borrow from the prime broker at Libor plus 25, 30 or 35 basis points. The spread between the two rates can be as much as 60 or 70 basis points.

"If you allow managed accounts to borrow from and lend to each other, you effectively eliminate that spread, which can create tens of basis points of extra performance and potentially offset the cost of the platform, and using tri-party repo arrangements means you are not creating cross-liabilities between the different managed accounts."

Even contrasting the costs of different managed account platforms may not be comparing like with like, says Gagnon, who argues that some providers incorporate a range of fees embedded in the structure. "When you focus on totally transparent fees, where everything is laid out to analyse and you can compare apples with apples, it's actually cost-neutral to use managed accounts by comparison with direct investment," he says.

"Our platform fee is 50 basis points, but what you need to look at is the total expense ratio, including administration, board fees, audit fees and registration fees, which may come to 65 to 70 bps. We make this up in three ways. First is by reducing the management fee of the hedge fund manager, because we do not need their middle and back-office services. This gains on average around 25 basis points. Innocap's average management fee is 1.28 per cent, compared with an average for the corresponding offshore fund of 1.52 per cent, a saving that is passed it on to the investor.

"Secondly, the NAV on a managed account is technically pure. We studied 150 audited financial statements from offshore offerings, and we found out that if you eliminate management, performance, trading and custodian fees, there were on average 30 bps of other costs that you don't find in a managed account, including everything from legal services to software development and Bloomberg access.

"Then we add what we can save with service providers such as prime brokers, because hedge fund managers are never incentivised to negotiate with their prime broker. They sign anything because they want to start trading. We have 12 different prime brokers and we play them against each other to get better treatment. On leverage, we get better terms than 90 per cent of funds. All this makes it roughly cost-neutral to invest in managed accounts if the fees are not hidden and everything is divulged."

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