An idea whose time has come?

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The turmoil that enveloped the hedge fund industry over the past two years as returns plummeted, investors rushed to redeem their holdings and managers stuck with illiquid holdings were forced to impose gates or suspend redemptions has given a substantial boost to the use of managed account structures by institutional investors. The big question is how far can the trend go: will managed accounts replaced pooled funds as the default investment choice, or will interest subside as memories of the crisis of 2008 fade?

There's no doubt that managed accounts are enjoying a resurgence. According to London-based Managed Accounts & Governance Consultancy, which was established at the beginning of this year by a group of experienced professionals to offer fund of hedge funds managers and other institutional investors access to their expertise in setting up their own investment platforms, managers of as much as half of all fund of hedge funds assets are considering some sort of shift to managed accounts.

For example, Man Group recently reported that its newly-established multi-manager business saw assets held in managed accounts grow from USD4bn to USD6bn over the six months to the end of September. Man, which had a total of USD44bn under management at the end of the third quarter, has been building up its managed account platform as an investor over the past decade and says there is burgeoning interest in the security, transparency and liquidity than managed accounts can provide.

"The interest in managed accounts has very much been stimulated by the events of the past year or so as funds imposed gates and suspensions," says Simon Schilder, a partner with international law firm Ogier in the British Virgin Islands. "The great advantage of managed accounts for investors with very significant amounts of money is that they won't be left at the mercy and whims of other investors in terms of appetite for risk. There is particular interest at the moment among investors that were in funds that experienced runs and imposed suspensions and gates, and particularly those with enough money to wield to make the use of a managed account structure effective."

Industry members note that there is considerable diversity in the types of managed accounts available, including public platforms offered mainly by banking groups to third-party investors as well as those established by fund of funds managers and private banks for their own investments, private arrangements between investors and hedge funds managers, and hybrid solutions such as institutional commingled funds reserved for long-term investors.

In addition, the motivations driving growth in managed accounts vary between investors. In the wake of the Madoff scandal, some are primarily seeking control of the assets to prevent fraud. Others are more concerned about the problems of illiquidity that have resulted from investment in a commingled fund when a large number of investors seek to exit at the same time.

Although the intense spotlight on managed account structures is a phenomenon of the past couple of years, the concept itself is much older. "Going back 30 or 40 years, the managed account was the way you opened an account in the commodities or futures market," says Dermot Butler, chairman of alternative fund administrator Custom House Global Fund Services. "It was only later that the people who were managing the money decided that this approach was costing them too much for services such as administration and started to pool investors' money in funds instead."

It was Custom House that in 2005 set up a managed account platform in Malta for National Bank of Canada, offering third-party investors access to what is arguably the long-established platform in the market. Now known as Innocap and with BNP Paribas as a 25 per cent shareholder, the business traces its origin back to an allocation of CAD28m by National Bank of Canada to hedge funds from its proprietary capital in July 1996. It began managing third-party money in 2000, and spun the platform

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out of the bank's treasury department into a separate asset management firm three years later.

Another pioneer of the sector is Lyxor Asset Management, today the operator of the world's largest managed account platform, which was first established in 1998 to serve clients seeking principal protection on a basket of hedge funds. Four years later the platform, which was then limited to in-house investment, was restructured from a closed-ended to an open-ended architecture. "What were simple accounts opened with a prime broker in 1998 were transformed in 2002 into individual hedge funds able to accept external money," says Nathanaël Benzaken, managing director and head of managed accounts development at Lyxor.

"It seems that the need we had in 1998 became a need for investors in 2008, when they realised that managers controlled the liquidity. In addition there was the Madoff scandal, which illustrated that hedge fund managers could still commit fraud. You have to be extremely disciplined in the way you select managers, and even then you cannot eliminate the fraud risk completely. The only way to do it is by creating a vehicle over which the manager has no control."

Lisa Fridman, associate director and head of European manager research at Pacific Alternative Asset Management Company, notes that Paamco has long-standing experience in building hedge funds portfolios for its clients using managed accounts, but she cautions that it is not necessarily a panacea for investors.

"There is a good case for segregation of assets, especially for larger clients that are long-term investors and don't want to be subject to the pressure of co-investors in a commingled fund that might want to redeem," Fridman says. "A separate account gives investors more control over the assets and transparency, and potentially they could have their own slightly different investment strategy.

"From the operational standpoint it might be difficult for the manager to look after a large number of managed accounts, but given the shift evident in the industry toward managed accounts and greater transparency in general, the practical response is for managers to set minimum limits for the creation of such accounts.

"In addition, investors need to understand that looking after managed accounts on their own platform requires a lot of research. If you set up your own separately managed account platform, you have become the investment adviser and you hire the managers as sub-advisers. You have to have a team supervising the investments, for instance making sure everything is within limits, and you need access to the legal expertise to negotiate a large number of contracts."

According to MAG Consultancy managing director Richard Day, the primary spur for the growth of managed accounts came last year with "a mismatch between what investors expected and what they got. A number of managers suspended or gated redemptions, or told their shareholders that they wanted to rewrite the terms of their investment completely and lock their money up for longer than originally agreed, otherwise the fund would be closed down and they would lose a much greater proportion of their money. These included a number of high-profile top 20 hedge fund managers.

"Fund of hedge funds managers got burned last year not only on performance but a number of infrastructure issues that hit their business model, notably liquidity. And investors also had issues concerning style drift, as large differences opened up between the mandates under which managers were supposed to be operating and what they were actually doing.

"Managed accounts can be used to control the investment in a number of ways, including taking care of style drift. Within a managed account infrastructure, if the investor reaches the point where they no longer trust the manager, they can take back control immediately, rather than being stuck behind six months' redemption notice. Even if the liquidity's not there they can take control of the assets, either for another manager to run or to close out the positions."

Day notes that managed accounts are just part of the solution. "There must still be strong governance within the managers you are allocating to, and trust, but the managed account acts as the policeman and the alarm company," he says. "The investor can keep watch on the trading

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adviser, and if there is any deviation from the investment agreement, an alarm will go off and sanctions may follow. No longer does the investor have to rely on the manager or administrator to find out what is happening with the assets."

A key issue has been the attitude of underlying managers toward managed accounts. "One drawback in the past has been the negative selection bias – the best managers just wouldn't do them," Day says. "That still exists, but it's not as big a factor. Managers that previously wouldn't have done managed accounts are doing them now. The stigma attached to running managed accounts has lessened.

Benzaken says that the change in attitude has been quite an abrupt one. "Whereas until recently it was a challenge to convince leading managers to accept managed accounts, now many of the industry's most highly regarded names, even star names, are approaching Lyxor to offer managed accounts to investors," he says, noting that technological developments have helped by enabling managers to run managed accounts at a marginal operational cost. Apollo, Gartmore, GLG, Marathon and Tudor are among the managers that have added funds to the Lyxor platform over the course of 2009.

Says Day: "Traditionally some of the very big managers wouldn't accept managed accounts because in some way it questioned their ability to run money, their infrastructure and their selection of service providers. That's aside from operating issues such as splitting the trade files, dealing with additional prime brokers and administrators, and potentially providing transparency they don't want to provide. But with many funds of hedge funds looking to allocate this way, they are buying into it."

Melissa Hill, managing partner of London-based arbitrage specialist Sabre Fund Management, is among the enthusiasts. "If you're confident of your performance and your strategy, is there any reason to have an offshore fund rather than setting yourself up on a couple of hedge fund platforms and running separately managed accounts; she asks. "It's much more flexible for the investor, and it should not involve much more work if you set yourself up with an administration platform as well.

"Most futures strategies started up not with a fund but with managed accounts, because it was easier to get notional funding, and where the strategy allows, there's no reason why this shouldn't be the norm for the rest of the hedge fund industry, especially as setting up a fund is itself becoming more and more expensive. There used to be a perception that you were a B-team manager if you accepted managed accounts, but this is clearly not the case now. Lyxor has proved that by opening accounts with some really premier names."

Still, not all the doubts among managers concerning managed accounts involve costs and administrative burdens, as Paamco Europe managing director Stephen Oxley acknowledges. "Transparency has been on institutional investors' agendas for a while but it's moved toward the top," he says. "We've always had transparency as investors because even where we've invested in the fund, we've been provided with position-level data by the managers, because we have a reputation for protecting the information. We have very secure systems and we sign confidentiality agreements, and we're not part of a bigger group that does other things like trading.

"Other managers of funds of funds may not get that transparency from managers of underlying funds and have to set up a separate account. But managers fear that when they have too many separate accounts, information about their trades will leak out to the wider world. And certain large institutional investors that may want separate accounts are also trading certain hedge fund strategies internally, including some of the Scandinavian pension funds and insurance companies. Managers may be wary about investors that could open a small account with a hedge fund manager, see what they're doing and maybe copy their strategy."

There is widespread agreement that as capital flows into the hedge fund industry turn positive again and market conditions continue to improve, managers of single hedge funds will at least grow more discriminating about the size and origin of the managed accounts they accept. "The shift in power from managers to investors will only last so long," Day says. "Already the better managers are beginning to close again as the pendulum starts to shift back toward managers. By the end of next year, you'll probably have missed the boat – there's probably a limit to the number of managed

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accounts the best managers are willing to handle."

Mike Leahy, a managing director with SEI Investment Manager Services, expects the minimum size of managed accounts to grow again. "Larger investors and fund of funds managers will continue to utilise the model, but the levels will go up. We've seen the pendulum swing one way, but the USD10m managed account won't be the preferred model going forward, either for the hedge fund manager or the investor, so the pendulum will swing back a bit.

"Once investors enjoy the transparency to receive this kind of position-level data, they are obligated to do some analytics on it, and you really need a critical mass of assets to support the infrastructure required. Not everyone has an appetite for full transparency or the system requirements necessary to perform extra due diligence on the top alpha generators or hedging of underlying investments. It's not the only model for the future, but I believe it will be a majority model, not a minority one as it is today."

Other industry members are confident that the trend toward increased use of managed account structures will be sustained in the long term. "The events of last year have accelerated the demand for managed accounts, although no doubt some people will revert to the good old days of putting money into commingled vehicles because investors' memories tend to be short," says Gabriel Bousbib, chief executive of Gottex Solutions Services, which was established by the fund of hedge funds manager to run its own managed account platform.

"However, a number of large institutional investors and asset managers have made strategic decisions to move into managed accounts because they are being told this is the only way their boards or trustees will allow them to continue investing in hedge funds. At the same time, managers have accepted that they will have to be much more accommodating toward managed accounts, even if it requires on their part increased infrastructure and capabilities to manage multiple pools of money at the same time."

Martin Gagnon, co-chief executive of Innocap Investment Management, believes the recovery in hedge fund performance this year may have calmed the headlong rush toward managed accounts that seemed to be looming in early 2009, especially for fund of hedge funds managers. "Because of their performance so far this year, funds of funds are seeing less pressure on their business model," he says. "Some have adopted solutions, some have not. Some said they would but now are backing away.

"After Madoff and Lehman, people are looking for a better model. There are hybrid solutions. You can obtain a little more transparency, but if you can't act, what's it really worth? It just means you're the best-informed loser. You need transparency and liquidity that go together hand in hand, and it all goes back to controlling the assets, which is what pension funds are now looking for. It may take them months, quarters or event years to act, but I believe the change is permanent."

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