Operational best practice for investors

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Following the financial turbulence, institutional and other investors increasingly began to investigate managed accounts as a solution to asset control issues that emerged with pooled fund investments: gates, suspension and other liquidity restrictions, vulnerability to fraud and operational problems.

While managed accounts can certainly provide investors with greater transparency, liquidity options and control of assets, they also require greater investor commitment in terms of time, focus and resources when compared to commingled investment. To optimise managed account potential, investors need to understand their increased responsibilities, and be rigorous during initial due diligence and ongoing supervision of fund managers, counterparties and service providers.

As with traditional hedge fund investment, the process begins with manager selection. However, the standard criteria of strategy fit, performance and overall reputation must be supplemented with careful consideration of the terms and limitations of the power of attorney under which the manager will run the managed account. This is especially true if the fund's investment parameters are not identical, or pari passu, with the manager's flagship hedge fund.

In addition to the investment management agreement, the investor is also responsible for establishing the contractual legal and trading framework in which the managed account will operate. In a commingled hedge fund, these details are the responsibility of the investment manager. They include bank and prime brokerage agreements, transaction agreements including ISDA and ISMA, and the account's contract with the service administrator.

The choice of administrator is key due to that service provider's role – through the reconciliation functions – as an independent oversight of investment manager and prime broker activities. Administrators should both be experienced in dealing with the complexities of managed accounts, and offer robust, scalable IT capabilities to handle the import, export and reconciliation of vast quantities of data. This matters equally for strategies with thousands of trades daily like statistical arbitrage and for producing the timely, customised reports the investor will require.

To monitor the account's operation, the investor will require a wide range of reporting, ideally integrated with risk analytics on the same platform. The administrator's independent performance and risk reports should be based on the same security master, pricing models and reconciliations to minimise the risk of errors inherent in transferring data between systems.

The administrator should provide daily, independently verified reconciliation of cash balances, collateral payments, custody movements, verification of securities settlement and balances, and transfer confirmations. And, to enable the investor to verify that the manager is operating the account as agreed, the administrator should provide P&L reports with aggregated position, region, currency and securities exposure for both individual and consolidated accounts.

Meaningful, timely data is central to investor oversight of managers and operational risk. The volume of managed account data available can be daunting. The administrator's reporting ability – daily, weekly, monthly, key risk analytics, exception-based formats – should offer high level views of key tolerance factors as well as drill-down detail.

Together the investor and administrator should identify the data framework and reporting timeframes that best facilitate informed investor decision-making. These criteria are best discussed during initial pre-investment due diligence, then within regular, scheduled ongoing due diligence reviews.

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