Managed account boom shows few signs of slackening

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Driven principally by demand from investors for greater transparency and liquidity of their investments, the growth of investment in hedge fund strategies through managed accounts continues to gain ground, with few signs that the relative recovery of the hedge fund industry over the past two years is either diminishing investor interest in the benefits managed accounts can offer or convincing managers that they can do without the perceived complexities and administrative burdens they involve.

On the contrary, new providers of managed account platforms continue to emerge in the marketplace, established by financial service providers including investment banks, fund of funds managers and administrators. They seek to reduce the hurdles to managed account investment for both investors and managers by bundling together a range of middle- and back-office services, and at the same time mitigate whatever increased costs managed accounts entail – something that is a matter of some debate – through economies of scale.

Managed accounts have existed for years in the hedge fund industry, but until recently have been largely the preserve of a handful of large institutional investors and represented a small proportion – 2 per cent is a much-quoted figure – of the sector’s total assets under management, in stark contrast to their central role in long-only institutional investment.

Over the past two years, however, an interlocking combination of events and circumstances – the crisis that obliged hedge fund and fund of funds managers to impose redemption suspensions, gates, side-pockets and other liquidity restrictions, the bankruptcy of Lehman Brothers that tied up fund assets, and the uncovering of Bernard Madoff’s colossal Ponzi scheme – have propelled managed accounts to centre-stage, billed as at least a partial means of preventing or reducing the impact of similar problems in the future.

Hard and fast figures on the extent of hedge fund assets invested through managed accounts are thin on the ground, but all the indications are that they are growing rapidly. A survey of 50 institutional investors carried out earlier this year by alternative investments research firm Preqin found that 16 per cent of respondents already had allocations to managed accounts and a further 23 per cent were considering a first allocation to managed account structures before the end of this year. Greater transparency was cited as a motivation by 41 per cent of the institutions surveyed, while better liquidity terms and increased regulator oversight were each mentioned by 22 per cent.

The impetus toward managed accounts was even greater among 60 fund of hedge funds managers polled in a separate survey. Nearly two-thirds – 65 per cent – said they were either running managed accounts for investors or considering doing so over the next 12 months, with investor demand running behind greater transparency and liquidity as a motivating factor. Unsurprisingly the trend was strongest among larger fund of funds managers, but the survey found that smaller firms were also contemplating offering managed accounts to their clients in greater numbers.

Since additional cost and trouble is one of the key factors cited by both investors and fund of funds managers that for the time being have set their face against use of managed accounts, the role of platform providers that promise to relieve these burdens is central to the future growth of the sector. The biggest and best known, run by Société Générale subsidiary Lyxor Asset Management, has seen assets grow by more than USD2bn over the past 12 months to around USD10bn, according to managing director and head of managed accounts development Nathanaël Benzaken.

“The growth in assets is the result of two big trends,” he says. “Some fund of funds managers have been asked by their clients to offer more liquid solutions with less of an asset-liability mismatch, and they have added managed accounts to their traditional funds of funds because they offer better liquidity and security. A few managers are now offering managed account-only funds of funds, which have an even better liquidity profile.

"The second trend, which has developed more slowly than we expected but which we believe is more sustainable in the long term, involves institutional investors. This year we are seeing an increased appetite for hedge funds among institutions because they have to manage the risk-adjusted return of their assets amid very low interest rates and depressed equity prices. To stabilise the performance of their assets, there are few alternatives to hedge funds.

"However, they cannot afford to be exposed to the likes of Madoff or other fraud again, nor can they afford to be gated or side-pocketed as happened in 2008, and they want much better transparency. That leaves no alternative to managed accounts. One reason we haven't seen many big allocations yet is because institutions such as pension funds, insurance companies and large corporates are still doing their homework on fees and due diligence. The next big opportunity for hedge fund assets to grow will be not solely but primarily through managed accounts because these investors want control, liquidity and transparency."

Benzaken is hesitant to indicate the potential size of the institutional inflows to come but believes they could be of a scale to transform the industry. "Pre-crisis we estimated the market share of managed accounts to be 2 or at most 3 per cent of total hedge fund assets, but this proportion will grow massively given the volume of assets managed by institutions that are poised to enter the market. We don't expect it to take over the entire industry, but within two years it could be 10 per cent and maybe as much as 20 per cent in five years."

Ron Tannenbaum, co-founder and managing director of GlobeOp Financial Services, says the crisis triggers of the past couple of years have simply accelerated a long-term trend that was already underway. "Managed accounts and data transparency have always been a significant business for us, it's just that recently it's grown a lot bigger more quickly," he says. "There was a surge of interest in the managed account concept post-Lehman and post-Madoff, each of which had its own effects, but the trend was already there.

"Investors were looking at factors like transparency and owning your own assets in the same way as in the traditional asset management industry – institutions wanted to work with alternative investments as they'd been doing on the long-only side for years. Lehman and Madoff just accelerated that trend and put large investors in a position where they would not tolerate pooled vehicle investment any longer. Many large institutional investors simply said that by a certain date they would move to a managed account structure."

Tannenbaum agrees that in some cases turning that intention into reality has taken longer than was initially anticipated. "From December 2008 onward, it's been rare to go to a meeting with a fund or an investor without talking about managed accounts," he says. "For three-quarters of last year, investors were asking a series of questions: What legal structure do we need? What tax issues do we need to consider? What liabilities are we creating for ourselves? How will we create these ISDA contracts? There was a real learning curve for all the market participants.

"But now the movement of larger sophisticated players into managed account structures is firmly underway, although not all of it is visible to the outside world. Quite a number of large investor platforms have very quietly effected the shift. We've been implementing these structures since 2009 and now see increased asset allocation to them."

John Sergides, head of business development and strategy for alternative fund services in Deutsche Bank's Trust & Securities Services business, argues that the move by institutions into hedge fund investment through managed accounts is far more significant than the much-ballyhooed growth of Ucits funds using hedge fund strategies. "The big shift for pension funds is the increase in their allocation to alternatives, in order to achieve better returns that can help them meet their liabilities," he says.

"You can see how many people in the market are investing via managed accounts or establishing platforms of their own to get the transparency everyone's looking for, meet their fiduciary responsibility and obtain oversight on what's really going on, and I only see it increasing in the future. If you can do this at a sensible cost, what's the downside;

Managed account platform providers say the issue of cost is sometimes a red herring because of the difference in the way charges are calculated between managed accounts and traditional pooled fund vehicles. In the end there may not be much between them, says Tim Thornton, managing director for product and strategy at administrator Butterfield Fulcrum, which launched its Altinus platform earlier this year.

"Once you start digging into the costs you find there is less difference than many people seem to think, because they tend to concentrate principally upon the headline fee for a managed account. Compared with a single-manager fund, the managed account offers more frequent reporting, but more of the operational cost is included within the administration fee.

"What you are paying for is limit monitoring and guidelines, daily risk reporting and the IT platform, and platform-wide service agreements ensure competitive pricing. Ultimately, depending on structure and scale, you're looking at a difference of between zero to 20 basis points compared with direct investment, which means it's not as incrementally expensive as many people perceive it to be."

Thornton says this extra cost will pay for itself if, for instance, it enables a fund of funds manager to convince clients that their investments are more secure and robust. "The extra cost gives you the information to be able to take decisions a lot earlier," he says, noting that pooled fund investments may involve a gap of as much as four months between receiving information on the fund and being able to make an investment reallocation.

"In the Altinus environment you're getting daily reporting, so you could decided in late December you want to reallocate," he says. "The notice period's a lot shorter because it's a liquid strategy, and there's no delay in the switching. Effectively you can execute on your decisions a month or two earlier than you would be able to in a pooled fund."

Gabriel Bousbib, chief executive of Gottex Solutions Services, which was initially established to service the needs of the Gottex Fund Management fund of hedge funds business, argues that the managed account charge should be viewed in the same way as an insurance premium. "You don't buy flood insurance because you expect to use it," he says. "A managed account that provides very strong mitigation of fraud, mispricing and other unpleasant circumstances is the equivalent of flood insurance, which is why it can't be 'free'."

However, Bousbib underlines that manages accounts can certainly be cost-effective. "As a large buyer of third-party services, such as administration and audit, we are typically able to negotiate fees that a smaller manager would not be able to negotiate on its own, and this also applies to dealing with prime brokers and other counterparties," he says. "We have been quite surprised to find that even in the case of some of the larger funds we deal with, we have been able to negotiate better terms in areas such as cross-margining and other elements of a prime brokerage or ISDA agreement than the flagship fund."

Adds Benzaken: "Benefits never come for free. When you invest in managed accounts, you receive transparency, security, better liquidity and reporting. In addition, managed accounts help deliver better allocation and control of risk. Thus investors need to ask themselves whether these are benefits they wish to obtain, and if so they should expect to pay a price.

"It's very much a question of how you value the benefits. Some investors believed that Madoff had a robust enough business process and they didn't need to protect themselves. But there's an argument that a modest annual fee is actually a cheap insurance premium against fraud and to ensure liquidity. If you have better transparency and liquidity you can better exploit market opportunities, reallocate your portfolio in a smarter way, and better control your risk factors. You have more tools to run your portfolio, which hopefully will translate into better performance."

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