Hedge fund managed accounts 2011

New spectrum of choices for hedge fund investors
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Managed account challenges for investors and service providers

By Simon Gray

Hedge fund managers may have long been reluctant to provide access to their services through managed accounts, but they are grateful to them now. With total assets in single-manager funds growing steadily past USD2trn, according to HFR, in the process leaving behind the previous high water mark from the second quarter of 2008, managed accounts represent a growing proportion of capital invested in the industry, even if assessing the precise level is a somewhat inexact science.

A much-quoted survey of the US hedge fund industry by capital markets research and consulting firm Tabb Group, published in November 2009, predicted that the volume of assets invested through managed accounts would rise from USD468bn that year to USD790bn in 2011.

Rating agency Moody’s Investor Services, which in May last year quoted considerably more modest estimates of USD41bn, just 2 per cent of total hedge fund assets, held by the top 10 platforms, remains circumspect in its most recent review of the industry, published in March. Moody’s notes that while managed accounts (along with Ucits vehicles) remain “popular modes of investment, neither product segment has grown materially as a proportion of the overall hedge fund universe”.

While managed accounts remain attractive particularly to very large and conservative investors, and continue to be aggressively sold by platforms, the report argues that the pace of asset growth among major managed accounts platforms has trailed that of the hedge fund industry as a whole.

“In 2010, several large institutional investors announced that they would be investing in managed accounts offered through large platforms, rather than investing directly in hedge funds,” Moody’s says. “Although managed accounts represent a fraction of the total hedge fund industry, this is a trend set to continue in the short term given perceived advantages such as independence, transparency and liquidity. “However, the proliferation of managed accounts as a major mode of investment in hedge funds also poses a number of risks,
Gottex Solutions Services offers institutional investors access to independent market leading infrastructure and support services required for better hedge fund investing, providing more flexibility, transparency and control over those investments.

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Wider choice for hedge fund investment

By Gabriel Bousbib

We all know by now the key benefits and drawbacks of separate managed accounts. Properly set up and operated separate managed accounts – not to be confused with a ‘fund of one’ – provide independent asset verification and valuation, a stable financing environment, the ability by both investor and the manager to control inflows and outflows, and superior governance.

The drawbacks of managed accounts are also well documented, including possible negative selection bias (since some top managers decline to offer separate accounts, even for very large investors), additional operating costs and tracking error compared with the manager’s flagship fund.

Thanks to healthy competition, operating costs for most managed accounts have been coming down. The buying power of managed account platforms and focus on total expense ratios, as at Gottex Solutions Services, has also achieved attractive pricing from administrators, auditors, custodians and financing counterparties.

However, for some platforms direct and indirect costs have remained high, producing significant tracking error between the managed account and the flagship fund. Additionally, investor-friendly liquidity terms for multi-investor managed accounts can create less predictable capital inflows and outflows, also a source of potentially significant tracking error.

Finally, multi-investor accounts revive the investor commingling issue that exists in traditional hedge funds. Gottex Solutions Services has implemented an innovative solution for its managed accounts, One-Click Partitioning, which mitigates the risk of excessive simultaneous redemptions.

Over the past 18 months investors and managers have come to appreciate that hedge fund investment does not involve a binary choice between two extremes, a single-investor managed account and a commingled vehicle with little or no transparency.

Instead, a wide range of investment choices is available to address the respective concerns of investors and managers. For example, issues such as asset pricing, governance and operational concerns can be addressed within a manager’s existing investment vehicle.

Gottex Fund Management, a large investor in more than 100 hedge funds, uses a comprehensive framework to determine whether it should deploy capital through a separate managed account or a commingled vehicle, taking into account factors such as investment and operational risk as well as expense considerations.

Risk criteria for using a managed account include strength of governance, liquidity and operational risks, transparency risk, likely tracking error, quality of existing service providers, independence of asset pricing, the mix of existing investors, and the quality and strength of financing relationships.

Expense analysis can also help determine the choice of vehicle. The cost of service providers through the managed account may be lower, and ‘most favoured nation’ clauses constraining the manager in the commingled vehicle may not apply in a managed account, while the practice of some managers charging internal expenses to their commingled vehicles may not be applicable to a managed account.

Clearly, some investors or particular investment programmes may need the total transparency provided by separate managed accounts. This may apply, for example, to capital charges optimisation, in the context of the Basle II framework, or to hedge fund investment using active macro and tail hedge overlays. In our experience, however, except in very specific circumstances flexibility over investment vehicle is critical to successful investment programmes.
such as concentrating operational risks into fewer counterparties (in the case of the large platforms), increasing the expense of managing investments and causing further fragmentation in the hedge fund industry.”

Nevertheless, the development of managed accounts as a vector for alternative investments offers significant possibilities for service providers, according to Alternative Managed Accounts: Opportunities in Fund Administration, a recent white paper published by Advent Software and Maples Finance (now Maples Fund Services).

The report argues that few institutional investors have the capability and resources to administer a multiple-manager account platform themselves, and that “administrators that can successfully leverage their infrastructure and adapt their skills to the needs of institutions will have the opportunity to expand their business into a whole new market beyond hedge funds”.

The authors note that many administrators already have the operational building blocks in place, combined with accounting expertise and experience in working with multiple managers, to administer managed account platforms for investors. However, they caution that launching a platform is “a formidable undertaking” and firms must decide whether the opportunity makes sense economically, justifying a commitment of substantial resources.

Investors are not limited to an up-or-down choice between managed accounts and pooled fund investment, but have a range of options, according to Gabriel Bousbib, chief executive of Gottex Solutions Services, the managed account platform established by Swiss-based fund of funds specialist Gottex Fund Management.

“The managed account sector continues to provide an important element of hedge fund investing,” he says. “However, we have long said that they are not a panacea, just one piece of the puzzle. There are different structures, different levels of managed accounts, and different levels of services. We have always approached the topic of managed accounts as one important element that provides hedge fund investors with more options.”

According to the Advent-Maples white paper, the crucial moment for the managed account sector came in 2008 when institutions that had been steadily committing an increasing proportion of their portfolios to hedge funds suddenly found themselves unable to redeem their investments as managers responded to investors rushing together for the door by imposing gates and other redemption restrictions.

“Hedge fund investors came to realise how interdependent they had become with each other as part of commingled vehicles,” the report says. “For example, if a critical mass of investors suddenly decided to reduce their holdings within a fund, some managers needed to exit positions prematurely to provide liquidity for redemptions, jeopardising less-liquid strategies and adversely impacting overall fund performance for remaining investors.

“Having to answer to their own constituencies and governing boards, institutional investors sought a way to access hedge fund strategies without incurring the operational and liquidity risks that made the funds so vulnerable to market volatility. The solution: managed accounts, run by experienced hedge fund managers pursuing alternative investment strategies.”

Managers may not necessarily have wanted to embrace managed accounts but felt that if they did not do so capital might well go elsewhere – at a moment when for the first time in years, even the biggest and most prestigious managers were looking to rebuild their assets under management following the performance losses and investor redemptions in 2008 and 2009. They perhaps also recognised that the alternative investment industry was only following in the footsteps of the more mature long-only sector, where segregated mandates have long been a well-established route for institutional money.

One of the chief beneficiaries of this trend has been the growing number of managed account platforms, where the provider takes on operational control of the assets from the hedge fund manager and delivers or contracts other services such as administration and risk management. Investors benefit from the liquidity offered by the platform provider but their capital is commingled, as it would be with direct investment in a pooled fund.

An important advantage of the platform approach is that it allows investors to benefit from the best practices instituted...
by the provider, according to Stefan Keller, head of managed account platform research and external relations at Lyxor Asset Management, whose platform is the industry’s biggest at more than USD11bn in assets under management.

“The investors have access to state-of-the-art risk management techniques, for example,” he says. “This is already part of our model, but it will soon be a requirement for the industry in Europe once the AIFM Directive has come into force in 2013. At Lyxor we have gone through all the funds that are on our platform as managed accounts and we know our approach already meets the directive’s requirements in areas such as liquidity management and stress-testing requirements. This offers more security for the investor.”

More difficult for institutions to undertake alone is the single-investor managed account approach, where the investor must oversee accounts run by multiple managers. “Few institutions have the operational infrastructure to deal with the complexity of aggregating data in different formats from multiple managers, [and] the legal or accounting expertise to value multiple investment vehicles properly,” the Advent-Maples report says.

All but the very largest institutions will need help from an external administrator to manage the myriad processes involved: “Each investment vehicle is a separate legal entity with its own rules, terms and mandate. The managers will likely have different formats for trade files. They will be trading different types of securities and in different currencies. The investor has to track its capital commitments to each manager.”

But the challenges, both technological and economic, are almost as daunting for the administrator, according to the paper’s authors. “The biggest challenge is the level of custom integration required – and the resulting cost – to exchange data with multiple managers,” they say. “Putting the right kind of infrastructure and flexible processes in place at a price point that makes sense is difficult to figure out.

“When a firm is the administrator for, say, a USD2bn hedge fund, the revenues justify the investment of time and resources to build the interface necessary to service the fund. Building 10 such integration points to process accounts of USD100m each on behalf of an investor is another matter. You need to determine not only whether your existing infrastructure is up to the technological challenge, but also whether the investment required is likely to pay off economically.”

The biggest information technology challenge facing administrators is integration, according to Tyler Kim, chief information officer for Maples Fund Services. “You have managers that are transacting daily and expect response files in the format they use for the operation of their flagship fund,” he says. “The second major IT challenge is compiling all the reporting from the managers into a format that enables the investors to understand what’s happening. For the benefit of investors, Maples has developed a managed accounts dashboard that rolls up all the information from our systems.”

The administrator may also be involved in other functions that in traditional investment arrangements are taken care of by the fund manager, but now fall to the investing institution. “They need proper legal counsel on fund formation, structuring, domiciling and governance,” the report says. “They may well look to administrators for guidance on matters where they lack experience, such as offshore funds.

“Investors will also want to consider some sort of oversight independent of both the investor and the platform to keep tabs on managers and further manage risks. Administrators must be able to account for a wide variety of different legal entities with different structures, rules, restrictions and governance.”

The report concludes: “This adds up to a big opportunity for fund administrators, not only to capture more assets under administration, but also to engage directly with investors and grow their client base beyond their traditional hedge fund clientele.

“To capitalise on the opportunity, however, administrators will need to adapt to a model that is the opposite of the hedge fund model – one investor, multiple managers. They will need to meet exacting requirements for consolidated reporting, position-level transparency and analytics capabilities. And they will need the robust technology infrastructure and integration capabilities to handle the complexity that a managed account platform entails.”
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Meeting investors’ transparency needs

By Stefan Keller

The hedge fund industry has just set a new record with more than USD2tn in assets under management, a recovery from the turbulence of 2008-09 that has been accompanied by a shift toward investment through managed accounts. Although this sector has become more competitive over the past couple of years with the entry of new providers into the market, Lyxor Asset Management continues to build on its strength as a platform provider, with 13 years of experience, more than 100 managed accounts and assets under management exceeding USD11bn as of April, including inflows of some USD1bn in the first quarter of 2011.

One of the key reasons institutional investors have turned to managed accounts is that they cannot afford headline risk, such as the gates, side-pocketing and other redemption restrictions imposed by many hedge funds managers at the height of the crisis – a problem that did not exist for clients of the Lyxor Managed Account Platform. In addition, institutions are seeking better risk management and uniform reporting. They need access to greater transparency because hedge fund investment has to be viewed as just one part of an overall allocation.

For example, at Lyxor we often receive queries about investors’ exposure to the so-called PIGS countries, Portugal, Ireland, Greece and Spain, to which we can deliver a precise response because we can view as many as 40,000 positions held by all the accounts on the platform. This helps investors such as pension funds to examine their exposure to these countries across their entire portfolio and assess their overall risk.

The hedge fund industry has changed considerably since its previous peak, with fewer managers in the marketplace amid a move toward consolidation and institutionalisation. Managers have had to reinvent themselves to restore confidence among investors whose demands in terms of reporting and risk management have grown considerably, to some extent taking precedence over pure performance concerns, as well as facing increased external regulation.

Managers’ willingness to listen more to the concerns of their investors is an important factor in their desire to work with managed account platforms. They have much to gain from doing so because of the proven risk-return performance of alternative investments over the past decade or so has brought home to institutions the importance of allocating more capital to hedge fund strategies.

This trend is being boosted by the overall improvement in the investment environment, as economic uncertainty has declined, despite the impact of unexpected risks such as political unrest in the Middle East and North Africa and natural disasters in the Asia-Pacific region. However, opportunities for skilled hedge fund managers continue to abound, as reflected in the positive performance of most strategies over the first quarter of this year.

The forthcoming EU Alternative Investment Fund Managers Directive represents good news for Lyxor’s managed account platform approach because most of the future regulatory obligations, in areas such as liquidity management, stress testing and other aspects of risk management, reflect the firm’s existing business model.

At the same time, some long-term institutional clients such as pension funds prefer to set up their own dedicated managed account platform rather than embrace a commingled investment approach. Lyxor also offers this service to investors who nevertheless want to benefit from the firm’s experience and expertise, high level of fraud protection and enhanced risk management framework.
With the fourth anniversary approaching of the onset of the credit crunch and the crisis that rocked the hedge fund industry, the growth in investment through managed accounts has proved an enduring legacy of the mayhem of 2007 and 2008. But industry members say there is much greater appreciation today than a couple of years ago that there is not a simple choice for investors between pooled funds and managed accounts, and that a range of options exist depending on their attitudes toward cost and the key benefits they seek.

An example of the evolution underway in the industry is the joint venture announced last November by OFI Asset Management and Gottex Solutions Services, the managed account provider established by Swiss-based fund of hedge funds manager Gottex Fund Management. Luma Solutions Services is a Luxembourg-based platform providing onshore managed account services to Ucits and other European funds, starting with an initial base of USD350m in assets under management. According to the partners, Luma is the first independent platform to offer managed accounts services for both Ucits and non-Ucits onshore funds to European and international clients. Gottex Solutions Services is providing managed account and risk management services, adding to its existing offshore platform established in the Cayman Islands and bringing its total assets
under management to more than USD1bn across a broad range of strategies and asset classes.

The platform aims to be the most technically advanced platform in what is becoming a crowded market, promising features including transparent pricing and integrated tax reporting. “This joint venture brings together our Cayman platform with OFI’s UCITS platform,” says Gabriel Bousbib, chief executive of Gottex Solutions Services. “We will shortly be at 25 accounts, and it means we can now accommodate Luxembourg UCITS and SIFs as well as offshore funds on the Cayman platform.”

An important aspect of the deal, according to Bousbib, is OFI’s experience in Luxembourg and European distribution capabilities. “We’re in the process of building dedicated distribution capabilities for some hedge funds on the platform,” he says. “These managers are approved by Gottex or OFI, they are benefiting from the platform infrastructure, and it makes sense in some cases to distribute these managers to certain markets in Europe as well as in the Middle East.”

The domicile of a managed account platform can be an important factor for some investors in the post-crisis environment, often depending on their own location. “In certain countries such as France, they tend not to invest in hedge funds unless they are packaged through a UCITS vehicle,” Bousbib says.

“In practice that means they will only be comfortable with a fairly narrow range of strategies. Across certain European markets, investors are often reluctant to invest in vehicles established in offshore jurisdiction such as Cayman. This reluctance is found to a lesser extent among Asian investors. In general, North American investors are indifferent to the platform’s location, while in some cases, especially in the Middle East, they actively prefer Cayman.”

To some extent UCITS-compliant structures, with their high level of regulation designed principally for retail investors, have been portrayed as a competitor to managed accounts, but Bousbib disagrees. “They are part of what I would describe as a continuum of options,” he says.

“UCITS funds are more heavily regulated vehicles that can be offered to a broader range of customers, but the constraints imposed on them, especially in areas such as liquidity, leverage, type of assets and trading strategies, will by definition narrow the alpha opportunity. It depends on the kind of investor. If you are trying to serve a more retail-oriented customer base, UCITS are more suitable, but if the strategy supports liquidity, there’s no bar on offering that liquidity to more sophisticated investors through a non-UCITS structure.”

Stefan Keller, head of managed account platform research and external relations at market-leading platform provider Lyxor Asset Management, also believes the two investment approaches are complementary rather than in competition. “UCITS involves the public oversight of asset management activities, while the managed account platform provides private oversight,” he says. “UCITS hedge funds are seen as more opaque in terms of structuring, for example the need to use derivatives to achieve the economic effect of short selling.”

“The UCITS framework allows hedge fund-like strategies to be offered in a regulated environment, which helps to raise the profile of hedge fund managers, but it is nevertheless an expensive and a more complicated route. However, alternative UCITS reach a client base that has not previously enjoyed access to hedge fund strategies.”

Bousbib says the trade-off between the advantages sought by investors in areas
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MAPLES FUND SERVICES
By Tyler Kim

In recent months, institutional investors have shown increased interest in the alpha-generating strategies associated with hedge funds. Capital inflows from pension plans, endowments and foundations are redefining the industry as these sophisticated investors seek to improve the way it operates. One trend is a shift toward investment through bespoke managed accounts as opposed to commingled funds.

The benefits of bespoke managed accounts programmes include better liquidity, control and position-level transparency. One often-cited barrier to launching such programmes is the operational complexity of administering them. In this article, we discuss some of these complexities and ways they can be addressed.

1. Multiple trade file formats. Rather than dealing with a single trade file as with a traditional commingled fund, a managed accounts programme must accommodate multiple trade files from different managers. Each trade file may have its own format, delivery mechanism, and protocol.

Moreover, managers may be used to dealing with administrators through sophisticated automated processes developed specifically for large multi-billion-dollar commingled funds; when engaged for a managed accounts mandate, they may expect the same processes to be replicated for a USD10m sleeve by the programme administrator. Fortunately, flexible systems and experienced systems integration teams can address such requirements efficiently and effectively.

2. Pricing consistency. Consistent treatment of securities held within different sleeves of a managed accounts programme is important. However, with multiple managers involved, each with their own conventions, this is not always straightforward to accomplish.

For example, two managers may hold the same thinly-traded 144A security, but each may use a different price source. A third-party administrator can help arbitrate and enforce consistent policies by utilising a standard, truly independent price source.

3. NAV cycle synchronisation. A managed accounts programme cannot be valued in total until all underlying sleeves have been valued. Different managers may have different timelines for finalising NAVs, creating timing issues between the reporting cycles of various managers in a managed accounts programme. An experienced administrator can help establish and implement valuation policies that strike a practical balance for all parties.

4. Performance reporting harmonisation. Despite standardisation efforts, performance reporting practices vary considerably between managers. In a traditional hedge fund, investors typically rely upon managers’ performance calculations. With managed accounts, this no longer needs to be the case.

However, detailed portfolio data could represent information overload to investors. By consulting an administrator’s business systems analysts, specified, uniform performance calculations can be incorporated into systems that synthesise data into accurate, readily accessible and easy-to-understand dashboards.

It could be daunting for institutional investors to embark on launching a managed accounts programme. Fortunately, fund administrators with the right expertise and systems can help investors to navigate these challenges more economically than they might suspect.

While platform fees may range from 30 to 85 basis points (before manager and administration fees), bespoke managed account programme administration fees will be closer to 10 bps. With the right assistance, investors can enjoy the benefits of bespoke managed accounts seamlessly and cost-effectively. ■
such as liquidity, transparency and control of assets, and the cost of providing them, will vary from client to client. He likens the question to the optimum number of police officers that should be hired to ensure safety in a small town: “You could argue that the optimum number is one police officer per household, but of course that’s not sustainable, because the cost is extremely high. Similarly, in an ideal world, the perfect investment structure is one vehicle per customer, but that has cost consequences based on the size of the investment, the strategy and the number of service provider agreements that this entails. Everything will be a trade-off.”

There is also a range of options depending on the precise benefits that the client is looking for. “For instance, the investor could be in a fund of one, the sole investor, but all the oversight, controls, and governance remain largely in the hands of the investment manager,” he says. “They can retain the services of a platform operator, but is a cost of 35 or 40 basis points warranted to monitor what the investment manager is doing? For vehicles with a single investor, the expense of services such as administration, IFSA agreements and prime brokerage may make investment less cost-effective than in a commingled fund.

“Commingled funds have their own trade-offs. How liquid is the underlying strategy? What mechanisms exist in the event of excessive redemptions? A very binary approach to managed accounts is a false debate. There are many different reasons why investors might prefer managed accounts. For example, they might like a strategy, but the manager doesn’t employ sufficient leverage to the investor’s taste, so they set up a separate account using more leverage. They may prefer a slightly different investment strategy from that of the flagship fund. They may have operational concerns that the manager is not willing to address.”

Bousbib notes that Gottex Solutions Services has devised its own solution to meet investor concerns about the impact on liquidity of investing through a commingled vehicle. “The idea was to find an approach that would treat everyone fairly, both investors that are redeeming and those that are remaining invested,” he says. “The usual solutions of suspension and gating tend to protect the investors that stay at the expense of those who redeem. Conversely, solutions that basically involve selling the most liquid part of the portfolio favour investors that are redeeming.”

The idea behind One-Click Partitioning is to try to balance the conflicting needs of both groups of investors. “For every managed account we predefine a redemption threshold, depending on the type of strategy. With merger arbitrage or liquid equities, it could be as high as 70 per cent, but for mortgage-backed securities it could be as low as 20 per cent. If the threshold is triggered, the account is automatically partitioned into two, and the account that represents the interests of the redeeming investors is liquidated.”

The importance of this, Bousbib argues, is that it prevents investors feeling obliged to redeem their investment because they fear getting stuck with illiquid assets if they don’t. “It acts as a safeguard and avoids unwanted redemptions,” he says. “During the 2008-09 crisis investors were afraid to be the last ones holding the bag, so everyone rushed for the door. Here they know there will not be arbitrary decisions by the board or the manager – it’s all predefined.”

Keller says that while transparency, and the risk management linked to it, is perhaps the primary advantage sought by managed account platform investors, it’s important
He adds: “The main lesson of 2008 is that hedge fund investors have to do their job properly and ensure there is no mismatch of liquidity. The managed account platform permits that sort of asset-liability management. Our investors have access to weekly liquidity, and they use it. Liquidity allows you to tweak a portfolio, to switch between strategies and follow new investment themes at the right time.”

Keller believes that one of the ways in which managed account platforms can distinguish themselves from competitors, and from the do-it-yourself approach, is the level and quality of service they offer.

“It’s about areas such as risk management and state-of-the-art reporting, which we will enhance further in 2011 by offering access through the web site,” he says. “It’s about giving clients access to dedicated research and providing more investment insight. This has a cost, but Lyxor has continued to invest all the way through the crisis because when competition is strong, you have to offer investors better service.”

By contrast, Maples Fund Services chief information officer Tyler Kim argues that the sheer diversity of client requirements in areas such as reporting make it hard to devise a satisfactory common solution.

“Every investor is different,” he says. “They are similar in that they want P&L and position data to be readily accessible. However, when you come to things like performance calculations, some may use an internal rate of return methodology, while others may be satisfied with month-over-month changes in NAV adjusted for cash flows.

“They are all very specific about what reporting they need for their board, and we have to follow that. There is such huge variation and complexity that we have found that the one-size-fits-all approach just doesn’t work.”

Karen Watson, global head of data management at Maples Fund Services, adds: “Most clients are focusing on risk management and exposure reporting as well as performance, but when you drill down beyond the overall themes, the detail is absolutely unique to each investor. That’s where a managed account platform is not as accommodating as a bespoke system.”