Fraud and liquidity concerns drive investor switch

Providers innovate to mitigate platform costs

Client demand gives impetus to new entrants
In this issue...

03 An idea whose time has come?
By Simon Gray

05 Administering a managed account
By Dermot Butler, Custom House

08 Building a managed account infrastructure
By Richard Day, MAG Consultancy

11 An option for the new investment landscape
By Jim Cass and Mike Leahy, SEI Investment Manager Services

14 Playing to our strengths: creating value for investors
By François-Régis Bocqueraz, Crédit Agricole Structured Asset Management

16 New investros needs prompt innovation among managed account providers
By Simon Gray

18 A different approach to managed accounts
By Marc E. Denogent, HFR Asset Management

21 Managed accounts are here to stay
By Nathanaël Benzaken, Lyxor Asset Management

23 A different managed accounts platform
By Martin Gagnon, Innocap

26 Innovative solutions lower investor costs
By Gabriel Bousbib, Gottex Solutions Services

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An idea whose time has come?

By Simon Gray

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 MAG Consultancy (it stands for managed accounts and governance), 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...
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In the current environment, many investors are seeking to use managed accounts in order to obtain greater transparency, flexibility and liquidity, as well as receiving increased protection against fraud by the manager, although how great a benefit transparency really conveys depends on the investor’s ability to understand the manager’s strategy.

The managed account investor must also be ready and equipped to shoulder some of the risk previously taken by the manager. Nevertheless, a switch from commingled fund vehicles to managed accounts is now increasingly an option for investors that are under pressure from their own stakeholders to demonstrate that they are doing all they can to minimise the risks not only of fraud but the illiquidity that became widespread over the past two years, leading to managers imposing gates, suspending redemptions and extending lock-up periods.

In many ways the trend toward managed accounts is taking the hedge fund industry back to its roots three or four decades ago, when investors opened accounts with investment managers to participate in the commodities and futures markets. However, pooled funds subsequently became more popular with managers seeking to reduce their administration costs. This remains an issue today – it is expensive to invest through a managed account, with all the costs of asset valuation and independent administration, unless the investment is of a considerable size, which is why managed accounts will not be a panacea for all.

Nevertheless, the additional cost can be reduced through the use of a managed account platform, the number of which is growing rapidly to meet market demand. Custom House already has extensive experience in this area, having undertaken administration of the platform created by Innocap/National Bank of Canada since 2005.

At that time the bank had 28 managed accounts on their proprietary desk for which it wanted to establish a vehicle that could by opened up to third-party investors. We designed a master-feeder fund in Malta, incorporating a master fund with a series of sub-funds that were all segregated cell companies. Each managed account was moved into one of the segregated cells, which are completely legally ring-fenced, so they cannot contaminate any other cells within the structure. This ensures that that there can be no cross-collateral liability of the kind that brought down the Amaranth Investors multistrategy fund.

Administration of the platform is facilitated by Custom House’s structure, with administration operations spanning the world’s time zones in Europe, the US and South-East Asia. We have a totally transparent and flexible system that enables us to start the day in Singapore at 8am, where we do all the trade capture for every transaction done the previous day in the various accounts, which now number more than 60.

In the afternoon the Singapore office reconciles all the existing open positions with the new positions and produce a reconciled book that shifts to Dublin, where the NAVs for the master fund are carried out, and then to Chicago, which calculates the daily NAVs for the feeder fund. The feeder fund now has some 47 sub-funds itself, reflecting the increasing number of external clients that are using the platform.

Managed accounts are here to stay, certainly for institutions concerned about the potential liquidity and fraud risks when investing through a manager’s pooled fund. In the wake of the turbulence of the past two years, the extra cost is considered a price worth paying.

Dermot Butler is chairman of Custom House Global Fund Services
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 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
THE LEADING INDEPENDENT ADVISOR ON MANAGED ACCOUNT PLATFORMS

The MAG Consultancy designs, develops and builds solutions for asset allocators as demanded in a new world of transparency, governance and control.

MAG is a 50/50 joint venture partnership between MSS Capital and IGS Group. The combined resource of the two firms creates the leading intellectual resource on advising, constructing and managing services in the managed account space.

MAG is able to offer its clients five unique services:

DISCOVERY - Following the assessment of a client’s individual needs, MAG is able to tailor a managed account solution that best encompasses the client’s investment objectives;

ADVISORY - Working with asset owners, hedge fund allocators and institutional investor clients, MAG is able to afford strategic advice on best-of-breed business practice and governance procedures for their Alternative Investments;

HYBRID - Partnering with best-of-breed service providers, MAG delivers market-leading managed account solutions for clients utilising a combination of existing and bespoke products;

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FIVE UNIQUE SERVICES, ONE CONSULTANCY
Having weathered the storms that have raged across the hedge fund industry since mid-2008, many funds of hedge funds and other allocators such as private banks and endowments are looking to re-establish their credibility with investors. The old model of outsourcing the governance of a hedge fund portfolio to a string of boutique management firms is being questioned and re-engineered to bring more appropriate levels of control back to the allocators.

The change in the fund of hedge funds model to enable fiduciary powers to be reclaimed on behalf of the investor has spawned much new thinking and better practice, the application of which is being embodied in the wide range of infrastructure designs known as managed account platforms.

Demand was already growing from funds of hedge funds seeking to re-engineer their business practices to protect themselves from a repeat of the liquidity problems they faced in obtaining redemptions from underlying managers, before the eruption of the Bernie Madoff scandal in December 2008 focused increased attention on the advantages of managed account investment in reducing fraud risk.

MAG Consultancy was established in early 2009 to meet demand among allocators such as funds of hedge funds for a managed account infrastructure that would resolve a number of the key operational issues that had caused such angst, such as the inability to control valuation policy, cash policy and the inappropriate use of gating.

The firm’s partners and staff, who include John Godden of IGS and Simon Hookway of MSS, have between them been closely involved in the design, building and running of more than a dozen existing managed account platforms and have been able to bring the benefit of this experience to those looking for advice and assistance in deploying a managed account strategy.

A huge dynamic shift is in prospect. Whereas historically some 3 per cent of assets allocated to funds of hedge funds has been invested via managed accounts, this is rising exponentially and could increase over the next year to as much as half of all fund of funds assets. MAG Consultancy is dealing with a broad spectrum of allocators including fund of funds managers, administrators and banks as well as hedge fund managers seeking to offer their own managed account infrastructure.

It has become apparent that much of the managed account capability has rested with product providers, which has limited the possible solutions and kept fees falsely high. MAG’s strength as the only independent adviser in the managed accounts space enables us to look at clients’ options with a completely clear eye and to provide advice on resourcing, costs, systems and legal structure.

Many allocators have rejected a fully outsourced managed account solution as carrying too many compromises, such as commingling with structured product investments or weak key service providers. But building an in-house managed account platform, with key functions outsourced but under the control of the allocator, requires careful planning if it is to be executed efficiently and effectively.

A managed account platform consists of various major components. First, the legal structure needs to be a cost-effective regime in a domicile that suits the target
investors and takes account of potential regulatory measures such as the EU Directive on Alternative Investment Fund Managers. Customer views will influence whether a platform should be onshore or offshore, or in the Channel Islands as opposed to Cayman, the BVI or Bermuda. Another key consideration is the relative merits of a corporate as opposed to a trust arrangement. There are some 56 separate legal documents on an average managed account platform – making these talk to each other is the trick to an effective regime.

The second crucial component is operational infrastructure, as the allocator moves to the new position of being the de facto trading middle office between the trading advisor (via the prime broker) and the fund. Unless the allocator is already experienced in such tasks this is probably best outsourced to a bank or administrator.

Third is risk monitoring. Managed accounts throw up daily position-level data that needs to be handled (usually by specialist IT) to monitor accurately for breaches against predetermined trading mandates. Last is fiduciary management, the key decision-making tasks including selection of managers, defining trading advisory terms and taking action in the event of breaches. This also extends to responsibility for valuations and selection of all service providers. Again, allocators are increasingly looking for outsourcing in this area.

Within a managed account infrastructure, it is the ability to act on information that creates meaningful control and is central to resolving governance issues. If a manager is in material breach of any major factor, you can take back control immediately rather than being stuck behind a six-month redemption notice. Even if the liquidity of the underlying assets is limited, you can take control of the assets, either for someone else to run or to close out the positions. Further benefits of a managed account platform include the fact that daily, highly robust data enables much more sophisticated portfolio management and risk monitoring tools to be used, while the common legal infrastructure allows a more dynamic allocation strategy to be deployed. Operational due diligence is applied on a platform-wide basis as all components and service providers are common, and scale benefits can be brought to bear to reduce service provider fees. In addition, corporate policy can be deployed effectively on behalf of investors – for instance, a view that Lehman was in trouble could have been acted upon immediately.

The scale required for a successful managed account platform used to be calculated in terms of an average minimum fund size of USD50 and total minimum assets of USD1bn. However, the advent of non-bank commingled facilities is set to reduce the minimum platform size necessary to just a few hundred million.

Another important change is the readiness of managers to meet requests for managed accounts. In recent months managers have become more accessible than ever, although increasing asset levels across the industry may see attitudes hardening over time. Managers will also, sensibly, limit the number of managed accounts they offer. As a result, there is a something of a race underway to get facilities established.

In the past creating managed account infrastructure has been expensive and time-consuming; two years and USD10m has been par for the course. Usually new platforms would be created from scratch, with no managers, infrastructure or assets. However, today clients tend to be running assets and have investments with managers already, so they are no longer building on a greenfield site. The migration of existing assets with an existing manager array will initially drive the design of the platform.

MAG Consultancy utilises its existing technology in all areas from legal documentation to risk monitoring systems to save clients time and money, and our staff resources include highly experienced lawyers, operations staff and administrators who have already been there, seen it, done it, and know where mistakes can be made or where costs can run out of control.

Having taken crucial but difficult decisions in the past, it is easier to develop solutions today. Many clients already have much of what they need and just need help to take the final step. With the right direction that can take less than six months, delivering a robust infrastructure for a tenth of what it would have cost in the past.
give 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 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,
Hedge fund managers are increasingly employing managed accounts instead of the fund of hedge funds model predominantly used in the past. This trend stems primarily from recent market events, as well as the increased focus by managers and their investors on market risk and liquidity in investment strategies, and reflects the increased level of transparency and control over the portfolio’s underlying assets offered by the managed account structure.

Funds of hedge funds have recently seen redemption requests met by the underlying funds establishing gates or suspending redemptions due to their own liquidity challenges, preventing the funds of funds meeting their own investors’ redemption requests. Funds of funds now seek more transparency on holdings in the underlying portfolios, better enabling them to carry out risk analysis and assess the likelihood of encountering gates or suspensions should they seek redemptions in the future.

Fund of funds managers are also more conscious of the need to match the liquidity provisions of underlying funds with what they offer to their own investors. In the past bridge financing enabled them to pay out redemption amounts without having to redeem from their underlying positions before they felt it necessary; but the volume of redemptions experienced by funds of funds in 2008 and the tightening of credit presented managers with a liquidity issue. The problem was compounded for funds of hedge funds with leverage financing in place, which in some cases were obliged to impose gates or suspensions themselves.

Meanwhile, hedge fund managers have become more willing to support managed accounts as they seek to attract new assets and retain existing investors. Whereas in the past, minimum managed account mandates were as high as USD100m, in recent months accounts have been established with as little as USD10m, depending on the strategy. As well as funds of hedge funds, investors such as pension funds, sovereign wealth funds and other large institutions are now investing more assets via a managed account structure.

Yet this may not suit all investors. For a fund of funds, it is typically more expensive than investing through a pooled vehicle due to the increased infrastructure required. Rather than simply accounting for a single investment and receiving valuations from the underlying fund, they now need sophisticated systems and expertise to track investments, calculate the value of all underlying positions and perform risk analysis.

In the future, the pendulum is set to swing back to some degree and smaller managed accounts will become rarer, in large part because institutions need a critical mass of assets to justify the infrastructure cost and effort. However, the extra expense can be mitigated in various ways, and the benefits can outweigh the costs – particularly for larger mandates where the underlying managers have more latitude to customise fees.

Other alternatives can help funds of hedge funds fill the infrastructure gap cost-effectively. Fund managers can benefit from the platforms and applications built by third-party service providers such as SEI, which has drawn upon its extensive experience in managing back- and middle-office operations of single-manager hedge funds and funds of funds to create a scalable platform and comprehensive analytical tool set.

In the end, it’s hard to pick a model that will fit everyone’s needs completely. Instead, managed accounts are just one solution managers should think about in determining what works best for their business and investors.
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
Over Review

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 even years to act, but I believe the change is permanent.”
Playing to our strengths: creating value for investors

By François-Régis Bocquerez

The past 18 months have brought vindication of the approach to hedge fund investment offered by Crédit Agricole Structured Asset Management. The CASAM alternative managed account platform offers investors access to the returns of single hedge funds or a diversified portfolio of hedge fund investments within a risk-controlled environment.

To start with, the platform’s benefits include enhanced liquidity with weekly or monthly dealing days on our feeder funds and very short notice periods, typically no longer than five business days. The fundamental principles of our platform are a premier legal and operational set-up, strict monitoring and enforcement of risk guidelines, as well as full transparency on independently priced positions.

The oversight and risk control functions undertaken by CASAM start with comprehensive due diligence as part of our manager selection process as well as ongoing portfolio monitoring. Hedge funds are selected through a stringent iterative evaluation process that identifies established hedge fund managers with proven track records.

Our selection criteria aim to identify trading managers with a high-profile pedigree and spotless background checks, recurring outperformance against peers and a clearly-defined risk management policy. One must also consider a series of sustainability factors in selecting managers, such as a solid trading and operational infrastructure and minimum assets under management to ensure the viability of the hedge fund manager’s provision of investment advice.

When it comes to the legal set-up, our hedge fund managers are contracted as trading managers of segregated accounts with legal ring-fencing. They sign investment management agreements that contain features including compliance and investment guidelines defined in accordance with CASAM standards and policies in terms of risk spreading, risk budgeting and liquidity. Adherence to guidelines is monitored by CASAM, which conducts oversight and risk monitoring and mitigation of the portfolio and operational risks associated with the various hedge fund strategies present on the platform.

Our infrastructure enables us to monitor and verify each managed account’s net asset value on a daily basis. Within the CASAM managed account operational set-up, the daily valuation agent is an independent party and the fund administrator is a separate entity within the Crédit Agricole group, applying best industry practice pricing protocols.

When combined with favourable liquidity terms, all these attributes allow us to lower considerably the risk of operational blow-ups and dampen the volatility of our client portfolios by bringing more predictability in the returns of our hedge managed accounts with much reduced fat tail risks, thereby maximising expected long-term risk adjusted returns.

Multi-faceted and adaptive open architecture

The flexibility of the platform is vital in an economic and financial environment characterised by uncertainty and lack of consensus among investors. The building block approach is ideally suited to meeting...
the requirements of clients that often have sharply divergent perceptions of the market and requirements.

We take pride in the ongoing conversations between our dedicated platform analysts and portfolio managers and various industry participants, who provide us with insight and advice on the strategies and managers best suited to fulfill our business partners’ needs. CASAM is therefore actively engaged in a constructive peer-to-peer dialogue whose objective is to share market and industry knowledge in order to help our clients or prospective investors in the execution of their allocation ideas.

We are continuously trying to bring on board selected managers in areas where we believe we can add value to the various types of hedge fund-based products offered by our investors and the Crédit Agricole Group, including through structured products. We are, however, extremely mindful of not tipping the other way into over-diversification, which in our eyes could lead to reduced medium- and long-term alpha as well as hidden costs.

Clients are now more than ever highly conscious of the impact of fees and costs on long-term performance. CASAM works actively to ensure that investors receive value for money, from negotiation of highly competitive management fees without compromising on must-have services such as top-quality fund administration and independent third-party valuation.

Our long experience and economies of scale enable us to provide independent valuation, risk supervision and reporting as well as segregation of assets on a single platform at costs similar to what direct investment in the equivalent pooled hedge fund would entail.

An enduring partnership
Our managed account platform is different to those of many of our rivals in that CASAM is not only an established fiduciary, but also is wholly owned by Crédit Agricole Asset Management, one of the world’s leading investment management companies and itself a critical component of the Crédit Agricole Group. It is also notably not part of an investment bank, which shields it from many internal conflicts of interests.

It therefore combines the appeal of institutional-quality services with the comfort of a trusted partner.

Our expertise lies in being able to provide and/or combine a broad spectrum of customised investment solutions from structured products to alternative investments. Our background in structured products brings with it a long-term focus, assisted by being able to rely on the financial strength and brand appeal of our parent group.

Since late 2008, client concerns have been as often about issues such as liquidity and risk management as performance. Although the pendulum may well swing back in the wake of outstanding hedge fund returns in 2009, CASAM is acutely aware of the importance of delivering on its promises of long-term capital preservation and diversification.

What has hurt the hedge fund industry over the past two years has been lack of accountability toward its investors. In the end it is not the many blow-ups that shake the industry to its core but lack of trust from existing and potential new clients. Last year, when investors needed their money back, CASAM returned it to them as they expected. Amid the biggest liquidity crisis in modern financial history, CASAM passed the ultimate stress test and won its investors’ hearts.
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.

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A different approach to managed accounts

By Marc E. Denogent

The HFR Group was founded in the early 1990s by Joseph G. Nicholas, who developed the managed account concept to resolve a structural problem that left hedge fund investors at risk from fraud and manager blow-ups. He also sought to fill the complete void of information about the hedge fund industry by establishing our sister company Hedge Fund Research, which today maintains one of the largest commercial databases of hedge fund information.

Since the early 1990s, the industry has grown exponentially and thousands of funds of hedge funds have been established. However, the initial problems persist and fund of hedge funds managers still struggle to build efficient portfolios through investments in flagship funds based on mostly incomplete and out of date information.

The tremendous growth in assets ended abruptly last year amid outflows that saw many single-manager hedge funds suspend redemptions, impose gates or create side-pockets. As a result, the hedge fund industry has recognised the need for transparency and other safeguards in order to make better decisions.

In short, the rest of the industry is now slowly moving to a model that HFR Asset Management has endorsed and operated for years. HFR utilises managed accounts within a trust structure, with an appointed trustee acting on behalf of unitholders. The trustee is independent of HFR, as is the custodian and the administrator – vital for a closed system.

Each hedge fund manager typically trades the HFR managed account pari passu to its flagship fund, but has no legal rights to the trust’s assets. The manager’s sole responsibility is to trade the fund’s account, while having no control of or access to its assets. For a managed account structure, complete segregation of all roles is vital, and HFR ensures that all those roles are functioning properly.

Each day HFR downloads all positions in the managed accounts directly from the prime brokers. It also obtains trade blotters from the managers daily and position files weekly. The firm’s risk team reconciles the positions for each manager, independently prices every security, and investigates any discrepancy between HFR’s valuation and the broker valuation. HFR independently prices each portfolio daily on a T+1 basis, and then reconciles the prices each week and at the end of each month with the administrator, which produces the official valuations.

A dedicated risk team ensures that each manager remains in compliance with its pre-established investment guidelines, which are tailored to each manager’s particular strategy, liquidity profile, sector exposure and instruments. Any breaches are assessed according to three levels of severity.

The risk team also maps every position of each manager within RiskMetrics and runs some 214 different stress tests for each portfolio based on position-level information, enabling HFR to understand and inform investors daily of the distribution of risk within each account. This is the basic tenet of portfolio management theory – understand the risk of what’s going into your book, and construct the portfolio based on that risk.

Independence also distinguishes HFR from other platform providers. Not being part of a banking group avoids certain conflicts of interest that could otherwise arise. The level of information we deliver to our clients is more comprehensive than that provided by other platforms. Finally, HFR is not a newcomer to the business in response to the recent market turmoil, but has been developing and honing managed account structures and processes since the early 1990s.
Managed accounts

Hedgeweek Special Report Jan 2010

www.hedgeweek.com

19

the issues of fraud, pricing and not least governance.”

In this environment, opportunities are rife for firms such as MAG 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
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Managed accounts are here to stay

By Nathanaël Benzaken

An important question currently being asked among hedge fund managers and investors is whether the current shift toward use of managed accounts will make them a permanent feature of the industry landscape, perhaps one day replacing pooled funds as the default option for investment, or whether some of the impetus will slip away as memories of the liquidity problems of the past two years start to fade.

Obviously, as the largest hedge fund managed account platform in the world, Lyxor has a vested interest in the growing demand among investors, but we believe this is a sustainable trend. That doesn’t necessarily mean that managed accounts will come to outweigh direct investment in hedge funds, but we do expect their market share – which accounted for perhaps 2.5 per cent of industry assets at the outset of the crisis – to grow exponentially.

The first reason is the declared intention of a wide range of investors, including funds of funds, family offices, private banks and other financial institutions, to increase their allocations to managed accounts. Particularly significant is the role of institutional investors, who are expected to account for the majority of new assets flowing into managed accounts.

For a pension fund manager, there’s absolutely no upside to taking on the risk of being defrauded when they invest in a hedge fund. If we can demonstrate to the chief investment officer of a pension fund that they can obtain the same performance while eliminating that risk, it’s a no-brainer – and already a number of large pension funds in the US have announced plans to switch their hedge fund investments into managed accounts.

Importantly, these big institutions have been keeping their powder dry over the past months and quarters and are already sitting on large piles of cash. Because of current US interest rate policy, there is a negative carry for investing in dollar-denominated money market funds, so institutions have an urgent need to redeploy their cash as quickly as possible.

A new element is the ability to attract leading hedge fund managers to managed account platforms. Whereas until recently it was more of a challenge to convince leading managers to accept managed accounts, now many of the industry’s best-known and highly-regarded names approach Lyxor in order to offer managed accounts to investors. An important factor in a manager’s acceptance of managed accounts is that technology now enables them to run a managed account at a marginal operational cost.

Whereas previously pension funds had two options, either to invest through a managed account platform or create their own, now they have the option of ‘renting’ a platform – that is, asking a provider to run a platform just for themselves. This means their investments are not commingled with those of other clients of the platform, while all the technology and operations are outsourced. This makes access easier for many investors.

A final driver of growth is that the enhanced transparency offered by managed accounts facilitates better management of investors’ portfolios. Funds offering quarterly liquidity at 90 days’ notice offer few options for rethinking portfolio allocation, but weekly or monthly liquidity and enhanced transparency enable investors better to manage their beta, optimise their allocation across different strategies, and manage their exposure to regions and sectors. This should result in a portfolio more fine-tuned to the investor’s top-down strategic view.
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.”

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
Innocap may not have the high profile of some players in the hedge fund managed accounts sector, but it has the longest experience of any of them. The platform was launched in July 1996 when National Bank of Canada made a USD28m investment in hedge funds from its proprietary capital and decided to do it through a managed accounts programme in order to retain control over the assets.

Following a period as an in-house programme, the platform started accepting third-party money in 2000, and three years later National Bank of Canada created Innocap by spinning the platform out of its treasury into a separate asset management firm. In 2005 the firm began to create its own legal vehicles and established an infrastructure that remains the only managed account platform where the assets are located onshore, in Malta.

Two years ago BNP Paribas took a 25 per cent stake in Innocap and adopted its present structure, with the 'manufacturing' and risk management activities carried out in Montreal and global marketing undertaken by representatives employed by BNP Paribas. This leaves Innocap with the backing of two substantial institutions with deep pockets yet independent of them both, and with diversified ownership that reduces any risk related to the fortunes of its parents.

Today Innocap has some 50 managers on the platform and nearly USD2bn in assets following the turbulence of the past two years, with more than 90 per cent of assets coming from institutions, including notably Caisse de Dépôts et Placement du Quebec, Canada’s largest pension fund. One of the factors that reassures institutional clients is that the firm has achieved Type II SAS 70 certification for the past three years.

The fact that Innocap was built for and by an institution makes it different from other platforms in many ways. For example, because it does not need to structure products on managed accounts, it can be flexible and adapt to clients’ individual requirements, for example providing daily liquidity for CTAs at the same time as handling more illiquid products with monthly or even quarterly liquidity.

In addition, Innocap ensures that no conflicts of interest arise with its parents. The firm uses more than a dozen prime brokers, and BNP Paribas is currently not one of them, while JP Morgan acts as banker to the structure. Whereas other providers seek to earn revenues from services to their managed account platform, in areas such as custody or prime brokerage, Innocap stipulates that it receives no other revenues than those disclosed to investors: no retrocessions, no rebates, no deals with distributors. It does not try to hide fees in high-margin structured products.

The firm runs an open architecture, so there are no share classes, and is totally transparent on fees. In addition, Innocap offers official daily net asset values for managers that use liquid enough instruments such as futures in order to provide daily liquidity. It’s almost unique in the market to be able to buy or sell strategies from high-profile CTA managers on a daily basis with three days’ notice.

All these distinguishing factors – having the longest running platform, offering daily NAVs, being built by and for institutional investors, having SAS 70 certification, and keeping assets onshore - coupled with the firm’s three values of open architecture, transparency on fees and no conflicts of interest, have made Innocap a solid choice for institutional investors and their consultants.
Managed accounts

Hedgeweek Special Report Jan 2010 www.hedgeweek.com | 24

industry

inDuStry management and reporting and the segregation of assets come on a single platform at a charge not materially different from that of 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 are 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...”
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As a fund of funds manager investing in hedge funds for more than 10 years, Gottex Fund Management currently manages more than USD8bn in assets, invested with some 100 hedge fund managers. Like other large hedge fund investors, starting in late 2008 we faced challenges with some hedge funds whose managers decided to gate or suspend redemptions, restructure or liquidate their vehicles. These events showed the clear constraints and possible pitfalls of commingled hedge fund investments.

Until recently, most high-quality managers were reluctant to operate separate managed accounts. The world has changed in the past year, and managers have become more willing to accept capital through managed accounts for some of their large investors.

Reviewing existing managed account platforms, we found that most were built for purposes that were not in line with our and our clients’ objectives. Many bank-owned platforms were designed to develop structured product activities, notably imposing high liquidity requirements and subjecting the accounts to short-term capital movements. We also felt that other platforms’ fees were high.

By contrast, Gottex’s goal was to address the issues of fraud, pricing, investor commingling and governance. An investor in a commingled vehicle is at the mercy of decisions by the hedge fund manager and/or board and can be impacted by the behaviour of other fund investors, and we felt existing platforms did not really address those issues.

We decided to use our in-house expertise and infrastructure to develop our own managed account platform. To service properly the needs of our funds of funds, as well as those of similar investors, we formed a separate business, Gottex Solutions Services, to provide managed account services to institutional investors.

In addition to standard features such as daily NAV estimates, independent pricing, risk reporting, independent asset verification and control of all financing agreements, the platform offers two unique investor-friendly features.

Through the use of tri-party repurchase agreements, NetFunding enables managed accounts in need of cash to borrow from other accounts on the platform that have excess cash. The platform acts as the facilitator between two managed accounts, and monitors the tri-party repurchase agreements with respect to haircuts and custodian choice.

In the event of excessive redemption requests, managed accounts on traditional platforms governed by the board process could become subject to suspensions and gates, the very elements driving investors away from commingled fund investments. The RedemptionPartitioning feature ensures that if redemption levels exceed a predefined proportion of a managed account’s assets, it will be partitioned for accounting purposes between the assets and liabilities of redeeming and continuing investors.

The manager is then required to liquidate the portion of assets and liabilities corresponding to the redeeming investors, starting from the redemption notice date. The partition is triggered on the notice date, giving the manager additional time to liquidate the positions, and redemption costs will be borne by those investors only. This balances the conflicting interests of redeeming and continuing investors and eliminates the uncertainty regarding the impact of other investors’ actions within commingled vehicles.

The recent entry of several new players has brought the number of managed account platforms to nearly 20. We believe the winners will be those providers able to offer a cost-efficient, reliable service geared to addressing the needs of investors, whether asset managers or asset owners.■
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 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."