Hedge fund managed accounts autumn 2010

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Managed account boom shows few signs of slackening

By Simon Gray

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

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

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

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

By Simon Hookway

Hedge fund managed account platforms were around long before the current boom in interest from investors began in the wake of the industry’s liquidity crisis, the bankruptcy of Lehman Brothers and the uncovering of the Bernard Madoff fraud. But now the platform sector is characterised by dynamic change as investor money flows into managed accounts and competition grows from new platform providers from across the industry.

The initial platforms were owned, run and managed by investment banks, headed by Lyxor Asset Management but also including Deutsche Bank. But all this has changed over the past year as a result of the industry problems as well as regulatory changes, as a new generation of managed account platforms starts to emerge at different levels.

Some are being established by administrators, others by big fund of funds managers, and there are signs that a fresh wave of activity is on the way involving investment banks that have not entered the sector already. The result will be more price-competitive, flexible, user-friendly and transparent platforms.

Evolution of the sector over the past 18 months has been driven by price as well as conflicts of interest. The investment bank platforms have many pricing points, from custody and prime brokerage to structuring, risk management and distribution, all of which need to generate revenues. Although a complete in-house solution looks as though it ought to deliver economies of scale, it suffers from lack of competition within the structure.

MAG Consultancy has been involved in the design and establishment of managed account platforms that are not trying to compete with an investment bank’s asset management arm, but whose components are delivered by providers that are cost-effective and well-resourced, have well-respected brands and are market leaders at what they do.

One key factor in these changes is much greater acceptance of the concept by hedge fund managers themselves. In the beginning it was assumed that the best managers would not countenance offering managed accounts. However, that view has changed since it became clear that some managers would not offer segregated accounts, such as Madoff, Amaranth or Bayou, because they were committing fraud or taking risks that they were not informing investors about.

The other main driver is big asset-owners with a fiduciary responsibility to their own investors. Pension funds or insurance companies investing large pools of cash have a responsibility to use the most cost-effective platform, employing the best available components and delivering information that allows them to make informed decisions. In this the alternatives sector is simply following the path adopted years ago by the long-only industry.

Managed account platforms has already lowered the barriers to entry for smaller institutions. Small family offices, charities, endowments and pension schemes have long enjoyed the benefits of transparency, liquidity, segregation of assets and verification through investment bank platforms, whether or not they are paying the right price. Now investors are waking up to a richer world of choice.

It’s not just about protecting investors from mishaps or fraud, but informing them better about the diversification of their portfolio, how managers are really performing and making their returns, and whether investors can rely upon that information to form expectations about the future and make forward-looking portfolio allocations. It enables them to conduct better risk management and receive better risk-adjusted returns.
“The next big opportunity for hedge fund assets to grow will be not solely but primarily through managed accounts because these investors want control, liquidity and transparency.”

Nathanaël Benzaken, Lyxor Asset Management

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

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

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

“However, they cannot afford to be exposed to the likes of Madoff or other fraud again, nor can they afford to be gated or side-pocketed as happened in 2008, and they want much better transparency. That leaves no alternative to managed accounts.

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

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

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The past two years have seen a surge in the number of institutional investors seeking to access hedge fund strategies through separately managed accounts, in the development of third-party platforms designed to ease the cost and internal resource requirements of managed account investing, and in the willingness of hedge fund managers to accommodate investors outside the traditional framework of pooled funds.

These developments answer a growing need among institutions for the benefits of absolute returns while retaining the transparency and improved liquidity stemming from control over the assets, as well as in some cases advantages in the tax treatment of fees. However, the development of managed accounts also presents various challenges at different levels of the value chain.

Firms must not only offer good product but institutionalise supporting data on trading decisions versus recommendations, risk mitigation strategies when markets move or mandate changes require action, and demonstrably monitor compliance guidelines. This means documenting investment decisions, risk guidelines and exposure management across all asset classes, and being able to tie ‘review and recommendations’ back to the actions taken by the traders as well as potentially for underlying externally-managed product. Middle- and back-office solutions gain importance as shortened periodic cycles are necessary to manage cash flows and billing to clients.

In turn this forces faster communication cycles with counterparties, custodians, and the fund administrator demanding automated communication and collaboration. Prior models involving adding Excel applications and hiring asset class mercenaries did little more than increase costs and operational risk, leaving firms less agile following the market collapse. Essentially, firms cannot rely solely on good returns, but must to prove the institutional quality of their systems and processes.

These challenges helped to steer the development of Advent’s portfolio management and fund accounting system, Geneva. Originally designed to meet the needs of the alternative investment industry, it has undergone significant enhancements for middle- and back-office support and offers unparalleled connectivity across the alternative ecology to deliver on the unique requirements of SMA platforms.

Geneva users include leading managed account platforms for third-party investors, such as GlobeOp and Butterfield Fulcrum. Most recently Maples Finance, an existing Geneva user for fund administration, used the system to create a managed account servicing platform for institutions.

Other clients include fund of funds managers that have responded to outflows by outsourcing management capabilities to institutions in a manner not dissimilar to a pure managed account, and bespoke asset managers leveraging existing relationships to deliver alternative product.

The driver for SMA offerings is the increased profitability a firm can leverage off existing structures – provided returns meet the fund objectives. However, the added due diligence imposed by institutions often strains internal systems and processes. Whereas hedge fund systems previously focused solely on investment objectives, today they must respond to institutional demands for incremental change reporting, comparative analysis, and rapid slicing and dicing of data to the underlier’s level.

While the ability to meet investment objectives remains key in attracting institutional assets, a firm’s process, procedures and ability to demonstrate adherence, monitor exposures, and earn the investor’s trust have become the second pillar.
managed accounts because these investors want control, liquidity and transparency.”

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

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

“Investors were looking at factors like transparency and owning your own assets in the same way as in the traditional asset management industry – institutions wanted to work with alternative investments as they’d been doing on the long-only side for years. Lehman and Madoff just accelerated that trend and put large investors in a position where they would not tolerate pooled

vehicle investment any longer. Many large institutional investors simply said that by a certain date they would move to a managed account structure.”

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

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

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

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

Managed account platform providers say the issue of cost is sometimes a red herring because of the difference in the way charges are calculated between managed accounts and traditional pooled fund vehicles. In the end there may not be much between them, says Tim Thornton, managing director for product and strategy at administrator
Solutions for Better Hedge Fund Investing

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.

www.gottexsolutions.com
New solutions on transparency

By Gabriel Bousbib

Gottex Solutions Services was established to service the needs of the Gottex group’s fund management arm, Gottex Fund Management, for risk transparency and managed accounts. We have deployed on the platform both managed accounts and transparent funds, that is, funds offering position-level transparency.

Following the early rush to managed accounts, investors now understand that rather than a simple binary decision, there is a continuum of possibilities that includes transparent funds, as well as solutions offering lower levels of transparency or less investor-friendly governance than a standard managed account.

The main benefits and drawbacks of managed accounts are known. Properly structured managed accounts provide for independent asset verification and pricing, as well as more investor-friendly governance. Conversely, managed accounts are expensive to set up and operate, many managers are reluctant to acquiesce to them, and the account may not trade pari passu with the flagship fund. In addition, contrary to common wisdom, managed accounts are only as liquid as the underlying assets they hold.

Transparent funds, where the fund administrator provides to a neutral third party the positions for risk processing, are becoming an increasingly popular alternative to managed accounts with institutional investors. While this does not at all mitigate fraud risk, the approach provides for more timely risk management, including in particular and most importantly monitoring of style drift.

Governance is another good illustration of a modular approach. In a traditional commingled hedge fund, while governance normally rests in the hands of the fund’s board, the 2008-09 experience showed that, first, boards depended on information provided by the manager, secondly, boards were not always as independent as described in the offering documentation, and thirdly, the removal of the manager was typically an uphill battle.

In a managed account, the manager has little to no governance rights as the platform operator can prevent the manager from trading the account, with some level of notice. Between these two extremes, however, governance risk can be addressed differently, through measures such as a properly-formed board of directors, more narrowly defined circumstances in which the fund can suspend or gate, or defined cases where the manager can be removed, any number of mechanisms that may not involve managed accounts.

Asset pricing is another illustration of possible modular approaches. An independent pricing committee, not controlled by the investment manager, can meaningfully mitigate pricing risk in a commingled fund.

Clearly, such a modular approach does not gainsay the advantages offered by managed accounts. In particular, an important but rarely discussed benefit of managed accounts relates to access to financing when liquidity dries up. An investor with, say USD50m in a USD1bn commingled vehicle is a sitting duck if the fund suddenly finds its financing counterparties unwilling or unable to provide financing.

In 2008, a number of funds were liquidated by financing counterparties. Due to the size of the financing lines involved, institutional investors cannot step in and offer term financing. However, if the investor’s USD50m is in a separately managed account, if the prime broker were to cut the line, the investor may be able and choose to replace it.
“As a large buyer of third-party services, such as administration and audit, we are typically able to negotiate fees that a smaller manager would not be able to negotiate on its own, and this also applies to dealing with prime brokers and other counterparties,” he says. “We have been quite surprised to find that even in the case of some of the larger funds we deal with, we have been able to negotiate better terms in areas such as cross-margining and other elements of a prime brokerage or ISDA agreement than the flagship fund.”

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

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

Butterfield Fulcrum, which launched its Altinus platform earlier this year.

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

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

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

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

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

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

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The surge of interest in managed accounts over the past two years has opened up the market to third-party investment platforms offered by a range of providers, including notably investment banks but also fund of hedge funds managers and fund administrators, that offer investors a broad range of middle- and back-office services including portfolio monitoring and risk management that otherwise they would have to undertake themselves or source separately from third-party providers.

The expression ‘platform’ covers various different kinds of service model. Tim Thornton, managing director for product and strategy at administrator Butterfield Fulcrum, also uses the term ‘utility’ to describe the Altinus platform that the firm launched earlier this year, in response, he says, to demand especially from big investors seeking protection for problems ranging from liquidity mismatches and capital lock-ups to outright fraud.

“Although managed accounts solve a lot of those problems, they create a set of problems of their own,” Thornton says. “An investor wanting to move to managed accounts currently really has two options, either to build their own platform or rent an existing one. To build your own platform will mean having to employ a large number of staff, receive a massive amount of data and do something with it, because you’re assuming extra fiduciary risk.

“A classic fund of funds investor tends to be good at selecting managers and monitoring performance, not at analysing
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www.customhousegroup.com
The global route to daily NAVs

By Dermot Butler

One of the key reasons investors seek managed accounts is that they want transparency and liquidity, so service providers must be able to administer managed accounts on a daily basis — as Custom House does. More than a third of the funds or accounts for which we provide net asset values receive daily dealing NAVs.

As administrator of the Innocap platform, which is structured as a Maltese master-feeder fund, Custom House uses its global network of offices, which includes operations in Chicago and Singapore as well as the group’s headquarters in Malta, to relay work between time zones around the world.

With a master fund containing more than 60 sub-funds representing managed accounts, the system must be capable of reconciling many trades a day, up to a peak of more than 60,000. Trade capture may start at the end of the working day in Chicago, but most of it is carried out in the morning in Singapore.

Once the open positions and trades are reconciled, European offices — Malta or Dublin — begin calculating NAVs of the master sub-funds, a process completed in Chicago alongside the NAVs of the feeder funds. Thanks to this global production line, Innocap receives the NAVs by 3.45 p.m. Chicago time on T+1.

It's a complex process that relies on a good IT system throughout the global operations. Some European administrators have made acquisitions in Asia that use different systems — very hard, expensive and time-consuming to integrate or replace. Employing the same system worldwide enables the organisation to see any accounts at any time in any office, as well as providing a very good disaster recovery system.

In addition to the Innocap platform, Custom House also administers managed accounts for other managers alongside flagship funds that hold the same assets in their portfolios. Complications may arise where managed account investors want different reports from those provided to fund investors, such as more detailed attribution between different markets, currencies and instruments, or different commodity contracts, needed to carry out risk analysis.

Seeing the manager’s positions on a daily basis is important for risk and portfolio management tools. Investors may not know that one of their managers is cancelling out the strategy of another because they happen to hold two different market views. Managed accounts provide transparency. Equally, daily liquidity means that investors can exit their positions and be paid very quickly. By contrast, a fund investor that wants to liquidate at the end of March may not be paid for three months.

The growth of managed accounts offers a solution to fund of funds managers that suffered during the crisis because they were unable to redeem out of their underlying investments and now need certainty of being able to match the liquidity offered to their own investors.

One major problem with a managed account compared with a fund investment is that an active manager, particularly a CTA, will provide reams of daily trading confirmations and statements — conceivably a bank box every morning. This imposes practical management and physical staffing problems for fund of funds managers, or indeed any institutional investor that an independent administrator, capable of providing the appropriate reports on a daily basis, can resolve.

Investors need an independent service provider to carry out accounting, oversight and administration, but not even managed accounts remove the need for proper due diligence and operational best practice.
conflicted platforms. We’re not promoting any particular managers or strategies, we’re just providing the infrastructure.”

Meanwhile, some members of the industry say the initial rush to embrace the managed account concept in the wake of the turmoil that shook the industry two years ago has given way to a more complex and nuanced approach to obtaining the benefits investors seek. For example, chief executive Gabriel Bousbib of Gottex Solutions Services, the managed account platform launched by the Swiss fund of funds manager, argues that investors and managers no longer face a simple black-and-white choice between pooled investment structures and segregated accounts. A broader range of options may be available, depending on what the investor wants and the responsibility they are willing or able to manage and pay for.

According to Bousbib, the accounts currently on the GSS platform include not only classic managed accounts but what he calls “transparent funds” that do not offer all the features of a fully-fledged managed account but provide investors with the kind of position-level transparency that is not usually available with pooled funds.

“The evolution we are seeing in the market is that people are understanding that rather than a binary decision between fully-fledged managed account or nothing, there is a need for a continuum of solutions,” he says. “The continuum includes transparent funds, which provide position-level transparency but not the governance oversight of a managed account, and lower levels of transparency.”

Bousbib describes as “knee-jerk” the reaction of many hedge fund investors in the immediate aftermath of the liquidity problems encountered by many hedge funds (and as a consequence the funds of funds that invested

“An investor wanting to move to managed accounts currently really has two options, either to build their own platform or rent an existing one.”

Tim Thornton, Butterfield Fulcrum Group
Operational best practice for investors

By Ron Tannenbaum

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

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

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

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

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

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

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

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

Together the investor and administrator should identify the data framework and reporting timeframes that best facilitate informed investor decision-making. These criteria are best discussed during initial pre-investment due diligence, then within regular, scheduled ongoing due diligence reviews.
"As a managed account platform our approach is to offer really open architecture and to work with different-sized groups with different needs. What’s really emerging is a desire for governance. Managed accounts aren’t necessarily the holy grail, but it is a way for investors to obtain that governance, because a managed account is in the investor’s name and they can control the assets. But that may be more than what most investors want to take on."

To move from investment in pooled funds to taking on managed accounts can be a culture shock for investors, according to Simon Hookway, managing partner of MAG Consultancy, which has assisted a number of new entrants to the market with the design and construction of their managed account platforms. "It’s a learning process, because many of these people have been raised on a diet from the manager of top five longs, top five shorts and some weird geopolitical diatribe cut and pasted from the pages of Newsweek, once a month, 15 days late," he says.

"They’re going from that world and over-reliance upon self-verified time series data that only reveals issues, good and bad, slowly over time. They’ve been starved of decent cross-sectional information about individual managers or their peers. As a result, a lot of the risk management software services and analytical systems that have grown up to over-analyse this vast data set are completely incapable of handling this new granular world."

However, Hookway says tools that can help investors analyse the new range of data they are receiving do exist, and that allocators can learn how to make use of this information. "There’s an adjustment process for that education, and money needs to be

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Dermot Butler, chairman of administrator Custom House Global Fund Services, agrees that the circle of managers willing to run managed accounts has expanded, but cautions that there are limits to the range of strategies that can be accommodated. “One must recognise there are some strategies it just doesn’t work for,” he says. “There’s no point in trying to do it for a relatively illiquid strategy. Some managers will simply say their strategy doesn’t permit managed accounts. They don’t work for real estate, or private equity, or some derivative strategies.”

Competition is hotting up among administrators to gain market share in the managed accounts business, with technology the key weapon. Ron Tannenbaum, co-founder and managing director of GlobeOp Financial Services, argues that the 10-year-old firm, which has provided services to platform providers since it was launched, has enjoyed a ‘greenfield’ advantage of having created its technological platform from scratch.

“Our largest expense apart from personnel and our largest area of investment every year is technology,” he says. “We’ve built short equity strategy focusing on greater China, and they came up with a new product that they run exclusively for us. We wanted a manager offering exposure to China in a liquid and volatility-controlled way, as opposed to long-bias strategies, and there aren’t many managers capable of doing that. Going forward, when we can’t find the right product available, we may again ask talented managers to design a strategy for us.”

Hookway notes that a common error among investors is not to ask too many questions of managers as long as they are making money: “The transparency in managed accounts means you can see whether the manager is making money in the way he says he is. If he is, you can have a higher degree of confidence in giving him more money, and that is a good thing for investors because their expected return and indeed their actual return is raised for a given risk budget.”

This greater potential scrutiny arguably places increased pressure on managers, but platform providers report a continuing willingness on their part to offer managed accounts, even among top industry names that in the past would have been considered unlikely to do so. Nathanaël Benzaken, managing director and head of managed accounts development at Lyxor Asset Management, notes that the world’s largest platform has added partnerships over the past year with firms such as Caxton, Tudor and recently Barton Biggs’ Traxis Partners.

“We have been convincing managers who never considered managed accounts before,” he says. “Now they have acknowledged that managed accounts are a respectable route by which to grow their assets. It’s like a snowball. If you have firms like Caxton, Tudor, Mariner and Marathon on board, it tells you that any manager can accept it. Second, it tells you we can not only run a liquid CTA strategy but also more complex ones like distressed, with Marathon, or even fixed-income arbitrage with Mariner.”

In April Lyxor added to its platform a China long/short equity fund run by Jim Chong for Martin Currie. Says Benzaken: “We went to Martin Currie and asked them to design a liquid large to mid-cap long/
Everything across a distributed architecture. Our messaging system for reconciliation produces real-time movement of the data. Without that you couldn’t produce the data fast enough to give the investor a full daily P&L and analysis of reconciliation breaks ready as they arrive every morning.

“Without real-time technology people would be staying way into the night just to look at the reports. For older administrators that haven’t really made the technology investment, it would be an almost insurmountable step to move from where they are now to where they need to be. For many administrators, the barriers to entry to the managed account business are too high.”

Tannenbaum says managed account business has come to GlobeOp through two main avenues. “One is through a portfolio of business from existing large managed account platforms, where GlobeOp becomes the engine inside the governance structure for their own vehicles. The other way is when current fund management clients come to us and say, for example, that they have a private bank that would like to open a managed account. In these cases the investor may be less sophisticated and may ask for very little in the way of extra reporting. However, the investors are comforted knowing that the money is their own rather than being part of a commingled fund.”

According to Thornton, the creation of Altinus has entailed a limited rather than major step-up in infrastructure and resources, given Butterfield Fulcrum’s existing activity in servicing portfolios on other providers’ platforms. “The operations, the daily environment, is our core business, and it doesn’t need a great deal of expansion, although the risk reporting, limit monitoring and guidelines side has required some addition of expertise and tweaks in our technology,” he says. “For areas that we don’t cover ourselves, we’re partnering with other service providers. For example, the platform has protocols around collateral management and FX management, and for their execution we’ve partnered with a well-known cash custodian.”

GlobeOp and Butterfield Fulcrum both use Advent Software’s Geneva portfolio management system. Tom Zdon, vice-president for solution consulting and business development at Advent, says the system is particularly well adapted to the demands of managed accounts because it was originally designed for the alternative space, and this is reflected in a marked step-up in client demand over the past couple of years.

“What’s particularly interesting is the non-traditional hedge fund space, as asset managers look to add alternative products to their existing separately managed account programme,” he says. “We’ve also seen a number of hedge fund manager clients who originally had a fund product and have now gone to a pure separately managed account model. In 2009 a large number of fund of funds managers could only survive by getting closer to their investors, essentially outsourcing their management capacity to these institutions and using their fund of funds platform in a manner not very dissimilar from a managed account product.”

The challenges involved in running managed accounts alongside flagship hedge funds – such as more frequent valuations, managing allocations and distributions between different investment pools or monitoring variations between investment mandates – require automation to avoid running up high levels of cost, Zdon says.

“In the separately managed accounts business, offline Excel spreadsheet practices that used to be acceptable are no longer so. For example, one hedge fund manager we work with reported that a simple request for exposure to a particular issuer was sometime difficult because often all the alternative assets were tracked off spreadsheets and managed by what we called ‘asset class mercenaries’ who had grown up within his firm and allowed it to invest in unlisted assets.

“But once institutional investors are calling you at 4.30 p.m. requesting a full set of reports, you can no longer rely on those off-sheet processes. Today managers are looking to rationalise and centralise all asset classes including underliers into a single portfolio management system that they can access at the click of a button rather than having to accumulate data from multiple systems. Managers that don’t have a system often rely on Excel to reconcile to their third-party administrators, missing key data that could help them justify higher NAVs.”