

# Evaluating Managed Accounts: Trends and Implications for Hedge Fund Managers

Over the course of the last decade, institutional investors have significantly increased their portfolio exposure to alternative investment vehicles, either through direct investments or investments in funds of hedge funds. While investors continue to show an appetite for the potential returns and diversification benefits that alternative investment vehicles provide, the model for investing is evolving. Hedge fund managers are now being asked to provide their clients with higher levels of transparency and control, greater liquidity, and more flexible fee schedules. One increasingly popular solution is the use of managed accounts.

## A Shifting Balance of Power

Historically, hedge fund managers have resisted offering managed accounts for a number of reasons:

- The heightened transparency of a managed account means investors have more insight into a manager's portfolio and trading strategies – their closely-guarded 'secret sauce.'
- Managers lose some scale in their trading strategies and counterparty relationships.
- Managed accounts are more operationally complex, and therefore more expensive to support.

As a result, until recently, managed accounts were only accepted by hedge fund managers for very large mandates, or by new managers seeking to build a reputation. However, for all but the most consistently outperforming of funds, the current climate is provoking a shift in power from hedge fund managers to their investors. Shrinking asset bases and weakening investor demand means many funds are wrestling with ways to

staunch the outflow, and attract new capital infusions where they can. That means that funds of funds and institutional investors with larger pools of capital have a much greater ability to dictate the terms required for investing their capital.

Investment managers who previously would not provide managed accounts for investors are now more accepting. Given that many hedge funds' pooled vehicles are considerably below their high-water mark, accepting new capital through a managed account could be an attractive option. Some of the world's largest hedge fund organizations are now directing more of their clientele into managed accounts. And depending on the strategy, hedge fund managers are also showing more willingness to provide managed accounts to investors who come with a smaller capital allocation.

## Why Managed Accounts?

When investors allocate money into a hedge fund's commingled vehicle, they become limited partners or shareholders, ceding control over the account to the hedge fund manager and, at times, having limited access to their capital and to information regarding the vehicle's market exposure. In comparison, with a managed account the hedge fund manager acts as an advisor, with authority to transact in the account, while the capital allocator (the institutional investor or fund of funds) retains ownership and control over the assets.

Hedge fund managers can highlight three main benefits of managed accounts to their investors:

1. **Transparency and Control.** Lack of transparency into trading positions has long been a lament for investors in hedge funds. A managed account provides investors full disclosure of the managers' investment activities – including investment transactions, holdings, leverage levels and asset

values. Armed with data from the advisor detailing this information, institutional investors with adequate internal resources are able to monitor their market positions and conduct their own risk analysis on each of their managed account portfolios. Where some of these institutions have multiple managed

accounts, they can aggregate the data to run risk analytics and stress tests across their entire portfolio universe to avoid various forms of concentrated market exposure.

Managed accounts can also provide increased control over the assets, as the investor can use segregated accounts with an independent broker or custodian bank of their choosing, rather than the assets being pooled in an account with a prime broker designated by the manager. This allows the investor to separately manage and mitigate counterparty risk to avoid unwanted counterparty exposure. Unlike a direct hedge fund investor, a managed account holder can receive further benefit by requiring an independent organization – whether a third-party administrator or valuation agent – to perform key accounting functions, including portfolio valuations. Independence in recordkeeping by an accounting agent of their choosing provides institutional investors with added assurance in regards to the accuracy of their investment valuations.

2. **Liquidity.** As the recent financial downturn has demonstrated, liquidity during times of market stress can be a major problem for institutions investing directly in hedge funds. Market uncertainty and poor trading performance amongst hedge funds has prompted a surge in redemption requests at a time

when market liquidity has been an issue. In response, many hedge funds – including some of the largest and best known names in the industry – have been unwilling or unable to meet redemptions, prompting them to suspend redemptions and/or impose limits on the amount of capital that can be withdrawn by their investors at a given time.

This situation can particularly impact funds of hedge funds, since they often offer better liquidity terms to their investors than they receive from the underlying hedge funds in which they invest.

Even if the hedge fund is able to honor redemptions, one of the concerns with a traditional pooled vehicle is that those investors who remain may be left with assets that may be illiquid and/or have lost significant value. A managed account, though, will insulate the investor from a hedge fund's reduction in liquidity related to other investors' redemptions.

3. **Fee Customization.** Hedge fund managers offering managed accounts can customize the fees and fee structure to a greater extent because of the individualized nature of the accounts. Typically, the degree of flexibility of this customization offered by the hedge fund manager is dependent on the investment strategy employed and complexity involved in supporting the account.

## Business and Infrastructure Considerations

There is no denying that managed accounts are more expensive to support and operationally complex to run, and can affect a hedge fund manager's scalability. The additional resource, technology and legal costs imposes a limit on the number of managed accounts a manager can cost-effectively support. Outsourcing the operational infrastructure can ease these burdens. A major constraint in supporting a managed account structure is the type of strategy the investment manager employs; it's easier to support managed accounts created for strategies such as equity long-short versus complex strategies such as bank loans.

But while the economics for managers may be less favorable than with their pooled vehicles, managed accounts may provide an attractive vehicle for raising capital and offering firms the chance to replenish and grow their asset bases.

As a result of greater acceptance by managers, and the strength of demand being shown by investors, estimates suggest that managed accounts could quadruple in 2009, according to HFM Week. To realize the benefits that managed accounts could have for an organization, the following two key questions must be considered:

- How will investment managers and service providers support the increased complexity in operational processes necessary to support managed account structures?
- Once investors achieve the goal of transparency by getting access to the information in question, what are they going to do with the data? Do they have the tools and know-how to analyze the information and use it in a meaningful way?

## Key Operational Components

Managed accounts, by their nature, bring a heavier operational burden than pooled vehicles. Their inherent individualization multiplies the trading and support functions facing the hedge fund manager, who has to separate the transactions for each account, handle the reconciliations with a proliferation of counterparties, and provide personalized reporting on each account's activities. Coping with the overall scalability constraints is a critical consideration.

Using a third-party service provider for managed accounts is an attractive alternative to alleviate the operational burden placed on the manager and satisfy investors' desire for independence.

As for specific operational requirements, first, the service provider must be able to account for and support the valuation of the instruments that hedge funds typically hold, not only for accounting purposes but for risk analytics and reporting. Validating those positions is also crucial. A robust process must be in place to reconcile transaction and holdings information provided by investment managers with the relevant custodians and prime brokers, and resolve any discrepancies on a

timely basis. Once information has been obtained and validated for all accounts with outside parties, the data must be aggregated for investor reporting. The next critical aspect is having the reporting and analytical capabilities that allow the data to be disseminated in a timely, clear and meaningful way, such that the investment manager can obtain an accurate overview of their investment information. The operational platform must support a daily operating environment to ensure that the information is current to support meaningful portfolio analysis.

It is important to note that for the risk analysis to have the most value, the institutional or fund of funds investor must have full transparency across a substantial amount of their book of business. Transparency on just a handful of funds is not sufficient to allow investors to accurately evaluate and mitigate their risks. Alternatively, when it is cost-prohibitive or is not possible to have managed accounts for an entire book of business, investors may require data feeds to obtain information for consolidated investment analysis. The need for timely, accurate, enterprise-wide analytics is only increasing.

## An Evolving Picture

The recent market conditions have caused managed accounts to surge in popularity. And while they may introduce support challenges for the hedge fund managers, they do present a valuable opportunity to attract clients and assets.

Investment vehicles will continue their evolution and the long-term picture for managed accounts will be shaped

by a combination of forces – for example, the impact that future regulation may have in stipulating greater transparency for the hedge fund industry as a whole.

As the industry evolves, it's clear that the winners will be the hedge fund managers who have the operational flexibility to adapt and provide products that meet investors' needs.

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