Managed Accounts – Back to the Forefront

The issue of transparency has returned to the alternative investment industry with vigour and urgency.

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As Bernie Madoff gets comfortable in his new surroundings, having traded his penthouse for the jailhouse, the issue of transparency has returned to the alternative investment industry with vigor and urgency. Perhaps no more obvious is this than in the very recent and profound resurrection of managed accounts in lieu of the typical hedge fund structure. Once relegated to the backwaters of the industry, managed accounts have returned as hedge fund investors demand, now more than ever, heightened control and disclosure with respect to their alternative investments. Given this renaissance, now would be an appropriate time to discuss the topic of managed accounts and understand its properties and characteristics.

The upheaval in the financial markets over the last few years has been varied but nonetheless stunning, with Bernie Madoff as just a single figure in this unbelievable period. Never before were the stalwarts of Wall Street so threatened with extinction, with firms like Bear Stearns and Wachovia playing the role of the dinosaurs in this ongoing evolutionary course. Compounding the issues further has been the complete meltdown in the global financial markets with almost all markets and exchanges suffering immensely. Each of these facets, whether it be fraud, bankruptcy, or the ebbs and flows of the global economy, has highlighted key items for investors which to this point were given insufficient consideration previously. These include portfolio and institutional transparency, the impact of severe negative performance outside the usual market drops, and counterparty risk. With these factors now on the tip of every investor's tongue, a new paradigm shift has taken hold and managed accounts are stepping up to fill the perceived void in the alternative investment marketplace.

The Basics

Generally, a managed account is not all that disimilar from a hedge fund. It is a segregated portfolio in which a fund manager is responsible for portfolio construction and security selection based on a given investment methodology. The fund manager is to undertake his or her investment strategy as per usual and manage the portfolio as in the traditional hedge fund structure. However, in managed accounts, and unlike what is seen in hedge funds, an independent third party (such as a custodian or fund administrator) has overall control of the account. That is, the fund manager chooses what to buy and sell and in what size, while the third party handles other aspects of the portfolio and reporting such as valuation, margining, and custody-related issues. Immediately, it is obvious why investors, in this age of increasing risk awareness, are flocking to a managed account platform.

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Advantages

An obvious benefit to the investor is in regards to who has control over the account. In a typical hedge fund, the investor's capital is pooled with others and is managed as a whole. In this framework, power over most, if not all, of the aspects of the fund is controlled by the fund manager. Many investors were impacted by this lack of control over the last year, as hedge funds enacted any number provisions to prevent investors from withdrawing some or all of their capital. These included, but were not limited to, gate provisions, side pockets, and payment-in-kind redemptions. However, within a managed account platform, the liquidity of the managed account is controlled by the investor rather than the fund manager, rendering these capital access issues largely obsolete.

A second advantage to managed accounts is seen in heightened transparency. As an example, a properly structured managed account platform should be able to deliver to a given investor the position-level holdings of the account. In this day and age, investors more than ever are seeking a better understanding of the risks their investments face and there are few better ways to do this than by knowing the actual portfolio construction. Rather than relying on a fund manager to give them broad, generalized information in a hedge fund structure, an investor can more fully understand their holdings and concentrations within a managed account, leading to a better understanding of portfolio composition and risk.

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Another major benefit to managed accounts comes in the form of customization. Since a single investor occupies the entire managed account, they can place their own specifications on the trading activity of the account. For instance, an investor could limit the fund manager from investing in illiquid assets, foreign-denominated securities, over-the-counter products, or place any other restrictions that were agreed upon in advance. With the aforementioned benefit of heightened portfolio transparency, it is simple and efficient for the investor to monitor any and all caveats placed on the portfolio.

To this point, most of the benefits listed above are from the investor's standpoint, but there are also advantages to a fund manager in utilizing a managed account platform. From a marketing standpoint, it can be advantageous to be receptive to managed accounts, if only because investors perceive all of the advantages listed above. As investors become increasingly aware of the benefits of managed accounts, they will look in greater earnest for alternative investment managers who are willing to step outside of the traditional hedge fund structure and offer more creative investment solutions. Also, as larger institutional investors become further inclined towards using the managed account platform, the investment manager who is willing to operate within a managed account structure can potentially have an easier time attracting substantial assets under management from a few sizeable, strategic investors.

Disadvantages

Despite all of the aforementioned benefits to using managed accounts, there are of course some drawbacks for both the investor and the fund manager. From the investor's standpoint, there can be an additional administrative burden on ensuring the assets in the portfolio are managed appropriately. For instance, say an investment manager runs a hedge fund with $100 million in assets and a managed account for a single investor with $100 million in assets. In theory, for any applicable trades and activity, the allotment should be split 50/50 between the hedge fund and the managed account. Note that this could include commission charges, fund operating expenses, fund administration fees, the correction of trade errors, and/or a host of other items. Care must be taken by the investor to ensure that their managed account is being treated equitably in all circumstances.

Also, the issue of the crossing of trades must be considered. Say a hedge fund has been hit with redemption requests and must dispose of a portion of their assets. In the above example, a ready and obvious buyer (assuming similar investment profiles) would be the managed account. However, the investor in the managed account must be wary of such circumstances and ensure that the trades are being exchanged at the fair market value for the securities in question and that the trades make sense from a portfolio perspective.

There are also additional burdens from the perspective of the fund manager. Notably, the investment strategies of the manager may be restricted by certain covenants demanded by the investor in the managed account. It is imperative, at the establishment of the managed account, that these restrictions are documented fully and both the investor and the fund manager understand their scope and scale. Additionally, though the investment manager may be anxious to increase his or her assets under management, the relationship should be carefully scrutinized to ensure that the given investment strategy can be properly executed and that the engagement is a good fit for the manager from a business standpoint.

In addition, there is the obvious administrative burden of having to potentially allocate trades between multiple accounts. In the above example, the manager was responsible for the 50/50 allocation and the investor and the independent third party overseeing the verification of this appropriate split. Needless to say, it is an additional layer of work performed by the fund manager to split all trades, expenses, etc. which has the potential to be an operational hindrance.

Conclusion

Managed accounts are likely to remain with the alternative investment industry indefinitely since they offer some considerable benefits to investors and fund managers alike. Most especially, large institutions, endowment funds, and pension plans with substantial assets under management will benefit from managed accounts, as they offer heightened transparency, risk mitigation and understanding, and control. However, given the additional costs associated with the managed account platform, both for the investor and the manager, it is unlikely that this avenue will be available or prudent for all investors in alternative investments. However, as managed accounts become more popular and are sought by investors with greater vigor, it is important that all parties are aware of the costs and benefits of these structures and are fully versed in their mechanics before creating or investing in such an entity. *

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