MANAGED ACCOUNTS: BALANCING TRANSPARENCY, COSTS

Managed accounts balance investors' demands for transparency and managers' desires for confidentiality.

Since the 2008 financial crisis, managed accounts have become an increasingly popular structure for investors who demand a level of transparency that traditional commingled structures lack. But the value of holdings-level transparency is linked to investors' abilities to convert that data into actionable information about risk and performance.

The Madoff scandal and 2008 credit crisis sparked an investor-led revolution in fund structures and transparency requirements. Since 2008, managed accounts – a long-time staple of traditional investment strategies – have emerged as a key alternative to the Limited Liability Corporation (LLC). Managed accounts and managed account platforms (MAPs) address key deficiencies of traditional commingled investment vehicles without the need for complex and costly ad hoc solutions, e.g., side letters and multiple share classes. While managed accounts and MAPs have variations, they share the following characteristics:

- Investors maintain beneficial ownership of all assets
- Liquidity terms and management fees can be configured to an investor's requirements.
- Investors are insulated from commingled risks and redemptions by other investors
- Investors have full access to position-level information

This flexibility and transparency, however, comes with a cost. While the legal costs of organizing a managed account may be lower than LLCs, the operational infrastructure and resources required to support them may generate higher overall cost. Still, with the 2008 crisis still on their minds, many investors decided the value gained from transparency and flexibility – when properly managed – outweighs the additional expense.

Getting from Transparency to Value

The challenge for managed accounts is how to derive the value from increased transparency. Capital structure can only create the potential for better investment management, and transparency available from managed accounts does not in itself create value.

LESSONS FROM THE CREDIT CRISIS

The 2008 financial crisis taught investors sobering lessons about the private investment model and their exposure to – and often-limited knowledge about – the inherent risks.

- Investors realized they were implicitly short options on credit, since securitized debt exposures are essentially short options against a borrower's default.
- Many did not fully understand the liquidity terms of their investments and were prevented from accessing capital when fund managers invoked gates, redemption limits and other liquidity management mechanisms.
- Redemption activity forced many funds to liquidate independent of their performance, affecting other investors in the fund.
- Many investors did not understand the amount of leverage in their investments, which added to the pressure to redeem.

Availability does not guarantee data's proper use or automatically extract its value. Investors also must put in place the means to analyze this data. While transparency into holdings is the first step toward transparency into performance and risk, it also requires additional expertise that further burdens the investor's management and infrastructure.

THE CHOICES: MANAGED ACCOUNT STRUCTURES

Investors have several options for incorporating managed accounts into their portfolios. The investor's own requirements, including resources and the role of alternatives within the broader portfolio, determine the most appropriate structure. Although there are countless permutations, managed accounts typically fall into three major categories.

Direct SMA Investment

In the simplest form, investors engage directly with one or more managers to set up a managed account. Often the manager's administrator will support the account and provide data to investors, though investors may in practice select the administrator. Investors may select any manager but must engage and negotiate terms with each manager. Some managers may not support managed accounts and many may have investment minimums for SMAs. Further, the process of translating holdings transparency into risk and performance transparency rests almost solely with the investor.

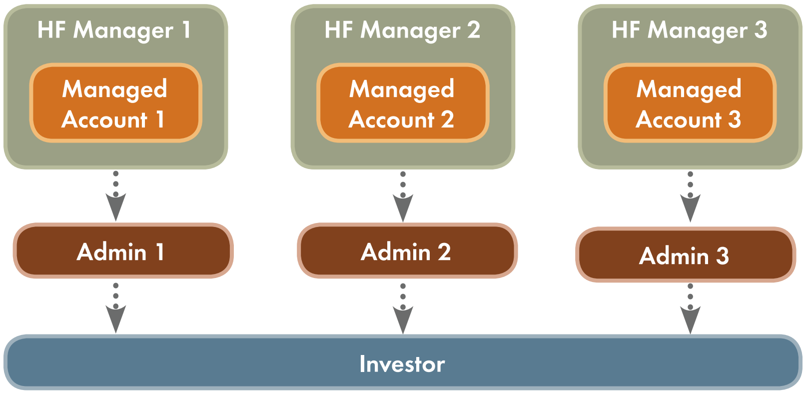
Hedge Funds Structures:
The Balance Between Returns and Transparency

Hedge fund structures reflect the delicate balance of needs between managers and investors. Investors have a natural interest in transparency; managers have a bias toward confidentiality. Early in the history of hedge funds, that balance tilted toward the needs of managers. Hedge funds were principally structured as private investments, providing hedging and leverage for sophisticated investors but with very little transparency into holdings.

As fund of hedge funds grew in popularity, their capital structure added an additional layer of abstraction between the investor and the assets in which their funds were invested, further obscuring market, credit and operational risks. The fund of funds (FoF) structure compounded commingled risks for advisors. Managing liquidity across multiple underlying funds while addressing redemptions at the investor level at a time when credit for bridge financing was scarce laid bare the instabilities of the FoF structure.

As the crisis of confidence deepened, the balance of power between investors and managers shifted. Institutional investors made transparency and better liquidity terms conditions for investment. These requirements, however, were incompatible with the traditional LLC structure, which obscured position-level transparency. Investors required new, more flexible capital structures to support customized terms. While new structures are emerging, managers' interest in protecting their competitive advantage remains a concern, and as such they have been slow to embrace full trade-level transparency.

FIGURE 1: DIRECT SMA INVESTMENT



Source: Northern Trust

MAPs

As SMAs have grown more popular, MAPs emerged to provide the operational infrastructure and data consistency to support managed account portfolios.

A sponsor will engage an administrator and select managers for the platform. Investors can allocate to any combination of managers based on their requirements. This provides a consistent operational framework and data set for investors and is typically supplemented by risk and performance analytics. Some sponsors may also provide advisory services to aid in manager selection.

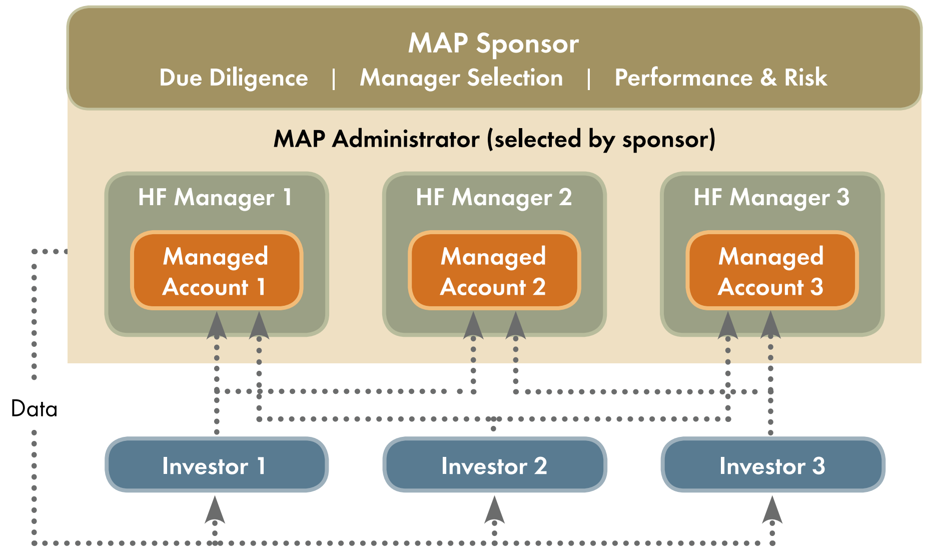
The sponsor's expertise and data consistency are major advantages in this structure, but they come at an additional cost in the form of the sponsor's fees. Also, while mature platforms may offer a wide range of choices in managers and strategies, newer platforms may have limited choices, and onboarding new managers can take time.

Proprietary MAPs

The largest institutional investors took the MAP concept a step further and created their own platforms. They engage an administrator to support operations, data, regulatory support and risk/performance and manage the selection and onboarding of the managers they choose.

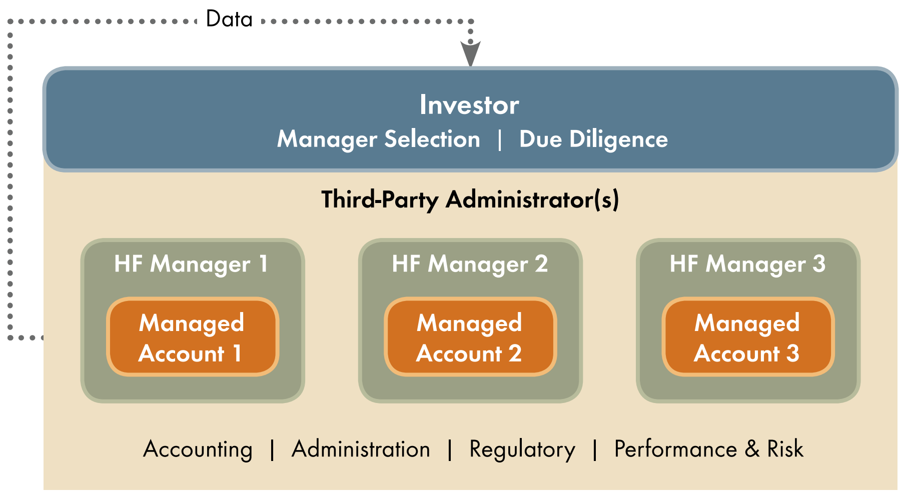
This option offers maximum flexibility and control, but at a substantial premium to direct SMAs or sponsored MAPs. These also require the investor to have in-house expertise to support manager selection and data analysis, and the investor is ultimately responsible for managing workflows among the managers, the administrator and their own systems.

FIGURE 2: MANAGED ACCOUNT PLATFORM



Source: Northern Trust

FIGURE 3: PROPRIETARY MAP



Source: Northern Trust

THE FUTURE OF MANAGED ACCOUNTS

Given the needs they fulfill, managed accounts look to be a permanent feature of the alternatives landscape. It is still unclear to what degree they will supplant commingled funds as the principal structure for hedge fund investment. Certain strategies, particularly those requiring large pools of capital like structured credit, will likely remain dominated by commingled funds. Industry practice will likely continue to evolve; sponsored platforms are a relatively new structure and the market has not yet exhausted its creativity. Looking forward, we expect new innovations especially around risk and performance metrics as investors seek greater benefit from their new-found access to information.

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