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Managed accounts: Transparency, liquidity and control

Beheerde accounts: Transparantie, liquiditeit en controle

PRIOR TO THE FINANCIAL CRISIS, investors reluctantly accepted the opacity of hedge funds because performance was strong and the industry was expanding exponentially. However, as the Dalai Lama once observed 'a lack of transparency can result in a deep sense of insecurity'. These niggling doubts surfaced at the peak in negative correlations across asset classes during the second half of 2008.

In the same way that the securitization of debts made it difficult for banks to know their true exposure to the credit crisis, hedge fund investors had no idea how aligned the risk exposures of their hedge fund investments were with those of their broader portfolios. With government securities being virtually the only asset able to perform well in a flight to safety, most found that their 'alternative' investments provided them with little, if any, downside protection.

Consequently, investors have demanded higher levels of transparency from the hedge fund industry and are seeking a more holistic approach in constructing their investment portfolios. Managed accounts ('MACs') are playing a very significant role in meeting these expectations.

What is a MAC?

A MAC is a standalone vehicle in which hedge fund managers are solely employed to implement their trading strategy. It is completely separate to any other portfolios/vehicles under their stewardship and the contractual role begins and ends at the investment decision level. The hedge fund manager is required to adhere to a strictly defined mandate, with independent service providers carrying out the other contracted functions of a hedge fund, crucially including the provision of complete position-level transparency on a daily basis to the MAC provider.

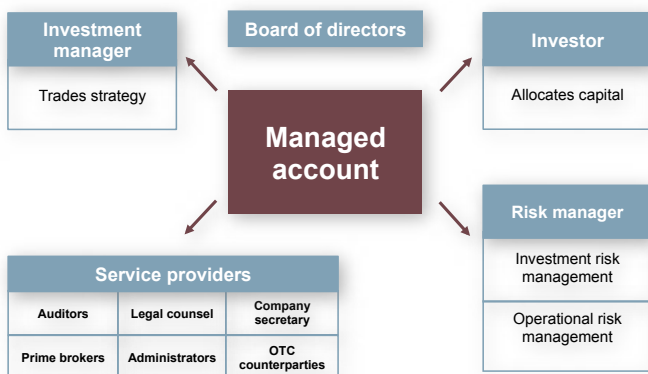


Fig. 1: The structure of a managed account (MAC)



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The underlying assets of the MAC are therefore entirely 'ring fenced' and held in the name of the MAC. As a service provider to the MAC, the investment manager's agreement (IMA) can be terminated for cause. Given the assets are owned by the MAC and not controlled by the investment manager, the integrity of the assets is assured.

Addressing the needs of institutional investors

According to a comprehensive survey published in June 2012¹, the five biggest concerns expressed by institutional investors - as illustrated below - are precisely those that the MAC proposition seeks to address. Consequently, it is not surprising that a more recent study² found that 69% of European institutional investors in its sample held a proportion of their hedge fund exposure in MACs, the majority of which gained MAC access through a fund-of-hedge fund provider. Indeed, one fundamental advantage of dealing with a fund-of-hedge fund provider is that they are often able to secure access at a reduced cost and on more favourable terms than investing directly.

1 Source: 'Asymmetric Returns: The Future of Active Asset Management'

2 Preqin 'Global Investor Report: Hedge Funds' (June 2012)

This growth in the popularity of managed accounts is indicative of a broader trend seen among institutional investors. They are keen to harness the potential for more consistent returns that hedge funds can provide, but they do not wish to incur any risks relating to excessive leverage, style drift and illiquidity.

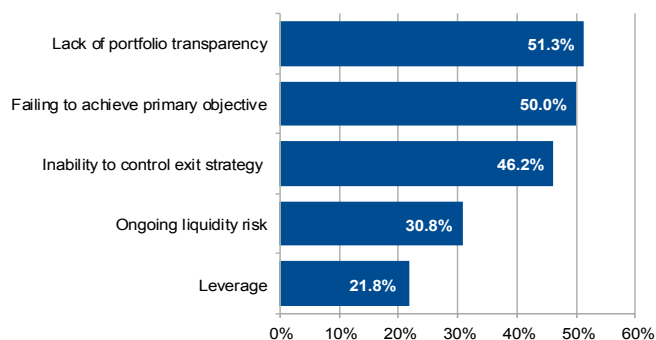


Fig. 2: The biggest concerns about hedge fund investing

In this context, MAC transparency can help to detect unacceptable deviations from the investment mandate at a much earlier stage. Moreover, the terms of the IMA provide the MAC owner with the authority to terminate the contract if the hedge fund manager fails to take prompt remedial action, or continues to breach the terms of the mandate in the future.

Effective use of transparency

Investors in MACs enjoy more intimate relationships with the investment teams that manage the underlying strategy due to the high level of transparency offered. The importance of daily MAC transparency extends beyond asset control and risk management. An experienced fund-of-hedge fund manager can use the daily data to enrich research and develop a deeper insight as to how the manager trades.

Sensitivity analysis, an example of which is illustrated below, can also be used to understand how a MAC will perform in different market scenarios. This information can then be aggregated at the total portfolio level in order to determine how the portfolio will perform in such conditions and to further analyse the individual components. This enables research teams to have a more informed dialogue with investment managers and allows fund-of-hedge fund providers to design optimal solutions for their end investors.

The chart below illustrates the power of reviewing the trading pattern of an investment manager using daily data points. The equity exposure of the manager concerned varies significantly during the months of November, December and January. A particularly notable feature is the evident fluctuation in conviction towards equities in



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December. However, analysis of month-end data in isolation would imply that positioning remained relatively consistent throughout the period.

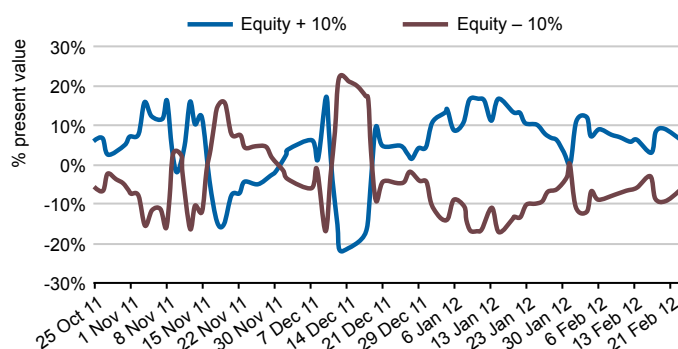


Fig. 3: The value of daily data: equity stress test illustration

Despite possessing substantial resources and expertise which they wish to deploy in allocating assets, comparatively few institutional investors possess sufficient risk management tools or data processing systems in order to utilise large volumes of daily data. While the MAC provider receives daily data, reporting to the end investor is aggregated at a level that provides them with the necessary insight of the trading strategy, but also removes the concern of investment managers that their strategies could be

replicated. This data aggregation is a key benefit of utilising a MAC provider that is an investor (i.e. a fund-of-hedge fund manager).

Liquidity and control when it is most needed

A common misconception of MACs is that they always provide better liquidity than similar non-MAC hedge funds. In many cases, it is simply neither possible nor responsible to offer (e.g.) weekly liquidity for a replicated strategy which typically provides monthly redemptions. One of our main goals in securing MAC arrangements is not to deliver more liquid versions of popular strategies, but to ensure our investors remain in control of their assets, even in the most extreme market conditions.

The problem that beset many hedge fund investors during 2008 was not just absolute illiquidity at the asset class level, but many managers felt compelled to impose redemption gates. This action purportedly served in the best interests of their investors, but was often motivated by self-preservation.

Consequently, the advantage that MACs offer is not so much 'better' liquidity but 'assured' liquidity. As the MAC assets are not commingled with others, the size of the mandate can be scaled to ensure total liquidity within the specified redemption period.

Quality over quantity

Within the fund-of-hedge fund arena, the fundamental objectives of developing MAC capabilities differ significantly from those of the other MAC providers (e.g. bank-owned platforms). For example, the managers with whom we offer MAC capacity go through the same rigorous selection process as any other managers on our approved list.

Acting in the role of an investor, rather than an asset gatherer, the preliminary source of all our MAC arrangements is our investment team. This group of 74 experienced investment professionals makes recommendations on the basis that the identified managers exhibit some form of competitive edge. This can take the form of a unique skill, such as superior analytics, or a demonstrable record of successful and opportunistic trading, which is clearly evident in the execution of the discipline.

Each manager then becomes the subject of an intensive due diligence process to validate investment and operational robustness. Consequently, the ongoing development of our MAC capabilities focuses on quality rather than quantity.

Holistic solutions not off-the-shelf products

In the alternative investments arena, the term 'asymmetric returns' is often used to describe the ability to provide significantly greater upside in response to a positive event than the downside incurred in respect of a negative event of the same magnitude. The author Alexander Ineichen

refers uncomplicatedly to the asymmetry between positive outcomes (*of which we cannot get enough*) and negative outcomes (*which we do not like*).

The possibility of generating asymmetric returns is greatly enhanced by the ability to drill through to the underlying risk exposures of a MAC and aggregate them across an entire investment portfolio. This drill through can be undertaken using daily, rather than monthly, data points to provide considerably enhanced risk exposure analysis. As is evident from the earlier example, risk exposures can change very little on a month to month basis yet vary significantly intra-month.

Where institutional investors lack the necessary systems to undertake such analysis, they can appoint a fund-of-hedge fund manager to assist in providing investment solutions (e.g. to act as portfolio manager with responsibilities for ensuring that investment exposures are consistent with clearly-defined objectives and risk tolerances at all times). Indeed, client requests for more detailed risk requirements, such as limiting exposures to individual risk factors across a portfolio, are now becoming commonplace.

In addition, the weights in the allocation to each of the broad hedge fund strategies can be tailored to complement an existing investment portfolio. The flexibility implicit in this approach reflects the importance of achieving the optimal blend on an individual basis. The ability to develop truly bespoke hedge fund solutions constitutes a major step forward in meeting the needs of institutional investors, especially in an era of high volatility and low nominal investment returns.

FRM

In July 2012, FRM combined with Man's Multi-Manager business to create one of the world's leading specialists in hedge fund investing (TowersWatson Global Alternatives Survey). FRM is the largest independent European based funds of hedge funds group and one of Man's core investment managers. The business offers a wide range of investment solutions including customised and advisory portfolios, commingled fund of hedge funds (FoHF), managed accounts and seeding. ☞

Sources

Fig. 1: Man database

Fig. 2: 'The New Dynamics of Hedge Fund Competitiveness' SEI Knowledge Partnership's fifth annual global survey of institutional hedge fund investors (February 2012)

Fig. 3: Man database

Summary

Managed Accounts: Transparantie, Liquiditeit en Controle

Voorafgaand aan de financiële crisis stemden beleggers met tegenzin in met de ondoorzichtigheid van hedge funds, vanwege de aantrekkelijke rendementen en de exponentiële groei van de beleggingscategorie. Echter, tijdens de tweede helft van 2008 op het hoogtepunt van de crisis kwamen de eerste twijfels toen de correlatie tussen verschillende beleggingscategorieën toenam. Sindsdien eisen beleggers meer transparantie van de hedge funds industrie en zijn ze op zoek naar een integrale benadering van de samenstelling van de hedge fund portefeuille. Managed Accounts ('MAC') spelen een zeer belangrijke rol om aan deze verwachtingen te voldoen.

Wat is een MAC

Een MAC is een separaat beleggingsvehikel dat uitsluitend door de hedge fund manager wordt gebruikt om de beleggingsstrategie te implementeren. Het is volledig afgezonderd van de andere portefeuilles die de hedge fund manager beheert. De hedge fund manager richt zich volledig op het beheer van een nauw omschreven mandaat. Onafhankelijke dienstverleners voeren andere functies van het beheer uit zoals de administratie en het op dagbasis verstrekken van de onderliggende posities aan de MAC-provider.

Inspelen op de behoeften van institutionele beleggers

Uit een recente studie blijkt dat 69% van de Europese institutionele beleggers een deel van hun hedge fund exposure middels een MAC implementeert, waarvan de meerderheid dit doet met een Fund of hedge funds beheerder. Het grote voordeel van een Fund of hedge fund beheerder is dat ze vaak in staat zijn een lagere beheervergoeding te bedingen en bovendien met betere voorwaarden.

Effectief gebruik van transparantie

Door de transparantie die geboden wordt, krijgen beleggers in MAC's een beter begrip van de hedge fund managers die het fonds beheren. Het belang van de MAC transparantie gaat verder dan alleen controle en risicobeheer. Een ervaren fund of hedge fund manager kan gebruik maken van de dagelijkse transparantie om beter onderzoek te doen c.q. een dieper inzicht te ontwikkelen hoe de portefeuillemanager de hedge fund portefeuille beheert.

Liquiditeit en controle

Een veel voorkomende misvatting van MAC's is dat ze altijd zorgen voor een betere liquiditeit dan vergelijkbare niet-MAC hedge funds. In veel gevallen is het niet mogelijk en ook niet wenselijk om bijvoorbeeld wekelijkse liquiditeit te bieden terwijl het reguliere hedge fonds maandelijkse redempties faciliteert. Onze belangrijkste doelstelling van een MAC is dan ook niet om een meer liquide versie van populaire strategieën te leveren, maar om ervoor te zorgen dat

beleggers de controle over hun vermogen houden, zelfs in de meest extreme marktomstandigheden.

Kwaliteit boven kwantiteit

Onze uitgebreide ervaring als belegger in hedge funds vormt de bron van onze huidige MAC dienstverlening. Een team van 74 ervaren beleggers selecteert op basis van een uitgebreide analyse wereldwijd de beste hedge fund managers.

Elke manager wordt vervolgens onderworpen aan een intensief due diligence-proces om het beleggingsproces en de operationele robuustheid te testen. Kortom, onze MAC dienstverlening is gericht op kwaliteit in plaats van kwantiteit. Integrale oplossing

De mogelijkheid van het genereren van asymmetrische rendementen middels hedge funds is sterk verbeterd door de zogenaamde 'look through' van de onderliggende posities. Hierdoor kunnen de risico's van een MAC beter worden geanalyseerd en kan deze worden geïntegreerd met de risicoanalyse van de totale beleggingsportefeuille.

Verder draagt de beheerder van de MAC er voor zorg dat de portefeuille te allen tijde voldoet aan de doelstellingen en restricties van de hedge fund portefeuille.

Ten slotte kan de allocatie naar hedgefondsstrategieën zodanig worden afgestemd dat deze een aanvulling is op de bestaande portefeuille. De mogelijkheid om een maatwerkoplossing voor de hedge fund portefeuille te bieden, vormt een belangrijke stap bij het voldoen aan de behoeften van institutionele beleggers, met name in een tijdperk van hoge volatiliteit en lage nominale beleggingsopbrengsten.

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