

## Alternative Investments through Managed Account Platforms: Not Exactly the Holy Grail



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## Managed Accounts and Alternative Investment Risk

### Summary

Managed Accounts platforms have taken off in popularity recently, with numerous providers offering solutions to increase transparency and reduce fraud risk. The increased demand for transparency and the promise of reduced risks to investing through more orthodox fund structures have driven this growth. Improved technologies are heralded as allowing more efficient management of multiple accounts, and reducing costs. Investment managers who have had difficulties raising assets into their existing funds through more traditional channels have also become increasingly willing to offer managed accounts at discounted costs or with lower minimum investments. The net effect is **a growing market for managed account platforms**, well documented by several industry surveys and white papers produced largely by managed account operators and alternative investment advisors.

Although there are indeed several advantages of managed account platforms over traditional hedge fund investment structures, they may not be the holy grail that investors are seeking to protect their alternative investment portfolios from fat tails, significant draw-downs, blow-ups, and, yes, even fraud. We have yet to come across a case of fraud committed by a managed account platform, however that is also a feasible outcome of uncontrolled shift of investments to such vehicles.

Investing through managed accounts certainly does provide multiple advantages over direct fund investing, particularly in the areas of position transparency, ownership and liquidity, however it remains crucial for investors and investment advisors to examine the full range of risks which can have a negative impact on their alternative investment portfolios.

In this paper, we seek to highlight some key considerations for allocators who are confronted with the question: ***“Should I invest through a managed account or straight into the fund?”***

## Managed Accounts

When examining the risk of investing through managed accounts, it is important to have a complete understanding of the tradeoffs of investing through these managed accounts and conventional investments directly into an alternative investment fund.

**Several advantages** which are named to investing via managed account structures are:

- Transparency
- Asset ownership
- Improved liquidity terms

Nevertheless, there are several drawbacks which may be overlooked given the contemporarily increased popularity, both from an individual investor's perspective, as well as from the perspective of the industry as a whole.

From an investor's perspective, a managed account investment may offer position transparency on the underlying positions, however **active monitoring of these positions requires significant resources** and give investors a false sense of security while exposing them to many of the same risks they are exposed to when investing through traditional hedge fund structures.

In all actuality, when opening a managed account with an investment manager, the account holder entrusts the manager with the execution of an investment strategy **in a similar fashion** to the fund(s) or account(s) they have managed previously.

## A New Managed Account has no Track-Record

Verifying track-records and the equality of future performance across managed accounts and funds is much more complex than it is in a fund structure, and is contingent upon service agreements, investment guidelines and proper execution between the investment manager, the managed account platform, and brokers. There are therefore several difficulties in confirming that you will indeed get what you think you are paying for.

**Operational difficulties** for managers trading one strategy across multiple accounts include:

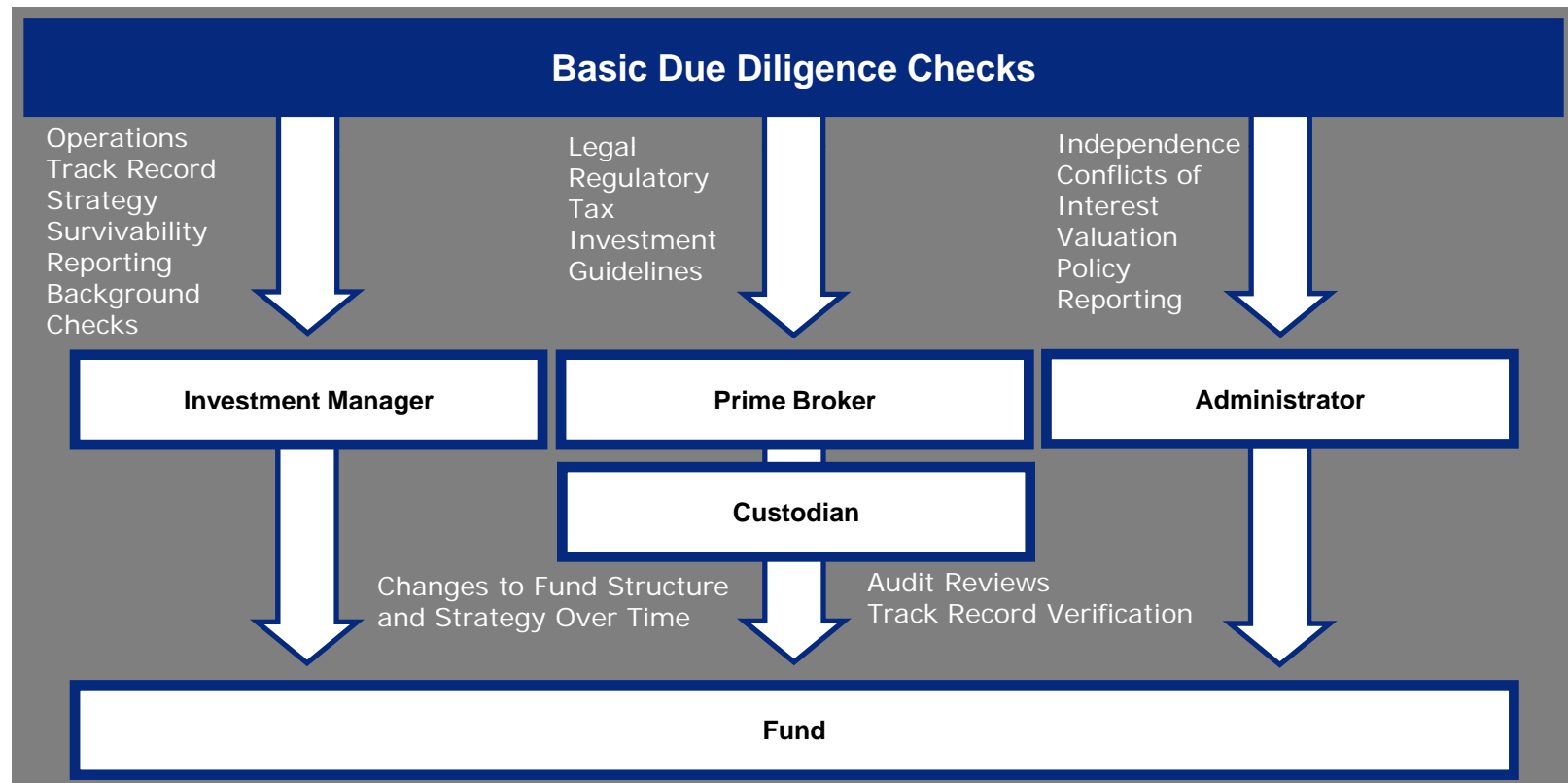
- The risk that one account is overlooked, unhedged or overleveraged
- One account is not given equal access to trades as other accounts using the same strategy

Similarly, holding periods, the liquidity of underlying investments, portfolio turnover and the time of entry can lead to different accounts having very different exposures although managed according to the same strategy, not only when first opening the account, but for a significant period thereafter as well. **Cross-checking and verifying order processing procedures, as well as understanding the liquidity of underlying investments, turnover, and the investment strategy** are therefore central to managed account due diligence.

Whether or not managed accounts are good for the industry is another matter entirely. Imagine an alternative investment industry composed only of managed accounts... no databases, no indices, no benchmarks, and very little transparency, making thorough due diligence an increasingly difficult task. In short, despite some advantages for individual investors, **a major move toward managed accounts may indeed represent a step backwards in terms of the industry's overall transparency** in a situation reminiscent of a prisoner's dilemma.

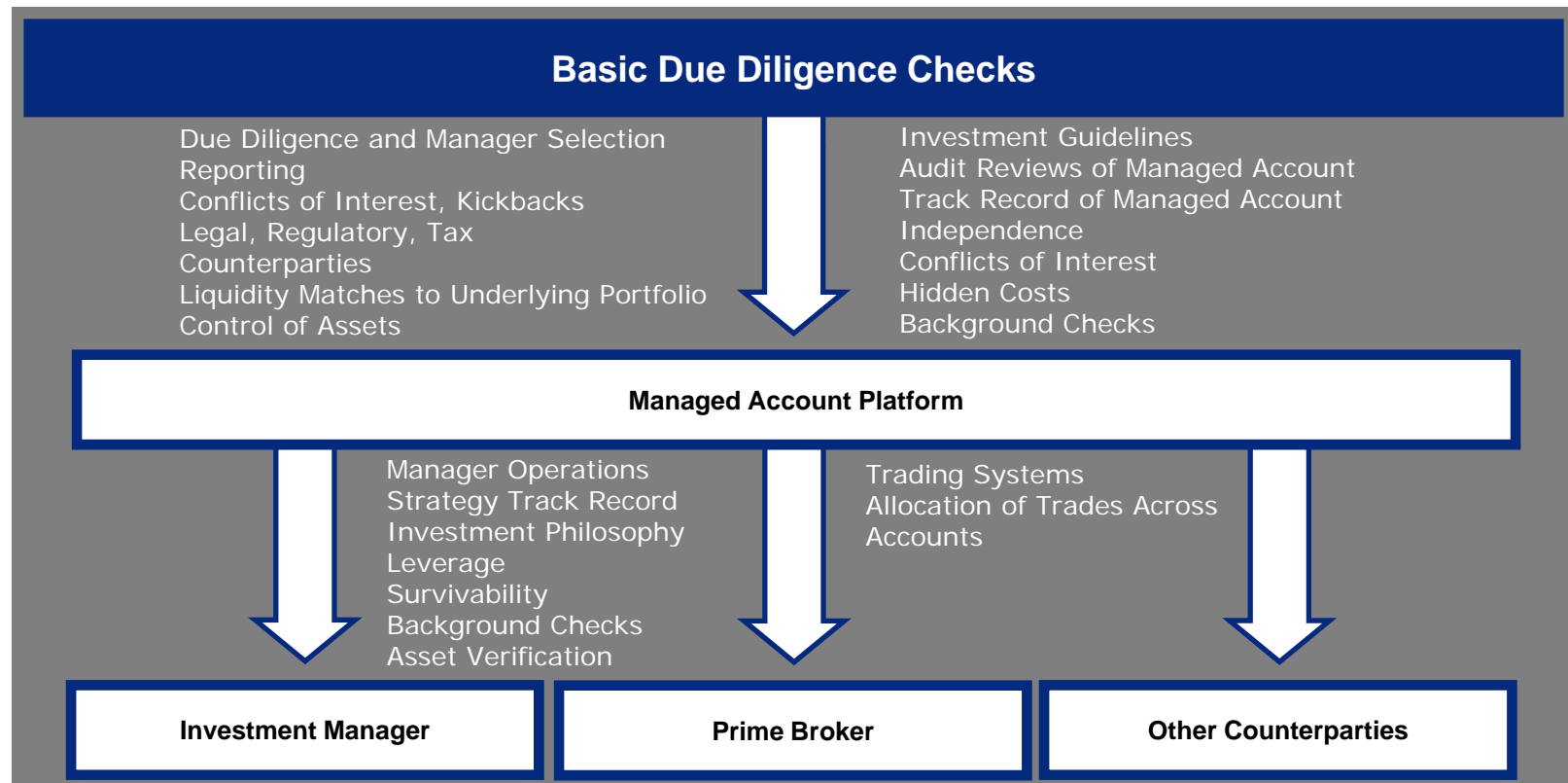
## Traditional Hedge Fund Setup

Conducting thorough due diligence on a fund requires collection and analysis of the primary risks of the fund through the investment manager and its counterparties, cross-referencing and verifying information. **Information is obtained through multiple channels and cross-checked** to identify yellow- and red flags in order to increase confidence in the fund's continued success.



## Managed Account Platform

Conducting thorough due diligence on an investment made through a managed account platform requires dependence on the platform operator, their legal set-up and agreements with the investment manager, among others. When the account is first launched, all previous performance in the strategy is *de facto* pro forma. Although position transparency may be available, strategy transparency may be obscured by special conditions and the investment manager may be selective in providing information only on successful accounts. ***Due diligence must be conducted on the managed account platform as well as on the manager and all counterparties.***



## Fund or Managed Account? It depends on the outcome of your due diligence...

Altogether, managed accounts can offer specific advantages over more orthodox fund investments, however they in no way reduce the need for professional due diligence and monitoring.

The structure of the managed account, the terms of the relationship between the platform and the fund manager, trading procedures, ownership, position monitoring, track records, investment guidelines and counterparties, among others, are key areas of concern when conducting due diligence on a managed account platform.

Additionally, reliance upon a managed account platform's own due diligence procedures while failing to independently verify and cross-check the operational risks of the platform operator as well as conduct thorough due diligence on the underlying managers may carry more risk than may be reflected by the large increase in demand for these vehicles.

Managed Account Platforms	
Advantages	Disadvantages
<ul style="list-style-type: none"> <li>▪ <b>Position Transparency</b></li> <li>▪ <b>Ownership of underlying investments</b></li> <li>▪ <b>Increased Liquidity</b></li> <li>▪ <b>Possible to Alter Investment Guidelines</b></li> <li>▪ <b>Reduced Risk Related to:</b> <ul style="list-style-type: none"> <li>▪ <b>Misappropriation</b></li> <li>▪ <b>Misrepresentation and incorrect pricing</b></li> <li>▪ <b>Trading outside of the operating mandate</b></li> </ul> </li> </ul>	<ul style="list-style-type: none"> <li>▪ <b>Monitoring Requirements</b></li> <li>▪ <b>Dependence upon Managed Account Platform Manager</b></li> <li>▪ <b>Complex Trade Execution</b></li> <li>▪ <b>Unequal Treatment of Investors</b></li> <li>▪ <b>Increased Costs</b></li> <li>▪ <b>Order Execution System Forced on Manager</b></li> <li>▪ <b>Operationally More Complex for Manager</b></li> <li>▪ <b>Conflicts of Interest (Kickbacks, etc.)</b></li> <li>▪ <b>Decreased Transparency with regards to:</b> <ul style="list-style-type: none"> <li>▪ <b>AUM</b></li> <li>▪ <b>Reliability of True Track Record</b></li> </ul> </li> </ul>