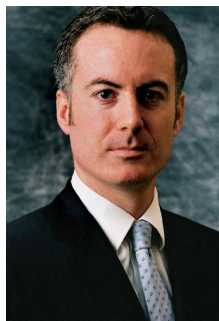


Managed Accounts: Helping to Restore Investor Confidence



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Investor confidence in hedge funds appears to be making a comeback. Just over \$1 billion of net investments moved to hedge funds in the third quarter of 2009, the first quarter of inflows since mid 2008, according to Hedge Fund Research.

Despite the rebound, the events of 2008 and 2009 – market turmoil, fraud and the widespread use of gates or suspension of redemptions – left a lasting mark on the industry structure. Investors and prospective investors, such as pension funds, sovereign wealth funds and other large institutions, are demanding higher levels of transparency and control, greater liquidity and more flexible fee schedules. They are requiring rigorous due diligence, risk management and financial controls, and are demanding independence and separation of functions related to valuation, pricing, compliance and custody.

This marked shift in investor dynamics has resulted in the accelerating demand for managed accounts.

- The number of investors that use managed accounts rose from 20% in 2004 to more than 50% in 2009.
- Upwards of 85% of hedge fund managers have seen an increase in requests for MA structures.
- Approximately 50% of hedge funds manage at least one managed account.

Managed accounts are now increasingly an option for investors who are under pressure from their own stakeholders to demonstrate they are doing all they can to minimize the risks of fraud, illiquidity and style drift. Hedge fund managers serve as sub-advisors to the accounts, with responsibilities limited to making investment decisions. Several MA structures have emerged that involve managed accounts, each with different service requirements: Single manager hedge funds accepting managed accounts and fund of hedge funds placing managed accounts. In addition, fund of funds are increasingly launching managed account platforms to offer investors easier access to funds and the advantages of the managed account structure.

Investor Benefits

Transparency and Control. Managed accounts provide investors deeper disclosure of the manager's investment activities – including investment transactions, holdings, leverage levels and asset values. They can also provide increased control over the assets because investors can use the prime broker or administrator of their choosing, rather than the providers designated by the fund.

Liquidity. As the recent financial crisis demonstrated, liquidity during times of market stress can be a major problem for institutions investing directly in hedge funds. A managed account can insulate investors from this risk by offering capability to redeem more frequently or on short notice.

Fee Customization. Hedge fund managers offering managed accounts can customize the fees and fee structure because of the individualized nature of the accounts. Some managed account investors have negotiated fee discounts relative to the fees paid by investors in funds run by the same manager.

Managers' Primary Concern: Operational Complexity

Although the managed account structure gives investors more control and visibility to the underlying investments, managers running managed accounts face significant challenges. In fact, they report that operational complexity is the number one reason they are reluctant to take money in from managed accounts.

Managed accounts bring with them more operational overhead than pooled vehicles. The accounts need most of the same daily and monthly accounting and trade processing services of a fund. In addition, the inherent individualization of managed accounts multiplies the trading and support functions facing the manager. The manager has to separate the transactions for each account, separate reconciliations with potentially a different set of prime brokers, personalize reporting on each account's activities, and track for performance differences with the main fund due to scale. Yet the relatively small asset size of the average managed account can make the operating costs as a percentage of assets look relatively high. Offering managed account investors enhanced liquidity can constrain the trading strategy and require managers to put in operational mechanisms for short-notice redemptions.

Without question, managed accounts are more expensive to support and operationally complex to run, and can affect a hedge fund manager's scalability. Outsourcing the operational infrastructure to a third-party service provider can relieve the manager of these responsibilities. Fund managers should look for a service provider with reporting capabilities flexible enough to meet the demands of the different account holders. Also key is the scale and automation of the provider, given the need to support account-level operations and reporting.

Managed account structures have become an important tool for hedge fund managers to attract new assets. With the right operational model and reporting capabilities in place, managers can overcome the operational challenges and thrive by providing individualized service and more frequent customized reports to this growing client segment.



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