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***Realignment of Interest in Hedge Fund
Investing Using a Managed Account
Platform***

***Another Lesson Learned from the Current
Crisis***

The many advantages of using managed accounts to invest in hedge funds have been well documented. However, the recent financial crisis has highlighted some features that were largely ignored by institutional investors and brought to light the immense value of asset control. The advantages go well beyond the usual transparency and liquidity, which have both been abused by manufacturers of structured products. Large institutional investors all agree that it is now time to rewrite the rules for hedge fund investing and that better corporate governance is much needed. We believe we should let hedge fund managers do what they do best, generate alpha, while taking control over business and administrative risks for which few are well equipped. In this article, we highlight the benefits of well structured managed accounts and suggest ways of achieving a better alignment of interest between hedge fund managers and their investors.

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Setting the stage with some history

Managed accounts have been around for a while. After all, this is how most institutional investors give mandates to traditional long only managers: as advisors to a portfolio which sits on the balance sheet of the institution. A custodian will usually be involved, but the institution keeps control over the assets while the asset management firm simply acts as an advisor. These asset management firms also offer commingled or pooled funds for smaller investors. In this case, asset control is effectively lost and it then remains with a third party.

When hedge fund investing became popular, the early wave of subscriptions came largely from private investors, family offices and high net worth individuals. The main objectives from the investor's point of view were to make sure that the investments would be non-taxable and that there could be no recourse against them in the case of losses. On the other hand, hedge fund managers simply wanted to get away from the usual constraints of long only management and as such wanted to face as little regulation as possible. From then on, it was only natural to popularize a pretty simple form of investment where the investor subscribes to a limited partnership controlled by the general partner and located offshore where regulation is weak. Just add to this set-up weak governance without an independent board and legal documentation entirely in favor of the manager and you pretty much get the picture facing today's institutional investors wanting to generate some much needed alpha through hedge fund investing.

Interestingly, the concept of managed accounts for institutional hedge fund investing never really took off. This is mainly because of the inherent structure needed by hedge fund managers. The fact that they go long as well as short securities means that they need

to borrow. Moreover, they transact derivatives, which imply signing ISDA agreements. Most legal counsel will recommend to pension funds not to do these operations on their own balance sheet as it can open the door to unlimited liability. Few institutional investors apart from the largest went through the trouble of creating their own off balance sheet structure offering limited liability. At the end of the day, most institutional investors reluctantly accepted the usual Cayman based limited partnership (or segregated portfolios companies) structure while relying on more and more complex side letters to obtain some form of protection.

National Bank of Canada was one of the first institutional investors to use managed accounts when it started giving mandates to hedge fund managers in July 1996. Other banks created similar platforms and they quickly realized that it was extremely profitable to use them for retail distribution of structured products loaded with fees. The transparency and liquidity of the managed accounts allowed the institution to offer highly leveraged products while taking little risk. These products were extremely popular early this decade. Consequently, there was little motivation to adapt and "clean" the concept for institutions.

What is a managed account?

We often see confusion between segregated (or separate) accounts and managed accounts. The former is simply a customized mandate that is housed on the legal structure created by the manager. It offers some form of flexibility, but no control over the assets, which we believe is the key aspect of a true managed account. In our opinion, a well structured managed account should see the hedge fund manager hired as a trading advisor with authority to transact in the account but no control over the assets.

The relationship should be governed by a well written IMA (Investment Management Agreement) containing a balance between investor protections as well as the rights of the hedge fund manager. This document shall be negotiated instead of imposed on the investor and it should encompass many issues going well beyond a simple description of how the money will be managed. It has nothing to do with the current vague and opaque subscription documents found in most hedge fund offerings. In the case of a managed account platform, the operator of the platform is responsible for the entire structure and to control, monitor and then report the activity of the manager to the investors. As such, it has, in most cases, fiduciary responsibility to the investor for its investment as well as to the hedge fund manager for the transparency into the portfolio. The end result for the investor is a net asset value determination which is independent and reliable. It is a vastly superior model for investors.

One of the key aspects of managed accounts is their great flexibility. They can be customized to take into consideration many different aspects of the investment. Unfortunately, this flexibility has not seen much leverage over recent years as managed account providers were too busy abusing the old model instead of trying to adapt it to suit the needs of demanding institutional investors. As we will see in the coming sections, managed accounts can be adapted and used by sophisticated investors with many different objectives and priorities.

The truth about transparency and liquidity

The advantages offered by managed accounts are numerous. It goes without saying that transparency and liquidity are the two most often mentioned. It is important to remember that these items remain available

for negotiation and that the model can be adapted. As such, it is a misconception that all managed accounts need to be totally transparent and extremely liquid!

Transparency. In terms of transparency, some hedge fund managers might want to protect themselves and request that the actual list of securities held in the portfolio remain with the platform operator while it allows for aggregate reports to be sent to the investors.

Many hedge fund managers are worried about their strategies being replicated by others. This is why a managed account operator does not belong on a trading desk and should be totally forbidden to trade securities. Moreover, the reports required by institutional investors often need to be customized. These bespoke reports can be complex and are seldom offered by hedge fund managers.

Translating the complex trades into a simple and clear report is one of the key roles of a managed account platform operator. Some other hedge fund managers might be willing to share the actual list of holdings with investors on a daily basis. On the other hand, very few investors could handle a list of thousands of trades every day. Many see transparency as a double-edged sword, as it actually comes with a responsibility! Very often, it is best to leave the list of daily transactions to the platform operators as they have the systems and resources to deal with this. It is not a coincidence that the most successful managed account platform operators actually emanated from large banks since they leverage the resources of these organizations.

For most institutional investors, it is best to agree on precisely what kind of aggregate information is needed on a weekly or monthly basis. It is usually best when it matches the metrics used in other parts of the portfolios so that VAR calculation or stress

tests can then be compared and risk budgeting becomes meaningful. The platform operator can also receive and monitor some guidelines like concentration, stop-losses or exposure and report only when triggers are being reached. This greatly reduces the resources required to monitor hedge fund operations as pension funds often operate with a minimum internal staff.

Liquidity. Most managed account platforms will offer excellent liquidity terms such as daily, weekly or monthly. It compares advantageously to most offshore hedge fund offerings with quarterly, semi-annual or annual redemption accompanied by lengthy notice periods. Moreover, many funds of hedge funds are now facing serious asset/liability mismatch as they promised better liquidity terms than what they had with the underlying hedge funds.

Generally, we believe that liquidity terms should be aligned with the investment horizon and the actual liquidity of the underlying securities.

For example, it is normal to require that certain futures-based strategies, like CTAs or FX trading, offer very liquid terms as much as daily dealing. On the other hand, it may be inappropriate to have a long term distressed asset manager looking for a recovery over a cycle to offer monthly or quarterly liquidity. In this case, a lockup might well be the solution. In this situation, investors should have a strong preference to have their money locked in via a managed account format rather than in a typical structure which offers very little investor protection. Even if the money is committed for a period of time someone is independently watching the investor's interests and fiduciary responsibility can be enforced.

Ultimately, the best structure would allow for transferability of units of managed accounts, offering long term money to the hedge fund manager while giving some

flexibility to the investor. Even pension funds with a very long term horizon might have liquidity needs because of asset allocation decisions or problems in other parts of the portfolio. It has proven to be a challenge to organize a secondary market for units of hedge fund investments, but some initiatives are underway and Innocap is contributing to try to find a solution.

The hidden advantage of managed accounts: asset control

The events of 2008 have highlighted the weakness of the old hedge fund investing model. These great traders and portfolio managers are not necessarily good business managers and they neglected some critical elements in their offering. Many investors painfully realized that asset control mattered as they witnessed the unraveling of the credit crisis. We will briefly describe what advantages can be gained with asset control.

First of all, the risk of fraud is greatly reduced as it is very difficult to disappear with the investor's money when you do not have access to it! This aspect is nothing new, and it has been historically well documented. The fact remains that "sleeping at night" is the number one advantage of managed accounts as operational and administrative risk is transferred from the hedge fund manager to the platform operator. Market losses, even severe ones, can still occur as market risk remains with the manager as long as he is operating within his guidelines, but at least the headline risk is well under control.

As mentioned earlier, most hedge funds need financing. This can take many different forms but there is always a lender facing the mark-to-market risk of the portfolio. (If there is none, then it is a long only mandate and probably should not be a hedge fund...) In any case, we have seen the ugly side of financing risk recently as many lenders changed the terms on the hedge fund

managers, asking for more collateral, increasing the rates and ultimately squeezing out the managers. Most were caught off guard and even very sound portfolios, with short exposure as the market was falling, were forced out of business. Now this is very ironic as many institutional investors like pension funds do not have funding issues and could have acted as lenders in such distressed situations. They could only passively witness forced liquidations and suffer heavy losses imposed on them by prime brokers. Ultimately, an investor could take ownership of the assets and avoid liquidation at the worst time. By using managed accounts, Institutional investors can step in and act.

The other side of the coin is that hedge funds may also have cash balances as leverage is sometimes obtained with derivatives and Over-The-Counter (OTC) transactions. In this case, it is extremely important to verify where this cash is being held. Most hedge fund managers simply leave it as excess cash with their prime brokers. In the event of prime broker bankruptcy, it becomes a general liability and chances are that this money is gone. Some hedge fund managers were also “optimizing” return on excess cash by using different structured vehicles. This is not necessarily bad, but it is a risk that investors must be aware of and it should be their decision.

Ultimately, the management of the cash becomes a credit decision, and each margin call should be questioned while no excess cash should remain with unwanted counterparties. A managed account allows the investor to decide how cash will be managed.

Just as we all require some form of diversification from our managers, it is unacceptable to have large exposure to specific financial institutions. Some hedge fund managers still use a single prime broker or mainly trade with one or two institutions facing huge potential losses in the event of

default. Management of counterparty risk has become crucial in recent months. Since it is a very large risk (equivalent in some cases to having 100% of the fund invested in the equity of a single financial institution) it is imperative for the investor to know about this and to control this risk. Moreover, in case of problems, a managed account operator can quickly take action to minimize the exposure to an unwanted counterparty. In extreme cases, a prime broker can be replaced in a matter of days, avoiding huge losses.

Essentially, it should be remembered that all the service providers surrounding hedge fund managers (prime brokers, custodians, administrators, trading clearers) protect themselves with some form of asset control and rarely lose money that way. It is an aberration that investors are not allowed to do the same in offshore hedge funds and this should be addressed.

General Partners vs Limited Partners: the issue of Independent valuation

The issue of having the general partner determining the valuation of the securities held by the limited partners is an old grudge of hedge fund investors. In theory, administrators are supposed to independently establish the value of the securities held in the account. However, few are well equipped to price complex and illiquid securities and they refuse to take this challenging task as it comes with a heavy burden of responsibility...

It means that most managers, as general partners, end up pricing the securities they own themselves and have it “stamped” by the administrator. In some cases, the prime broker may also be doing part of this task. However, it is a small improvement as they are the ones selling and/or financing these same securities, which is another conflict of interest. There have been some attempts to resolve this issue in the US with the introduction of AU332 and FASB157.

However, accounting firms have been busy finding solutions to circumvent the issue instead of mandating their investors to obtain truly independent valuations of the securities. This problem climaxed last summer when the US Department of Labor issued a letter to an ERISA governed pension plan pointing out that the fiduciary responsibility of the trustees mandated that they obtain independent valuations of securities held in a limited partnership. They claimed that the valuations of the general partner alone were not enough and even threatened legal action if the situation was not corrected.

A managed account does not exhibit the same weakness as securities are priced by the owner of the assets and true independent pricing can therefore be obtained.

General Partners vs Limited Partners: the issue of Independent Boards

Another issue which has started to surface recently is the fact that offshore hedge fund board members are rarely independent. In the case of trouble such as liquidation, gates being imposed, or the creation of side pockets, many investors have found very little comfort by trying to address these issues with the hedge fund's board. Having an ineffective board, and therefore weak corporate governance, is not an issue when everything is running smoothly, but it becomes a nightmare when investors realize that they are held prisoners of the structure in which they invested. The board will too often end up protecting the business model of the hedge fund manager instead of the investor's interest. This conflict of interest is obviously prevented in a managed account structure.

The role of prime brokers

Since the late 1990's, the prime brokerage operations of large investment banking firms have been hugely profitable. Since prime brokerage requires different

services from some departments of the same firm, those that were able to break the silos and act in a coordinated manner took the lead and were able to reap the benefits. Essentially, the idea behind a prime brokerage offering is to bundle three essential services: clearing of trades, custody of assets and financing.

The best prime brokers focus on equity long/short since stock lending and financing is the most profitable sector of prime brokerage. Once again, recent events have highlighted the fact that bundling these three offering has been awesome for investment banks, but maybe a disservice to investors. As much as prime brokers are essential to clear trades, it is unclear why hedge fund managers need to obtain their financing and custody assets with prime brokers.

The answer could be that they control stock lending which is essential for so many hedge fund strategies. Prime brokers have been able to bundle the other services in exchange for this much needed lifeline. The financing problems of many hedge funds in 2008 have proven that it may not be optimal to have unsecured lending from a prime broker. Moreover, the bankruptcy of Lehman has demonstrated that custody of assets with a prime broker might not be ideal. At the very least, with a managed account, an investor could act in case of problems.

Re-hypothecation

The concept of re-hypothecation, ignored by most until a few months ago, is now on everybody's lips. This is how prime brokers finance themselves. If leverage is involved in a fund, a portion of the paid-for securities may be lent by the prime broker to third parties. Without getting into the details, suffice it to say that many hedge funds are now facing lengthy legal battles to recover their assets as the liquidators painstakingly go through Lehman's books.

There is uncertainty about what kind of recovery they will get. It is not entirely clear if assets that should have been segregated were actually booked this way and if securities were clearly identified as type 1 when they should have been. Even if investors end up getting all of their money back, which is far from certain, it will take months of costly legal battles. Meanwhile, opportunities are gone, market losses may be severe and confidence is lost.

It doesn't have to be that way. Some astute investors are currently exploring different structures where financing is obtained from a bank and custody of assets is done with a traditional custodian with segregation of assets clearly defined. Obviously, none of this can be done in a traditional format but a managed account is the ideal structure to obtain this much needed unbundling. The traditional prime brokerage offering is being questioned and managed accounts offer the flexibility to create a better model.

Re-alignment of interest using managed accounts

Many institutional investors are now looking at modifying the way they will invest in hedge funds. We have described how the recent turmoil has highlighted the weaknesses of the old model. Moreover, there has clearly been a shift in power from hedge funds to their investors. Each investor is different and they focus on specific concerns. We will now list some of the advantages of managed accounts to highlight what can be achieved while using them.

- Customized reporting, including daily NAV, P/L vectors and factorial analysis allow for a better analysis of beta component of the returns. This means you can get more alpha from your investments.

- More nimble decision-making allowing for better rebalancing of the portfolio.
- Monitoring of style drift.
- No surprises such as gates or lock-up suddenly imposed on investors.
- Avoid reputational risk, as negative headlines are limited.
- Building more strategic relationships with certain hedge fund groups as the safety of managed accounts allows for more concentrated investments.
- No more conflicts of interest, partial boards, GP/LP issues.
- Ultimate ongoing due-diligence process.
- Independent valuation of securities.
- Mandates can be customized to the specific needs of the investor.
- The managed account platform operator acts as an extension of the internal staff allowing for knowledge, transfer of intelligence and better decision making.
- It allows more comfort in allocating to early stage managers by removing operational and administrative risks.

Limitations of managed account solutions

In order to be objective, this paper should address the usual criticism that investors will hear about managed accounts.

We often hear the same 4 negative elements about managed accounts. Let's look at them as well as some counter arguments.

“Best of breed managers will not accept managed accounts.” There are two types of managers that typically refuse managed accounts; those trading illiquid and difficult to value securities not suitable for managed accounts and the very large managers that are independent enough to say no. In the first instance, we just need to adapt the model and provide monthly instead of daily NAV. In the second case, avoiding very large hedge funds should not represent a loss in performance as countless studies have demonstrated the outperformance of smaller early-cycle managers. Moreover, it is important to note that the environment has changed drastically over the recent months. Many managers facing large redemptions may now think twice about refusing a managed account for an institutional investor.

“Managed accounts typically underperform.” We usually see this argument put forward when performing a simple analysis of the underperformance of investable indices vs their non-investable comparables. Because investable indices are based on managed accounts, this is the conclusion that is easily reached. When making the correct adjustments for biases and the cost of illiquidity, the underperformance is negligible. Furthermore, these managed account based indices suffer from many flaws in their construction, which has nothing to do with an actively managed portfolio representing best of breed managers accessed via managed accounts.

“Managed accounts are mainly for structured products retail distribution.” It is true that managed account platforms have traditionally been abused in order to create hugely profitable structured products. If a platform is loaded with structured products, it may be at odds with the long term objectives

of a pension fund. Therefore, a potential investor should value a high percentage of institutional assets on a platform. Moreover, institutional investors should demand the highest institutional standards such as GIPS compliance as well as SAS70 (or FRAG 21) audit. Finally, investors should demand an open architecture, the elimination of conflict of interest as well as no hidden costs in order to have a clean business model.

“Managed accounts are too costly.” In order to analyze this aspect, one should look at the total expense ratio of accessing a manager via the offshore LP and a managed account. In order to do this, we surveyed more than 100 offshore hedge funds audited financial statements. We found a surprisingly high average of 45bp in costs excluding management and performance fees as well as all costs related to trading. This is because other types of fees such as legal, operation and “others” are often included in offshore funds. This 45bp needs to be compared to the direct costs of managed accounts. Moreover, there are many other advantages coming from negotiations with service providers and prime brokers that are more difficult to value precisely. Because managed account platforms operate with many prime brokers, it is possible to negotiate better terms than offshore funds (such as financing) in almost all cases. We can conservatively estimate these savings to represent at least 20bp. At the end of the exercise, when taking into account all the costs involved, we can claim that managed accounts are not necessarily more expensive and that both options can have very similar total expense ratios.

Conclusion

It is clear that recent events have highlighted the flaws in traditional hedge fund investing. Institutional investors are actively looking for a realignment of interest with their

hedge fund managers. Trustees simply cannot exercise their fiduciary responsibilities with the old model and they are looking for better corporate governance. The current crisis represents the ideal catalyst to change the model as the power has shifted. We have well documented the numerous advantages of managed accounts and especially their

flexibility in answering many of today's concerns. Now is the right time to change how institutional investors access hedge fund talent and strategies and we believe managed accounts represent the ideal tool for a new model to emerge.

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