An Investment Decision for the New Economic Reality:

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Hedge Funds or Discretionary Managed Accounts?

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Managers of funds of funds, institutional investors and family offices have long sought to invest their assets with professional money managers, with the expectation that the investment advice provided by these professionals will lead to greater returns. In the wake of Bernard Madoff's arrest, and the allegations against him of perpetrating a massive criminal securities fraud and similar allegations against other managers, these investors should now put greater thought into the means with which they invest with professional managers and the degree of control afforded to those managers. This article will provide guidance with respect to the relative benefits and risks associated with investments in unregistered collective investment vehicles, particularly hedge funds, versus the retention of third-party managers who have discretionary investment authority over managed accounts.

Investments in hedge funds

In recent decades, investors have increasingly directed a substantial amount of their investments to hedge funds. Generally, a hedge fund is a private investment vehicle that pools capital from a number of investors and invests the pool's aggregate assets in securities and other tradable instruments, often using leverage to take positions that are larger than would be otherwise available. Hedge funds generally operate under exemptions from registration available under the Investment Company Act of 1940, as amended. Therefore, they are not required to abide by many of the affirmative and negative restrictions associated with registered investment companies (ie, mutual funds). Hedge funds employ one or more of a wide variety of investment strategies and often utilise a sophisticated hedging of their positions to minimise investment risks and provide superior returns to their investors.

Positive attributes of hedge funds

The benefits of investing in hedge funds have long been championed by hedge fund managers. These benefits include:

- **Experience:** most fund managers have the investment experience and industry know-how necessary to allocate resources and assume risk in a manner that maximises profit. This experience is often a significant factor in the manager's ability to draw new investors to the fund.

- **Economies of scale:** hedge funds, as collective investment vehicles, are able to take advantage of economies of scale by using large pools of capital to take long positions, and hedging positions that are significant from a size and/or risk perspective.

- **Cost efficiencies:** unlike solitary investors, hedge funds are often able to negotiate better brokerage and clearing rates, due to their high volume of trading.

- **Investment opportunities:** the availability of a large pool of capital offers hedge funds the ability to participate in investments with high minimum investment requirements and to have proprietary access to certain investment opportunities and information.

Negative attributes of hedge funds

The benefits of investing in hedge funds are tempered by the risks associated with investments in unregistered entities. These risks include:

- **Lack of transparency:** investors in hedge funds are often unaware of the securities held by the fund, and such investors may, in fact, be restricted from accessing or disclosing such information. Periodic hedge fund reporting is often limited to monthly or quarterly reporting of the fund's net asset value (NAV) and the value of the investor's capital account or share-holding.

- **Liquidity:** hedge fund managers are often able to limit the rights of investors to withdraw their capital. For example, managers may impose lock-ups, gates, holdbacks and/or suspensions, each while the investor's capital is still at risk and potentially still subject to fees. Furthermore, withdrawals from hedge funds by large investors could cause the fund to be forced to liquidate some of its investments, which could have an adverse effect on future returns for the remaining investors. Managers of funds of funds must take further care to match the liquidity terms offered to their own investors to the liquidity of the funds of funds' underlying investments, which efforts on the part of such managers may include the co-ordination of redemption periods, the prior notice period, and the distribution of redemption proceeds.

- **Fraud:** as evidenced by the Madoff case and others, the potential for fraudulent activities is as prevalent in the hedge fund industry as it is in the entire financial system. In a study of the operational risks associated with hedge funds, the EDHEC Risk and Asset Management Research Centre reported that fraud is a prominent factor in hedge fund collapses and that three sources of risk were prevalent in 85% of hedge fund debacles analysed in their study.[1] These risks may be summarised as follows:

  - **Misappropriation:** the risk of deliberate diversion of assets from the fund by the fund manager occurred in 30% of the cases analysed by EDHEC.[2] Generally, misappropriation may occur at two levels: first, from the inception of the fund, in which case the assets may never reach the fund's accounts; and second, by the diversion of capital through basic transfers or through unauthorised trading activities with third-party accomplices.

  - **Misrepresentation:** the risk of misrepresentation, which comprises all cases where the fund manager deliberately modifies the information delivered to investors, occurred in 41% of the cases analysed by EDHEC.[3] In a hedge fund context, misrepresentation may take the following forms: the modification of audited accounts or statements provided from the administrator and prime broker; or the deliberate incorrect marking of securities to inflate the overall performance of the fund.

  - **Unauthorised trading:** the risk of trading outside of the hedge fund's mandate occurred in 14% of the cases analysed by EDHEC.[4] As a hedge fund receives more capital and the potential investment opportunities that exist within the fund's mandate dwindle, fund managers may seek to expand the scope of their trading activities outside of the mandate, and attempt to create greater returns on new strategies that have not been clearly disclosed to investors, a phenomenon commonly referred to as 'style drift'.[5]

Investing through managed accounts

An alternative to investing in a collective investment vehicle is to open a brokerage account and grant discretionary or non-discretionary trading authority over that account to a third-party manager. A managed account allows the investor to contract the services of the manager without any of the concerns associated with intermingling the investor's capital with the capital of other investors. The managed account arrangement is generally documented through a Managed Account Agreement.

Positive attributes of managed accounts

The terms of a Managed Account Agreement are subject only to the negotiations between the individual investor and the manager. As such, managed accounts may be tailored to the investor and offer a wide variety of benefits, including:

- **Control:** the manager of a managed account may have discretionary or non-discretionary authority over trading in the account. Each offers the investor a degree of control over the account. In either case, the manager generally does not have custody over the assets in the account and, therefore, the risk of misappropriation is low.

- **Non-discretionary authority:** in the case of a manager with non-discretionary authority, the investor has complete control over trading in the account and disbursements from the account. The manager's role is only to recommend specific trades and strategies to the investor, which the investor is free to accept or reject at their own discretion.

- **Discretionary authority:** in the case of a manager with discretionary authority, the manager is authorised to trade in the account in accordance with specific investment guidelines. Trading by the manager outside of the investment guidelines constitutes a breach of the Managed Account Agreement.

- **Fees and taxes:** managed accounts provide the opportunity for investors to negotiate fees with the manager on an individual basis, and to decide whether or not to incur additional costs, such as retention of an auditor to review the account's books and records. The investor also has greater control over their individual taxes and is able to direct the manager to realise losses in individual securities to offset certain gains, including gains earned by the investor outside of the managed account.

- **Transparency:** direct ownership of a managed account entitles the investor to transparency with respect to the account's underlying holdings. The investor can also require reporting from the manager as frequently as desired, even on a daily basis and with accompanying risk reports. This allows the investor to confirm that the manager is not engaging in style drift.

- **Liquidity:** Generally (though subject to negotiation with the manager), the owner of a managed account has generous liquidity rights with respect to the assets of the account. These rights allow the investor to take corrective actions at an earlier stage if a risk violation occurs, and to minimise the negative effects of such a violation.

Negative attributes of managed accounts

While managed accounts offer unique benefits to investors, they are often significantly more complicated for investors to open and to operate in comparison to the process for subscribing for interests in a hedge fund. In addition, the negative attributes of managed accounts include:

- **Costs:** due to the ownership of a managed account by a single investor, the costs associated with opening a managed account are borne wholly and directly by the investor. These include formation costs, trading expenses and the legal fees associated with negotiating the Managed Account Agreement. These costs could lead to variances in overall returns from the execution of a similar trading strategy by a hedge fund.

- **Performance:** managers of managed accounts who are required to perform reporting and risk assessment functions on a daily basis may be required to retain additional staff to perform such functions (often leading to greater fees for the investor) or, if these functions will be performed directly by the manager, the manager may have less time to devote to trading and research, which could have a detrimental effect on the performance of the managed account.

- **Reduced efficiencies:** managed accounts that are not well capitalised may not be able to satisfy the minimum capital requirements necessary to participate in certain investments. Further, while some managed accounts are established to track the trading strategy of a manager's hedge fund, the reduced efficiencies inherent to managed accounts often make it impossible for the manager of the account to replicate the performance of his hedge fund.

Conclusion

As investors consider their options in the new realities of the investment management industry, both hedge funds and managed accounts remain viable investment options. The increasing skepticism with which investors may treat the industry could lead to a more pronounced view of the negative aspects of hedge funds. However, it would be erroneous to believe that these attributes could be avoided with managed accounts, as the complexity of some strategies and inefficiencies of managed accounts could result in difficult or unanticipated results. Regardless of the ultimate investment choice, it is clear in that in a post-Madoff world, investors must devote substantial attention to conducting a full due diligence of the manager ultimately responsible for managing the investment, a sentiment recently highlighted in the *Report of the Investors' Committee to the President's Working Group on Financial Markets*, which focused on the principles and best practices for hedge fund investors.[6]

Endnotes:

1. EDHEC, *Mitigating Hedge Funds' Operational Risks*, June 2008, p. 20.

2. Ibid.

3. Ibid.

4. Ibid.

5. Ibid.

6. See 'Principles and Best Practices for Hedge Fund Investors,' *Report of the Investors' Committee to the President's Working Group on Financial Markets*, 15 January 2009.

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