

Hedge Fund Investments: Using Separately Managed Accounts

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This paper was written to give hedge fund investors a better understanding into another option when making hedge fund investments; separately managed accounts. The majority of hedge fund failures have been due to fraud and operational issues rather than poor investment decisions. Hedge fund investments made through separately managed accounts have become the structure of choice for investors seeking to minimize the risk of fraud and operational risk.

The contents of this paper include;

- I. Traditional hedge fund structures
- II. Issues with the traditional hedge fund structure
- III. Separately managed accounts
- IV. Benefits of separately managed accounts
- V. Costs of separately managed accounts
- VI. Which hedge fund managers will provide separately managed accounts?
- VII. Who owns the separately managed account?
- VIII. What are the liquidity terms of a separately managed account?
- IX. Conclusion

I. Traditional Hedge Fund Structures

A hedge fund is an investment company that is generally structured as a limited partnership or limited liability company ('the partnership'). Investors purchase shares or interests in these companies to earn a rate of return on the invested capital. The partnership would have at least one prime brokerage account relationship, and this account would be wholly owned by the investors of the partnership. The prime brokerage account should be maintained at an independent prime broker and the prime broker should be reputable.

Since the partnership owns the prime brokerage account, each investor indirectly owns a portion of the prime brokerage account. The expenses of the partnership are generally limited to tax deductible expenses of the investors. These expenses generally include; the cost of executing and clearing the securities, interest

expense that is charged by the prime broker, regulatory fees and other trading related expenses, the cost of the annual audit, administration costs, legal costs including the cost to create the partnership and other administration costs. The fees paid (i.e. management fees and incentive fees) to the hedge fund manager are generally treated as a profit allocation to the general partner. There are other ways to treat such fees paid to the hedge fund manager depending on whether the trading activity qualifies as ‘trading’ or ‘investing’ but this paper will not touch upon these tax issues. This paper assumes that the trading activity qualifies as ‘investing’ as defined in the IRS regulations.

The partnership would earn profits and losses from the hedge fund strategy (i.e. trading gains and losses, and interest) and would be offset by the fund expenses noted above (‘gross return’). The fees paid to the hedge fund manager would be allocated to the general partner as a profit allocation. The terms hedge fund manager and investment advisor are used interchangeably. Note that this is an allocation of profits rather than an expense. The distinction being made is that the general partner is a partner (allocation of profits) rather than a service provider (expense). The gross return less the hedge fund manager fees are generally referred to as ‘net returns’.

The net returns are realized by the hedge fund investors, or the partners of the fund. The hedge fund manager generally sends a performance update to the partners on a monthly or quarterly basis. Most hedge funds do not disclose the full details of the investments in the partnership. The administrator prepares monthly statements for each investor and reconciles the activity with the prime broker. The independent auditor reviews the work performed by the administrator, verifies the support documentation, independently revalues the securities in the prime brokerage account, and selects individual transactions for detailed testing, among other things. The investor would receive an independent statement at the end of the year, generally fiscal year end, which validates the value of the hedge fund investment.

The partnership has investment terms that are generally applicable to all of the partners. The investment terms include; liquidity provisions, pricing and lock-ups. The liquidity provisions include the amount of notice (‘notice period’) that must be given to make a withdrawal and how much time the investor must wait until the funds are returned once the notice has been provided (‘redemption period’). Pricing includes the fees that are charge to the partners. The fees include management fees, incentive fees and early termination fees. The management fees generally range from 1 to 3%. The incentive fees generally range from 15% to 30% of the hedge fund profits. The early termination fees generally range from 1% to 5%. The logic to early termination fees is that investors whom redeem early or often would be done so at the cost of the remaining investors. These early termination fees are generally realized by the fund for the benefit of the other investors, to offset such redemption cost. Some hedge funds have lock-up terms and this term defines the minimum amount of

time the investor must have the invested funds in the hedge fund partnership. If an investor redeems the investment prior to the lock up term, then the early termination fees apply.

There are instances in which hedge fund managers would negotiate the standard terms with a prospective investor. Such negotiated terms are included in what is referred to as a 'side letter'. It is appropriate for prospective investors to request copies of all side letters as the general partner has a fiduciary responsibility to treat all investors the same. The hedge fund manager has flexibility with the investment terms when issues of timing and investment amount are considered. For instance, an early partner ('investor A') in the hedge fund may receive better investment terms than a partner ('investor B') that invests in subsequent years once the business is well established. It is often argued that investor A is taking additional operational and execution risk than investor B, and the additional risk often justifies the better investment terms.

II. Issues with the Traditional Hedge Fund Structure

Issues with the traditional hedge fund structure can be separated into fraud, lack of transparency, liquidity, pricing and potential tax issues. The fraud or service provider issue is easily highlighted through situations that have been reported in the marketplace. The hedge fund named Bayou did not have an independent auditor and did not have an independent prime broker. The hedge fund named Wood River did not have an independent auditor and the prime broker that was presented to the investors was not in fact the actual prime broker. These issues could have been avoided by having independent auditors and independent prime brokers

Wood River highlights the transparency issue when they made an unusually large investment in one company. The investment amount in this one company was in excess of the investment guidelines that was presented to investors and not having transparency into the underlying investments.

The liquidity issue is that an investor has notice periods and redemption periods before redeeming the investment. There are hedge funds that offer quarterly liquidity but most hedge funds have at least one year lock ups.

Investors are charged an early termination fee, and that fee is generally excessive relative to any value lost due to the early liquidation.

The potential tax issues arise when non deductible expenses are incurred by the fund, and these expenses are not tax deductible to the partners.

The above issues are inclusive and should not be deemed as the only issues with the traditional hedge fund structure.

III. Separately Managed Accounts

Hedge fund managers have been providing the same investment management services to investors, using the same investment philosophy as their respective hedge fund strategy, in a separately managed account.

The hedge fund manager would be buying and selling the same securities, and managing the assets *pari pasu* with the hedge fund. Meaning, if a hedge fund had \$100 million of assets and there was \$25 million in the managed account then 75% of all investments are allocated to the hedge fund and 25% are allocated to the managed account.

The gross trading performance of the managed account should mirror the gross trading performance of the hedge fund. The investor may add investment guidelines to the separately managed account and these guidelines may create know variances between the two investment vehicles. For instance, if an investor wanted highly liquid investments then the agreed upon guidelines could prohibit investments in illiquid securities.

The same tax issues apply for the managed account that apply for the hedge fund; the deductibility of expenses when considering an allocation of profit to a partner (generally deductible) versus an expense to a service provider (generally non deductible for 'investment companies'). The investor would create a partnership and the investment advisor would be a limited partner. This partnership structure would offer more protection if the payments to the sub advisors were challenged by the IRS. The investor would likely incur some legal costs in creating a partnership but that would be offset against the savings of not have the hedge fund expenses (i.e. amortization of legal start-up costs, audit fees, administrative fees and other fund expenses). Investors should consult their tax advisors before making investment decisions.

IV. Benefits of Separately Managed Accounts

The separately managed account offers better liquidity terms, lower expenses, full transparency and monthly (sometimes daily) validation of the investment value.

The separately managed account inherently offers daily liquidity to the investor. This inherent feature exists because the owner of the separately managed account ('the investor') can terminate the trading authority of the hedge fund manager at any time. There are certain risks that the investor must assume if the hedge fund manager is directed to liquidate the investments and the hedge fund manager resigns (see 'Costs of Separately Managed Accounts' for more information).

When the investor is effectively the owner of the managed account, the investor can decide on whether or not to incur the additional cost of an audit and whether the services of an administrator are needed.

The investment advisor will likely continue to use the same execution venue for all trading activity and the separately managed account will likely benefit from the existing execution rates of the investment advisor. Generally, prime brokers charge commissions based upon the total value of the account and the transaction activity. Since the investment advisor would be using the existing execution platforms the investor would leverage from the lower commission charges.

The investor will have full transparency into the investments and will receive monthly statements from the prime broker. The statements will include current valuation for all of the investments.

V. Costs of Separately Managed Accounts

The costs of separately managed accounts generally include; additional administrative effort of the investor to ensure that the assets are being managed *pari pasu*, and additional effort on behalf of the hedge fund manager to allocate trades to the managed account and to ensure that the trades have been cleared.

It is important for the investor to reconcile the gross trading performance of the managed account to the performance of the benchmark hedge fund. Some issues or notable differences between the two accounts include; security positions that are not properly weighted according to the capital allocations (hedge fund net assets: managed account net assets), security positions in one account and not in the other account, crossing of trades, excessive commission charges, and the potential over allocation of trade errors to the managed account versus the hedge fund. If a hedge fund had \$100 million of assets and there was \$25 million in the managed account then 75% of all investments are allocated to the hedge fund and 25% are allocated to the managed account. When investment advisors cross trades they are matching buy and sell orders between the hedge fund and the managed account. The investor should ensure that these crosses are executed at market rates at the time of execution. The liquidity in the underlying security and the order size should be considered when comparing the market executions to the crossed trade. Investment advisors often cross trades when the liquidity in the underlying security is very low and the commissions for executing the trades are high. Commissions for crossed trades are generally lower than market orders. Some investment advisors still use soft commission dollars and these commissions make for additional administrative effort for the investor. The investor would need to review the soft dollar services and ensure that the service benefited the managed account and the charge to the managed account was proportionally correct. To minimize this effort, it is often easier not to allow soft dollar commission trading for the managed account and offer the manager a fixed annual research allowance.

The hedge fund manager will allocate trades to both the hedge fund and the separately managed account. Most execution tools in the marketplace have allocation tools, and the allocations are performed automatically.

The hedge fund manager would have to perform an additional operations check to ensure that all of the allocated trades have cleared. The investor should periodically review the listing of trade breaks to minimize costly trade errors. The investment advisor may ask for a lock up period or termination fees to cover the administrative effort of establishing the separately managed account. Most hedge fund managers will manage assets through the managed account structure for a similar fee that is charged in the benchmark hedge fund, while some managers seek to earn higher management fees due to the additional administrative efforts required under this arrangement.

VI. Which Hedge Fund Managers Will Provide Separately Managed Accounts?

The decision of whether a hedge fund manager will manage assets in a separately managed account is generally a function of the investment size. Investment advisors that have less assets under management will generally permit lower minimum amounts.

Some hedge fund strategies or small investment amounts can not effectively be managed in a separate account. For instance, fixed income strategies that entail the use of over the counter derivatives or the trading of securities in 'odd lots' the management of the assets maybe less efficient.

VII. Who Owns the Separately Managed Account?

The investor should be the owner of the managed account. Since the investment would generally be done through a partnership to take advantage of the tax benefits, the investor would be the general partner of the partnership and the investment advisor would be a limited partner.

The investment adviser is generally granted the right to make investment decisions on behalf of the account and only the investor would have the right to transfer funds out of the separately managed account. Limiting the right to move cash improves the controls against potential fraud in the account.

VIII. What are the Liquidity Terms of the Separately Managed Account?

Since the owner of the managed account (the investor) can terminate the trading authority of investment adviser at any time, the separately managed account investment offers daily liquidity. There is execution risk; the risk that upon instructing the investment adviser to sell the securities in account, that the

investment adviser resigns. The investor and the investment advisor should agree upon the liquidation terms in advance to minimize this risk.

IX. Conclusion

The separately managed account offers hedge fund investors various benefits over the traditional hedge fund investment structure. The required controls for the separately managed account structure this investment approach may not be practical for all investors. The benefits of liquidity, transparency, fraud controls, and controls over cash movements generally outweigh the associated costs or challenges with the separately managed account.

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