

## Opinion: A Case for Alts-Focused Separate Accts

Article published on January 6, 2011

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In the wake of Bernard Madoff and other scandals, institutional investors have revisited their approach to hedge fund investing. Some institutional investors are now tapping mutual funds and other more-regulated vehicles to get exposure to alternatives. These trends stem from the increased transparency, liquidity, and regulatory oversight offered by these more regulated investment vehicles. Many of the larger institutions have also gravitated to larger managers. But these approaches provide only a partial solution for institutional investors. An alternative avenue can be the institutional separate account, a solution that provides flexibility, transparency, and access to a wider range of asset classes.

Mutual funds using hedging strategies have recently gained popularity with institutional investors, a trend that has been aided in part by new distribution initiatives from managers such as AQR Capital, Brevan Howard and Paulson & Co. However, while the mutual fund is somewhat hospitable to basic long/short funds, strategies such as managed futures, distressed investing and convertible bond arbitrage can be problematic to run in mutual funds given daily valuation, daily liquidity, and SEC limitations on borrowing.

Likewise, some institutions have tried to improve their experience with alternatives by funneling their investments into the largest hedge funds. Picking the “IBM” of hedge funds might provide comfort for plan sponsors, particularly if they are invested alongside many of their fellow institutions. However, some argue that investing only with the largest funds runs the risk of underperforming and delivering a higher correlation with systemic risks, given the sheer size of these funds’ portfolios. An additional risk is that when underperforming, large funds experience simultaneous large outflows from their larger investors, requiring the fund to liquidate large chunks of their portfolios. Finally, as funds grow very large, the revenue earned through management fees may lead the general partner to become risk-averse, preferring the predictability of the management fee to the variability of performance fees.

For institutions looking for a customized experience, institutional separate accounts may offer a more flexible solution. Research from Preqin conducted last year noted that 16% of institutional investors already have allocations to institutional separate accounts, with another 23% contemplating this arrangement for their hedge fund investments. Indeed, some of the largest public pensions in the world have announced plans to invest via segregated institutional separate accounts rather than pooled funds.

Under this arrangement, custody and administration are conducted by providers of the client's choosing, rather than the hedge fund manager. When the manager wishes to place a trade, trade instructions are routed to the custodian. This approach can offer clients increased flexibility in a number of ways. First, the custodian can provide the client full transparency of the portfolio at any time, possibly even in real time. Second, either through pre-determined rules or ad hoc alerts, the client can direct the custodian to reject individual trades that might violate its investment policy guidelines. Third, the client can customize the strategy to some degree (for example, by setting sector, position, and leverage limits). Fourth, the types of fraud committed by Ponzi schemes under self- or affiliated custody are rendered impossible by the designation of independent administrator and custodian. Fifth, because the account is a stand-alone solution, the institution is not commingled with other clients. This avoids the imposition of gates or the need for forced selling which might depress asset prices in the portfolio and lead to poor performance. Finally, especially for larger institutions, institutional separate accounts may offer clients a format to negotiate lower fees with the manager, as opposed to paying the going rate as a limited partner.

The institutional separate account solution, while novel, is quite powerful. Some hedge fund industry observers estimate that as much as 5% of assets are already invested outside of pooled vehicles, with the percentage poised to rise threefold over the next few years.

If the shortcomings of investing in hedge fund limited partnerships were exposed in the market crisis, institutional investors might consider other implementation solutions, rather than abandoning alternative investing altogether. Fortunately, institutions have more choices today: if daily liquidity, valuation, and low minimums are must-haves, mutual funds should be considered. But the traditional limited partnership is not going away, particularly among larger hedge funds, which accounted for much of industry inflows in 2010. Finally, for institutions seeking to harness the power of sophisticated investment techniques not possible in a mutual fund, hedge fund institutional separate accounts offer increased transparency and risk management. While each institution will need to consider the vehicles appropriate for their own investment, liquidity, and transparency objectives, it's good to know that multiple solutions are available.

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