Separately Managed Accounts

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Each time period in history presents its own investing challenges. As a result, investors have different preferences in different market situations. After the liquidity crisis in 2008, many investors realized that other investors in the same funds could impact their returns because of premature withdrawals. Also, the Madoff situation and other high-profile frauds cause many investors to question whether they should ever again give an asset manager custody of their assets. Therefore, separately managed accounts ("SMA's") became very popular in the post-2008 environment.

While investors' desire for SMA's was a logical response to the troubling events of 2008, such accounts are not be the panacea many investors expect. First, they require a great deal of effort on behalf of an investor. Instead of simply receiving and reviewing a monthly statement from a hedge fund manager regarding their investment in a fund vehicle, SMA investors have to find a custodian for their assets, arrange and negotiate all the requisite trading agreements with mutually agreeable brokers, monitor and review the daily trading data that they will receive as an SMA investor, and more. Second, depending on the nature of the investor's business, SMA's have the potential to create a great deal more liability for investors as often they are assuming the risk that goes along with many of the tasks involved in setting up, maintaining and monitoring a actively traded account on behalf of their respective clients and investors. Oftentimes after setting up SMA's, investors find that they do not have the infrastructure, skill or risk tolerance for all that SMA's entail and they ultimately revert back to fund investing as many have done in recent years.

Another often overlooked aspect of the migration to SMA's is that fact that from a liquidity perspective, they are only as beneficial as the liquidity of the underlying instruments traded by the hedge fund manager. Indeed, if a manager is investing in instruments that are illiquid and, presumably, requires some kind of lock-up provision from its investors as a result, the liquidity advantage gained from opening an SMA as opposed to investing in a pooled fund will essentially be non-existent barring some specially negotiated liquidity provisions between investor and manager. Thus, even in a 2008-like scenario in which SMA investors immediately want out of an investment, if that underlying investment is illiquid and they have not made the contractual relationship with the manager necessary to somehow circumvent that illiquidity, the SMA investor will be forced to wait out the crisis and hope that the value of the assets in which it is invested returns. Investor demand for more transparency, another driving factor behind the move by many to SMA's, is another potentially misguided goal of SMA investing. Certainly having good transparency, and thereby fully understanding what a manager is doing with your money, is an important and desirable outcome of any hedge fund investment process. However, unless

an investor is prepared to review and assess dozens or even hundreds of trades each day, week and month and put the data resulting from those trades in some kind of useable and helpful form, the full transparency of an SMA is largely meaningless to most investors. Moreover, the glut of information often presented by the full transparency of an SMA can potentially lead investors to overanalyze, and even prematurely second-guess a manager. This in turn can result in the sub-optimal situation where a jumpy investor redeems an investment before it has a fair chance to achieve its objective and as such, the investor may end up worse off for having invested in an SMA as opposed to a less transparent pooled fund vehicle.

Finally, SMA's present a potential problem that few think of before investing: tracking error. Most hedge fund strategies are built upon the assumption that the manager will be trading a pool of assets gathered in the form of a hedge fund vehicle that is of a certain minimum size. SMA's in many cases evolve as pools of assets that are adjunct to a hedge fund's primary trading vehicle and which require a manager to somehow tailor the investment strategy that has been crafted for a fund to a separate and distinct pocket of capital. If an SMA is of sufficient size and aligned with essentially the same infrastructure of brokers and technology of a manager's flagship hedge fund vehicle, then in all liklihood, the trading results of SMA will likely mirror those of the pooled vehicle. However if SMA is of insufficient size, linked to sub-optimal brokerage relationships, or burdened by restrictive trading rules or other limitations spelled out in an SMA agreement, the potential for tracking error, particularly of the negative sort, becomes quite prominent. In such cases, SMA investors have to decide if the benefits of the SMA structure outweigh the fact that they are not able to access the full impact of the manager's strategy. For most investors, this is not a worthwhile tradeoff as the whole point of hedge fund investing for many is to achieve superior returns.

Ultimately, there is a place for SMA's in the alternative investment world and they certainly can address some of the unfortunate consequences of 2008. However, for the reasons detailed above, they are not a solution for all investors. For larger, more sophisticated institutional investors that have the resources available to gather and organize large lots of information, SMA's offer a tremendous opportunity to gain better control of investments and compare and contrast managers within a portfolio. For smaller, less sophisticated investors, SMA's in most cases present more problems than they solve and they may even lead to fund performance and an investment experience that is far inferior to that they would have achieved by allocating to a pooled fund vehicle instead.

To learn more about SMA's and other topics relating to the hedge fund industry, please join and get involved in the California Hedge Fund Association in 2013 and beyond. Visit www.calhedgefund.org for more information.