

Transparency and Liquidity

THE GROWTH OF SEPARATELY MANAGED ACCOUNTS IN THE HEDGE FUND INDUSTRY

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Executive Summary

Transparency and Liquidity: The Growth of Separately Managed Accounts in the Hedge Fund Industry is an independent study commissioned by Pershing LLC and produced by Greenwich Associates that examines the growing popularity of separately managed accounts (SMAs). SMAs are being embraced by investors who are seeking a means of creating transparency and providing access to liquidity in their hedge fund investments, and they are being accepted—if sometimes reluctantly—by hedge fund managers as a means of attracting assets and deepening relationships with clients. The findings of this independent study are based on detailed interviews conducted from September to November 2009, by Greenwich Associates. Forty-one hedge fund and investment managers and 27 leading institutional investors participated in the study.¹

Key findings of the study include the following:

Investors and hedge fund managers both viewed SMAs as an effective tool for meeting increased demands for transparency, liquidity and influence on the investment philosophy. However, gaps exist between investor demand and the willingness of hedge fund managers to offer SMAs.

- > Hedge fund managers saw SMAs as an important tool for attracting investor assets and forging deeper, long-term relationships with clients by tailoring offerings to the specific needs of investors and providing them with “emotional peace of mind.”
- > However, hedge fund managers cited operational issues and resource demands, such as setup and ongoing administrative costs, as serious drawbacks to offering SMAs.
- > Moreover, by offering SMAs as alternatives to pooled or commingled funds, hedge fund managers have less control over liquidity and long-term assets as investors have fewer obstacles to withdrawals.
- > Investors and hedge fund managers both disagreed on the asset threshold at which SMAs should be available. Fund managers preferred a higher amount of assets to cover administrative costs.
- > Although most hedge fund managers have the infrastructure needed to offer SMAs, operational burdens and costs deter most from proactively marketing them—potential gains from attracting increased capital may not outweigh expenses.

SMAs Today

- > Nearly 80% of the hedge funds interviewed currently offer SMAs, which are available to hedge fund investors in a range of sizes, strategies and structures. However, there is no market-standard SMA—each SMA has its terms, size and strategy negotiated between the investor and the fund manager.
- > Two-thirds of hedge funds managing SMAs place the typical account size between \$50 million and \$250 million, with SMAs making up about a quarter of their total assets.
- > Investors looking to use SMAs are mainly interested in simple domestic equity and fixed income strategies. Almost 40% of fund managers that offer SMAs do so for all hedge fund strategies, but many investors see

¹ Unless otherwise noted, all percentages and figures cited are based on data provided by those investors and fund managers who participated in the Greenwich Associates study. Hedge fund manager assets under management (AUM) averaged \$46 billion and investor plan assets averaged \$25 billion.

the additional administrative and back-office costs as not worthwhile for indexed strategies, smaller mandates such as international mandates or inherently less liquid investments such as private equity.

- > The average minimum requirement for SMAs reported by hedge fund managers is approximately \$75 million.
- > Fewer than 50% of hedge fund managers offering SMAs place standard fees on SMAs. The majority, rather, applies fees based on the size of the account, the negotiated structure and the underlying strategies. Although hedge fund managers have traditionally charged fees along the 2/20 lines, SMAs represent a new vehicle with so many negotiable parts that a standard fee cannot address their complexity.
 - Three-quarters of investors say that their fees fluctuate with the size of the investment. One investor noted that “once an account gets to a certain size, fees are negotiable.”
 - Fund managers may lower fees in return for longer lockups and may charge higher fees for the increased transparency and reporting.
- > However, only 31% of hedge fund managers have explicit protection against redemptions and withdrawals in their SMA contracts, and only 10% of investors say they have agreed to such clauses in their contracts.

Administrative and Operational Obstacles

The results of this study revealed that hedge fund managers are offering a wide variety of SMA structures customized to meet the needs of investors. Fund managers are often willing to accept the higher costs and operational burdens imposed by SMAs because they believe the provision of these accounts will help them attract assets and form stronger, longer-lasting relationships with clients.

Administrative and operational burdens may involve initial contract negotiations, accounting and ensuring that managers comply with the terms of an SMA. For many hedge funds, ensuring that satisfactory transparency is provided requires extra resources and personnel. While statements and prospectuses are standardized with pooled funds, an SMA requires customization of accounting and reporting. SMAs with uniquely defined investment strategies require a great amount of attention from portfolio managers, and may distract them from the fund’s core investment philosophy.

Nevertheless, managers are quite selective when deciding which SMA structures to accept; normally, only large investors qualify. Hedge fund managers will consciously weigh the costs versus the benefits before accepting a negotiated SMA structure.

Throughout the industry, many hedge fund managers are not proactively marketing SMAs. Most fund managers only provide SMAs to clients who demand or request them—and even then, they are only provided to clients with investments large enough to warrant the additional costs and operational requirements. Most fund managers seem reluctant to encourage their clients to use SMAs, but would prefer that they direct their assets toward pooled funds.

Demand for Transparency and Liquidity Has Increased

For better or for worse, fund managers can expect the number of institutional investors requesting more transparency and liquidity to increase in coming months and years. Just as the market crisis forced investors to address shortcomings in their own risk management and due diligence processes, they are now insisting on much higher levels of disclosure from all external asset managers with regard to both portfolio holdings and

investment and operational processes. This new demand for transparency will most likely become the new paradigm as the relationship between investor and manager has changed significantly.

Approximately 45% of hedge fund managers reported that pooled investors are pushing for higher levels of transparency. In addition, after learning some painful lessons about the value of liquidity, investors are reassessing the role of illiquid assets within their portfolios and doing everything they can to ensure liquidity within hedge funds and all other investments. Almost 45% of hedge fund managers said that they are experiencing pressure from their investors to eliminate lockup periods and redemption notice requirements—a share that tops the proportion of managers reporting pressure from investors to reduce fees.

Overall, investors are asserting themselves and insisting on higher levels of control. It is in the interest of most fund managers to accommodate these demands, and SMAs appear to be emerging as the preferred tool for doing so. This study examines how managers are reacting to these new demands, the areas where SMAs would be mutually beneficial and how to close potential gaps between the needs of investors and the needs of fund managers.

Advantages and Benefits of SMAs

According to the study, investors see SMAs as a way of addressing many of their important concerns regarding hedge fund investments:

Nearly two-thirds (63%) of the 27 investors who participated in the study cited the greater “input” they would have into an SMA strategy as one of its primary benefits. Many investors have experienced significant losses in the last year and are looking for greater input into the risk management aspect. In addition, SMAs are also a useful vehicle to block certain investments on social or ethical grounds.

- > More than half of the investors pointed to daily transparency as a central reason for using SMAs, a benefit that—in the wake of recent financial scandals—many investors associate with better protection against fraud risk.
- > One-third of the investors cited enhanced liquidity as a main benefit of SMAs.

“We can have more customized guidelines, customized input and customized control. The investments are more trackable and transparent.”

– An investor with plan assets of over \$1 billion

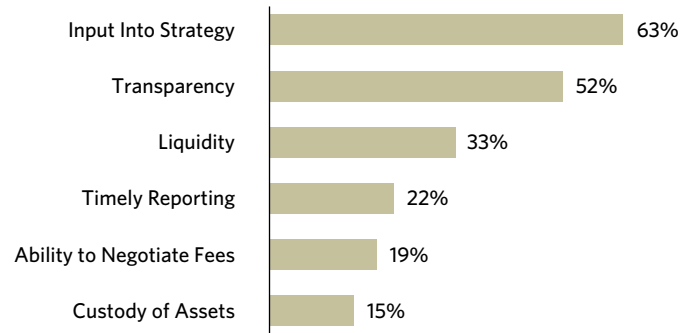
“There is a lot more transparency than in a commingled fund. There’s more flexibility. We can see what they are buying and selling and reporting is more timely. We have the ability to critique. Finally, there is the liquidity.”

– An investor with plan assets of \$520 million

“With SMAs, we have greater control of, and can stipulate exactly, what the manager can do. There are shorter lockup periods and better rates.”

- An investor with plan assets of \$21 billion

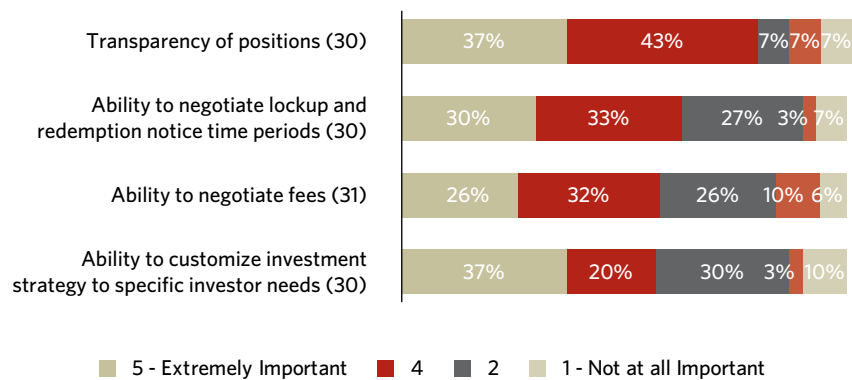
Figure 1. Advantages of SMAs According to Hedge Fund Investors



Based on 27 investors

Most fund managers have adopted a reactive approach rather than actively promoting SMAs. Several factors contribute to this ambivalence, but fund managers recognize their clients’ desire for greater transparency, liquidity and input on investment strategies.

Figure 2: Factors That Hedge Fund Managers Believe Are Important to Clients When Choosing an SMA Structure



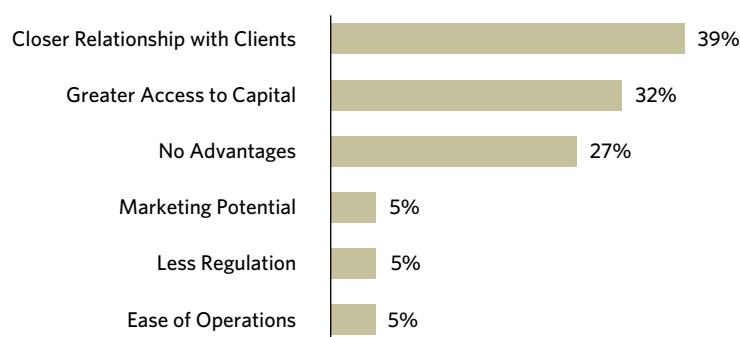
The number in parentheses indicates the number of hedge fund managers.

Because SMAs can often efficiently address many of these important investor concerns, hedge fund managers believe these accounts can attract new client assets and also help forge better client relationships. As one fund manager said, SMAs foster a “tighter client relationship based on joint efforts to tailor the account to the client’s needs.” Another fund manager agreed by saying, “Once you get over the hurdles, SMAs are actually great things to have because, hopefully, the client won’t be the ‘fast-money’ type of investor.” Another fund

manager concluded, “Investors hope for full transparency and emotional peace of mind. They feel better that their money is safe.” This kind of security should lead to longer-lasting relationships that will result in greater asset flows and increased profitability.

However, a significant number of hedge fund managers have yet to experience or see any advantages to offering SMAs. An obvious gap exists between hedge fund managers who do not see benefits in SMAs and those who have offered an SMA structure and experienced new business and asset flows. An opportunity exists for those engaged in an SMA to fine-tune its structure and establish it as a formidable competitor in the market to traditional pooled funds. As the financial crisis has shown, transparency and liquidity are now far more important and investors are likely to more heavily consider these factors when choosing a hedge fund manager.

Figure 3: Advantages Hedge Fund Managers See in Offering SMAs



Based on 41 hedge fund managers

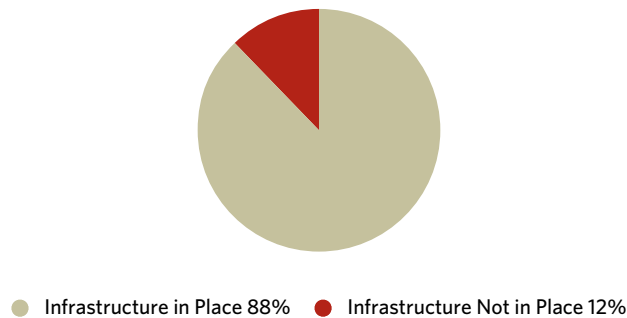
With such marked interest from investors, one would expect hedge funds to be actively courting investors with these accounts. However, less than a third of fund managers surveyed described themselves as very aggressive or aggressive in marketing SMAs—and over half described themselves as not marketing SMAs particularly aggressively at all.

Why Are Managers Hesitant to Proactively Market SMAs?

Given the reputation of hedge funds for closely guarding their investment strategies, investor demands for greater transparency are a potential point of contention. However, 60% of the funds interviewed were not particularly concerned with disclosing their investment strategy, with only 25% expressing outright reservations. In fact, more than 75% of fund managers believed that pooled investors will ultimately demand the same level of transparency as SMA investors.

The reluctance does not seem to arise from issues of investment or operational capability. Although 38% of fund managers cited an equity-based strategy as the most common for SMAs, an equal proportion said that they have the capacity to offer SMAs in “all strategies,” with the obvious caveat that the mandate be within the fund manager’s area of competency. The majority of fund managers surveyed claim to have the necessary infrastructure in place to support SMAs. However, hedge fund managers may only claim to have the capability in certain circumstances, such as for a specific type of investment philosophy or in order to capture a large asset mandate.

Figure 4: Infrastructure of Hedge Fund Managers to Support SMAs



Based on 41 hedge fund managers

In the end, it appears that hedge fund managers are weighing the simple question of whether the additional operational burdens are worth taking on at the fees and terms investors want. More than 60% of the hedge fund managers who participated in the study cited operational issues and resource demands as serious disadvantages associated with SMAs, and more than a third cited additional costs. Several fund managers also mentioned concerns that the better terms accrued by clients in SMAs could alienate clients in their fund's pooled vehicle.

"It's costly for the client, a burden to the manager. The client is not invested alongside the portfolio manager. People in the [pooled] fund vehicle question terms of those with SMAs."

- A hedge fund manager with \$1.7 billion AUM

"There are no real advantages [over pooled funds] for managers, unless they can raise significantly more money. Smaller managers can take a more client-centric approach."

- A hedge fund manager with \$500 million AUM

"[With SMAs,] there are a lot of bookkeeping, questioning of positions and performance and operational challenges. We lose control of the dissemination of information. Everyone can always see our positions."

- A hedge fund manager with \$400 million AUM

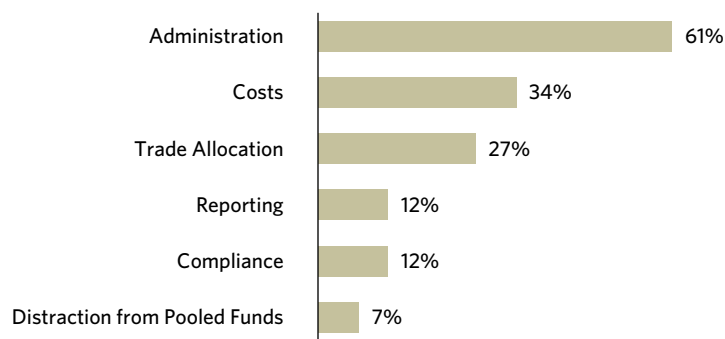
Another fund manager described the increased costs SMAs impose on managers as “administration, overhead, time and money.” Interestingly, the selection of a prime broker has been an area with little tension. Most investors do not expect to have significant influence in the decision, but most fund managers are nonetheless willing to give investors input—assuming, of course, that the manager is comfortable with the prime broker’s capabilities.

Finally, by proactively offering SMAs, hedge fund managers may inadvertently dissuade investors from or lose opportunities to attract investor assets to pooled or commingled funds. SMAs can invite lengthy negotiations over fees and access to liquidity. On an ad hoc basis with highly important clients, SMAs can be worth these constraints, but leverage and profitability would likely decrease if offered to the entire investor base.

Disadvantages and Costs of SMAs

Hedge fund managers recognize the increase in operational and personnel resources needed to handle an SMA. Customizing accounting and reporting, the extra time and attention needed for a uniquely tailored investment strategy and the logistics of keeping multiple accounts separate from pooled assets are real challenges.

Figure 5: Disadvantages Hedge Fund Managers See in Offering SMAs



Based on 41 hedge fund managers

Financial costs and operational demands are leading many fund managers to place restrictions on SMA availability. About 30% of hedge fund managers offer SMAs only to institutional investors. Other hedge fund managers use a more subjective standard, only providing SMAs to investors they deem savvy or sophisticated enough to handle them. Hedge fund managers may do this to herd assets into already established pooled funds to cut down on administrative and operational costs. If investors cannot make effective use of the increased reporting and their ability to influence the strategy, fund managers will be even more reluctant to offer an SMA. One fund manager with \$1 billion in AUM said that his firm provides SMAs only to “*intelligent investors—those who have the internal skills to understand and act on their responsibilities, which are much greater than with pooled funds.*”

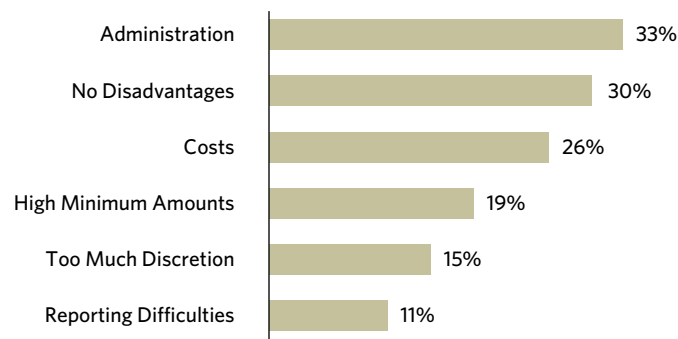
Although the potential benefits of SMAs are clear, investors recognize that the demands and incremental costs associated with SMAs can be significant and perhaps not appropriate for all investments. One-third of investors cited the administrative burden of SMAs as a challenge, and more than a quarter cited associated costs.

“Costs for a pooled fund can be favorable because they are spread across all of the participants in the fund. Transaction costs can be shared by all of the participants and one investor does not have to bear all of the costs, as in an SMA.”

– An investor with \$290 million in plan assets

However, 30% of investors said they did not see significant disadvantages at all. In fact, a majority saw the difficulty of establishing an SMA as about the same as enrolling in a pooled fund, a view quite distinct from that of a hedge fund manager. One investor noted, “*The upfront effort is harder, but the ongoing administration is not more difficult or costly.*”

Figure 6: Disadvantages Hedge Fund Investors See in Using SMAs



Based on 27 investors

The manageability of SMAs for investors partially depends on the strategies they wish to pursue, with most concentrating on active equity and fixed income strategies. SMAs are considerably less commonly used by investors for smaller or more illiquid investments, such as real estate and private equity, or in index strategies.

“Typically we employ SMAs for 130/30 strategies.”

– An investor with \$290 million in plan assets

“We wouldn’t consider SMAs for private equity or international, as it’s not worth the back-office headache.”

– An investor with \$500 million in plan assets

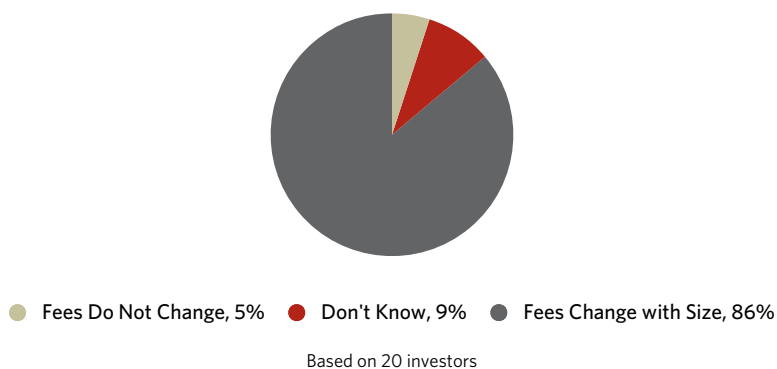
However, the bottom line for investors is that in the vast majority of instances, the perceived benefits of SMAs clearly outweigh additional burdens.

Bridging the Divide

Despite any shortcomings of the structure, there is no doubt that both the supply and demand for SMAs are on the rise. Almost 90% of hedge fund managers said that they had the necessary infrastructure in place; yet far fewer actually offer SMAs. In addition, 85% of investors said that there is an ample supply of managers willing to discuss and supply SMAs. The question therefore is, on what terms?

Fees are obviously a critical area of negotiation. One manager commented that fees “vary based on the underlying product line and the alpha [expected return].” Nearly 75% of fund managers cited fees as varying with the size of mandates.

Figure 7: Hedge Fund Investor Views of Fees Relative to Size

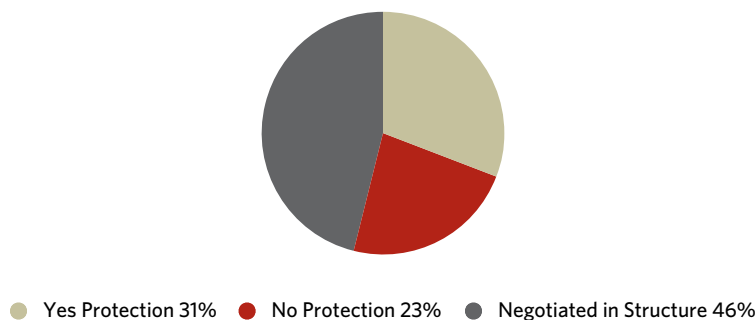


Eighty-six percent of investors saw all of the central characteristics of SMAs—fees, terms and investment size—as subject to negotiation. Not surprisingly, fees vary with the size of mandates and strategies employed. Eighty-six percent of investors recognized that fees change with the size of the investment, while 70% expected fees to differ from a like-size investment in a pooled fund.

“Yes. Each [SMAs and pooled funds] are tiered differently depending on the asset class.”
- An investor with \$660 million in plan assets

Protection from early withdrawal of funds is another important area of negotiation: 75% of managers said that they had some kind of protection, which represents an interesting disconnect from investors, 90% of whom perceived few, if any, restrictions.

Figure 8: Protection for Hedge Fund Managers Against Early Withdrawal or Redemption



Based on 41 hedge fund managers

The most fundamental gap between the investors and fund managers surveyed is in the level of investment at which SMAs are attractive. Even the most sophisticated investors would be hard-pressed to find a fund manager willing to offer an SMA for a relatively small account. The average minimum investment suggested by investors is \$38 million, with 40% suggesting \$25 million or less. In contrast, the average minimum investment requirement reported by hedge fund managers is \$77 million, with 56% of managers requiring an investment of \$25 million to \$250 million for an SMA, 20% requiring larger amounts, and 20% requiring smaller amounts.

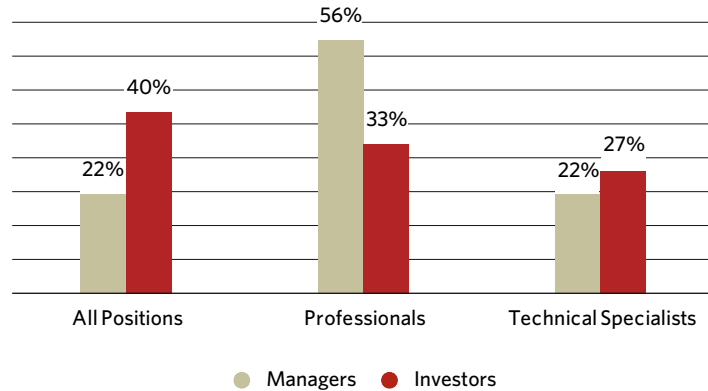
"It depends on strategy. If there are high margins and the SMA is structured to use minimal internal resources, the minimum is lower."

- A hedge fund manager with \$1.2 trillion AUM

"A typical amount should be \$100 million or more—enough to cover all of the additional time, effort and paperwork."

- A hedge fund manager with \$500 million AUM

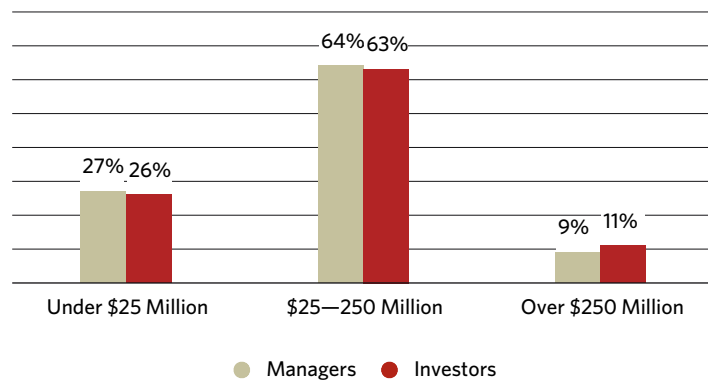
Figure 9: Minimum SMA Investment Size—Managers versus Investors



Based on 27 investors and 41 hedge fund managers

Note that the gap between hedge fund managers and investors may be narrower in reality than it is in terms of expectations. Both see the typical SMA as most often in the \$50 million to \$250 million range, though the average reported by fund managers is \$267 million, which is still well above the \$122 million average reported by investors. If investors and fund managers can agree on a minimum amount, plan assets may swell over time toward an amount that both will have anticipated and with which both will be comfortable.

Figure 10: Average SMA Investment Size—Managers versus Investors



Based on 27 investors and 41 hedge fund managers

Looking Forward

SMA's seem poised to assume a prominent role in the “new norm” that is gradually taking shape in global financial markets after the market crisis. The new focus of investors on risk management has, in many cases, rendered the old “black box” model of hedge fund management obsolete. The market needs a new mechanism for investing that provides enhanced levels of transparency, liquidity and control. SMA's fit that description. As investors gravitate to the SMA structure, so will managers, too, will managers in search of new assets and longer-lasting relationships with clients.

Before SMAs can emerge as a standard feature of hedge fund investing, the market will have to address disconnects between fund managers and investors about the economics and terms of the structure, most importantly, the investment size at which SMAs should be available to investors. It is evident that something will have to give for the market to achieve equilibrium. Although it appears that some institutional investors hoping to establish SMAs might be disappointed in the short term, it is entirely possible that investor needs in the post-crisis environment will push the industry and individual managers to provide SMAs on a much wider basis.

From a fund manager's perspective, the keys to accommodating investor interest are clear:

- > Allow flexibility in permitting the input of investors into investment strategies
- > Create transparency in policies and practices to minimize administrative burdens on clients
- > Provide liquidity on reasonable terms
- > Invest in compliance infrastructure to maintain operational effectiveness

Fund managers should bear in mind that addressing these goals may also require alternative structures such as tri-party custody agreements along with SMAs to provide investors with the security and diversity of counterparties they desire.

To that end, fund managers should also consider strengthening business operations internally and through partnerships with consultants and prime brokers.

- > Prime brokers can be especially helpful in assisting in the reporting for individual SMAs by establishing a clear account statement for hedge fund managers.
- > Prime brokers can also work and consult with investors to help decipher and understand the investment information.
- > Furthermore, prime brokers have the back-office capabilities to ensure that accounting is in compliance with regulations and that both sides are adhering to the SMA agreement.

Investors, for their part, will need to recognize that these benefits come at a cost to managers. Investors should:

- > Ensure that they have the necessary resources to fulfill *their* obligations in an SMA without asking managers to deviate too far from core investment competencies.
- > Instill confidence in managers that the additional effort involved in SMAs is worth their while, whether through some form of redemption fees, lockups or notification periods.
- > Consider whether the amounts they are prepared to invest are appropriate to the additional administrative burdens and other demands placed on their fund managers.

In the near term, some investors looking to employ SMAs will inevitably hit speed bumps as some fund managers will decide that the size of some accounts are not worth the imposition of new costs and burdens. But the fact that SMAs so clearly meet the needs of investors in the post-crisis market environment ensures that they will continue to proliferate. As they do, investors and fund managers will find common ground and industry norms will emerge regarding account size and other factors. This will represent an important maturation of the SMA market and set the stage for significant growth in the SMA structure in years to come.

Ideas Without Limits

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