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Papers

Generating returns through better relationships: How managed custody accounts benefit managers and investors

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Abstract

Institutional investors are under significant pressure to maximise returns. To that end they have focused on reducing fees and consolidating their portfolios according to the best ideas of their best managers. A few pioneering US public pension plans and public

university endowments have been early adopters of Managed Custody Accounts (MCAs) in efforts to maximise their ability to participate in the best new products and control costs and fees. An MCA creates a platform through which an investor can quickly and nimbly invest across any of an investment manager's funds, products and strategies. Because fees and expenses are negotiated at the platform level on an aggregate assets under management basis, parties are able to create an efficient investment process with a fee structure that motivates the manager and investment team, encourages investors to consider all of the manager's products, and has the effect of maximising the investor's investment levels with a manager. This efficiency also allows public investors to react quickly to managers' new products as other legal terms are built into the MCA agreement at the onset of the investment relationship. This paper will discuss the typical investment process of public investors, from manager selection to funding of new traditional products, contrasting it to the MCA process, and highlighting the benefits that MCAs provide to managers and investors alike.

Keywords: managed accounts, pension plan, alternative investments, expenses, returns, endowments, university

GENERAL LANDSCAPE

Today, US public pension plans, including state, county, municipal and other similar government-sponsored plans, manage almost US$4 trillion in assets in furtherance of their missions to provide retirement benefits to over 23 million current and retired public sector employees.[1] Public university endowments manage approximately US$89bn[2] in furtherance of their missions to provide economic support to their universities and financial aid to their student bodies.

In order to meet these responsibilities, the investment teams of public pension plans have put approximately 15.6 per cent, or US$590bn,[3] of plan assets to work in alternative investment products such as private equity, venture capital, hedge fund and real estate strategies through pooled investment vehicles, single investor funds, and managed accounts. Investment teams seek to maximise risk-adjusted investment returns, and public university endowments similarly allocate 50 per cent of their assets, approximately US$45bn,[4] in alternative strategies.

These public investors are under significant pressure to maximise returns in light of growing underfunded pension liabilities and growing financial aid needs. This has manifested in the way they are deploying their investment capital. As public investors' investment teams grow more sophisticated, they are looking to reduce the fees and expenses that drag on their investment returns. Specifically, public investors are forgoing investments in funds of funds,[5] which for years offered accessibility and investment diversification, and lessened the labour-intensive individual manager selection process by putting that in the hands of the funds of funds managers. The well understood cost of these benefits was an extra layer of fees and expenses at the funds of funds level. In addition, public investors are consolidating their investments in fewer managers, but leveraging those managers' full menus of investment options and products.[6] This ideally provides public investors with leverage in negotiating special terms for investments, most notably, economic provisions including management and performance fees as well as expense limits. In our experience, cost, complexity and lack of transparency often weigh against certain investment options, while efficiency, simplicity and transparency typically aid investing. When it comes to ongoing investments, particularly co-investments and direct investments, we find that public investors typically seek assurances of fiduciary duties.

NEW MANAGER/PRODUCT IN-TAKE

Today, public investors are largely forfeiting the nimble manager in-take processes of funds of funds and replacing them with their own longer-term comprehensive due

diligence process for new managers and products. That longer process at times may preclude public investors from moving quickly with respect to a new investment opportunity and, at worst, may limit the ability of the investor to make an investment in a new or marque manager whose fund may be oversubscribed and/or is operating on a compressed time line to fund closing.

As public investors move towards this more focused individual manager selection, they must do so in a manner that complies with legislative and administrative legal requirements and that considers the public scrutiny that accompanies the public investors' investments. Legal requirements applicable to public investors can result in expanded negotiations and additional provisions in legal documents and fund side letters around compliance with required standards of care, conflicts of interest, certain local statutes, insurance coverage, sovereign immunity, reporting, ongoing due diligence, administrative matters and choice of law and venue provisions, to name a few. Public investors often post minutes of meetings memorialising their manager selection and termination discussions. As a result of taking investment capital from public investors, managers will usually have aspects of their relationships with public investors and certain top level product information on the underlying portfolios made available to the general public pursuant to state open records laws. Often, public investors will issue a request for proposal (RFP), where managers are invited to compete for appointment as a manager of a specific strategy a public investor needs to employ. These RFP responses can be expensive, require substantial investment of staff and resources, and can take months to come to conclusion. Increasingly, public investors treat these RFP responses as material representations and as the foundation of their relationship with the manager. Over time, managers have grown accustomed to these processes and requirements as a cost of doing business with public pension plans and endowments.

Even as the investment offices of public investors grow, they often look to supplement their manager selection process by hiring investment consultants to assist with investment manager selection as well as with investment and operational due diligence. The consultants, as fiduciaries to the public investors, usually vet managers and their investment staff, products and track records, portfolio risk and liquidity, and perform background checks on key investment and management staff of the manager. The consultants often perform comprehensive operational due diligence (including applicable regulatory and tax analysis) on managers and will perform on-site meetings at managers' offices where they will meet with chief financial officers, heads of operations, IT security personnel and trading staff, as well as any in-house lawyers and chief compliance officers. The consultants may also interview or request information from the manager's key service providers, including prime brokers, auditors, administrators and outside counsel. We have also seen investors' due diligence reviews include the assistance of auditors, from time to time, in reviewing internal controls.

TRADITIONAL INVESTMENT OPTIONS

Public investors, like all institutional investors, must also decide how to invest in a new strategy. The most common avenue for investment has traditionally been a pooled investment vehicle with other non-affiliated investors, but the options for entity type and jurisdiction abound. Gone are the days where investment decisions were simple and limited. Today, investors in pooled vehicles may be asked to determine whether a Delaware limited partnership or limited liability company, Luxembourg S.a.r.l, or SICAV, a Cayman exempted limited partnership or exempted limited company, Irish plc or ICAV, European Union UCITS or AIF or some other entity from another jurisdiction, or

simply a managed account is the right choice for their investment in light of the underlying portfolio investments. Some structures are well established and tested for the desired regulatory and tax effects, while other structures are still emerging and questions remain as to their efficacy for the desired purposes. Moreover, new structures may not have the benefit of legal guidance from courts or administrative bodies to support the benefits and protections to investors they hope to secure. Opinions of counsel may or may not be provided, and their scope may be limited.

In pooled vehicles, investors take on the risk of their fellow investors to some extent. Public investors, as is the case with all investors, must consider the default risks of their fellow investors, as well as the instability that may arise from one or more significant investors electing redemption and/or withdrawal rights in open-ended funds such as hedge funds or if ERISA applies. These game theory challenges often take on lives of their own for investors considering a pooled investment vehicle. Some public investors manage to escape these issues by opting for funds of one where they are the sole investor in a fund or strategy. Funds of one usually provide the sole investor increased transparency, better terms and pricing (with respect to management and performance fees), the presumption of limited liability and enhanced protections inherent in being the sole investor. Managers typically require a relatively high minimum investment in funds of one, as the organisational and operating expenses and operational demands can often match those of pooled vehicles.

For public investors looking for complete transparency and to minimise the risk of fellow investors and the operational and enterprise risks of managers and their businesses, investment management accounts offer some relief. Managers are granted authority to manage the assets of the public investors in the accounts of the investor. This avenue provides low expenses by dispensing with additional entities, albeit at the cost of foregoing the limited liability that investment vehicles provide investors. Depending on the investment assets, managers may want to set up specialised prime brokerage, futures or derivatives accounts in the name of the investor to properly execute their liquid market strategies. If the desired providers or counterparties are not already in place, then setting up those accounts can introduce delays to launching the applicable strategies. In the context of real assets and private equity, investment-specific special purpose vehicles (SPVs) are invariably called for, reintroducing — potentially — the very problems the separate account investor sought to avoid.

After a public investor's investment team and the investor's consultants are satisfied with a manager and a specific investment product, the public investor usually requires additional approvals from the investor's board of trustees, board of regents or applicable governing bodies, and perhaps sign-off from both the applicable state's procurement office and office of the state attorney.

LIMITATIONS ON TRADITIONAL INVESTMENT OPTIONS

The traditional investment options provide different baskets of benefits and drawbacks depending on the nature of the investors and investment strategy. Even with respect to one manager, depending on the strategies employed, investors may prefer to use one or more of the available options.

Negotiating each new product with an investment manager as the products become available naturally leads to delays in finalising the documentation as spelled out above, and may result in pricing inefficiencies as the products may not be priced with the public investor's overall assets under management in mind.

These one-off negotiations are effectively started anew with some efficiency built in for familiarity of parties where the public investor has an established business relationship with the manager. In addition, many

of the procedures and due diligence queries outlined above will still need to be cleared. This limits the ability of a public investor to react quickly to changing economic environments, as was the case in 2007 and 2008, and its ability to perhaps invest in certain co-investment opportunities offered with little to almost no lead time to closing. All of the above keeps attorneys for managers and public investors alike 'burning the midnight oil', with foreseeable costs.

MASTER CUSTODY ACCOUNTS

The investment team at the San Bernardino County Employees' Retirement Association (SBCERA) created a new investment structure during the summer of 2012. SBCERA's priorities were to manage their relationships (including fees and expenses) while maintaining the ability to invest in new products to take advantage of fleeting market inefficiencies and opportunities. Together with its investment consultant NEPC, SBCERA's investment staff brought the concept of their new strategy to SBCERA's Board, which subsequently approved the structure, subject to satisfactory negotiations of an agreement to govern the relationship with each of the managers. SBCERA put in place the necessary legal architecture to govern this novel investment structure, the Master Custody Account (MCA).[7]

Mr James Perry, CFA, CAIA, Head of Institutional Investor Solutions at MaplesFS, who served as Senior Investment Officer at SBCERA in 2012 and later worked for the Texas Tech University Endowment and was instrumental in the drafting and negotiation of the original structure, explained, 'The creation of the MCA structure was driven by a desire to focus on the best investment opportunities available through a manager while minimizing agency conflicts and establishing a Board approved governance structure for the relationship. A Master Custody Account allows an institutional investor to focus on the needs of their investment program and work with managers as partners and solution providers instead of just looking at the individual product offerings. The investor also has greater flexibility to monitor and shift its exposures through a MCA structure than through traditional fund or separately managed account offerings.'

Since SBCERA's rollout of the MCA, other public investors and endowments, including Texas Tech, have started adopting this process for building and expanding certain investment manager relationships. Mr Tim Barrett, CFA, formerly the Chief Investment Officer and Executive Director at SBCERA, and now the Associate Vice Chancellor and CIO at Texas Tech University Endowment explains that at Texas Tech, 'We quickly adopted the approach and now have over 12 MCAs with managers in our portfolio and over 10% of our current portfolio in various idiosyncratic positions with our managers. We are able, in short, to get the managers' best ideas into our portfolio while reducing overall costs. As important, we receive detailed Investment Committee level memos on each investment, with follow-up documentation, allowing us to gain much deeper insight into the managers holdings compared to a standard fund investor.'

The typical MCA effectively creates a platform through which an investor can invest across all of an investment manager's funds, products and strategies (whether pooled investment vehicles, funds of one or specialised managed accounts), co-investments and direct investments. Because fees and expenses are negotiated at the platform level, the parties are able to create a fee structure that motivates the manager and its investment team, encourages investors to consider all of the manager's products, and has the effect of maximising the investor's investment levels with a manager. Increased investments in the platform usually yield lower management and/or performance fee rates pursuant to sliding scales, where fee rates drop as the investor's overall investment level in the platform

increases. All transparency and administrative matters are addressed, as is the fiduciary relationship, indemnities and the like. A one-off negotiation would not accomplish this effect as cleanly.

The MCA is not for use with all managers, however. The main characteristic of a potential MCA is for the public investor, with assistance from its investment consultant, to identify potential managers that have broad capabilities and an attractive menu of investment products or are open to developing new products to address the investor's specific needs. In the case of SBCERA, the investment staff reviewed and selected managers based on the capabilities, pricing and opportunities available through each manager's platform focusing on its ability to expand current positive business relationships with existing managers.

An MCA allows the public investor to invest in the right people and their best and most timely ideas and deploy capital across established and new strategies efficiently. The MCA Agreement basically establishes a separately managed account on the manager's platform. The MCA sits atop and governs the separately managed account, and delegates to the manager the authority to manage certain of the investor's assets in the investor's custody account (at their custodian for administrative matters) in accordance with the investor's guidelines and invest those assets across all or a defined menu of current and new products (including investing directly in portfolio companies) on the manager's platform. It individualises the relationship at the top level, instead of having a series of investments lacking an overall theme or consistency. Any new allocations or reallocation of the investor's assets within the platform by the manager requires the prior approval of the investor's Chief Investment Officer to ensure proper investor oversight. This process is much more efficient than one-off investment processes and alleviates the need for new in-depth diligence, full-blown RFP processes and various levels of approvals each time the assets are allocated or reallocated across the manager's products. Instead, the detailed investment on-boarding process, including applicable board approval, is limited to the initial adoption of the MCA Agreement relationship.

The MCA allows the public investor to negotiate all key terms and other items required by laws applicable to the investor just once, rather than with respect to each investment in a new product in the manager's platform, because all of these terms are imposed at the MCA level and are indirectly imposed on the manager's targeted products notwithstanding the underlying products' governing documents. One other valuable component of the structure for an investor is the ability to craft customised individual and aggregated product reporting to fit the investor's needs and reduce the burden on its internal staff. The reporting and legal provisions and tax considerations of MCAs are filled with nuanced value opportunities for the manager and the investor alike, and experienced counsel can swiftly identify and address these considerations in connection with the signing of an MCA Agreement.

Counsel should still review the underlying governing documents applicable to any investment in a new product on the platform, prior to execution of that new product documentation. The investor's legal counsel should ensure that the investments are consistent with the MCA and any regulations or policies applicable to the investor. Even with this expense, the MCA structure inherently provides material cost savings to the public investor. SBCERA has established and maintains multiple MCA relationships with premier investment managers and is open to establishing more with additional qualified managers.

In consideration of lower fees, a public investor may promise periodic commitments to the account for a defined period of time, subject to the ultimate authority of its board to revise these targets. MCAs may also include detailed provisions around offsets for transactions, break-up, directors' and officers'

and similar fees on terms negotiated by the parties at the onset of the MCA relationship, and such terms would govern or be netted against the economic terms of any particular fund or product economic arrangements. The account may incorporate an incentive or performance fee with hard hurdles, catch ups or any other features appropriate under the circumstances, including caps on expenses related to the account, in each MCA. Again, because these negotiations by the parties occur at the time of adoption of the MCA, it is a one-on-one discussion where the investor's promise of additional assets affords it improved negotiating leverage. A public investor can thus be comfortable that its investments in the products on the platform are not being driven by a manager's incentives to collect the highest possible management fees.

CONCLUSION

Investment managers have seen a shift in the industry by institutional investors to reduce the number of managers in their stables. Merely investing more money in one or more products offered by a manager in an ad hoc process does not, however, necessarily yield the efficiencies that a relationship based on a carefully crafted MCA could offer. Public pension plans and endowments should consider implementing MCA-like arrangements, and for the right managers it can be a mutually beneficial relationship. Managers should favourably view the opportunity to strengthen business relationships with public investors through the use of an MCA. For smaller and mid-sized managers who are open to considering expanding product options, an opportunity to have one or two key investors investing through MCAs will afford it stability of assets under management and independence to employ its investment strategies, as well as business continuity. That stability will reduce the time spent marketing to grow assets at smaller denominations, as well as reduce the investor relations pressures that come with having investor rolls of a large number of smaller investors. All managers generally aspire to having a stable and flexible capital base — that is what the MCA relationship can provide them.

We have spoken above about the benefits the MCA affords public pension plans and endowments, yet other public and private institutional investors and even funds of funds should consider the benefits of implementing MCAs with their key investment managers. Although other investors may not necessarily need the efficiency of process that public investors derive from the MCA structure, all institutional investors would benefit from a more carefully crafted expanded investment partnership with certain key managers to create a strong alignment of interests between the parties.

The traditional approach of public investors and managers could be viewed as one of non-stop negotiating. Those of us that work with MCAs prefer them because they allow our clients and their managers to get on with doing what they do best.

Looking back at the last four years since SBCERA started using MCAs, Donald Pierce, CFA, SBCERA's Chief Investment Officer, reflects, 'The MCA was the result of prior account structures that were developed and refined to reflect a single guiding priority — that the experience with a manager was not just a collection of fund experiences; rather the total experience with a manager at the investor level — this meant that prior experiences were included at the investor level. A powerful concept we have often referred to as "Manager Netting". The way we sought to capture that investor experience was through a master account contract that would ensure there was one contract that took precedence over each individual contract that we might have to participate in to access assets.'

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