BOREALIS
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THE STRATEGIC TRADE-OFFS

Hedge Fund Managers and Separately Managed Accounts

Introduction

Separately Managed Accounts (SMAs) have become an increasingly common way of investing with hedge fund managers, particularly early-stage managers, for a variety of reasons. The decision to accept SMA mandates from investors presents hedge fund managers with a strategic opportunity – and dilemma! While SMAs can provide early-stage managers with access to sizeable, fee-paying capital, SMAs may be accompanied by complicating factors.

Managers navigating the SMA landscape must consider how these relationships complement their overall market positioning and growth strategy. With proper planning and structure, SMAs can serve as valuable components within a diversified business model that includes both separately managed accounts and commingled funds.

This white paper explores the factors that hedge fund managers should consider before integrating SMAs into their businesses.

Why Do Some Investors Favor SMAs?

- **Customization:** Investors can tailor investment strategies, risk exposure, and portfolio composition to align with their specific objectives and constraints.

- **Transparency:** SMAs provide greater visibility into holdings, trades, and risk metrics, all of which can enhance portfolio monitoring, particularly when integrated with a platform provider.

- **Liquidity:** Investors can negotiate liquidity terms that better suit their needs compared to standard hedge fund lockups and redemption periods.

- **Control:** Investors own the assets of an SMA and in times of market stress can direct liquidation as needed. Investors can also take advantage of direct control/ownership of assets and enhance returns through programs such as securities lending.

- **Expedited Due Diligence:** The operational due diligence process can be a shorter process given the SMA investor – not the manager – is providing the investment platform.

- **Leverage Flexibility:**
    - For more capital light strategies (e.g. market neutral equities, CTAs), SMAs may allow investors to apply their own leverage for that investment, enabling greater capital efficiency than might be available in a commingled structure.
    - For more capital intensive SMA strategies (e.g. long-only, long biased equities), investors could pledge the SMA positions as collateral to obtain leverage for other parts of their portfolio.
- **Risk Management:** Investors can implement their own risk measurement methodologies and action protocols, ensuring alignment with their institutional framework rather than depending on the manager's approach.
- **Efficiency:** Some investors, particularly large institutions, may benefit from direct ownership of assets and optimization of cash balances, while also avoiding commingled fund complexities, expenses, and counterparty risks.
- **Fee Negotiation:** SMAs often allow investors to negotiate lower fees or customized fee structures compared to standard hedge fund terms.

Manager Considerations for SMA Relationships

Primary Considerations

- **Partner or Employer/Employee Dynamic:** When entering into an SMA relationship, managers must assess whether they are functioning as true investment partners or as part of an arm's-length employer/employee-like relationship. An employer/employee dynamic can limit the manager's investment discretion and autonomy, potentially leading to conflicts in strategic decision-making, particularly at inflection points in markets and in the manager's business and portfolio.
- **Mandate Overlap with Fund:** A key consideration is whether the SMA's investment mandate aligns with the hedge fund's core investment strategy. If the SMA closely mirrors the main fund, it can streamline research and execution as well as diminish the perception of being a distraction. However, if the SMA has significant deviations in the strategy it may lead to resource inefficiencies, distractions, and risk-management challenges.
- **Drawdown Triggers:** Unlike commingled hedge funds, SMAs may have specific drawdown triggers that investors can exercise, creating divergence in risk tolerance and management between the SMA and the fund. This can impact portfolio management and stability for the firm and fund as the SMA and fund need to be managed differently. An SMA with a tight drawdown trigger may result in the manager being forced to reduce risk or even liquidate the SMA on short notice at an inopportune time for their strategy, potentially adversely affecting positions held by the fund.
- **Short-Term Performance Monitoring:** With the additional transparency and control of assets, SMA investors can track real-time performance. Some SMA investors may use this data to engage the manager on a (much too) frequent basis, creating a distraction and shifting the manager's focus from medium-/long-term compounding of capital to short-term results.
- **Client Concentration Risk:** While Markowitz said, “Diversification is the only free lunch in investing,” the same can be said of investor base stability. A heavy reliance on SMA mandates can lead to client concentration risk. If a large SMA investor terminates, it can materially impact the manager's business stability. A business with a sizeable fund with a diversified group of LPs alongside an SMA relationship or two is likely better suited to withstand adverse investor decisions.

- **Source of Capital:** SMAs have historically been most commonly deployed at managed account platforms, large asset managers, and multi-manager funds. More recently, asset owners (e.g. state pensions, sovereign wealth funds) have been using SMAs to more efficiently invest in certain managers and strategies. Given the stability and long-term orientation often accompanying asset owners' capital bases, these SMA relationships may be longer-lasting.

  When accepting SMAs from other asset managers or intermediaries, managers should recognize they are inherently absorbing platform risk. Even if the manager performs well, they may face redemptions if the overall platform underperforms, as end clients may reduce their platform allocation entirely. Conversely, SMAs controlled directly by asset owners typically evaluate the manager solely on their own merits, potentially providing greater stability and mitigating exogenous business risk.

- **Use of Transparency:** Investors typically have access to full portfolio transparency in SMAs, including real-time position reporting. While this fosters trust and alignment, it can also expose the manager's intellectual property and trading strategies, leading to potential front-running and portfolio replication risks. Managers should be keen to understand the purpose and breadth of the transparency provided.

- **Operational Demands for the Back Office:** SMAs introduce higher operational complexity, requiring dedicated infrastructure for customized reporting, compliance oversight, and separate trade execution or trade allocations. SMAs also have the potential to introduce a new roster of service providers, from prime broker and custodian to risk management systems. These demands may necessitate increased staffing and technology investments, thus increasing operating expenses at the firm.

- **Expense Allocations:** Unlike commingled funds, many SMAs do not permit pass-through of investment research tools and services, which may result in more of these costs being borne by the manager.

Secondary Considerations

- **Fees:** SMAs often involve fee negotiations with investors seeking lower management and performance fees compared to traditional commingled hedge fund structures. Managers must weigh the revenue trade-offs against the benefits of attracting SMA relationships.

- **Fund Investment:** While SMAs can significantly increase a manager's total assets under management, they often do little to catalyze growth in commingled fund products. Institutional investors constrained by size limitations in their manager selection process typically focus solely on commingled fund AUM, rather than total firm assets when making allocation decisions. Some SMA investors may be willing and able to make an additional investment in the commingled fund to help address increase the size of that vehicle.

- **Liquidity Terms:** SMAs often require customized liquidity terms, which may not align with a hedge fund's primary strategy or commingled fund. While greater liquidity can attract institutional SMA investors, it may force managers to liquidate positions at unfavorable prices during times of market stress. Offering preferential liquidity terms to SMA investors can create conflicts with the manager's ability to raise capital in the fund, as potential fund investors may be unwilling to accept subordinate liquidity terms compared to SMA accounts.

- **Personal Investment:** Due to their structure, SMAs don't allow the manager to personally invest in the same vehicle as the investor. This is as much of a consideration for investors when trying to align with managers as it is for the manager. For managers that only manage SMAs, they do not have a vehicle to invest alongside investors and must rely on a personal trading account.

- **Tax Characteristics:** Tax implications of SMAs can differ significantly from those of a commingled hedge fund, particularly regarding capital gains treatment, pass-through expense structures, and jurisdictional tax considerations. Incentive compensation for SMAs is typically taxed as ordinary income for the manager, while the incentive compensation from a fund may maintain the income or gain/loss character of the manager's strategy, via a performance reallocation from LPs to the GP. As a result, SMAs may lead to a lower after-tax compensation for the manager.

Conclusion

The decision to incorporate SMAs into a hedge fund's business model represents a critical strategic choice that can alter the trajectory of an organization. While SMAs can provide access to substantial institutional capital and accelerate a firm's growth, they can also introduce complexities, conflicts, and constraints that may impair the organization's ability to execute its strategy and achieve its long-term objectives.

The ultimate success or failure of an SMA program typically hinges on the careful consideration and structuring of three key elements:

- Alignment of interests between the manager, SMA investors, and fund investors.
- Incentive structures that promote rational behavior during periods of market stress.
- Operational architecture that can scale without compromising the core business.

When these elements are properly balanced, SMAs can serve as a powerful tool for growth. However, when misaligned or poorly structured, they can create conflicts, operational burden, and strategic constraints that overshadow their benefits.

As managers evaluate SMA opportunities, they should resist the temptation to focus solely on the immediate benefits of increased assets under management and revenues. Instead, they should carefully consider how each specific mandate fits within their broader strategic framework and ensure that the terms, structure, and relationship dynamics support – rather than hinder – their long-term vision for the firm.