Pimp my mandate: the flexibility and customisation possible with SMAs are attractive factors

A custom fit

More and more investors are pursuing separately managed accounts with big brand private debt managers. But while the flexibility they offer is welcome, these accounts require strong governance. **Anna Devine** reports

Investors are savvy in how they allocate cash. Paring down manager numbers and signing tailored investment agreements are en vogue with private debt investors. But that flexibility has costs in terms of liquidity and diversification.

Fundraising for credit strategies hit $90 billion over the first nine months of this year, according to PDI Research & Analytics, up 10 percent on 2014's full-year total (see page 38 for more details). The numbers are impressive but don't capture all the capital raised more quietly through separately managed accounts (SMAs). Speaking to managers and investors though, it's apparent that SMAs are on the rise.

UK pension funds are reducing their equity and fixed-income buckets to allocate to alternative credit, Mercer's European Allocation Survey for 2015 shows.

SMAs surged in popularity post-crisis as institutional investors sought to cut counterparty risk. A single mandate with one manager is intuitively easier for an investor to deal with than sitting within a commingled fund with numerous limited partners.

> "I EXPECT THE NUMBER OF SMAS HELD BY THE TOP 10 PRIVATE CREDIT MANAGERS TO DOUBLE OVER THE NEXT TWO TO FOUR YEARS"
> **Ben Schryber**

The flexibility and customisation possible with SMAs are also attractive factors. They can be structured to buy and hold assets or include the option to allocate capital more opportunistically.

The $133.9 billion Teachers Retirement System of Texas bumped up its credit accounts with Apollo Global Management and KKR by $2 billion apiece in April, bringing the mandates to $5 billion each. Having never invested in infrastructure debt before, Austrian insurance company UNIQA has agreed to award Macquarie Group with a €1 billion account, *PDI* understands. And other smaller UK

SEPARATELY MANAGED ACCOUNTS

pension funds have also announced recent adventures into alternative credit.

Though the customised route is typically the preserve of larger institutional investors, that is changing, says Ben Schryber of placement agent First Avenue. "One of the really important and fascinating trends [is that] some smaller investors are writing really big tickets to go the SMA route.… Smaller LPs are getting into the SMA game, so to speak."

Almost every state pension plan is playing in credit via separate accounts, Schryber says. Investors can get fee breaks with SMAs, somewhere in the region of 50 basis points on management fees while also demanding a higher hurdle rate. For this reason some LPs prefer a single $100 million SMA to investing via 10 managers at full fees, he argues.

They are also the perfect solution for those lacking the resources or expertise to time the market. And SMAs structured to allow both liquid and illiquid investments can deliver faster deployment rates than a closed-end private debt fund.

Most LPs able to write a $75 million-plus ticket for credit are moving towards SMAs and away from fund investing, Schryber adds. And they are going with big brand name managers that can invest up and down the capital structure, possess liquid and illiquid capabilities and have both performing loan and distressed capabilities.

In the UK too, pension funds are looking for exposure to alternative credit by investing with a single manager. The £15.5 billion ($24 billion; €21 billion) Scottish pension fund Strathclyde announced in August it is looking for a multi-credit manager to manage £300 million. The £4.8 billion London Pensions Fund Authority agreed a £150 million multi-credit mandate with Apollo in May. And in a more niche strategy, the £20 billion Public Protection Fund announced a £400 million allocation to Pricoa Capital for a UK private placement strategy in September.

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> **Tim Humphrey**

BRAND NAMES

Mandates are also growing in size because when managers hit their target returns, investors will part with more cash. And it is the big brand managers raking in the capital.

This puts pressure on the fundraising efforts of smaller managers and funds of funds. Certainly, the PDI 30, a ranking of the 30 largest fundraisers over the last five years published in September, indicated that the largest managers are cementing market dominance.

Over the last five years, a total of $379.5 billion was raised by the 30 firms captured by the ranking. Of that, the share of the top 10 managers grew from 56 percent in 2014 to 62 percent this year. "I expect the number of SMAs held by the top 10 private credit managers to double over the next two to four years," Schryber says.

In private corporate debt, SMAs are synonymous with more liquid parts of the market – large-cap leveraged loans and to some extent high-yield bonds.

Marc Pereira-Mendoza, a leveraged credit sales managing director who is also responsible for Credit Suisse's European CLO business, noticed four to five years ago that pension funds and insurance companies were starting to award mandates to larger European managers as they became more comfortable with the loan product, its structure, returns and low default rates.

He says there is a perception that capital raised within SMAs could now surpass CLOs sees that injection of capital as positive for liquidity and for the development of the loan market. US CLO volumes hit $124 billion last year, while in Europe issuance totalled €13.7 billion, according to S&P Capital IQ.

Mike Clancy, co-head of credit management at Rothschild Merchant Banking, which oversees a number of SMAs, agrees it's good for liquidity and allows investors exposure to alternative fixed income.

SMAs are much faster to set up than funds, he says. "They are less costly and easier to administrate. Some institutions only do managed accounts," he says. But they are not for the inexperienced, he cautions.

When investing this way, size is paramount, says Paul Hatfield, chief investment officer at Alcentra, which manages a number of plain vanilla bond and loan SMAs in the US and Europe as well as multi-strategy mandates. They will consider separate accounts from around €200 million and up. "It's about making sure that you've got enough scale so that you can spread the costs and make it cost effective both for the investor and for the manager plus making sure you've got enough diversity across the strategy."

He's seen more requests for multi-strategy credit, which, at Alcentra, means special situations, structured credit in the form of CLOs and direct lending. Investors might seek equal exposure across

instruments or vary their weightings. "We've had a number of people that want to do bespoke multi-strategy, perhaps more on the family office and private wealth side. We have had pension funds show increasing interest in this area as well," he says.

And distressed or special situations are sectors that investors are increasingly looking to access.

"As the cycle turns, we expect interest rates to increase and refinancing needs to increase among borrowers. That means there will be more opportunities in special sits, so we expect to expand that part of the multi-strat [offering]," Hatfield says.

WHAT COULD GO WRONG?

The attractions are clear but there are also drawbacks. First is the opaque nature of the market. Most investors are not required to disclose their SMAs. They are regulated in the US but not in Europe, *PDI* understands.

SMAs are highly-contested mandates, leaving the door open for managers to chase accounts that don't make sense costwise, driven by a desire to grow assets under management.

Fees are sometimes higher with SMAs because they involve more work, a source says. And there is a danger that the ill-equipped or inexperienced might leave themselves open to rising costs. And while some managers remain flexible on fees, others are getting stricter.

One market source says: "There is no question that it's competitive and there are very different sizes and disciplines that people in the market use."

SMAs can also present a governance issue with different pockets of capital sitting alongside each other, Derek Williams, head of private markets at bfinance, notes.

The solution is finding the right match. "Essentially [it's] resolvable by right sizing the market opportunity with the manager's dry powder and solid and robust fair allocation policies," says Williams.

One of the nuances that investors must look for is whether allocation documents are transparent, particularly as co-investment is a central theme for SMAs. "For the mid- to larger platforms, or ones with that ambition, this pooling approach is adopted by most. Disclosure on shared deals is key, and clearly whether the debt deal is hold to maturity or not is also very important," says Williams.

Tim Humphrey, managing director at Macquarie, which has collected £2.5 billion for infrastructure debt since 2012, says of the risks: "It's naturally less efficient for a manager to run a large number of bespoke SMAs and will inevitably translate into more costs than if a manager was doing it through a pooled fund structure."

Humphrey says that SMAs are better-suited for larger allocations and where investors want something tailored: "It's worked well for some of our £200 million-plus commitment sizes where those investors are set up to hold those assets directly."

Smaller mandates are being executed, says Humphrey. Macquarie has also partaken in a fund-of-one, *PDI* understands, where assets are held in a vehicle rather than on balance sheet.

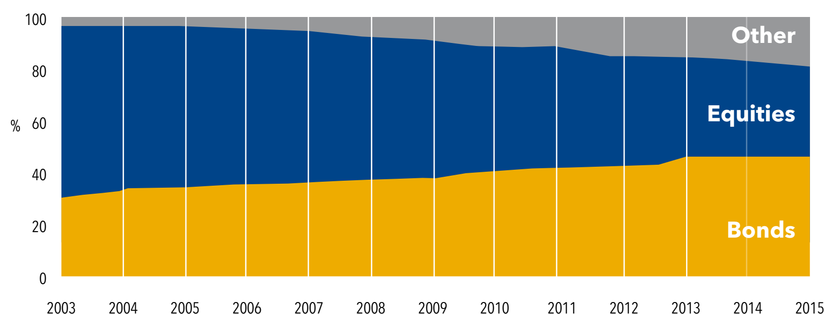
Pooled vehicles can sometimes deliver more liquidity than SMAs, he argues, particularly when dealing with smaller loans. "While most investors are buy and hold there is always the possibility they would like to sell. If you hold a limited partnership interest worth £50 million, say, in a larger pooled fund – where the fund is rated and monitored by major consultancies on behalf of their clients – then finding another pension scheme to take that off you potentially provides a liquidity option that you wouldn't have with a SMA," says Humphrey.

Hatfield also argues in favour of funds. "We're happy to do SMAs at the right size, but most managers would rather get funds in on a co-mingled basis," he says.

So while it's not quite time to write off the commingled fund just yet, larger investors have been using SMA accounts for decades and are getting braver with allocations. In a low-yield environment and in preparation for a much-anticipated distressed cycle, it makes sense to build in flexibility.

However, investors must remember that the gap between good and bad deals is probably widening. And spreading the love, or in this case capital, also helps spread the risk. ■

CHANGES IN ASSET ALLOCATION FOR UK PLANS



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