Hedge fund managed accounts 2014

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Rise of liquid alternatives adds to the managed account toolbox

By James Williams

The ways in which investors are employing managed accounts to build their exposure to alternatives are becoming multifarious. Many of the well-established public platforms are having to cater for a wide spectrum of needs, from straightforward commingled funds for first-time investors right through to sophisticated infrastructure solutions for the largest institutional investors. But it’s not just the structure that investors are considering; the rise of liquid alternatives means that onshore funds – UCITS, AIFs and ‘40 Act funds – are becoming just as popular as offshore funds.

“What makes this more complex is understanding the motivations of the investor. What are the reasons clients are coming to us? Is it liquidity? Customised mandates? Transparency? To bring existing offshore investments onshore? There are lots of different drivers at work,” comments Martin Fothergill, Managing Director, Head of Hedge Funds, Deutsche Asset & Wealth Management.
Fothergill says that the bank increasingly views this as a liquid alternatives business rather than a managed accounts business. It is able to offer investors four different product lines:

- dbAlternatives - the bank’s traditional MAP where each external hedge fund manager is appointed as a sub-advisor
- dbSelect
- UCITS funds
- ’40 Act funds

“We view liquid alternatives as a space that includes various types of managed accounts and various flavours of regulated vehicle,” says Fothergill.

“You might have an investor that wants exposure to hedge funds, they want managed accounts and understand the benefits but aren’t in a position to pick their own managers. We would then offer our advisory services to build them a portfolio of managed accounts. The next stage of that lifecycle would be where a client is comfortable choosing their own managers. They might choose managers already on our platform, and in some cases ask us to add a manager (or managers) that they have selected independently.

“At the far extreme, you’ve got investors who already invest directly in a number of hedge fund managers and want to shift them into their own private infrastructure platform.”

What this shows is that MAP providers today must be as open-minded and flexible as possible. The concept of public platforms blindly pursuing an exercise in distribution and trying to raise as many assets as possible, regardless of what investors want, has been confined to history.

Back in May this year, BNY Mellon completed its acquisition of HedgeMark International, LLC, a provider of hedge fund managed account and risk analytic services, where it now sits as part of BNY Mellon’s Asset Servicing business.

In early 2013, HedgeMark launched its Dedicated Managed Account (DMA) solution to offer investors a fully customised route into hedge fund investing.

“For the largest hedge fund investors the dedicated account solution addresses most of their key issues associated with hedge fund investing: control, transparency and governance, and to some extent fees.

“IT was a natural extension of BNY Mellon’s core servicing on assets to provide enhanced services for investing in hedge funds. The challenge in the hedge fund space is dealing with multiple counterparties including prime brokers, futures clearing merchants, ISDA counterparties: the complexity is much higher. Traditional systems that process equities and bonds don’t necessarily work for hedge funds so clients need the additional support of a customised MAP.

“Today we are working with more than 20 clients across our DMA and risk offerings,” confirms Andrew Lapkin, CEO, BNY Mellon HedgeMark.

Private mandates: full control and customised terms

When, though, should an investor decide to go down the customisation path? And should this always mean that the funds are private or can they also be commingled?

One of the important distinctions between a private platform and a public platform is that clients choose the hedge funds they want and negotiate the fees directly with each manager.

“On a traditional MAP the platform will select the manager, negotiate the discounted fees with the manager and the platform provider keeps that fee discount as their spread. Investors pay the manager fee plus in many cases a platform or access fee. In our case, clients choose the managers they want and they control the negotiation of the fees with each manager. DMAs also allow clients to negotiate how the fees are structured, including the ability to better align fees with performance. As an example, they could incorporate a fee clawback in periods of performance drawdowns,” says Lapkin.
On the surface, average hedge fund performance in 2014 has been underwhelming but when one has a clear window on performance, as Lyxor Asset Management does with its commingled managed account platform, the picture becomes more nuanced.

“There have been two major events that have negatively impacted hedge fund performance. Firstly, the slide in equity markets earlier in the year, which affected long/short equity and to a lesser extent equity market neutral strategies. Secondly, the merger arbitrage space was impacted in October as a result of some large M&A deals not going through. Long/short equity and event-driven strategies were the two strategies that investors were most overweight this year,” confirms Daniele Spada, who was appointed the head of Lyxor MAP in May this year.

Indeed, the average long/short equity hedge fund is only up +2.20 per cent YTD according to Hedge Fund Research, whilst in event-driven that figure is a modest +1.02 per cent.

However, looking at the average performance is not always that helpful.

“There are many managers, including those on our platform, that have performed very well this year. Some of our CTA managers and global macro managers have delivered strong performance. Overall, the average hedge fund performance is not a good indication of the opportunity set for investors, whether they are investing in offshore funds or managed accounts,” says Spada, noting that market neutral and some long-bias funds have also done reasonably well.

One interesting trend that Spada and his team are seeing is increased interest among institutional clients for UCITS funds that are usually more designed for distributors. Lyxor currently offers three funds with assets already exceeding USD1bn.

“We’ve been very successful with one fund in particular - the Lyxor/Tiedemann Arbitrage Strategy Fund, a merger arbitrage strategy run by TIG Advisors. Since it launched in February 2013, the strategy has grown to approximately USD700m in AuM,” confirms Spada, adding that Lyxor is preparing to launch its next UCITS fund, hopefully before year-end.

This is an interesting development because it shows that institutions are using the managed account structure not just to remove commingled risk from offshore hedge fund investing but to build onshore portfolios in a more regulated framework.

“We want to broaden the UCITS offering but in the spirit of Lyxor MAP, we are very selective in the managers we work with. We are working closely with our analysts and Lyxor’s distribution partners to understand investor demand and what preferences they have in terms of strategies in UCITS for 2015.

“We are building a good overview for 2015 and have identified some names that we wish to add to the platform,” says Spada.

That the AIFM Directive is now in play further adds to this trend. Cognisant of this, Lyxor began the task of relocating its MAP from Jersey to Luxembourg this year; a huge task that has involved initially moving Lyxor’s FoHF products.

“We have started to prepare the migration of a first batch of hedge funds on the MAP, which should be completed in the next few months. It’s definitely something that we need to do to continue freely marketing funds on our platform across Europe.

“Our investors know the platform very well, so it’s not something that has stymied the development of the platform. It’s an ongoing exercise, which we will continue to focus on alongside developing the UCITS platform,” concludes Spada.
“With DMA you can create investment guidelines specific to that one investor, similar to the long-only space. The investment manager is hired to trade a portfolio under strict investment guidelines. It may be that the investor has a social responsibility element and doesn’t want certain stock, sector or country exposures.”

Innocap Investment Management Inc. (“Innocap”) is a strategic alliance between National Bank of Canada and BNP Paribas. With more than a decade of investing in hedge fund strategies and approximately USD2.74bn in assets under advisory (as of 16 May 2014), Innocap has seen demand rise in the last couple of years for dedicated managed accounts. That said, it does still run a couple of commingled accounts on its Canadian platform and a couple on its Maltese SICAV platform, the latter being managed by Innocap Global Investment Management Ltd.

“In some instances investors are happy to open an account and share it with others but our main focus with clients lies in the dedicated managed account space,” explains Jean Baram, Managing Director, Business Development & Investor Relations, Innocap Investment Management Inc.

As at 31 October, approximately 47 per cent of its clients were pension funds.

“This is now dominating the other solutions we have on the platform. Around 85 per cent of our assets are now in these dedicated accounts and dedicated relationships,” adds Baram.

When asked what the key drivers are for investors going down this route, Baram stresses the need for flexibility.

“At the end of the day, a pension fund wants flexibility in the mandate during the lifecycle of the investment. In 2011 and 2012 in Europe they had some concerns over counterparties and asked asset managers to stop dealing with some of them.

“It’s not only flexibility of the mandate that they require; it’s flexibility of the entire investment.

“Also, they want flexibility with fees, choice of jurisdiction, transparency and liquidity. In commingled accounts you have side letters, equality of treatment, which might not suit a large institution. For us, it’s always been about customisation. Given the costs involved, you need to commit a sizeable allocation - USD35-50m for each fund. Commingled accounts are still relevant for investors who aren’t able to invest such amounts into a single manager,” says Baram.

Daniele Spada, head of the Lyxor MAP, notes that institutions are coming to Lyxor with more specific requests. He says that institutions want more thematic portfolios, concentrated exposures in certain strategies and less diversification in terms of number of funds.

“Institutional clients realise there is value in hedge funds especially when one uses them selectively and the right exposure is chosen. They can customise this exposure using private platforms. It is a trend that gives them the freedom to make informed investment decisions. They get a lot more services from a MAP that they wouldn’t necessarily get from direct investment,” says Spada.

To that end, commingled platforms like Lyxor are looking to leverage the experience and research capabilities they’ve built since 1998 to cater to the increasingly bespoke needs of investors by presenting themselves as more than just an infrastructure solution; they are investment platforms, who understand what investors are trying to achieve with hedge fund investing.

“They are asking platform providers like Lyxor for highly customised services, either just by providing them with the infrastructure, or, more frequently, by customising the mandate to meet their specific allocation needs. This extends to customising information they need to use to monitor their allocations and so on.

“They want to aggregate their hedge fund exposure with their broader portfolio allocation,” says Spada.

“Traditional systems that process equities and bonds don’t necessarily work for hedge funds so clients need the additional support of a customised MAP.”

Andrew Lapkin, CEO, BNY Mellon HedgeMark
This need for a 360 degree view of risk exposure within the portfolio is arising as investors no longer view hedge funds as separate to their equity and fixed income allocations; they are becoming intertwined, using hedge funds as strategic overlays within the overall portfolio.

“One of the key linkages we have now that we are a BNY Mellon company is a connection to the data of the Bank’s custody and accounting clients. This allows BNY Mellon clients to request that their total portfolio flows into our risk systems so that we can provide risk analytics on the total plan. It really helps investors understand what role their hedge fund program is playing within the portfolio. It helps them view hedge funds more as active managers and less as a distinct asset class,” states Lapkin.

At ABN AMRO Private Bank, they are starting to integrate managed account technology to bring enhanced reporting capabilities to their clients’ wider portfolios.

“What we are now doing in the Netherlands for our discretionary portfolio managers – completely separate from hedge funds – is utilising the managed account technology used in our dedicated FoHF vehicle and overlaying that onto our clients’ portfolios of equities, bonds, cash, FX to give them enhanced portfolio and risk aggregation reporting,” confirms Marc de Kloe, Head of Alternatives and Funds.

Advisory services sit at the midway point on the spectrum of managed account investing. Where the public versus private debate becomes more nuanced is that some investors are using the likes of Deutsche Bank to construct portfolios of commingled funds, portfolios of bespoke funds (higher allocations needed), or a mixture of the two.

“Advisory services continue to be important for us. The pipeline that we have heading into 2015 would suggest that advisory, in combination with managed accounts, is becoming more important for a growing client base that is looking for that combination of benefits provided only by a MAP and institutional advisory group. Our public platform remains equally important, it’s just that we see a lot more requests now around advisory and private MAP solutions,” says Fothergill.

Based on asset inflows in 2014, Deutsche Bank’s investors still largely favour straightforward commingled investing.

“We have products that are advised portfolios of public (commingled) managed accounts. We have portfolios of private accounts. And we have some products that are a mixture; some are commingled managers, some are managers that are private just to that client. It’s a ‘pick and mix’ approach.

“The majority of assets are still in commingled accounts, but next year the number of private mandates is expected to rise,” states Fothergill.

Baram adds that typically, a pension plan will come to Innocap with a list of managers and ask them to suggest any others that might be worth considering.

“We see demand for advisory services more on the wealth management side where clients need help in terms of sourcing managers and constructing portfolios,” comments Baram.

The rise of liquid alternatives and growing investor awareness of hedge funds are making the managed account space more complex as the range of choices and levels of customisation increase.

But as institutions look to better integrate hedge funds into their wider portfolios, Lapkin thinks this will favour some platform providers more than others: “For big institutional investors, it makes sense for them to extend what they do on the long-only custody side to incorporate hedge funds. We think that longer term it will be the larger custodians like BNY Mellon that will play a dominant role in structuring these private Dedicated Managed Account platforms.”

“"We are utilising the managed account technology used in our dedicated FoHF vehicle and overlaying that onto our clients’ portfolios to give them enhanced portfolio and risk aggregation reporting."

Marc de Kloe, ABN AMRO
Unlocking alpha via FundLogic Alternatives
UCITS Platform

Through its FundLogic Alternatives Platform, Morgan Stanley has established itself as one of the leading providers of alternative strategies in a UCITS format. Our goal is to leverage our financial expertise and network of alternative asset managers to identify the strategies best able to unlock alpha.

FundLogic Alternatives gives you the opportunity to access experienced managers with solid track records, within the highest levels of transparency and liquidity with the following key features:

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Morgan Stanley
Giving investors efficient access to hedge funds

Interview with Stephane Berthet

“We are different from our competitors in the managed account space by construction. When we launched our multi-asset platform the objective was more to serve clients than to distribute managers,” states Stephane Berthet, Executive Director at Morgan Stanley and head of its FundLogic Alternatives platform.

By clients, Berthet is referring both to the hedge fund managers who wish to launch regulated vehicles such as UCITS funds by leveraging off the bank’s multi-asset FundLogic platform, and investors who are looking to gain more efficient access to hedge fund strategies.

From day one, Morgan Stanley’s managed account solution was clear: to deliver investor-centric bespoke solutions. Berthet notes that the mix of investors looking to use managed accounts includes large asset managers, family offices, pensions, insurance companies and banks who might have capital or regulatory issues and for those that find that the direct offshore vehicles prove too costly an investment.

“Aside from managers and existing hedge fund investors we are also seeing a third category: managers approaching us because they have investors who know about our structuring expertise and technology and want better access to hedge fund strategies,” says Berthet, noting that three types of requests have been coming in this year.

Firstly, insurance companies looking to meet Solvency II requirements. This has been one of the main drivers of investor discussion according to Berthet. Secondly, traditional long-only asset managers making their first foray into hedge funds but who want to avoid the commingled route. Thirdly, hedge fund managers wishing to launch regulated funds.

“We are working on a number of deals right now with large hedge fund managers who want to launch their own UCITS funds,” confirms Berthet.

There are between 30 and 35 managers on Morgan Stanley’s managed account open architecture platform. Where possible, these managers are used in more than one bespoke mandate. Typically speaking, a large institution will come to Morgan Stanley and take a “pick and mix” approach to building the mandate.

“One once we have shown the investor the current list of managers, then subject to the investor’s size of investment we will then be happy to onboard any manager(s) they have already identified.” According to Berthet, there are two drivers helping to drive growth in managed accounts.

“On the one hand, large pension funds with a long track record in hedge fund investing increasingly need a bespoke arrangement, be it in terms of strategy (for socially responsible investing purposes), in terms of fees, etc. Moving into a more controlled structure might be better suited than continuing to invest in Cayman funds. On the other hand, tier 2 and tier 3 investors, whose boards of directors and investment committees have historically not been keen on hedge funds, are looking to managed accounts as an effective solution for portfolio diversification.”

Given that investors want specific reporting when running a private managed account mandate, Berthet says that the majority still tend to favour a range of strategies: CTAs, credit, event-driven, global macro, equity long/short and market neutral. Illiquid strategies are avoided.

“There are two main goals when investing in a managed account. One is to provide enhanced liquidity, giving flexibility to investors should they need to exit a strategy. The other is to increase the reliability of the risk management and governance by re-allocating such responsibilities from the hedge fund manager to a third party platform provider,” concludes Berthet.
Despite the decision by CalPERS to divest their hedge fund investments, for the vast majority of institutions they remain a crucial part of their asset allocation. Some of the more sophisticated pension plans are building in-house capabilities to strengthen their expertise in manager selection.

Indeed, as Bruce Keith, CEO of InfraHedge, an open architecture MAP owned by State Street, comments: “Quite a few of our clients already had existing private managed account platforms but wanted better risk management, better operational oversight.”

InfraHedge, whose assets under management have grown from USD11.45bn

Private platforms: Why buy the whole car when you can customise the parts?

By James Williams
“Quite a few of our clients already had existing private managed account platforms but wanted better risk management, better operational oversight.”

Bruce Keith, State Street

in 2013 to USD15.2bn, was launched in 2011 in order to allow institutional investors and allocators to set up private platforms to their own specification and design.

This is helping institutions to focus on manager talent and build tailored hedge fund portfolios in line with specific return profiles, country/sector exposures, liquidity terms, leverage levels and so on. By controlling the assets, the investor is able to mix the right ingredients together to produce the desired level of performance, whilst at the same time outsourcing all the operational, risk monitoring and compliance tasks to the platform provider; hence why these tend to be referred to as infrastructure solutions.

In a recent report by State Street entitled Pension Funds DIY: A Hands-On Future for Asset Owners, one quote in particular stood out. It was made by Richard Brandweiner, CIO at First State Super, one of Australia’s largest superannuation funds.

Brandweiner said: “Can we insource some components of the process and outsource other components? Traditionally, we’ve bought the whole car. Maybe we need to buy the engine or buy the brakes or buy the engineering capability and just build the car ourselves.”

This demonstrates how institutional investors are thinking about customisation.

“I believe that what hedge fund managed accounts provide to investors really hasn’t changed. To some extent it’s the only way to outsource the governance of an unregulated fund to a third party and ensure that there is someone actively monitoring the account on a regular basis,” says Stephane Berthet, Executive Director at Morgan Stanley and head of its FundLogic Alternatives platform, continuing:

“Traditional managed account platforms are under a little bit of pressure because they are more expensive than say UCITS fund platforms, which themselves offer good liquidity and transparency. However, a customised managed account is a more sophisticated business model. Once they have their managed account solution set up, institutions are able to effectively rent the operational infrastructure from the platform provider.

“As it is fully customised they need to have bespoke reporting to address their own idiosyncratic risks and their own needs in terms of capital efficiency treatment; so you have to be very flexible on the delivery mechanism. You cannot be in a position where you just sell funds and tell institutions that is the most efficient way for them to access alternatives; that’s simply no longer the case.”

Keith is encouraged by the fact that whilst clients tend to start with more liquid strategies, the platform is now starting to see investors expand into more complex strategies and move through the liquidity spectrum. “It’s pleasing to see that clients are using managed accounts to access a full range of investment strategies.

“Not only are they moving into credit strategies, asset-backed derivative strategies, we’re also seeing investors stipulate that rather than mirror the flagship fund they are setting out the risk/return that they need from a specific manager. It’s become less about replicating the reference fund and more about using managed accounts to deliver on specific investment objectives and goals.

“The institutional investor is starting to demand more from customisation. This should have a positive impact for manager relationships as they will be delivering solutions rather than products. It is no longer valid to say, ‘This is our reference fund, this is how we do things, and this is the price’,” states Keith.

Back in 2009, ABN AMRO Private Bank approached Lyxor Asset Management to build a dedicated multi-strategy FoHF on the Lyxor MAP. As Marc de Kloe, Head of Alternatives and Funds at the Dutch bank explains: “It helps us on the liquidity side, and with understanding portfolio risk a lot better. Hedge funds are a mysterious beast
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Customisation: Perspective on trading

By Louise Guillemette & Poseidon Retsinas

The managed account space is evolving from the traditional standardised and commingled offering toward customisation for single investors. Innocap offers its investors dedicated investment vehicles of multiple types, across multiple jurisdictions, featuring multiple fund administrators and service providers.

As part of this customisation, Innocap focuses on matching the brokers, clearers and counterparties ("BCCs") used by the hedge fund manager ("Trading Customisation"). The goal is to create a trading environment that allows the manager to effectively implement its strategy. Meanwhile, agreements with BCCs ("Trading Agreements") are negotiated by Innocap’s in-house attorneys with the investor’s best interest in mind.

Reducing negative bias of managers

The traditional, standardised and commingled managed account offering may struggle to attract highly in demand managers. In such a non-customised environment, the manager may be forced into using the managed account’s preferred BCCs or the investor’s account at particular BCCs, which has significant trading and operational impacts.

For instance, the manager may be forced to split trades (i.e. instead of placing one block trade with one counterparty and then allocating across funds, a manager would need to place separate trades across different counterparties). Moreover, managers prefer to use the same BCCs as their flagship fund since it reduces the potential for operational errors and eliminates the need to create additional operational structures/relationships.

Furthermore, by making the same BCCs available to the manager, the manager can implement its strategy more faithfully and in a cost efficient manner. The same products and pricing available to the flagship fund can be available to the managed account.

Questions investors should be asking...

- Does Trading Customisation come at the expense of time to market?
- How many BCCs does their platform have relationships with? Are these BCCs vetted and monitored on an ongoing basis by legal and risk?
- Are the legal terms negotiated by in-house attorneys, or is this task outsourced? If outsourced, how are the costs passed down to the investor? What terms does external counsel focus on when negotiating Trading Agreements?
- What is the content of the negotiated terms? How should the terms differ from those obtained by the manager for its flagship fund?

At Innocap

For 10 years, Innocap’s in-house attorneys have been negotiating Trading Agreements (Prime Brokerage, ISDA, Futures, OTC Clearing, Repo, etc). Innocap has built relationships with most major BCCs across the United States and Europe. These relationships facilitate Trading Customisation and allow for timely implementation of new funds with sound legal terms.

Innocap’s attorneys negotiate terms that seek to protect the interests of the investor. Special attention is taken in relation to segregation of assets, liability of sub-custodians, rehypothecation, margin requirements, events of default and termination. Trading Agreements are drafted to permit termination of a manager without resulting in immediate close-out.

Innocap’s in-house attorneys work closely with Innocap’s risk and operations personnel, thereby creating synergies and cost savings that may not exist when legal work is outsourced. The practical experience gained by having lawyers sit alongside risk and operations helps in focusing legal negotiations on the terms that matter most.
and understanding how they behave in different market conditions by stress testing portfolios really helps our clients.”

Lyoor was chosen, says de Kloe, because they wanted someone to manage the portfolio. For them, having an asset manager linked to the dedicated mandate was an important consideration when choosing the most suitable platform.

Certain strategies like CTAs have a long history of association with managed accounts. This tends to be based on the classic model where the investor opens an account with their designated bank and gives them power of attorney.

Jerome de Lavenere Lussan is the founder and managing director of Laven Partners, a regulatory compliance and fund due diligence consultancy. Laven Partners reviews managed account agreements that clients have in place at the brokerage to check what limits are in place etc, but this account structure is only the first option.

“The other option is to use one of the platforms. What is a MAP? One still sees a lot of the names from the pre-financial crisis, there haven’t been that many new entrants. Some have disappeared like Alphametrix in the US. I think the MAPs have all generally grown in terms of assets but this is a tough space to crack because of the difficulties to:

• Set up the platform infrastructure;
• Risk management – you need comprehensive IT and risk systems in place;
• Legal set-up costs – made harder because of new distribution rules in the EU.

“In recent times, more people have avoided the bank ‘managed account’ format – usually because of costs or perceived conflicts – and have gone with the fund format on a MAP. The platform is like an umbrella fund of one, where each sub-fund has one client. So managed accounts to me means one investor that sees exactly what assets are held in their name. They either choose to have their own internal risk controls (running an account with their designated broker) or they use a MAP to avail of their risk controls to get a clearer picture of what’s really happening inside the fund,” explains de Lavenere Lussan.

The problem with having a classic managed account is that the investor gets neither an NAV, nor an audit because there are no expenses going through the account as such. That’s why the fund structure format is growing in popularity with private platform providers.

Whilst the main appeal of customisation and outsourcing the infrastructure to a platform is appealing, de Lavenere Lussan urges caution.

“We get sent requests by investors to deconstruct some of the top platforms. Do you really get a better deal by using independent platforms? You get better disclosure but do you really get better cost benefits?

“What clients want when building customised solutions is trust, security, and sound operations. They want to see a top custodian in place, who ideally also works on the administration side for better cost efficiencies. You have to take your time to study what you’re buying. You’ve got to do your due diligence when using managed accounts, and decide on whether it’s best to use the classic account structure with a bank, which means no full reporting or NAV, or use a fund structure. I think a lot of clients are lured in by a false sense of comfort, essentially through marketing and not through an understanding of a platform’s operations,” opines de Lavenere Lussan.

Michael Hart, a veteran of Aberdeen Asset Management, has just joined...
Amundi’s alternative asset unit as deputy CEO and global head of business development. Discussing the drivers surrounding customisation, Hart notes that as investors generally allocate to more than one hedge fund they are using managed accounts as a toolbox to get an optimal allocation.

This, says Hart, gives the following benefits:

- “They can manage exposure to asset classes: since they have transparency on positions of each managed account, they can aggregate/consolidate these positions and exposures for a more holistic approach of their portfolio of hedge fund managed accounts
- Volatility is something not all investors can “take on”, therefore, using managed accounts and their adjusted leverage levels is also a way to achieve a desired volatility
- Fine tuning between diversification (which may dilute performance) and concentration (idiosyncratic risk of being exposed to blow ups). Since investors benefit from our strong due diligence approach, diminishing the risk of blow up, our investors can focus on a more concentrated portfolio and seek higher returns
- For our Family Offices and FoHFs clients, we have seen an increase in the use of the quantitative model approach that they use for hedge fund selection on their portfolio of hedge funds. They deploy their quantitative approach more aggressively on managed accounts in order to benefit from the liquidity and ability to select good short-term performers.”

One potentially important catalyst for further managed account adoption is Solvency II.

Berthet sees this as an important driver going forward. Morgan Stanley has the solution set and the expertise to help insurance companies overcome the capital cost impact of investing in hedge funds by the way it constructs its managed account mandates.

“Insurance companies tend to be large investors in fixed income and credit. In the current environment, with low yielding returns, it will be difficult to make the necessary returns to keep on top of liability management and deliver a guaranteed return rate of 3 to 4 per cent. If they know that for diversification purposes they need to find extra yield, the idea of adding a hedge fund portfolio on top of their fixed income allocation is driving their decision.

“However, once they decide to invest in alternatives, if they invest in Cayman funds without transparency, they will be charged 49 per cent of capital; this is the Solvency Capital Requirement. With additional transparency, the SCR can be improved, especially for credit and fixed income strategies. However, equity strategies will continue to be penalised. That’s not going to incentivise insurance companies to invest in equity strategies,” says Berthet.

The Catch-22 situation here is that, to Berthet’s earlier point, fixed income isn’t performing well enough.

“If they want to go beyond just investing in credit and fixed income, insurance companies will need to have not just the managed account but also to have efficient access to that managed account and to those equity-related strategies in order to reduce their SCR to 15 to 10 per cent.

“We can achieve this because when we set up the managed account portfolio for the client swaps are used to create both the derivative exposure to the strategies as well as an efficient delivery mechanism.”

Looking ahead into 2015, Keith concludes: “I think the long-term trend is one where institutions want to have greater control over their hedge fund portfolio and how it fits into their wider book. In a low interest rate environment you want to make sure that you’re finding the right mix of managers and performance in order to meet long-term liabilities.”