MAPs set to grow as volatility returns to the markets

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Hedge fund managed accounts set to grow as market volatility returns

By James Williams

We live in an age where technological innovations like the e-hailing company, Uber – on track to becoming the most successful start-up ever – and Netflix, which data maps our viewing preferences, are empowering us to live increasingly customisable lifestyles. And in the world of hedge fund investing, the same rules apply, particularly for institutions who want control, transparency, and investment mandates that work on their terms, not those of the manager.

In that sense, managed account platforms are in a highly favourable position in 2015. Take the California State Teachers’ Retirement System (Calstrs). It is currently discussing the possibility of moving up to 12 per cent of its portfolio, equivalent to a whopping USD20billion, into US Treasurys and hedge funds. If they do, one can be sure that a dedicated managed account will be the preferred option.

Andrew Lapkin is the CEO of HedgeMark, which BNY Mellon acquired on 1st May, 2014. Back in late 2012, HedgeMark launched
its Dedicated Managed Account (DMA) offering to offer institutional investors a customised hedge fund managed account solution with an integrated position-level risk analytics platform to provide high-frequency risk and performance reporting.

As of 2nd February, 2015 HedgeMark’s DMA assets totalled approximately USD1.6billion. Discussing with Hedgeweek how managed accounts are helping improve the way that institutions access hedge funds, Lapkin says that customisation is a key factor.

“For many large institutions, a direct allocation into an existing hedge fund is not what they necessarily need. We’ve seen this in what I call ‘high convexity’ hedge fund strategies; these are similar to tail-risk strategies designed to make money in all markets not just in downward markets.

“It could, for example, be an options-based strategy, allowing the manager to put on more long-dated derivatives positions for a single investor with a longer time horizon. It means the manager doesn’t have to worry about redemptions that could impact the strategy.

“Then you have the idea of tailoring. The right fund for pension fund A might be very different for pension fund B depending on their needs and risk tolerance. The nice thing about having a dedicated managed account is that it allows the investor to set the risk/volatility level that is most appropriate for them. Increasingly, we are seeing interest for our DMA solution not just to mirror the manager’s flagship fund, but more to get exposure to the key investment ideas,” explains Lapkin.

Amundi is one of Europe’s leading managed account platform providers. The Dublin-domiciled MAP is seeing clear demand for fully customised mandates, which, according to Michael Hart, deputy CEO and global head of business development for Amundi’s alternative asset unit, represent the majority of the platform’s USD5billion in AUM.

“We are working on a large mandate for an institutional client. They liked the fact that we were proactive in our approach when looking at the managers and various strategies to fit with the mandate’s objectives. They appreciated that we aren’t just a distribution platform. We are also co-investors in mandates and our approach of selecting managers onto the platform is extremely stringent,” says Hart.

“Another point that this client liked was that when they asked whether a manager they selected would be automatically added to the platform, our response was, ‘only if it passes our operational due diligence.’ From an investment risk perspective, Amundi has never had a fund blow-up on the platform and we want to keep it that way. Also, our operational due diligence team do not report in to the investment committee; they work alongside the investment committee, they are completely separate and have power of veto.”

So what is it that makes customisation beneficial to institutions, aside from all the usual features of control and enhanced transparency, when investing in hedge funds?

“Carve out” strategies
From a strategy perspective, it is clear that the main quid pro quo between manager and investor is enhanced alignment of interests. The earlier example of convexity strategies illustrates how managers are able to take comfort in knowing that the investor has a long-term commitment to pursuing the strategy. From the investor’s perspective, they take reassurance that the manager will be able to execute the strategy without distraction, and hopefully maximise the alpha component.

Taking this a step further, a custom mandate enables investors to build out a portfolio that gives exposure to the best aspects of a manager’s strategy, rather than the strategy as a whole. This is customisation at its best, stripping out X

“Increasingly, we are seeing interest for our DMA solution not just to mirror the manager’s flagship fund, but more to get exposure to the key investment ideas.”

Andrew Lapkin, HedgeMark
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Lyxor Asset Management has developed another innovative solution for investors to allocate to liquid alternatives in a cost-effective fashion. In addition to offering commingled and segregated managed account solutions for hedge fund investing on the Lyxor MAP, investors can now avail of a multi-manager managed account solution, which, structurally speaking, is similar to the multi-manager '40 Act alternative mutual fund springing up in the US.

As Daniele Spada, Head of Lyxor MAP, explains, the solution answers the needs of investors who want diversified exposure to a particular investment theme without investing in a fund-of-funds, which will typically contain a slew of funds to provide single strategy exposure.

“That's a key difference to a normal single manager mandate,” says Spada. “We've received a lot of requests, particularly from private and wealth management clients, for diversification solutions to their long equities and fixed income exposures. What they are asking for is a performing solution with contained volatility, limited correlation to traditional assets, flexible allocation to different alternative strategies and cost efficient; and that's where we came up with the idea of having one UCITS multi-manager managed account containing a selected group of managers.”

The advantage of this arrangement is not only that it answers the diversification needs of the client, it also offers greater flexibility and cost-efficiency compared to a traditional fund-of-funds. With a single managed account, managed by a group of selected managers, it is easier to reduce or increase exposure to a specific strategy without bearing all the administrative costs and the timeframe of creating a new fund mandate every time.

“You can close or reduce exposure to a strategy altogether, which is much easier than closing a fund and adding a new one,” says Spada. “Most of the requests we are getting for this multi-manager solution are coming from wealth advisors who like this cost-effective solution. When we speak to managers about running a daily liquidity version of the strategy, we tend to focus on good names who are already running liquid strategies. The challenge is obviously the full replication of their strategy within this multi-manager format.”

Currently, Lyxor is working on a multi-manager mandate for external clients and has also commenced work on an internal project, whereby Lyxor will launch a multi-manager managed account fund for its investors.

“This is a new investment solution to the Lyxor UCITS platform,” says Spada. “Both multi-manager solutions will offer daily liquidity.”

Last year, Lyxor was entrusted by the Societe Generale group to provide fund selection services on the long-only universe to its private banking group, opening up a far wider investor audience.

“We now have 10 analysts covering mutual funds and 20 analysts covering hedge funds. Lyxor has become a real centre for fund research, selection and advisory, both on traditional and hedge funds, beyond our historical expertise in managed accounts.

“The alternative UCITS universe is the result of the convergence between the mutual fund and the hedge fund world. When you build one of these multi-manager managed account solutions, having such a comprehensive expertise on funds is very helpful to pick the best manager for a given strategy. In a multi-manager solution the expertise of a hedge fund manager offering a liquid alternative version of his strategy and the talent of a more traditional long-only manager can co-exist and deliver very good results,” concludes Spada.
per cent of a strategy’s exposure to certain securities and keeping the rest. This is typically referred to as a ‘carve out’. One option could be to build a mandate that only ever has exposure to a manager’s top 10 or 20 investment ideas.

“We have done this for a couple of clients,” says Hart, “where they’ve expressed interest in a strategy, but only certain elements of it. We would then approach the manager and say, ‘we’d like to invest in you on our MAP but we want this piece of the strategy carved out.’ And typically managers are happy to do this as we usually invest a minimum of USD50 million from day one. This normally happens when constructing a mandate with a client and a strategy doesn’t exactly fit their overall investment objectives.”

Lapkin confirms that carve out strategies have proven popular with HedgeMark’s clients. Not only does this help investors control the make-up of the strategy, but having a segregated mandate also empowers them to dial up or dial down the amount of leverage that the manager employs. Some might want to juice up the returns, others might want to reduce them. This will depend on the strategy – a fixed income arbitrageur uses inherently more leverage than a global equity long/short manager.

“We’ve seen a much greater willingness among our clients for concentrated investments. One of the issues for hedge fund investors is that their approach to risk management is to diversify across a range of different hedge funds and the problem with that is you end up in an over-diversified world. Managed accounts allow investors to make a more concentrated investment with a particular manager because it is a risk-managed fund; it has investment guidelines and mitigates style drift.

“It might mean that the investor chooses to make the strategy a higher volatility version, for example, which they can effectively monitor within their overall portfolio,” explains Lapkin.

**Cash efficiency**

Another area where managed accounts are useful is with respect to cash efficiency.

Investing in traditional hedge funds, if you want USD100 million of exposure you have to allocate USD100 million. However, by their very nature, hedge funds are cash efficient (especially those using derivatives) and as such a large portion of assets are held as cash.

In a DMA, the investor only needs to put in sufficient cash for the strategy to run properly and meet its margin requirements. That can leave 50 per cent cash – sometimes more – to be deployed elsewhere by the investor.

“We saw in the financial crisis that when investors needed liquidity they redeemed from liquid hedge funds, regardless of good performance,” notes Lapkin. “With a custom mandate, investors using managed accounts would have the option to withdraw excess cash not required to support the current holdings, and therefore avoid having to redeem their entire hedge fund investment.”

It’s not only investors than can benefit from cash efficiency when using a managed account.

Managers can also reap the rewards, especially start-up managers who want to get their strategy up and running without incurring the substantial costs associated with setting up a standalone fund; which in today’s regulatory climate are climbing higher.

Linear Investments Limited is an FCA-approved full service mini prime broker (Linear Mini Prime) providing full prime brokerage, custody and execution services to small and mid-sized hedge funds. Linear’s clients not only benefit from going down the cost-efficient route of establishing a managed account, but also from getting access to some of the top prime brokers’ electronic trading platforms. This is made possible because of an omnibus account structure that Linear uses, pooling together all of its clients’ positions when executing trades on their behalf.
SS&C Technologies services four of the world’s top 10 managed account platforms, providing a critical administration function in the MAP space. The firm has continued to grow the number of clients (both MAPs and individual fund managers) in 2015 and as Tom Kirkpatrick, European COO at SS&C GlobeOp, observes, hedge fund managers are taking on more managed account mandates.

“For some of our larger clients, we’ve seen investors writing sizable investment tickets for managed accounts. We support managers mostly on the middle office side of things, as sometimes the investor will have their own preferred administrator. We are still able to help managers with operating scale; being able to split trades, making sure the correct controls are in place for each of the legal entities. We help managers maintain operational control of their managed account mandates on a daily basis,” says Kirkpatrick.

According to Colin Keane, Ireland Country Head at SS&C GlobeOp, this has been one of the reasons for SS&C’s success in Luxembourg and Ireland.

“European Umbrella structures inherently have a Sub-Fund infrastructure so we’ve been able to apply the same operational structure that we use for existing offshore managed accounts to regulated products availing of the QIAIF, SIF or UCITS frameworks,” says Keane, adding that one interesting growth dynamic this year has been the emergence of multi-strategy products as MAPs look to help investors overcome regulatory limitations such as concentration limits under UCITS IV.

“Managers who have a number of separate strategy Sub-Funds across their platform are leveraging off the existing Fund returns and combining these strategies into one multi strategy Sub-Fund, creating a new product offering for their investors.”

As more investors turn to managed account vehicles to improve the way they access hedge fund strategies, be it offshore or in a European regulated AIFMD or UCITS wrapper, administrators need to have technology prowess, as well as human expertise, to process fund data and publish it in the formats that their clients need on a daily basis.

“It could be an accounting report, a NAV report, a risk report, a regulatory report. Whatever the report, we believe we’ve got a broad range of services and the technology and human skills to deliver a market-leading administration service to managed account providers,” says Kirkpatrick.

“We are continuously focused on the accuracy and transparency of our reporting to MAPs, trading advisers, as well as investors,” notes Keane. The infrastructure that SS&C has with respect to its proprietary systems and software is not only important, but also “one of our key differentiators, compared to other administrators.”

“Process integration is a common term in the industry, but how many administrators provide an end-to-end internal solution?” stresses Keane. “Many providers need to leverage external providers to assist with aspects of MAP reporting, be it EMIR reporting, a portfolio accounting system, right through to risk and regulatory reporting. SS&C is a market leader in these services and can offer these either as bundled or as stand-alone services. This flexibility to provide a complex product, such as Annex IV reporting, has been very valuable.”

Kirkpatrick says that having expertise and the internal reporting synergies “provides our clients with a high degree of confidence, knowing their data is housed under SS&C’s infrastructure”. Understanding clients’ needs is key, but as Keane concludes, having proprietary tools at its fingertips gives SS&C a significant advantage in delivering optimal solutions to its clients.
“Currently, we have 165 clients, of which 45 are hedge funds,” says Jerry Lees, Chairman at Linear Investments. “That we perform trading and execution for most of our clients is important because it generates commissions fees, which keep our underlying prime brokers happy given how much focus they are placing on return on equity.”

Linear offers a managed account solution that is beneficial to managers, and is an important adjunct to investor-focused MAPs. Lees says that the hedge fund PB currently has approximately USD500million in positions but several projects in the pipeline are expected to more than double these assets. “We expect to see our assets accelerate,” states Lees. “Any emerging manager with less than USD100million in AUM struggles with the costs. One way of dealing with the cost/expertise issue is to outsource as many of the functions as possible. Linear bundles many of these functions together into monthly fees with no long term lock in or participation in the fee structure or shareholding of the fund manager.”

“For example a manager might opt for trading desks for their team, all their emails and calls recorded and archived for seven years, disaster recovery, risk management, compliance management and an Appointed Rep structure, together with outsourced Capital Introduction. Linear package all of that together with our PB business.

“What we are providing is a transparent, economic solution to emerging managers that allows them to get on with their strategy and build track record without being borne down by detail and cost.”

Currently, Linear has 60 prospective managers in the pipeline, all of who have gone through the screening process. Lees expects to bring 30 or 40 onto the platform over the next 12 months.

**Multi-manager Managed Accounts – a new trend?**

In the US, the rise in prominence of liquid alternatives has led to the proliferation of ‘40 Act alternative mutual funds. Structurally, these differ to alternative UCITS funds in Europe. Managers are not able to charge performance fees, and as such many ‘40 Act vehicles are constructed as multi-manager arrangements where individual managers agree to act as sub-advisors. What this means is that ‘40 Act funds are highly liquid versions of their hedge fund strategies; ‘hedge fund lite’ in other words.

Over at Lyxor Asset Management, a similar approach is being developed to provide an additional solution on its managed account platform; specifically the Lyxor UCITS platform. The reason for this is to help clients meet their diversification needs, as well as reduce costs by investing in a single fund comprised of multiple managers as opposed to a traditional FoHF.

“Liquid alternatives that are packaged in a UCITS regulated framework are usually less expensive than the offshore version of the strategy. On the Lyxor MAP we have Jersey-domiciled funds, which make up the bulk of the platform. In the past two years we’ve added UCITS managed accounts for which we have negotiated the best possible fee level for our investors’ fees that are lower than traditional offshore funds. For the same reason, a UCITS multi-manager managed account will be more cost-effective,” explains Daniele Spada, Head of Lyxor MAP.

He says that the kind of clients who are targeting a UCITS multi-manager solution are not necessarily those who would invest in pure offshore vehicles and are more sensitive to regulatory constraints by nature. “They need de-correlated and cost efficient investment opportunities, but in a regulated wrapper as regulation becomes stricter and stricter in terms of what alternative investments can be offered to retail investors. This is the route we take when structuring one of these UCITS multi-manager solutions. We typically discuss with

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2015 has certainly been an interesting year thus far, with macroeconomic negativity and uncertainty mixed with idiosyncratic events resulting in a sustained period of market volatility, with the traditional fear gauge or VIX Index peaking at 50.78 on 24th August, the highest level since 2009.

In theory, this increased level of volatility and dispersion amongst financial markets should allow hedge funds to distinguish themselves from traditional strategies, fighting back against the increasing criticism of the last five years that questioned their purpose. In fact, many of the larger industry names have struggled, with the asset weighted, large manager biased HFRX Global Hedge Fund Index down by 3.05% YTD to 30-Sept versus a decrease of 1.53% for the equally weighted HFRI Fund Weighted Composite Index.

As a result of the prolonged underperformance of these household names, many investors, including Sciens, have for some time been focusing on small to mid-sized hedge funds. We believe that managers can greatly benefit from being nimble and flexible in their investment strategies, leading to the delivery of attractive risk adjusted returns, with lower correlation and all whilst being strongly motivated to deliver performance rather than gather assets. Indeed the majority of strategies run on the Sciens Managed Account Platform (MAP) have less than USD 1.5 billion assets under management.

Investing in small to mid-sized managers via a MAP offers great comfort to the investor, knowing that an experienced and independent platform provider is responsible for all operational and fiduciary controls, thus freeing up the hedge fund manager to focus on the investment strategy.

For early stage managers who have perhaps yet to invest in sufficient middle and back office infrastructure, a MAP can be vital in securing institutional capital. A managed account platform should offer independent risk monitoring, ensuring that the hedge fund manager stays on mandate within its expected investment constraints at all times, thereby providing a valuable resource during periods of market stress.

At Sciens, we approach running a MAP very differently to many of our peers, maintaining a buy-side perspective, leveraging our institutional fund of hedge funds experience to help us select and perform extensive due diligence on good managers for our clients, while monitoring risk in a meaningful and accurate way that is appropriate for each individual investment strategy.

For example, the risk monitoring of a Managed Futures strategy requires a completely different skill set and expertise to the analysis of a Credit fund. Sciens has also moved away from simply offering the traditional MAP strategies focusing on managed futures and equities, and continues to expand its offering with the recent addition of Volatility Trading, Structured Credit, Power Trading and Distressed Debt strategies, all of which have seen good performance in 2015.

The Sciens managed account team ensures that the best possible infrastructure is in place, working with dedicated in-house legal, risk, compliance and operations teams while also employing external service providers such as administration, audit and custody.

This year, Sciens’ infrastructure development has seen the addition of an EU-onshore umbrella structure. This allows hedge fund managers to offer investment solutions to European investors under the Alternative Investment Fund Managers Directive (AIFMD). Significant interest has been generated, in particular from US and Asian managers looking to continue marketing their strategies within the EU.
clients what they believe is an acceptable level of fees for their own end investors and then we help them to select the best strategies and managers to fit their framework.

“Fee level is obviously not the main criteria to select strategies and managers. In general, when we approach managers to act as sub-managers to these initiatives, we usually target those who are already familiar with the concept of liquid alternatives. They are quite open to discussing these opportunities and we tend to find that fees rarely become a sticking point,” says Spada.

Looking ahead

As market volatility returns, investors are looking for more defensive strategies to protect their portfolios from downside risk. This should act as a catalyst for MAP growth over the next 12 months. Amundi’s Hart says that investors are looking more at platforms to get exposure to emerging and mid-sized managers “because they need that reassurance that the MAP has control and transparency - daily look-through, T+1 risk reporting, etc, which is provided to the client on an aggregated basis, through weekly reports, as opposed to relying on monthly reports from the manager when investing directly. They need a safety net, just in case something goes awry with the manager.”

In conclusion, Lapkin thinks that another potential growth driver will be the need for active risk management, especially among FoHF managers as they look to enhance the transparency and risk reporting on underlying managers. This offers two potential benefits:

- The ability to improve portfolio construction – are managers working well together?
- Greater active risk management – closely monitoring correlations among managers in the portfolio, levels of beta exposure to the market, etc.

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Daniele Spada, Lyxor MAP
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Through a bespoke consultative-approach, Amundi partners with its clients to provide suitable, flexible and cost effective alternative investment solutions.

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Australia is next market for AIFMD-compliant MAP

Interview with Michael Hart

Amundi Alternative Investments was one of the first managed account platforms in Europe to become fully AIFMD-compliant. With approximately USD5 billion in assets, the Dublin-domiciled platform is perfectly placed to capitalise on growing demand from the USD2.02 trillion Australian Superannuation market for investment solutions that offer a clear value-add (and value for money).

At least this is the view of Michael Hart, deputy CEO and global head of business development for Amundi’s alternative asset unit. Having just returned from Australia, Hart says that the main concern of institutional investors is transparency and identifying potential conflicts of interest.

“The Australian government is saying that pension funds need to focus on the fees they pay. There can be no control over the outcome of an investment but there can be control at the beginning of an investment in terms of what is paid. That’s not an argument that the pension funds are particularly in agreement with. They might be paying X amount in fees for a manager delivering superlative performance but what the government is implying is that they should focus on the cheapest (but not the best) managers to invest with. I think this has rattled a few of them a bit,” says Hart.

And herein lies the opportunity for Amundi. It is extremely competitive on fees, and is probably one of the most cost-effective managed account providers. Not only can it address the fee issue, and deliver tangible value for money solutions without compromising the quality of managers, it can also help pension funds with respect to transparency and governance; two other important metrics that their performance is being judged on.

“This plays into our hands,” says Hart. “Unlike a lot of other fund managers, we have no conflicts of interest or even potential perceived conflicts of interest. We have gone down the AIFMD route with our MAP. We can’t, for example, use our own in-house prime broker. Instead, we have a list of 15 or so external prime brokers that our underlying hedge fund managers use.

“So our model is as ‘clean’ as it possibly can be and that should help us in Australia. When I explained what AIFMD is, and why Amundi had decided to go down that route, it was received extremely positively. As sophisticated investors, they are relatively agnostic in terms of investing onshore or offshore as long as they can get access to first-class managers and can benefit from a governance viewpoint.”

The Amundi MAP currently invests with 26 managers although the analyst and due diligence team have a wider universe of 80 or so managers that remain on the radar, should Amundi decide that one or more would fit with a particular client’s customisation requirements. At present, the 26 managers fit its clients’ specific needs.

“We are only as good as the managers we work with or research. The team in London search for new managers on a daily basis,” notes Hart.

One of the big advantages to a MAP is that institutional investors have greater transparency into how their investments are playing out. They can ascertain a particular manager’s sector exposure, country exposure (e.g. China over the summer, when its stock market lurched wildly), what the aggregate beta exposure is and so on.

As such, daily liquidity is less of a concern. According to Hart, institutional investors are more concerned with operational risk, governance, and accessing decent managers with a solid track record than having daily liquidity.
“With respect to Australian institutional investors, they want value for money and any managers that they invest with have to offer extremely competitive fees. It depends on the manager and the strategy they run but it is our job to negotiate, as hard as possible, on behalf of the client. We have to be seen to be adding value in as many areas as possible. It’s a competitive market out there,” comments Hart.

Manager selection is critical. Like US and UK pension funds, many of the Australian pension funds know the blue-chip billion dollar names in the industry and are quite capable of accessing them on their own. Where they want value from a MAP provider is accessing mid-sized and emerging managers. “With those, there is far greater business risk so you need to have robust due diligence and an experienced operations team, which Amundi has.

“We’ve also just onboarded Complus, which is a mid-sized global macro discretionary manager based in Hong Kong. We are the only platform they are on. They’ve got a 15-year track record, never had a negative year, but a lot of people are unaware of them. When I was talking to pension funds in Australia, a couple of them had heard of Complus and when we mentioned the fact that they had just joined the platform, they said that was exactly the kind of manager they were looking for. Being able to invest in managers like this via a managed account mandate, which reduces business risk, is very attractive to them,” suggests Hart.

Earlier this year, Amundi awarded a EUR50million mandate to Connecticut-based FrontFour Capital Group, a boutique event driven manager. The mandate was to develop an AIFMD-compliant version of the US fund, which has a track record dating back to 2006.

These are precisely the kinds of managers that global institutional investors want access to, and why they are increasingly turning to platforms to create segregated mandates to off-set the fact that mid-sized managers might not be as operationally robust as a USD1billion manager.

“Investors expect us to have a global reach and identify emerging managers and mid-sized managers in all regions, otherwise I’m not sure they would consider working with a platform like ours. They know what they want, many of them have extremely knowledgeable in-house teams and they are extremely well run. All the Australian Supers hire talented people within the industry to work for them internally. You really need to be on your toes when working with them, and bring something of clear value to the table; to help them either as an extension of their in-house team or to work on developing external mandates,” explains Hart.

Indeed, the majority of Amundi’s mandates are fully customised dedicated accounts for single investors. One of the advantages of the MAP is that it doesn’t have an umbrella structure, legally speaking. Every client is in a separate silo so there is no potential for contagion.

“Although it’s more expensive, structurally, for Amundi to do this, it is far safer for our clients. And again, this is something that has been well received by the Australian institutional market. If the client wants to move their investment out of one of the funds on our platform, or increase their allocation, it has no impact on the other investors,” adds Hart.

With market volatility returning with a vengeance in 2015, hedge fund managed account solutions are looking as attractive as ever. For those wishing to build a defensive position to protect against downside risk in their overall portfolio, hedge funds are a vital tool. In Hart’s view, there is no doubt that Australia offers huge potential as the pressure on fees paid by pension funds continues.

“It’s not going to happen overnight but I’m far more positive having now been to Australia and spoken to some of its institutional investors. In my view, Amundi ticks a lot of boxes for them. They have to justify why they intend to stay in hedge funds and to show they are obtaining value for money for their hedge fund managers.

“If they can demonstrate that they are using a platform where there are no conflicts – or potential conflicts – of interest, where the mandate is legally segregated and where fees are properly negotiated and demonstrate that they are following a code of best practice, that helps enormously,” concludes Hart.
Managed Account Platforms offer Solvency II relief

By James Williams

Solvency II regulation, which is aimed at European insurance providers to improve transparency on the cost of capital related to their underlying assets – think of it as Basel III for insurers – is set to make managed accounts an even more popular vehicle moving forward.

Due to be ushered in on 1st January 2014, the European Insurance and Occupational Pensions Authority (EIOPA) stated that the market wasn’t ready and that it should be pushed back two years. As such, the insurance community must now demonstrate a plan to demonstrate how they will be Solvency II compliant when the regulation comes into effect on 1st January 2016.

In France, meanwhile, the Autorité de contrôle prudentiel (ACPR) decided last year that all French insurers commence Solvency II-like reporting as a preparatory exercise for two years, leading up to the 2016 implementation date. This, says Sarj Panesar, Global Head of Business Development, Insurance, at Societe Generale Securities...
Services, lead to a number of clients to ask, ‘We invest in funds, we manage money ourselves and we also have capital allocated to managed account platforms, how can you help?’

“As a result, we built a Solvency II reporting solution. We collect underlying holding data from funds that they manage, take data from managers who manage segregated mandates and data from managed account platforms, which we then normalise. We bring all of that normalised data into our fund accounting platform, which is the same platform we use for mutual fund accounting across Europe.”

The reporting starts off with a tri-party template (TPT), which typically suffices for fund managers. Under Solvency II, however, this is just a starting point for insurers. “They will then say they want more data here, additional fields there, and so on. If the data is within our data repository, it can be reported upon. We deliver the data via our standard website called SGSS Gallery within which there is a report rights tool, whereby you can simply drag and drop various data points to construct a table and produce a report.

“If the data isn’t in there, we will try to source the data and create a customised report,” confirms Panesar.

Insurers are putting in place solutions to make more efficient use of capital in terms of how they manage their reserves within the constraints laid down by the regulator. Be it for hedge funds, real estate debt, infrastructure debt, or private equity, insurers will increasingly need to have consistent look-through capabilities on their underlying investments to ensure that capital costs - calculated by using the Solvency Capital Ratio (SCR) - are not too high.

“Simply put, Solvency II is another way of saying ‘transparency’,” says Daniele Spada, Head of Lyxor MAP. “One of the main reasons to invest in managed accounts is also that the client can segregate the assets allocated to a given manager and get full position-level transparency and risk monitoring. That helps insurers to calculate more easily and more precisely the capital consumption of these investments. By default, Solvency II says that if you put money in hedge funds without any specific model or transparent way of calculating the capital consumption of those investments, there is a 49 per cent cost SCR.”

“We have done the calculation on the managed accounts on our platform and there are only a few strategies that have a 49 per cent capital cost. Having the transparency really helps investors to determine more precisely the SCR at both the single fund level and an aggregated portfolio of managers. Regardless of whether they can invest in a single managed account - either segregated or commingled - or a portfolio of managed accounts, we can easily help them in the calculation of the SCR number.”

Martin Fothergill is Global Head of Hedge Funds for Deutsche Asset & Wealth Management. He notes that 2015 has been one of the best years for Deutsche AWM’s Alternatives & Fund Solutions (AFS) platform as investors continue to see the virtues of gaining exposure to hedge funds via managed accounts.

“The platform has attracted north of USD2.5 billion of inflows so far this year. Managed accounts per se, don’t solve the problem, but some of the features that MAPs can offer are a great solution for Solvency II,” says Fothergill, noting that Solvency II does represent a jurisdictional challenge for investors as, say, AIFMD does. He says that there are two approaches that investors can take for Solvency II.

“One is a transparency route: providing clients with the transparency and/or the SCR for them. That lends itself very well to managed accounts because of their inherent transparency. Second is more of a structuring approach where you can...
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The benefits of boutique MAPs

Establishing a hedge fund, let alone attaining the necessary investment track record to entice allocators, is a challenging proposition. The cost of setting up a hedge fund has skyrocketed amid growing regulation and investor demands for institutional-standard infrastructure. Citi’s 2014 Hedge Fund Industry Operating Metrics Survey estimated managers required a minimum of USD310million in AUM to ensure their two per-cent management fee covered all of their operational and regulatory overheads.

It is arguable this figure is too high, although most market participants would still put that break-even threshold between USD100million and USD150million. The problem is compounded as institutional investors are bound by strict risk mandates which contractually prohibit them from gaining excessive exposure to a single hedge fund. Building an investment track record is essential for any manager to solicit meaningful institutional capital. One of the biggest challenges new-launch managers face when exiting proprietary trading desks at major banks is that their former employers are often reluctant to disclose an audited track record of performance. Building a track record from scratch at a fund can take two years, and a lot of cost. Utilising a managed account platform is one way managers can build up an investment track record without incurring all of the regulatory and operational overheads that come with it.

Linear Investments allows emerging managers to leverage its managed account platform, enabling them to utilise multiple managed accounts, instead of building up a fund. This allows the manager to build up a track record, and grow its business so that eventually it can market to institutional investors and demonstrate solid performance.

One of the core benefits of this MAP is that it is wholly regulated by the Financial Conduct Authority and obviates the need for managers to go through various regulatory registration exercises, many of which can prove time-consuming and distracting to their day-to-day money managing activities. The FCA approval process can take upwards of six months, with huge amounts of documentation requirements and advice from legal counsel. This can be expensive, and an enormous burden when managers are trying to get their feet off the ground.

Linear’s Malta-based platform is also wholly compliant with UCITS and the Alternative Investment Fund Managers Directive (AIFMD), enabling managers to attain compliance without having to undergo the upheaval themselves. A study by BNY Mellon estimated initial AIFMD compliance for the average asset manager could cost anywhere between USD300,000 and USD1million.

Having a MAP to provide this regulatory umbrella for AIFMD and UCITS makes enormous economic sense. Furthermore, MAPs such as the one offered by Linear Investments will provide managers with pre- and post-trade risk management. This negates the requirement for managers to build or buy these systems or infrastructures internally, allowing them to focus on attaining alpha and developing a strong track record, which will help showcase their talent in today’s tough capital raising environment.

It is critical that emerging hedge fund managers are not stifled by their managed account platforms, a situation that can sometimes arise at banks.

Having a boutique MAP can allow emerging managers to gain access to investors that will actually allocate to them, such as family offices or High-Net-Worth-Individuals (HNWIs); organisations that Linear Investments has cultivated and has relationships with. As such, it is crucial managers look towards a provider which can offer them flexibility and high-quality service, and allow them to grow AuM to institutional levels.
effectively put a stop-loss into a client’s investment so that they only have a certain amount of capital at risk, and then the SCR is based on that amount of capital.

“Investors will have different views on those two approaches depending on their own specific needs,” explains Fothergill.

The structuring approach that Fothergill refers to involves using a total return swap arrangement within the managed account mandate.

Say an investor makes a EUR100million investment. Using a swap arrangement, they might only need to put down EUR20million to get that level of exposure. “This is the stop:loss or floor that I referred to, whereby you only have that amount of capital at risk. If your SCR is 49 per cent for hedge funds, but you’re only putting EUR20million ‘at risk’, then that dramatically reduces the impact of that 49 per cent SCR; it is based on EUR20million as opposed to EUR100million,” says Fothergill, who notes that when calculating the SCR for Deutsche Bank’s clients, the key is having transparency in the first place. This is achieved by using the same system for daily risk monitoring and reporting, and having data in a format that can be used across multiple accounts.

“This is the infrastructure challenge of running a successful MAP. You’re pulling in a lot of data, but it is the management and the cleaning of that data that has to be consistent across multiple managers and accounts. Once it’s all set up it’s relatively straightforward but the devil is in the detail,” says Fothergill.

Panesar says that one of the big issues in the alternatives space has been the lack of transparency in terms of providing investors with look-through capabilities; something that is vital for insurers (and potentially pension funds in future) and which explains why they have a preference for investing via a MAP.

“I don’t think the alternatives world has been adept at marketing themselves to insurance companies – it tends to be that insurance companies seek out fund managers rather than vice-versa,” says Panesar, who refers to a number of instances where insurers have decided to divest their assets from fund managers unwilling to disclose their holdings to those who are more Solvency II friendly.

“The platform has attracted north of USD2.5billion of inflows so far this year. Managed accounts per se, don’t solve the problem, but some of the features that MAPs can offer are a great solution for Solvency II.”

Martin Fothergill, Deutsche Asset & Wealth Management

“I spoke to the COO of a fund manager in March, who said that they weren’t interested in Solvency II because they had only had one insurance client. I saw him again in September and asked how it was going. He responded: ‘Well, I’ve now got about 30 insurance clients, and they’ve all come via platforms so we’ve had to do something’.

For MAPs to support insurance clients, it is important to provide a broad range of strategies that go beyond the usual suspects of equity long/short, global macro, etc, especially as institutional investors look for more exotic, niche alpha-generating strategies.

Josh Pickford is a director at London-based Sciens Capital Limited. He thinks that the industry is moving away from the traditional black box hedge fund investment model towards the requirement for full position-level transparency for many institutional investors. He says that Sciens’ risk management expertise has always been a core part of its offering.

“That comes from our long history and experience in asset management as a fund of funds, allowing us to define appropriate risk management for individual fund strategies. Something that platforms have been criticised for is focusing too much on equity and managed futures strategies, which are relatively simple to report on. We don’t stick to those strategies. We have a diverse line-up of strategies, such as aviation-focused, credit and structured credit, which are quite different to the usual strategies people associate with MAPs.”

Bringing an investor perspective to its MAP, and a well-honed risk framework,
Please explain what you think is driving the continued increase in demand for hedge fund managed accounts?

Andrew Lapkin: Institutional investors are under increasing pressure for their portfolios to generate returns to meet their liabilities or other investment goals. This task has become even tougher in the current investment environment, especially given historically low interest rates. As a result, hedge funds are an attractive option on the basis of returns with an expected lower correlation to other more traditional strategies. A challenge for many institutional investors is that investments in traditional hedge fund structures create a number of issues including a lack of control, transparency and independent governance as well as co-investor risk.

Joshua Kestler: These issues with investing in commingled hedge funds were highlighted during the Financial Crisis of 2008 which resulted in increased investor focus on a solution. The use of managed account structures provides a key mechanism for investors to address many of their key concerns with legacy commingled hedge fund structures. As investors have become more focused on control, transparency, governance and investment customisation, the industry has seen an increase in the use of managed accounts as a means to achieve those objectives.

Can you discuss some of the ways that hedge fund managed account platforms have evolved over the past few years?

Andrew Lapkin: A growing trend in recent years has been the adoption of Dedicated Managed Accounts (DMAs) by institutional investors. DMAs are typically single-investor funds established for the exclusive use of an institutional investor. DMAs allow an investor to maintain greater control over their assets, receive full position-level transparency and customise the account structure as well as specific strategies. Large institutional investors such as public and private pension plans and insurance companies have been the most significant users of single-investor DMAs as this option is better suited for those investing $100m or more in each DMA.

Joshua Kestler: Another trend that has been developing recently is the creation of customised managed account platforms or “multi-investor DMAs” by advisors and asset and wealth management firms. The first movers in this space were fund-of-fund managers who built customised managed account platforms which could be used to build portfolios exclusively for their clients. These multi-investor DMAs can be customised to meet the needs of particular clients or client segments. For example, DMAs can be structured onshore in an EU jurisdiction such as Ireland or Luxembourg to comply with AIFMD regulations or as a Cayman trust to appeal to the institutional Japanese marketplace. The use of DMAs also allows fund-of-fund managers to receive and provide a level of transparency across portfolios to meet clients’ risk management and, in certain cases, regulatory requirements (i.e. Basel III and Solvency II). Fund-of-funds typically allow investors to access their managed account platforms either indirectly via investment in their fund-of-funds products or directly as part of a discretionary or non-discretionary advisory mandate to build a custom fund of fund portfolio. More recently, we have seen some fund of fund managers allowing investors direct access to particular managed accounts while leveraging their due diligence and manager oversight processes.
As the investment manager, the sponsor will perform initial and ongoing due diligence on the sub-advisors and will provide ongoing investment and risk oversight for each fund based on the availability of position level transparency. This model is particularly appealing to investors who may not have the resources or desire to perform these functions directly. Investors may also benefit from fee reductions negotiated by the sponsor with managers along with improved transparency and client reporting, lower minimum investment amounts and the overall ease and efficiency of investing through a single platform with consistent documents and processes.

Are multi-investor DMA platforms being built and operated in-house at asset and wealth management firms or are certain functions being outsourced to third-party providers?

Joshua Kestler: The early fund-of-funds firms that adopted multi-investor DMA models had to build and operate their platforms internally as there were really no specialised managed account service providers at that time to support them. Over the past five years, specialised service providers like HedgeMark have emerged to support institutional investors in the development and operation of their own customised DMA platforms. Today, it is less common for a firm to internally build and operate its own platform.

Andrew Lapkin: It really comes down to basic economics - launching and operating an institutional quality managed account platform requires customised technology as well as a significant number of specialised staff. The required infrastructure is expensive and therefore is less scalable and efficient for a single firm to build that infrastructure when they can outsource key non-investment functions to a third party service provider. In the end, by working with a managed account service provider, these investors will have their private platform up-and-running more quickly while leveraging existing technology and experienced, specialist staff, and generally at a lower cost than if they had to build the infrastructure themselves.

Andrew Lapkin: This approach of allowing direct access to underlying funds is a good model for both private banks and consultants building customised multi-investor DMAs for their client bases. These large asset managers, wealth managers and other advisors can achieve economies of scale, improve the investment and risk management process and provide improved investor reporting by pooling clients’ assets to negotiate managed account arrangements with hedge fund managers.

The benefits of single-investor DMAs seem clear, but can you explain how mid-size and smaller investors benefit from multi-investor DMAs?

Joshua Kestler: Mid-size and smaller investors can potentially benefit from “multi-investor DMAs”. Multi-investor DMAs are organised by a sponsor – for example, a fund-of-funds manager, wealth manager or consultant. The sponsor will typically serve as the investment manager of each fund and will hire each hedge fund manager a sub-advisor of the relevant DMA fund.
should make Sciens well positioned to support Solvency II reporting, according to Pickford. He confirms that over the last 12 months they have added a volatility trading strategy, a European structured credit strategy, an event-driven strategy, an Emerging Markets strategy “and we are about to launch a Nordic power trading fund. We are able to establish the infrastructure for such funds precisely because we have that direct experience as an investor.

“A structured credit strategy has a very different risk reporting set-up and requires different data feed. As such, we have added data licenses on index / single name CDS and synthetic CDOs, for example, to effectively report on the underlying holdings of that fund,” confirms Pickford.

Aside from the full reporting and analytics service that SGSS provides for Solvency II, it also provides the SCR calculation; not just for investors, however, but increasingly for asset managers.

“Fund managers who are insurance company-friendly are putting together strategies that include an SCR. This indicates to the insurer that the manager is thinking about how they allocate their capital. They are thinking like their investors.

“The smarter ones are providing this SCR as part of the presentation pitch; performance numbers against benchmarks, VaR, but also the SCR number,” says Panesar.

Over the years, SS&C GlobeOp has built its administration platform to bring and capture data and publish it in multiple formats. This is helping it provide Solvency II reporting as part of its regulatory solutions capability.

As alluded to above, the SCR is a critical number for insurers in order to become capital efficient. This means that the quality and integrity of the fund data is paramount.

“We spend a lot of time and effort cleansing the data and making sure that what we publish is accurate,” says Colin Keane, Ireland Country Head at SS&C GlobeOp.

“We integrated into our systems the likes of Advent, which send us data that we clean and push it into our internal systems ready to be published to our clients.”

“For Annex IV reporting under AIFMD, we build a structure around how we populate it. The client gives us the data, the assumptions they want to use, and we then perform the calculations process for them. They then review the outputs of the report to make sure they make sense before approving submission to the regulator. It’s a very interactive arrangement that we have. We collate the information based on client and regulator requirements, and aim to make the AIFMs’ lives as straightforward as possible,” adds Keane, who confirms that a similar approach is used for Solvency II.

“One important point is that we can offer regulatory solutions as a bundled service or on an individual basis i.e. for AIFMD reporting, UCITS, Solvency II. “

Tom Kirkpatrick, SS&C GlobeOp

The transparency needs faced by insurers will probably apply to pension funds in the coming years,” opines Spada.

“If managers think it’s complicated putting all the data together for Solvency II, the complexity is only going to increase when European pension funds themselves require Solvency II-type reporting,” concludes Panesar.