Better control over fee structures and risk appetites

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An article by CNBC on 17th October 2016 revealed that New York state had paid hedge fund managers USD1 billion in fees over the last eight years. The New York State Department of Financial Services said pension investments in hedge funds had been a giant failure, resulting in USD2.8 billion in underperformance.

This is exactly the kind of negative press that hedge funds get tired of. At the end of the day, institutions should know exactly what they are buying, and how much it will cost, and enter into each hedge fund investment with eyes wide open. One billion dollars in fees is a significant figure, but ultimately investors have to take responsibility for the fees they negotiate and, more importantly, the managers they choose to invest with.

The fee issue will forever polarise opinion but one of the most effective ways to control fees is to use managed accounts.
“Amid low interest rates and a strong performing equity market, whilst few hedge fund strategies are outperforming but are providing diversification benefits, people will question whether the higher fee model makes sense,” says Peter Sanchez, CEO of Northern Trust Hedge Fund Services.

He says that while investors who choose to invest through managed accounts probably incur costs to set up a MAP or fees from joining an existing platform, “investors will potentially reduce the performance fees or management fee that they pay to the manager if they are delivering a significant capital allocation”.

Negotiating fees is precisely what managed account platforms like Man FRM, one of the industry’s leading platforms with approximately USD10 billion in AUM, will do on behalf of their large institutional investors; those looking to have their own dedicated structures.

Keith Haydon is Chief Investment Officer at Man FRM. He believes that one can control the expenses in a managed account much more effectively than investing in a manager’s offshore fund. “There are often extra chargeable items in a hedge fund that are not included in the headline fee (e.g. the hedge fund incurs costs for travel and research) but might be included in the small print. We would look to exclude the pass-through of costs.

“We have some funds where we don’t pay them a management fee at all, but we do pay them a higher performance fee after a 5 or 6 per cent hurdle. If a manager makes 6 per cent, I might not mind giving him a 30 per cent performance fee for any returns over and above that hurdle rate,” says Haydon.

Using managed accounts to negotiate fees should be exercised with caution, however, depending on who the manager is. If they are running hundreds of millions in AUM, Haydon’s reference to hurdle rates and higher performance fees is fine. If, however, they are an emerging manager with a modest AUM, stripping the management fee can be dangerous.

Bruce Keith is the CEO of InfraHedge, an open architecture MAP owned by State Street, which has seen its total AUM climb from USD19.3 billion to USD26.3 billion during 2016. He says: “Customised mandates make up the vast majority of the AUM with very few clients choosing to mirror a manager’s commingled fund.

“The main driver for large institutional investors choosing private managed account platforms is the desire for enhanced transparency and oversight of customised portfolios at a lower price point.”

**Performance woes**

The last few years have tested investors’ faith in hedge funds, as a broad asset class, with performance considerably lower than expectations. This, alongside the fee issue, has added to the negative perception of the industry. In an environment where hedge fund returns are not beating the S&P 500 and likely not beating bond portfolios in terms of returns and volatility, says Sanchez, “institutional investors will invest in hedge funds. If they get full transparency where, for example, they can manage style drift and leverage; if they are able to protect against fraud; if they can negotiate fees. That’s where managed accounts can give them improved transparency at reduced costs versus a normal LP investment.”

Of course, managed accounts cannot improve performance, per se. There is no secret sauce to using them. But what they can do is allow investors to more effectively monitor their investments.

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Using a MAP benefits emerging managers

Interview with Daniele Spada

Lyxor Asset Management runs one of the most well established MAPs in the hedge fund industry, having established it in 1998. It has seen a lot of hedge fund talent come and go over that time.

When it comes to investing in emerging managers, Lyxor is well placed to provide investors with the confidence, and assurances, needed. Whilst historically, emerging managers have tended to outperform larger established names – thereby making them an appealing alpha generator component to a portfolio – they often have less robust infrastructures. This is a risk for institutions.

As Daniele Spada, Head of Lyxor MAP, explains: “Using a managed account structure is now one of the main functions of a MAP in supporting institutional clients. If institutions want to look for new sources of alpha, they definitely have to look for small and mid-sized managers. We have had several discussions with large institutional clients who are asking us to help them select and perform due diligence on these kinds of managers.”

When institutions seek to build a portfolio of hedge funds, Spada says that given the portion of assets is often substantial it makes sense to assign a small percentage of those assets to smaller, up-and-coming managers who have yet to become household names. “The reason why they don’t allocate directly to these managers is precisely because their infrastructure is often a bit weak. They might not necessarily be experienced at customising their investments or risk guidelines for a large institution, and the level of reporting they provide tends to be quite basic; institutions expect to see a high standard in all of these areas.

“As such, they rely on MAPs like ours because we run what we call an asset management model. We do active manager selection and active investment and all the necessary operational due diligence,” explains Spada.

This is a key role of MAPs as not all institutions will necessarily have the internal resources to scout for talent and create manager wish lists.

“Our clients want to know what we think about the skills of managers, which we do when we run our investor due diligence, and also what we think in terms of operational due diligence; are there reputational risks that the client hasn’t seen? Is the manager’s infrastructure robust enough to support customised investments? We can answer these questions,” says Spada, confirming that most institutions invest using their own dedicated managed accounts.

He says that institutions prefer to use dedicated structures when accessing emerging managers for two reasons. Firstly, they have specific requirements regarding risk and investment guidelines and reporting. “Secondly, they usually want to allocate a significant amount of assets. This allows them to justify the cost of having a dedicated vehicle. Typically, a client will come to us and say they have X amount of assets to allocate. We then help them select the managers, validate the names, perform the due diligence, and then we run the vehicle.”

Lyxor recently selected a couple of emerging managers to add to the platform, which a large institutional investor decided to allocate to via a dedicated account, in addition to some existing managers on the platform. “For one of these managers the client decided to invest part of their allocation directly with them, through our commingled managed account. There are many different combinations available to our clients when it comes to investing in hedge funds,” concludes Spada.
“Once you have a consolidated view across managers, we find sponsors leveraging our platform to centralise the service model for things such as collateral management, cash and FX execution, etc. This leads to reduced costs, improved efficiency and drives net performance across their business,” explains Sanchez.

That ability for platforms to offer a consolidate view across investors’ traditional and alternative managed account portfolios can go a long way to helping them understand the drivers behind their hedge fund allocations and build a much clearer picture of where the best alpha-generating returns are coming from; this in turn can help institutions justify their hedge fund allocations to investment boards.

Use of carve-outs
One of the most effective ways of using managed accounts is to materially adjust a manager’s investment strategy to an investor’s particular requirements. This ability to customise a strategy is often referred to as a carve-out and it is something that Man FRM does for the majority of mandates on its platform.

Again, whilst this will not guarantee out-performance, a carve-out can at least provide the best possible opportunity to achieve a desired outcome.

Haydon points out that there is often a natural gap between what hedge funds want to produce when they are privately owned, and what clients want to buy. Managers want longevity and growth, there is a lot invested in the hedge fund and if it goes wrong it’s a disaster.

“For an investor, they might hold a diversified portfolio of 10 and 20 hedge funds and if one goes wrong it’s not a disaster, they just replace it with another one. So there is a different psychological view as to what a hedge fund represents to the manager and to the investor.

“The investor running a diversified portfolio may want much greater risk in the individual funds than a hedge fund manager wants to run in his own business. This constitutes a gap in the utility function and the appetite for risk, which can be hard to close without using managed accounts,” explains Haydon.

“The main driver for large institutional investors choosing private managed account platforms is the desire for enhanced transparency and oversight of customised portfolios at a lower price point.”

Bruce Keith, InfraHedge

Dial up the risk
The simplest approach to closing that gap is for the multiple fund investors to increase the risk level in the strategy they wish to allocate to. In many cases this is possible because hedge funds often don’t use all the capital that the investor places with them. Leverage tends to come from the instruments as opposed to borrowing money.

Take a CTA with a 10 per cent volatility profile. He may deploy USD15 out of every USD100 and the other USD85 might be held in T-bills.

“An investor could adjust the mandate at three times the exposure level, move it from 10 per cent to 30 per cent volatility and they would still have USD50 out of every USD100 sitting in T-bills to cover margin calls. The manager might not want to run a 30% volatility product for their private fund, but this can potentially be achieved using a customised managed account,” says Haydon. “We run most of our equity long/short exposure at 1.5 to 2 times the level of exposure that might be available in a manager’s flagship fund.”

By having a dedicated MAP, institutions are able to look at hedge fund managers as trading experts. “That means they are able to go after some of the smaller managers that can generate higher risk-adjusted returns because, from the operational side, they don’t have to worry about the risk of fraud, for example: they own the assets and are simply using the manager for his trading acumen,” says Andrew Lapkin, CEO of HedgeMark, a BNY Mellon company.

Discussing carve-outs, Lapkin comments that one of the benefits they offer investors is the ability to invest in a portion of a
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Dedicated managed accounts can overcome allocation concerns

Interview with Andrew Lapkin & Joshua Kestler

Large institutions face a Catch 22 when it comes to investing in hedge funds. On the one hand, despite performance having been muted for the last few years, institutions still broadly appreciate their importance as part of a diversified portfolio. On the other hand, negative media coverage that continuously compares hedge fund performance to the broader markets, not to mention continued questioning over exorbitant fees, means that institutions face external pressures to justify their allocations.

"What is interesting is that the major flows into hedge funds really seem to be driven by the super institutions such as public and private pension plans. Those are the same investors that are under immense pressure to justify the value of hedge funds in their portfolios," says Andrew Lapkin, CEO of HedgeMark, a BNY Mellon company. "These pressures are being driven more by political and emotional forces rather than rational investment analysis. The value of hedge funds is being questioned in part due to performance, but largely because of flaws in the traditional hedge fund investment structure including high fees, lack of control and lack of transparency."

The dedicated managed account structure really gets to the heart of these issues, shifting hedge fund assets into client-owned and controlled vehicles. The dedicated managed account structure allows investors to negotiate both the amount and structure of fees with managers. Helping clients setup and operate their own private managed account platform is what HedgeMark offers with its Dedicated Managed Account (DMA) solution.

"We feel that the DMA structure provides an opportunity for institutions to change the debate; to take control of their assets and demonstrate that they have a solution to specifically address the concerns that people are raising about hedge fund investments. Most institutions will say they don’t mind paying the 20% performance fee when the fund exceeds an agreed benchmark return. However, investors are getting frustrated at paying these fees in situations where their funds are trailing expected return targets" added Lapkin.

"A dedicated managed account structure allows investors to restructure how performance fees are calculated, for example, by adding a hurdle rate. This structure limits the performance fee to a percentage of net gains in excess of an agreed rate of return – allowing the investor to only pay for outperformance," explains Joshua Kestler, HedgeMark’s President and COO.

A recent CNBC article made a point of showing that New York State had paid hedge funds fees of USD1 billion over the past eight years. It added that New York State Department of Financial Services said hedge funds had been a “giant failure”, resulting in USD2.8 billion of underperformance for the two state retirement systems.

Not to suggest that using managed accounts can alleviate performance issues but they can go a long way towards addressing these negative sentiments; justified or not as they may be.

Most public pension plans still believe that hedge funds play a valuable role in their portfolios, but they are bowing to broader political and media pressure, which is causing them to either cut their allocation or eliminate their hedge fund book altogether.
“We believe that the response to the issues raised with hedge fund investments should be to use managed account structures as a means of addressing these issues. Our clients have had significant success in terms of reducing fees and developing creative fee structures that better align the interest of the investor with those of the manager,” confirms Lapkin.

That is only one part of the equation though. The other is that a lot of investors don’t understand that there are operating expenses within hedge funds that lie outside of the 2/20 fee structure. Service providers such as fund administrators, auditors and lawyers also have to be paid and many managers charge business expenses such as research, technology, travel, etc, to their funds.

But as Kestler explains: “One of the tremendous benefits of managed accounts is that the investor has complete expense control and complete expense transparency. They know exactly what expenses they are paying and the manager is removed from the process by which expenses get approved and allocated to the managed account. The client only pays for expenses which they have agreed to pay.”

Thanks to the transparency of its DMA solution, HedgeMark is able to provide its clients with daily performance information and performance attribution. Clients know exactly what’s driving returns down to the position level. Arming investment professionals with the tools to evaluate hedge fund performance is critical in helping them improve their investment decisions as well as the quality of their ongoing discussions with managers.

“Historically, it’s been extremely difficult to monitor and analyse managers,” says Lapkin, “because all you’ve had to go on is a performance number at the end of the month. You don’t necessarily know if the manager is really adding alpha. In the DMA structure, you can look at performance data every day and understand what the return drivers are, how a particular manager is correlated to other managers in the portfolio and so on. It takes hedge fund investing into a completely new realm of analysis.”

Increasingly, investors seem to recognise the value in managed accounts. However, the adoption of using these dedicated structures has been slower than one might have expected given the value proposition, largely because of the amount of resources it requires at a firm to implement such a solution. The staff and technology demands are prohibitive for pension plans and most other institutional investors. This has led to an increased demand for outsourced solutions.

HedgeMark specialises in supporting institutional clients in the development and operation of their own private hedge fund dedicated managed account platforms by allowing clients to outsource these non-investment functions.

“The investor can focus on what they do best, which is building the portfolio, selecting managers, negotiating key terms and is able to outsource the handling of non-investment functions. The same applies to the hedge fund manager. They can focus on managing the investment strategy without dealing with setting up the managed accounts, oversight of the administrator, review and approval of the NAV, etc,” Kestler added.

“Overall, outsourcing and the option it presents is key to the broader adoption of managed accounts and I think it will help the hedge fund industry because it empowers institutions to adopt a solution which addresses many of the issues with traditional hedge fund investments and changes the conversation back to the value add that hedge funds can bring to their portfolio,” says Lapkin in conclusion.
They might really like two thirds of a global macro strategy, for example, but may feel there is too much emerging market equity exposure, or too much credit exposure.

“By using a managed account, investors can tailor the strategy specifically using one of these carve outs, allowing them to exclude certain exposures that they may already have in their portfolio. Taking this tailored approach can also increase the willingness of the manager to do a managed account as it may be perceived as reducing the potential for cannibalisation of the manager’s existing commingled fund,” says Joshua Kestler, President and COO of HedgeMark.

He confirms that some of the more typical carve-outs HedgeMark has seen include changing the risk profile, echoing Haydon’s point, whereby an investor might want a more levered version of the strategy, or reduce the risk and use the strategy as a fixed income replacement.

“Being able to adjust the leverage profile to fit the investor’s investment goals is a powerful proposition for a dedicated managed account,” says Kestler.

Strategies that investors favour for carve-out purposes include CTAs, macro strategies and credit strategies, as well as tail-risk strategies.

“This is largely because investors want an effective way to hedge against market risk. Managed accounts work very well for these types of high convexity strategies because each investor is going to be slightly different in terms of the use of derivatives, etc.” adds Lapkin.

Management of liquidity

Dedicated managed accounts can also be used by investors to better manage their liquidity.

Where there is a mismatch between the liquidity of instruments in the vehicle and the liquidity terms that the investor has with the hedge fund, in such a situation people tend to be uncomfortable pooling their assets in a commingled vehicle. If other investors in such a vehicle decide to redeem, one might be left holding illiquid assets in the fund that cannot be sold in line with one’s liquidity requirements.

“Liquidity transformation can be abused on the part of the managed account holder and they may end up shooting themselves in the foot.”
Keith Haydon, Man FRM

They might then choose a managed account, with no carve-out, but at least they hold the assets and don’t have to worry about other investors redeeming.

“We might look at a strategy where 95 per cent of it is held in liquid assets, whereby we would be comfortable getting our money back within say 40 days following a market stress event, but the other 5 per cent is held in private markets. If we say to the manager, ‘We’d like to run a managed account so please remove that 5 per cent allocation,’ they often will. Straight away you’ve mitigated the problem of liquidity by doing that,” comments Haydon.

That is one of the reasons why so many managed accounts have failed to produce good investment returns because the liquidity transformation that has been imposed on the manager has been too strong: i.e. the investor wants daily liquidity in a quarterly liquidity strategy. The manager might end up with a much more constrained version of the strategy and any previous track record no longer applies

“Liquidity transformation can be abused on the part of the managed account holder and they may end up shooting themselves in the foot,” opines Haydon.

With MAPs continuing to embrace technology, they are helping investors overcome the very issues that often get sensationalised in the wider mainstream media: high fees, lack of transparency and so on. Moreover, with carve-outs offering a bespoke investment experience, there is a good chance that institutions will continue to invest and keep faith in alternative assets.

“Offering overlay FX management and aggregated collateral, cash and treasury management are unique ways for platforms to provide operational alpha. I would say that some MAPs are on the cusp of providing these capabilities,” concludes Sanchez.
Linear Investments allows emerging managers to leverage its managed account platform, enabling them to utilise multiple managed accounts, and avoid having to go down the costly route of setting up a hedge fund on day one.

“At this date, Linear has 105 active hedge fund/managed account prime brokerage clients live. Over the past three months we have brought on 10 new clients; five prime brokerage, one managed account and four hedge funds. We are actively in discussion with 12 new clients (two thirds based in the UK) who are thinking of joining the Linear platform, in addition to several early stage enquiries,” explains Jerry Lees, Chairman of Linear Investments.

Moreover, Linear’s Asset Manager joint ventures enable Linear to set up Irish, Luxembourg, Malta, or Cayman structures that meet UCITS and AIFMD directives.

In that sense, a MAP plays a vital role, not just for investors who want greater control and transparency over their hedge fund allocations, but for new managers who need a cost-effective solution.

As Lees explains: “In terms of regulatory set-up and technology set-up, if you are a small start-up manager it’s not worth setting up a hedge fund straight away. It makes more sense to set up a managed account structure because creating a hedge fund with EUR5 or EUR25 million will mean you are going to struggle from a cost/revenue perspective.”

There’s also not enough of a tax advantage to doing so. If someone launches a hedge fund with EUR10 million and the manager uses a 1/10 fee structure, for example, and they make a 10 per cent return in Year One, they are only going to generate EUR200,000.

“It’s impossible for small start-ups to stay in business without using managed account platforms that give them a lower cost alternative. The message we have is ‘keep it simple’. Run a managed account on an FCA regulated platform, with all the infrastructure support that comes with that: use of Linear regulatory capital, back office, compliance, risk management, regulatory reporting, transaction reporting, trade execution and clearing, IT systems and recorded calls/data, track record audit and so on,” says Lees.

Linear clients have the option of joining the platform as an Appointed Representative. This saves them a huge amount of time and money setting up their own regulated entity. The cost of complying with AIFMD is several hundred thousand euros and the AIFM is required to have initial capital of at least EUR125,000. Under the platform, Linear has covered these costs and capital distributed across multiple firms.

“We can get a new client up and running as an Appointed Representative in five to six weeks, for a fixed monthly fee, whereas it would take up to a year to apply for their own regulated license,” confirms Lees.

The beauty of this arrangement is that managers fully own the track record, which is recorded within Linear’s systems and can be audited. Then, if they are ready to set up a hedge fund two or three years down the line, they can take the audited track record with them.

“In short, we provide full operational support. We have 135 trading desks, technology infrastructure: everything is set up ready for them to start trading. They can use our regulated structure at a fraction of the cost of setting up their own fund,” concludes Lees.
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Speaking recently at a New York Hedge Fund Roundtable event, Robert Akeson, COO of Daewoo Securities (and the event moderator) was quoted as saying that small and emerging hedge fund managers, as a group, consistently outperform other managers. "However, as the physicists like to remind us from time to time, there are no free lunches...these managers are also known for their operational risk and many studies reflect that when these funds fail or disappoint it has a lot to do with operational risk," said Akeson.

This is a challenge that institutional investors must face as they increasingly turn towards emerging managers to add a bit of zest to their hedge fund portfolios. But there is a solution: the managed account platform. A tried and tested method, long used in the traditional fund space, for institutions to control the assets in managers they invest with, and at the same time benefit from enhanced operational transparency and liquidity terms.

Heinrich Merz is CIO of Amundi’s alternative investment unit. Amundi operates

**MAPs offer springboard for emerging managers**

Managed account platforms allow institutions to broaden out their hedge fund allocations and invest in emerging managers with confidence, thanks to the strong operational controls they provide. At a time when some of the larger established names have suffered performance issues, diversifying into a wider mix of unknown managers is becoming of strategic import to institutions. By James Williams
one of Europe’s leading MAPs with approximately USD5 billion in assets. He says that the ability of segregated managed accounts (SMAs) to manage the increased operational or due diligence risk of smaller and emerging managers is one of their key benefits.

“On balance, however, we emphasise the advantage of customisation to either enhance the alpha (e.g. focus on a manager’s key alpha generating strategies) or control risk (e.g. exclude strategies) that we perceive to have greater embedded tail risk of somewhat more established managers (i.e. not ‘day one’),” says Merz.

There are a number of different reasons for why investors wish to allocate to emerging managers. They might be looking for more performance from emerging managers because they are less constrained by overcrowded trades in the markets, or simply wish to gain exposure to more interesting, niche strategies that few others are looking at.

Also, if large institutions concentrate too many of their assets among the same universe of say the top 100 largest hedge fund managers, and returns aren’t great, it adds to the pressure of why they invest in alternatives and fuels some of the negative perceptions that exist with these vehicles.

Finding managers that might be young (in terms of track record) and small in AUM terms can give institutions a chance to really diversify away from their peers.

“It’s a learning curve for investors. It’s a change from what they’ve usually done so it takes time. In the beginning, clients who use our DMA solution tend to focus on trying to convert established managers. Now there’s a much greater focus to go beyond merely looking at large fund managers and consider smaller, talented managers,” comments Andrew Lapkin, CEO of HedgeMark, a BNY Mellon company.

“Using a managed account platform to access emerging managers is, generally speaking, not difficult because these are managers who are actively looking to grow their asset base. It gives the investor more comfort to allocate to them using the managed account structure for many reasons: managing risk exposures, style drift, liquidity, leverage and so on,” adds

“*When you look at the hedge fund portfolios of most large asset owners you see the same names over and over again.*”

*Joshua Kestler, HedgeMark*

Peter Sanchez, CEO of Northern Trust Hedge Fund Services.

Joshua Kestler is President and COO of HedgeMark. In his view, investors have become preoccupied with certain brand names of funds. “When you look at the hedge fund portfolios of most large asset owners you see the same names over and over again,” observes Kestler. “It is somewhat understandable as there is comfort in choosing the largest funds because it reduces reputational risk than if they invest with a smaller or lesser known manager. However, if most pension plans are invested in the same brand name managers and those managers perform poorly in a given year it brings down the image of hedge funds in general.”

Studies have shown that early stage managers tend to outperform later stage managers who have a lot of capital and find it hard to generate alpha as a result; they become asset gatherers.

As such, there can be benefits to branching out beyond the most popular hedge fund names in the industry and as Kestler is quick to state: “I do think dedicated managed accounts can give investors the comfort to do so. They don’t have to worry as much about the manager’s operational infrastructure and can take a chance on a smaller manager with strong investment acumen or pedigree. We’ve definitely seen some clients take this approach and have success with it, and their portfolios are performing well this year.”

Amundi’s Merz thinks that a significant degree of large manager underperformance over the last few years can be traced back to position crowding. He says that the position transparency that SMAs provide “allow our portfolio managers to manage crowding across portfolios more accurately”.

One could argue that irrespective of the
Consolidated IBORs deliver MAP transparency

Interview with Peter Sanchez

Managed account platforms (MAPs) vary in size and sophistication. At one end of the spectrum, the simplest MAP provides a separate ownership structure whereby a single investor invested in a MAP is required to manage each counterparty relationship with the administrator, the prime broker(s), OTC counterparties, FX counterparties, repo counterparties and so on.

The traditional fund of funds (FoF) investment model is structured so that the FoF manages the overall allocations into the hedge fund on behalf of the investor. However, transparency tends only to be provided on a monthly basis, and typically with a one-month lag.

In some cases, the level of transparency relies on third party risk or data aggregators, which provide varying level of granularity. Month-end data that managers typically send to independent aggregators is used to provide P&L, attribution and risk vector analysis to MAP sponsors providing this more basic level of transparency.

“The difficulty with this is the investor doesn’t get real-time investment management oversight nor are they able to monitor risk exposures, liquidity, leverage or style drift on an intra-month basis. More importantly, because they don’t get detail at a transaction level, it creates a problem of normalising position and securities data across managers,” says Peter Sanchez, CEO of Northern Trust Hedge Fund Services.

The problem that Sanchez refers to is that when MAPs or FOFs receive this data from third party aggregators, it is not normalised to account for a consistent valuation policy or risk model across all managers on the platform. Nor does it take account of intra-month changes that might not reveal spikes in performance volatility, or indeed shifts in liquidity or leverage.

At the opposite end of the spectrum, the third and most sophisticated MAP model is one that provides full integration across all managers, such that it enables the platform to provide near real-time transparency. These platforms focus on daily trade processing, reconciliation, daily risk and performance attribution reporting and are able to provide a consolidated investment book of record (IBOR), giving sponsors an holistic view across all managers and strategies.

“This approach also provides the opportunity to generate improved performance through an optimised treasury function – managing liquidity, financing, counterparty and FX exposure across multiple managers. Investors can also work with the manager to customise their exposure to particular investment strategies, with more or less leverage, or with a carve-out of a particular strategy to complement an investor’s overall portfolio,” says Sanchez.

Such platforms are well placed to support the ever-changing investment needs of institutions as they seek out managers running niche, idiosyncratic strategies in non-crowded areas of the market. Distressed debt, special situations, bank loan and direct lending strategies – many of which operate at the more illiquid end of the liquidity curve – are complex, and as such require the platform sponsor to provide sophisticated data management capabilities to provide investors with the requisite transparency.

Indeed, Sanchez points out that the most sophisticated investors seek to integrate ‘alternative assets’ data into their long-only portfolio decision-making process – a step which typically involves the MAP working with the investor’s custodian or data warehouse provider to create a holistic view of the risk and performance of the entire portfolio.

As a leading administrator, Northern Trust has built the technology infrastructure needed for MAPs to run the most advanced,
integrated platforms, with Sanchez confirming, “all of our MAP relationships involve providing daily capabilities.”

“We enter into a service relationship with the platform provider in a way that white labels our capabilities. We’ve just signed on with one of the largest institutional investor advisors in Europe. They are white labelling our risk and compliance and treasury capabilities as they prepare to roll out their managed account platform,” confirms Sanchez.

As hedge fund managers roll out new strategies with an even wider array of instruments, the ability for any platform provider to generate a consolidated IBOR is no easy feat. Again, only those able to deliver daily transaction and position-level data across the platform are in a position to do this. Northern Trust is uniquely placed to provide this capability because across its systems it only ever works with a single data set.

“We don’t have a separate equity system or bond system or OTC system, and we don’t have a separate system between our IBOR (middle office) capabilities and our accounting capabilities, known as ABOR. This is quite unique in the administration space. What this means is we are able to create an IBOR at any point during the day. The consolidation of IBOR across multiple managers and strategies is really what our system does in the context of attribution tagging,” explains Sanchez.

In order to extract value from a consolidated IBOR, MAP sponsors need integrated compliance, risk, performance and treasury tools that are derived directly from that golden copy data set.

One of the main reasons that institutions use managed accounts is because they allow them to manage their portfolio in an aggregated fashion. They can combine all of their different strategies across alternatives and align them with their investment objectives. And for the more sophisticated investors, they integrate their hedge fund managed accounts with their traditional long only investment portfolio of bonds and equities.

“This allows investors to know the correlation between investments in both portfolios; that is a powerful proposition, having a lens that can be applied across all of their external managers.

“I think transparency is therefore a critical feature of the managed account structure. It helps investors to manage the performance of the overall portfolio in an aggregated way across their long-only and hedge fund portfolios,” says Sanchez.

At the heart of any good MAP offering is quality of data. Not only does this refer to accuracy of data, but also completeness, timeliness and insight.

Sanchez views completeness to mean that all attributes of a trade are captured. This is especially true of complex assets such as IRS/CDS or structured products where missing economic elements can impede analysis of a portfolio’s true performance or risk profile.

Insight, says Sanchez, depends on the robustness of the data set. “The key is to give the investor the capability to do something with the data in a meaningful way like correlation to their other investments, liquidity management or concentration of positions. Using data normalisation tools allow investors to manage data in a productive way.”

That ability for MAP sponsors to provide genuine insights into the data they provide to investors is a powerful proposition. After all, investors do not want to receive massive data files every day that are hard to make sense of. Rather than reams of numbers, they want patterns, trends, data presented in reports and charts that summarise exposure levels by asset class and geography. That way, they can make quicker more considered investment decisions.

To perform the oversight and governance functions most effectively, Sanchez observes, sponsors are finding that they need daily trade level data that allows them to monitor exposures, style drift, performance attribution, risk and compliance in a meaningful way. “Even when investors do not expect to make frequent investment decisions, this level of granularity is necessary to provide accurate and complete information over time,” he says.

In conclusion, Sanchez believes there are significant synergies to platforms that have the ability to run off of a consolidated IBOR.

“They can net FX exposures, net collateral requirements and funding requirements of managers or offset currency balances across managers. Having that holistic view across the platform is one of the key value-adds a MAP sponsor can provide.”

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size of the manager there will always be some degree of enterprise operational risk. Such is the depth and variety of hedge fund managers that a five-person quantitative fund could well have a more advanced IT infrastructure than a 50-person equity long/short fund. What a MAP allows the investor to do, says David Young, President of Gemini Alternative Funds, LLC (‘Gemini Alt’), is remove operational risk concerns from their overall risk analysis of a manager.

“They can analyse managers based purely on the investment thesis and how they employ that thesis to generate returns. That is a huge plus, not just for young emerging managers, but small established managers. I’ve seen situations where pension plans won’t talk to anyone with less than USD500 million in AUM; there are an awful lot of high quality fund managers operating below that threshold,” comments Young.

Gemini Alternative Funds, LLC (Gemini Alt) operates an open architecture environment that facilitates the creation of dedicated managed accounts (DMA) for large institutions. The infrastructure is supported by Gemini Alt’s parent company, NorthStar Financial Services Group LLC (NorthStar), which has more than USD455 billion in AUM.

As well as the DMA platform, Gemini Alt also operates the Galaxy Plus platform, a CFTC and NFA regulated platform that provides a lower investment option to non-pension fund investors.

Young confirms that they are now currently in the process of launching a second platform, the Galaxy Plus Hedge platform, a MAP that will give investors access to a variety of hedge fund strategies to complement its CTA-focused Galaxy Plus platform.

“We already have four managers with investor seeding in place we are just working through all the legal documents. The aim is to broaden the scope of our offering. We have a strong Managed Futures platform and we want to achieve more balanced diversification for our investors,” adds Young.

The DMA platform covers any underlying trading strategy on either of the Galaxy platforms. Young confirms that Gemini Alt are currently working with a prominent US endowment that specifically wants to allocate to emerging managers.

“I’ve seen situations where pension plans won’t talk to anyone with less than USD500 million in AUM; there are an awful lot of high quality fund managers operating below that threshold.”

David Young, Gemini Alternative Funds

“One of the concerns they have is the infrastructure that these managers have in place. They believe that the manager can generate alpha but they want to make sure there is a standardised infrastructure that they feel comfortable with.

“Over the next year, this endowment is looking to launch 10 emerging managers through us on the DMA platform. They can have the manager focus exclusively on the trading strategy and use the platform to provide the operational infrastructure and control. They are choosing the single strand that they like most about the manager – the strategy – and using the platform to build everything else around that strategy,” says Young.

Given that there are 8,000 or more hedge funds to choose from, a high proportion of which are smaller and emerging managers, getting manager selection right when looking to build a dedicated managed account portfolio is crucial.

Daniele Spada is Head of Lyxor MAP. He says that being able to support its clients at the pre-allocation stage is one of the key features that differentiate the Lyxor MAP from other platforms.

“This is particularly important in the context of the market environment we see today. With hedge funds suffering this year, including some large names, it is important to be able to select managers, including, in this context, emerging managers.

“We are an asset manager and we actively select managers. Our approach, and ability to do research and due diligence, is crucial. It’s what institutional investors are missing and really need. Our business model is not a supermarket, distribution-type business model,” explains Spada.

Since the financial crash, there has been a
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Allocations to alternative investment strategies have continued to evolve as asset owners – in particular pensions, endowments and family offices – have become more knowledgeable about, and comfortable with, these strategies.

Direct investments into hedge funds, funds of hedge funds and alternative mutual funds are not meeting the increasingly complex needs of today’s institutional investors, where flexibility, tailored reporting, transparency and cost efficiency are key factors.

Today, asset owners are searching for the appropriate structure and relationships that will provide them with the services and controls that meet their individual, committee and board requirements. The need for more control and governance, reduced fees, increased transparency and flexibility is only expected to increase over time.

Acquiring and managing quality staff, staying abreast of technological demands and creating an infrastructure that maintains a strong control environment can add significant costs to the investment process. Maintaining a state of the art operational infrastructure requires every day focus on staff education and development, technology capabilities and advancements and continued testing of process and controls to mitigate non-market risks. These requirements are highly specialised and significantly removed from the investment process of research and trade execution.

Investing in alternative strategies through individual managed accounts is the ideal solution for asset owners; however, it also presents them with significant operational and administrative burdens. Investing in alternative strategies through individual managed accounts is the ideal solution for asset owners; however, it also presents them with significant operational and administrative burdens. In fact, it would be prohibitively expensive and highly impractical for most asset owners to create the internal operational expertise and infrastructure to effectively administer and manage a portfolio of managed accounts.

Service providers need to provide asset owners with the flexibility that they require. Oversight has dramatically changed and asset owners need depth and breadth of information to meet their own expanding reporting requirements.

Historically, an administrator might be viewed as an alternative in providing many of the requirements needed by asset owners. However, increased demands such as operational due diligence, cash management, risk management/monitoring, guideline monitoring and potentially strategy rebalancing are needs and services that may not be part of an administrator’s service offering.

Managed account platforms (MAPs) have been created to provide many of the services required by asset owners. MAPs are a logical evolution of the investment process, providing users with tremendous depth and breadth of services as well as confidence in the investment structure.

Asset owners have the ability to negotiate fees with advisors, maintain strong governance, utilise risk and guideline monitoring tools, have complete transparency of data and process, and receive timely and effective reporting. These attributes have become “must haves” for today’s asset owner, and the requirements will only grow over time. MAP operators need to be flexible enough to meet today’s requirements and have the ability to adapt to more changes.

Investments in alternatives have witnessed a unique evolutionary process. Long gone are the days of investing in an advisor and getting a ROR back every 30 days. Investors now require the investment to provide governance, transparency and ultimately complete control back to the asset owner. MAPs are the answer for accessing advisors in a structure that provides a solution to the needs of today’s investor.
polarisation in the marketplace. Investors have been looking for the same characteristics in a fund and the result is that assets have flowed to the top decile of fund managers. Spada agrees that investors should avoid to invest in the usual big names and “be a bit more open-minded and look for smaller and mid-sized managers – there is a lot of talent and different ways of running similar strategies in this part of the market.”

The same is true in the UCITS world. The concentration of assets in bulge bracket managers is very high. Most investors have invested in big names and funds that offer a lower range of volatility.

When it comes to taking a bit more risk and investing in less mainstream funds with higher volatility profiles, Spada says “there are not many investors that do this. We work to build portfolios of managers with our clients and we usually suggest allocations mixing large established managers in the core of the portfolio with a satellite of mid-sized emerging managers.”

The types of strategies that Lyxor has been looking at this year to source new managers, established or emerging, include: market neutral and variable bias long/short equity strategies; global macro, despite performance being a bit off this year; and event driven strategies. “They suffered last year but some are performing very well this year, at least on our platform,” says Spada.

“We believe that ‘day one’ investment carries significant operational risk: it takes time for a new investment team to bed down. As a result, we continue to maintain a high threshold for early stage/emerging manager investments whether through SMAs or otherwise.”

Heinrich Merz, Amundi

Amundi too helps to source lesser-known outperforming managers for its clients. “However, we also believe that ‘day one’ investment carries significant operational risk: it takes time for a new investment team to bed down. As a result, we continue to maintain a high threshold for early stage / emerging manager investments whether through SMAs or otherwise,” clarifies Merz.

He says that the emphasis at Amundi is on making the selection itself. “Nevertheless, in addition to other channels, we use our network of clients to source managers and have taken on portfolios of managers from clients.”

Platforms such as those operated by HedgeMark and Gemini Alt are slightly different in that they do not advise on manager selection. They provide the infrastructure solution that allows investors to invest safely and securely in managers that they themselves have a preference for.

“For hedge funds that join Galaxy Plus Hedge we will do background checks, analyse the investment thesis and make sure we have a strong understanding of how the alpha is generated and whether it is unique. Everything we are launching at the moment is investor-driven,” states Young.

Large institutions might use Gemini Alt’s DMA platform and onboard a series of pre-selected managers, following which smaller institutional clients have a chance to allocate to on one of the commingled Galaxy platforms. “Galaxy Plus and Galaxy Plus Hedge give them close to the same attributes that our larger institutions are able
to enjoy. Is the liquidity daily? No, it’s weekly. Is the transparency provided at the position level? No, it’s provided at the exposure level.

“But it’s still a better investing experience for investors than investing in the manager’s offshore flagship fund.”

Much is made of the investor experience when talking about using MAPs but what about the managers themselves? Such are the costs of setting up a hedge fund today that many emerging talents need an alternative solution. Whereas the MAP is an effective investor solution, it is equally an effective route to market for new managers who do not want the burden of running their own fund.

One such MAP is London-based Linear Investments, which provides a complete one-stop shop solution for those looking to trade their strategies and build meaningful track records; and in effect, catch the attention of investors for the reasons stated in this article.

“We work with a number of family offices and other investors who like early stage managers,” comments Jerry Lees, Chairman of Linear Investments. “Generally it doesn’t make sense to start properly marketing a fund until they’ve built a solid track record. As a rule of thumb, they have to have a full three-year track record. Investors don’t believe in back-tested performance, the real world doesn’t have the benefit of hindsight.

“When a new manager joins our platform we do not charge for a managed account, other than the normal brokerage/execution or financing of the positions. We turn over very large volumes in all sectors: fixed income, equities, futures and options. As a result we can offer some of the most competitive commission and financing rates in the market.

“Also, as part of the managed account platform, because we run all the middle- and back-office processes we can give managers full reporting capabilities. This means they don’t need to use an external auditor or an administrator, Linear can supply the track record, or provide the data to an external auditor.”

Linear helps managers on the marketing side using a suite of software packages that can analyse the performance of the fund, produce all the necessary outputs that an investor needs such max drawdowns, Sharpe ratio, beta, correlation and so on. Moreover, if the manager wants to raise capital Linear will summarise the fund’s statistics in a one-page report for distribution to appropriate seed investors.

“These documents sit within the capital introduction section of our website. We have around 20 factsheets on individual funds at the moment. It shows track records, fund performance, etc. We also distribute these out to family offices and contacts that we have, and that we know are interested in those specific strategies,” says Lees.

Such platforms are playing a vital role in bringing through the next wave of talent. Some will go on to run large successful hedge funds, others will fade away. But the fact that they have an incubation model available to give them a chance to succeed, and to hopefully attract institutional investor capital, is not to be underestimated.

“I would estimate that 20 or 30 Appointed Representatives on our platform have gone on to run their own hedge funds over the last few years.”

Jerry Lees, Linear Investments

HedgeMark’s Lapkin says:

“If investors are going to maintain their hedge fund allocations going forward they are going to have to look beyond the names that everybody has invested in for the last decade.”