Dedicated MAPs can improve hedge fund investing

Flexibility and ability to improve risk appetite

Enhancing investor access to niche strategies
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How dedicated managed account platforms can improve hedge fund investing

By James Williams

With market volatility always top of investors’ minds, the ability to assume greater control over a particular investment strategy using a managed account structure has grown in significance in the last few years. With markets due a correction, and investors keen to optimise the way they allocate to hedge fund strategies, taking a customised approach – as opposed to necessarily using commingled managed account platforms or ‘public’ platforms – continues to resonate.

This is playing to the strengths of dedicated platform operators, with the infrastructure expertise needed to meet individual client demands.

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 per cent of a strategy’s exposure to certain securities and keeping the rest.

One carve-out option, for example, could be to build a mandate that only has exposure to a manager’s top 10 or 20 investment ideas.
Another benefit of the managed account structure is that it allows investors who would not ordinarily invest in hedge funds gain exposure to managers in a more controlled and transparent fashion. The managed account is a more expensive option, but the upside is that investors get far greater insights into the make-up of the portfolio, rotating in and out of strategies as and when necessary.

**Customise carefully**

Achieving customisation in a dedicated platform solution, however, requires careful consideration by an institutional investor.

“Overall, I would say a large number of MAPs in the marketplace have become a lot more institutionalised and the service offering has become a bit more standardised,” comments Sam Thompson, head of the managed account platform business at Man FRM. “It used to vary across different platform providers but we’ve seen a general trend whereby, as the industry has matured, there has been a more consistent delivery of traditional managed account services.

“As we see increasing demand from investors to customise their hedge fund exposure, one of our core strengths is that as an allocator ourselves, we can offer a lot of add-on services to help institutions implement their hedge fund programme.”

Part of that value-add service, at least from Man FRM’s perspective, involves leveraging off of an extensive risk and investment team, both within FRM as well as the wider Man Group.

“For example, we’ve developed in-house a range of risk premia strategies with the AHL team and Numeric – two of our quantitative investment businesses. We feel the best client mandates that we have are ones where we work most collaboratively with the end client,” says Thompson.

If the nuts and bolts are all the same, what other elements around the edges does a platform offer to help implement an investor’s hedge fund allocation programme? The value-add services that Thompson alludes to might include manager selection, identifying investment ideas, helping manage portfolio exposures, etc.

“That’s what will set MAPs apart, going forward, and that’s what we remain focused on,” he says.

“Overall, I would say a large number of MAPs in the marketplace have become a lot more institutionalised and the service offering has become a bit more standardised.”

Sam Thompson, Man FRM

Taking a creative approach to fee structuring is particularly relevant. Not that platforms should attempt to second guess the managers they are working with. Ultimately, it is the investor that is looking to work with the manager to reach an agreement, when it comes to accessing specific parts of their investment strategy in a cost-efficient way.

As Thompson says: “It’s about making sure investors know what types of fees they should be paying for the exposure they are taking. Whereas commingled funds take a more blended approach to fees (to satisfy all investors), in a custom mandate the investor has more flexibility. The manager might agree to lower fees for more liquid sleeves of their portfolio, and higher fees for more capacity-constrained, illiquid sleeves.”

**Turn the risk dial**

In today’s low rate low return environment, having the ability to control how much risk one puts into an investment strategy is a substantial benefit; after all, it is the investor who controls the mandate; the manager is simply hired to execute on it.

“That is one of the significant benefits of our Dedicated Managed Account (DMA) solution,” says David Young, President of Gemini Alt. “People might want different amounts of leverage in the carve-out strategy. A client we are currently onboarding is just one example of the demand for customisation today. I don’t think it’s that uncommon. I wouldn’t say it’s as much as 50 per cent of our business but we do get a lot of requests for DMA solutions.”

“The ability to alter the amount of risk provided by individual managers is probably the most frequent request we
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Lyxor MAP to build on alternative UCITS demand

Interview with Daniele Spada

Next year, Lyxor Asset Management, one of Europe’s leading managed account platform providers, celebrates its 20th anniversary. Over that time, it has seen, and responded to, changing market dynamics. More recently, this has meant focusing on building out a larger range of liquid, regulated alternative UCITS funds on the Lyxor Alternative UCITS platform.

Offshore commingled and dedicated funds still dominate the Lyxor MAP, in terms of AUM (EUR13 billion), but the compass bearing has changed with respect to future evolution.

As Daniele Spada, Head of Lyxor MAP, explains: “Four years ago, the bulk of our managed accounts were a range of offshore commingled funds mainly selected for institutional investors. Over the past two years, however, the Lyxor platform has definitely changed in terms of its priorities as related to the products and services we offer clients. The level of assets on the offshore fund platform remains strong and we still have big names but interest among our investors has focused mainly on regulated UCITS funds.”

In addition, Lyxor’s investor base has shifted to a more balanced mix between institutional and distribution. More than just a managed account-based offering, Lyxor’s MAP has, says Spada, become a centre point of expertise, “providing clients with research, selection, products and infrastructure services in order to help them with fund investments across different asset classes”.

Lyxor has enjoyed great success since it started launching UCITS funds on the platform at the end of 2013. Over that period, the platform has grown to USD2.6 billion (compared to USD1.6 billion last year) and currently boasts 12 funds, nine of which are external managers including the likes of Winton Capital, Chenavari, TIG Advisors and Sandler.

“We have been pioneers in launching strategies that were not really mainstream, such as Chenavari, which is not your typical credit long/short strategy. We focus on launching funds that really are genuine diversifiers for our investors. We want to make a difference to existing offerings in the UCITS space, where long/short equity funds dominate the European space and try to find managers who are doing something a bit different who can complement our platform offering,” comments Spada.

As well as evolving the Lyxor MAP to bring on board single-manager UCITS, 18 months ago Lyxor launched an innovative multi-manager UCITS fund. The portfolio consists of a number of daily liquidity strategies and offers a novel upgrade to the pre-existing fund-of-fund model.

By virtue of using a single managed account framework to access a slew of funds, Lyxor has been able to reduce the investor expense ratio because investors pay only one layer of fees. “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.

This makes it 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. In the coming years, Spada confirms that Lyxor will probably develop its range of alternative multi-manager funds even further, in new asset classes.

All told, Lyxor has positioned its MAP such that investors can choose to invest in commingled offshore hedge funds, commingled regulated hedge funds (UCITS but also AIFMD-compliant funds to a lesser extent), a multi-manager UCITS fund, as well as leaning on Lyxor for segregated managed account solutions.
We’ve spent a lot of time this year investing in the services around the platform,” explains Spada. “Our role is not only to give investors access to a good menu of funds, it is also to actively engage in advising our clients and understanding their global asset allocations. Our advisory capabilities apply to investing in funds that we have on the platform but also in funds that we may select from the external fund universe using our fund research capabilities.

“Indeed, we have reinforced the fund transaction and research team so that today, we have the ability to select long-only fund strategies as well as regulated and unregulated hedge fund strategies.”

This is a critical point with respect to alternative UCITS funds. Some of Lyxor’s investors use this as a specific asset class that is kept separate from their traditional asset class investment considerations. However, around one third of clients use alternative UCITS within their traditional asset class portfolio allocation.

“They come to us perhaps due to the need to select a few equity long/short strategies to reduce the directionality of their long-only bucket. We may advise them to invest in one of the funds on our platform, or in an external fund that may meet their specific needs. With respect to UCITS funds, they don’t typically ask for dedicated vehicles. Most of the time they are fine investing in the commingled managed account,” adds Spada.

Over the next two years, the plan is to select another 10 single-manager UCITS for the platform to meet investor demand. “We still see a lot of interest in alternative UCITS. It looks like the amount of assets will have grown by at least 10 per cent by the end of 2017 so it’s still growing fast.

“There are many managers who were a bit reluctant to provide their strategy in a UCITS format – especially US managers – who are now increasingly getting in touch with us so that is a positive sign,” says Spada, confirming that quantitative strategies and alternative risk premia strategies are very much on the agenda. He expects the next fund launch to come from one of those strategies.

“In the alternative risk premia space the models are working a little bit better and the results have been quite satisfactory. We are ready to offer something in that space to investors. There is still more need for long/short equity funds using a market neutral approach, either discretionary and/or systematic. That’s another area where we will try to do more.

“Also, if you believe investors are getting nervous about ‘toppish’ markets, and central banks could pull back, then global macro strategies, which have suffered a bit in recent years, are probably the right strategy to take advantage of imbalances created by a light reversal in monetary policy. The fourth strategy area we are looking at for 2018 is event-driven,” outlines Spada.

At a broader level, Spada confirms that Lyxor’s ongoing strategy will be to continue to develop its ability to design customised solutions for its clients, be they single managed accounts or dedicated investment platforms.

“We will keep facing significant macro and market challenges in a framework of increasing regulatory pressure. Our customised solutions will enable institutional investors to address these challenges,” concludes Spada.
receive related to custom mandates,” adds Edward Lund, SVP Business Development, NorthStar Financial Services Group, LLC.

Manos Chatiras is Head of Multi Asset Products at Deutsche Bank. He says one example of customisation work this year was for an institutional client looking for a bespoke regulated vehicle investing in liquid alternatives.

“The investor wanted to achieve a diverse portfolio utilising the full universe of liquid alternatives, including more esoteric strategies as well as alternative risk premia, with the ability to monitor and manage capital ratios for the portfolio to meet their regulatory needs.

“Deutsche Bank built a customised solution which included investments in bespoke strategies designed exclusively for the mandate, as well as investments in a number of our existing liquid alternatives strategies. The solution also provides customised risk and position-level reporting to the investor and their hedge fund advisor to facilitate capital ratio monitoring and management,” outlines Chatiras.

Another benefit to having a customised platform is the infrastructure support that comes with it. Rather than focus on the costs of hiring internal staff, an investor outsources everything to the platform operator.

“The cost involved to building one’s own MAP infrastructure is significant,” says Young. “You need systems in place and people in place to run them. When you’re allocating to any hedge fund strategy, it’s not just the reconciliation of the data, it’s also reporting on that data.”

The CIOs of pension plans or endowments are often burdened with spending significant time on operational services. Using a platform provider, says Lund, “is a way for them to alleviate these burdens by using a standardised process, allowing them to focus on investment decisions”.

Scientific precision
Sigma Analysis & Management delivers turnkey infrastructure solutions for institutional investors. Boasting a team of quantitative specialists with academic backgrounds in physics, mathematics and computer science, Sigma’s value-add is the sheer processing and analytical power it brings to bear when looking at performance attribution and risk exposure in clients’ portfolios.

“We have programmers and trained physicists on staff with the expertise to build software that we use to deep dive into portfolios to determine style drift and alpha decay, as opposed to just doing correlation analysis,” comments Michael Rudd, Senior Director of Investments.

“We go a step further to really determine what the drivers of returns are and offer unique solutions to augment returns for clients. Our mission is to provide investors the tools to maximise the extraction of alpha from our custom managed account solutions, whether it is through enhanced portfolio monitoring, capital efficiency, or fee realignment.”

Show me the alpha
Customisation has the ability to improve the investor’s hedge fund experience, which ties in closely to the one issue that always seems top of mind: fees.

Provided the investor can see without ambiguity that the manager’s strategy – be it a carve-out or not – is working such that the returns are mostly alpha, and not mostly market beta, they are happy to pay performance fees; by they 20 per cent, 17.5 per cent; whatever the agreement.

“We hear more and more from investors that they are perfectly happy to pay for alpha but are left frustrated when they find themselves investing in a product where the manager isn’t able to clearly explain where the returns came from, in terms of beta or alpha,” comments Andrew Biggs, Director of Portfolio Analytics at Sigma.
LumX Group Limited ("LumX"), who has been developing and managing alternative investment programmes for over 25 years, is in the process of redomiciling the LumMap managed account platform, from Jersey to Ireland.

The purpose of this is to extend the platform’s capabilities such that funds on the platform are AIFMD-compliant and can be freely distributed and marketed to investors in the EU.

“The platform originated from our requirements as an asset manager,” explains Eric Bissonnier, CIO, Alternative Solutions, LumX Asset Management. “The aim was to better manage risks that are harder to control in a commingled fund format. If we have issues with some structural aspects of a manager’s fund – the obvious one being pricing, but also asset verification, and lack of transparency - we would prefer to go the managed account route.”

Operating the platform, and catering to traditional as well as alternative strategies, LumX is able to onboard managers with specific investment goals in mind. Historically, it has worked with complex, less liquid strategies “so that we’re not at risk of other investors redeeming if the strategy is having a tough time in the market, which could lead to knee jerk selling and force everyone to redeem”, says Bissonnier. “Managed accounts also favour discussions with managers to customise certain investment guidelines depending on the risk/return objectives of clients”.

The platform has been designed to meet high fiduciary standards of governance and is unique in the sense that it is fully integrated with LumRisk, a risk aggregation and reporting platform that gives LumX daily, position-level transparency on its investments.

“Clients rarely need to know position-level detail but they do like to have an aggregate view of the portfolio, and this is something the managers on LumMap are quite happy to provide,” confirms Bissonnier.

When it comes to pricing OTC instruments, investors in commingled funds must rely on the manager’s pricing models, trusting that these reasonably reflect realisable market values, and that published performance is not skewed by optimistic valuations.

Using platforms like LumMap, which provide fully independent valuations, tight control over mandate guidelines and limits, and direct verification of asset custody and ownership for each of its funds, this pricing risk is significantly reduced for the investor. “You need to have some oversight on this,” stresses Bissonnier. “Normally this should be done by the fund itself with independent directors, but in practice they will tend to rely on the manager’s input as they might not have the skills to price certain single securities. We have the expertise to model all types of securities in considerable detail, and the benefit of fully independent service providers”.

“I think the two combined – independent pricing and independent risk/guideline monitoring – means that the main areas of conflict of interest between the fund and the manager can be addressed in a way that doesn’t really cost more to the client. These are two key elements that differentiate managed accounts from traditional offshore funds.”
Bissonnier thinks this can make a big difference: “You’re not relying on the manager’s communication, in terms of what the risks are and how they represent them. You can make your own mind up by looking at the portfolio directly. This brings a lot of comfort to the investor. They can communicate with the manager on an equal footing as they already know what the portfolio’s risk profile is. They can talk about how they arrived at that position, and have a more meaningful discussion.”

He says that the future of LumMap is to make it available to any fund manager and asset owner who needs a bespoke structuring solution, whether that is under AIFMD or any other tailor-made structure with the required controls and transparency of a managed account.

“We have the capacity to understand the issues and to structure investment vehicles that are more consistent with how an investment manager would approach it, rather than, say, a custodian. That has clear advantages in terms of understanding strategies and the ability to structure funds for non-EU managers who do not have an investment manager in Europe. “To access the European market they want to partner with someone who has an extensive experience in researching and investing in their strategies,” says Bissonnier.

Indeed, there is a broader application to what LumX is doing. The first is to extend distribution, creating funds for managers based on investor demand.

Secondly, and more specifically, it will involve creating funds for managers in response to the regulatory requirements of their European clients. A third consideration is to leverage the platform’s umbrella structure to operate private platforms for single family offices.

As Bissonnier says in conclusion: “They want to have a simplified structure, where they have proper control of the umbrella in terms of fiduciary management, and a sufficient level of transparency that can be adapted, in terms of how and where members of the family office split their assets from a trust perspective.

“The structuring is a bit more complex but the machinery is the same.”

Investors are increasingly looking towards more illiquid hedge fund strategies in order to access illiquidity premia and thereby boost returns. Given the complexity of these strategies, having a partner that actively monitors the manager, delivers the requisite controls and transparency, and takes away the operational burden, has clear benefits.

Supporting managers who wish to access the European market and offer AIFMD-compliant versions of their strategy is equally beneficial and that is what LumMap provides.

“We are better suited to less liquid strategies compared to other platforms. We have historically been able to serve a short biased credit fund on the platform, trading long/short single-name CDS, as well as a levered loan fund, and a diversified event-driven fund with a distressed credit bias. Naturally, we have also implemented managed account versions for a number of long/short equity funds, and managed futures strategies,” illustrates Bissonnier.

This ability to provide a managed account experience for illiquid funds on LumMap is particularly appealing to those investors who are seasoned hedge fund investors. By providing up-front transparency on illiquid strategies – as well as liquid ones – in terms of what the portfolio looks like day-to-day, it avoids any unpleasant surprises if a strategy experiences turbulence.
“In 2017, that’s frustrating when rates are low and access to market beta is extremely cheap. The markets have gone north the last few years. So for a sophisticated institutional investor, they want to look for the ability to disentangle beta from alpha and are willing to pay for alpha.

“We take that very seriously and view it as a call to action. We have our own fee lab where we can go through any number of iterations of fee structures. We spend a lot of time looking at factors for return attribution analysis – if a fund says it is doing $X, but really it is only doing 0.75 $X and 0.25 $Y, is that what you, the investor, think you are paying for?

“Technology allows us to do a lot of sophisticated analysis on a portfolio to determine where those returns are coming from,” adds Biggs.

This is a vital consideration when partnering with a managed account platform provider. Control is the optimal word when using managed accounts. The more control one can gain by getting clear insights into a strategy’s performance, the stronger position the investor will be in to further negotiate on fees and ensure that their interests are aligned with those of the manager.

Technology developments have really pushed the dialogue forward in this respect.

**Engineering excellence**

Innocap has been very much at the forefront of innovation when it comes to structuring bespoke platform solutions for its institutional clients. If one thinks of Sigma as the role of the scientist, Innocap is the engineer. The more infrastructure solutions it works on over time, the more Innocap’s team sharpens its expertise.

“We are mindful in constantly working towards improving every single component of our platform, including our relationships with counterparties, in order to provide clients with a high-quality investment experience. Our approach is highly customisable. The degree of flexibility we can deliver to large asset allocators ensures our solutions are adaptable to their evolving reality. This is one of the main reasons why Innocap is selected as platform provider.

“Over time, we have built strong partnerships with some of the largest public pensions worldwide, which have given us a privileged view of both market trends and best practices,” comments Jonathan Planté, Manager, Business Development & Investor Relations, Innocap.

Because of its capacity to tailor managed account to allocators’ needs, Innocap is agnostic to the types of strategies to be onboarded on its platform. As Planté says: “We don’t focus on the denomination of a specific strategy but on the instruments to be traded.”

He continues: “We have experience in very illiquid assets. We are often asked if we have the capacity to deal with private equity strategies. If you think about it, the typical private equity fund is a buy and hold strategy implemented with OTC stocks. It’s not anymore complex for us than other instruments we are currently dealing with, such as non-performing loans, distressed or physical commodity.”

**Caveat emptor**

For all of the customisation benefits of a private platform, from granular analytics on performance and risk to carve-out options, creative fee structures and the ability to widen out the mandate to illiquid strategies with the same level of control and transparency, there are still risks involved.

Not all managed account platforms are necessarily created equal and there are some in the industry who feel much more investor education needs to be done. Especially for those who wish to have a dedicated platform.

One of those is Joshua Kestler, President and COO of HedgeMark. In his view, most of the top 10 platforms in the market offer totally different underlying services.
Man FRM (‘FRM’) is a leading provider of alternative investment solutions. Working with institutional investors worldwide for over two decades, we offer a comprehensive suite of innovative solutions, drawing on the resources of one of the world’s preeminent alternative investment groups. FRM is focused on the need to help investors maximize the benefits they receive from alternative investments. To accomplish this, we offer a range of hedge fund and liquid alternative investment options in a number of formats, including our sophisticated managed account platform.

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Custom managed accounts help optimise investors’ risk appetite

Interview with Sam Thompson

There is often a natural gap between the risk profiles that hedge funds want to produce, and what institutional clients want to buy. As such, there can be a different psychological view as to what a hedge fund represents to the manager and to the investor. An investor running a diversified portfolio may want much greater risk in the individual underlying 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.

Sam Thompson is head of the managed account platform business at Man FRM, a division of Man Group since being acquired in 2012 and whose MAP currently has USD14.2 billion of assets, as of 30th September 2017.

Thompson says that one of the potential benefits of a managed account is that investors can adjust the risk profile using notional funding, adjusting leverage, to help optimise their overall portfolio target risk.

“The majority of large institutional investors are using some form of risk budgeting at the portfolio level,” says Thompson. “They want to meet their portfolio risk target in the most capital efficient way, and managed accounts are a potentially useful tool for achieving this.

“At the moment, just over 50 per cent of the platform business is for dedicated managed accounts. These mandates have dominated new business this year.”

This demand is coming both from new client mandates as well as existing Man FRM and Man Group investors moving into or increasing their allocation to managed accounts.

Thompson says that many of the new mandates are from institutions that are significant allocators in the hedge fund space and are looking for dedicated managed accounts rather than to pool their assets with other investors. They want bespoke structures where they are the sole investor.

“That has a number of potential benefits that one traditionally associates with managed accounts – transparency, control, cost containment – but one of the main drivers behind wanting one of these structures is the flexibility it offers them to customise investment mandates.

“We’ve always thought of managed accounts involving some level of customisation. At the most basic level, most managed accounts impose some kind of risk constraints on top of a hedge fund manager’s strategy. If there are certain types of exposures that they don’t want, the investor will contractually restrict the manager in terms of what they can use in the mandated portfolio.

“For example, some of our clients – especially public pension plans – like to have their own dedicated managed account so that they can implement ESG factors such as restricted lists of stocks,” explains Thompson.

“Some investors will take customisation further than others but most have certain restrictions that their trustees or boards of directors insist on being applied. They are looking across their investment portfolios as a whole, they are not looking at hedge funds in isolation. By having a dedicated managed account solution, institutions can easily apply the same investment policies to hedge funds that they are using across their allocation programme.
“That helps investment committees justify and explain their hedge fund allocations to boards of directors and trustees,” adds Thompson.

There are two key drivers behind the increased use of dedicated managed accounts. The first relates to the opening point regarding risk appetite.

To expand further on this, investors want the ability to control how much they dial up or dial down risk in an investment strategy. This simply isn’t possible in a commingled fund where every investor is treated the same. Having a managed account is somewhat autocratic. The investor wants to be in sole charge.

“When you’re investing into a commingled fund there is dichotomy between the utility function that the manager has, in terms of setting the risk level for the fund, versus what an investor will receive. When structuring a comingled fund and establishing the risk profile, the manager has to consider doing so in a way that allows the fund to be marketed to a wide range of investors,” remarks Thompson.

Also, the individual manager has a large financial incentive in the fund’s performance. Having skin in the game is important but it can mean that the manager is at times incentivised to be more risk averse.

By contrast, if the individual hedge fund is just a small piece of an institutional investor’s total allocation, by default their risk sentiment towards the fund will be markedly different to the manager’s.

“For strategies like global macro, in order for investors to pick a manager that can potentially have a meaningful impact on their portfolio they may have to make a very large capital allocation because the manager is running a low risk profile. That is quite a capital inefficient process for an institution,” says Thompson.

The second key driver for customised mandates is that they allow the investor to explore carve-out strategies that stand a better chance of meeting their return expectations. Part of this, says Thompson, is that at the larger end of the investor spectrum there are much bigger illiquidity budgets than other investors might have.

“When you are looking at an individual manager’s commingled fund, they oftentimes have to restrict the percentage of the portfolio that can go into illiquid assets. Whereas actually an investor might think this manager has great expertise in sourcing and managing those types of investments. By having their own managed account, they might decide to make those investments a much larger percentage of the portfolio, in order to take the illiquidity premia.

“In other cases, a certain strategy or trade idea within a manager’s portfolio becomes constrained by the least illiquid or capacity constrained part of the portfolio,” adds Thompson.

As a crude example, a manager may have five strategies in the portfolio and has set guidelines such that each of those five strategies cannot be more than one fifth of the portfolio. If one strategy (the most capacity constrained) can only have USD100 million allocated to it that limits the overall size of the portfolio to USD500 million.

Even though one of the strategies might be able to take capacity of up to USD1 billion because it is trading highly liquid securities, as the manager is capped by the less scalable part of the portfolio they can only allocate USD100 million.

“As a result, there is excess investment capacity that a manager is not able to monetise. That presents an opportunity for managed account investors to customise their mandate with this manger to access additional exposure to their more scalable ideas and potentially at a lower fee.

“Having a carve-out strategy that is designed to take advantage of that spare or excess capacity in the more liquid scalable trade ideas, using bespoke fee terms, is something that makes up a large proportion of the customised accounts we have on the platform,” concludes Thompson.
“How do we as an industry come up with a best practice model that investors use as the standard service offering necessary for operating a managed account platform? Right now it’s all over the place.

“Some platforms offer more of an investment solution, some just provide data and risk aggregation technology, and others are offering a funds-of-one solution, which means the manager maintains primary control over operations rather than the platform. Unfortunately, the industry has done a very poor job at educating investors about what they need and what they should be looking for in a managed account provider,” argues Kestler.

Even when the client has created a private platform, and is the sole investor, there can often be too much reliance on the underlying manager. This is not what a custom MAP is meant for.

“The role of the manager really has to be restricted to trading the portfolio,” asserts Andrew Lapkin, CEO of HedgeMark. “They shouldn’t be involved in pricing, they shouldn’t be moving cash. So many investors and platforms still end up delegating operational functions to the manager, which severely diminishes the control benefit of having a managed account. We believe that the number of platform providers that offer a suite of services which allow investors a true private managed account platform is still quite small.”

Planté says that some MAPs are operated by service providers outsourcing some key services, making it difficult for clients to assess the real cost of using a platform.

“As platform provider, we believe that full transparency on cost is a must, especially while drafting prospects’ proposals. Total cost of launching a managed account as well as charges to be incurred by the fund, during its life, should be clearly stated to allocators fairly early in their platform provider selection process.” states Planté.

“The best advice I can give to an investor is spend as much time as possible evaluating the differences between platforms, try to define what is important to you, and then make sure the platform you choose is able to deliver the required services.

“The last thing an investor wants is to be overburdened because the platform they choose requires the use of unexpected internal or external resources, or because they’re not getting what they thought they were paying for. We see that as a real issue going forward, as a result of lack of investor education,” concludes Kestler.

“Unfortunately, the industry has done a very poor job at educating investors about what they need and what they should be looking for in a managed account provider.”

Joshua Kestler, HedgeMark
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Managed account structures: ultimate flexibility

Interview with Andrew Biggs & Michael Rudd

It is fair to say that Sigma Analysis & Management, based in Toronto, takes a uniquely quant-focused approach to the way it operates managed accounts. Founded in 1999 by Professor Luis Seco, director of the Masters of Mathematical Finance programme at University of Toronto and RiskLab, and David Rudd, past Chair of the Montreal Exchange Futures Committee, Sigma was designed to assist Canadian public pensions in analysing their hedge fund investments.

Originally based in the Fields Institute for Research in Mathematical Sciences, and comprised of a team of individuals with PhDs in physics, math and computer science, Sigma has grown over the past 18 years to become an investment manager whose quantitative strength is now complimented with top tier global investment, operational and legal expertise.

True to its risk management roots, Sigma’s growth has been purposefully strategic. Unlike some other managed account providers, Sigma has remained a boutique firm, wholly employee owned, which allows it to operate as a true fiduciary to its clients. By avoiding the conflicts presented by being part of a larger conglomerate, Sigma is able to act independently on behalf of the client in establishing a structure with the appropriate service provider relationships and maximum flexibility.

“Since 2006 we’ve focused on building out a turnkey solution for investors and working as a trusted partner,” says Andrew Biggs, Director of Investments. “We focus on being hands on and mindful of the client’s needs. That bears itself out in terms of how we approach managed accounts. It ends up being a very bespoke product that we build for our clients.”

Its quantitative bend and independence has allowed Sigma to bring an unrivalled expertise in risk management and analytics to the managed account experience, delivering customised investment solutions to institutional investors.

Notably, it has been working with institutional investors since 2006, delivering multiple custom managed account platforms that have provided the investor with enhanced transparency, control and capital efficiency, of which have led to a greater understanding of alpha generation as well as the implementation of many innovative fee methodologies.

“From our perspective,” says Michael Rudd, Senior Director of Investments, “transparency is the starting point. While managed accounts bring many ‘defensive’ capabilities, Sigma’s guiding principle has always been that managed accounts should also be used ‘proactively’, to extract additional alpha via smart risk management. For example, in the defensive bucket I would put liquidity, position and style drift monitoring, and in the proactive bucket I would put fee discussions, and alpha extraction.”

“Sigma has built technology to pinpoint exactly where the returns are coming from,” says Rudd. “We can summarise and aggregate position level information to come up with a meaningful understanding of returns in portfolios.” By getting to the very heart of an investment strategy to ascertain where the returns are coming from, investors now have technology that allows them to distil a more meaningful understanding of a manager’s strategy and managers appreciate the enhanced dialogue that investors can bring to the table.
“We developed a proprietary suite of tools to gain transparency into the portfolio, dissect strategies, etc, and this has really helped us to better understand managers’ investment strategies,” continues Biggs. “Having access to that type of information and having high quality data, which is one of the bigger challenges across MAPs, sets us apart in the marketplace. The trading, programming and mathematics backgrounds we have allow us to be an active fiduciary and trusted advisor to our clients as opposed to simply providing a structure.”

This enhanced transparency and Sigma’s proprietary tools have also borne themselves out in helping create structural alpha through smart fee arrangements. Leveraging the capabilities of its own internally-developed Sigma Fee Laboratory or “Fee Lab,” Sigma has been able to analyse fee structures to determine the appropriate arrangement for both the client and the manager. “We have found that the enhanced transparency of managed accounts has resulted in long-lasting partnerships between investors and managers,” says Rudd.

In addition to transparency, Sigma has also maximised the benefits offered by the managed account structure with respect to capital efficiency. Sigma has developed highly capital efficient structures, which are particularly beneficial to institutions in today’s protracted low rate environment.

For example, rather than fully funding hedge fund investments, Sigma’s platforms are able to access the same level of risk allocation for investors at a fraction of the capital required in direct investments. This provides investors not only capital efficiency but an opportunity to reduce overall fund costs. If an investor chooses, excess cash can be put to work by using a variety of hedging overlays with futures and other derivative instruments.

“Investors can be more proactive in terms of developing alpha generating strategies that are more capital efficient, and managed accounts open the door to overlay trades, rather than making a full capital allocation to a fund or account,” explains Rudd.

In running capital efficiently platforms, Sigma takes control over collateral and counterparty risk management.

“We take care of collateral management and we handle the allocations to all the different counterparties, making sure there is enough margin to hand for each investment strategy. We are able to minimise counterparty risk from that perspective by limiting the amount of capital at each of the counterparties to what is needed to run the platform, as opposed to holding excess cash balances” says Biggs. “Considering that most service provider costs are based on AUM, this allows strategies to be run much more efficiently. The cost savings can be material, making managed accounts a must-consider for all institutional managers.”
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. Whatever the reasons, using separately managed accounts are one of the most effective tools for institutional investors. And a way to break free of the shackles of investing purely in blue chip names.

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 hedge funds at all, adding fuel to the fire of negative perception that exists among political parties and the wider media.

Of course, the minute an institution uses a dedicated managed account it renders the “Why are you investing in a hedge fund?” argument obsolete: all that matters here is the investment strategy. A hedge fund is just the legal structure wrapped around it. Access to the manager’s adroit stock picking skills or global macro expertise: that’s all an investor cares about.

In that sense, it also renders irrelevant the size of AUM the manager is running.
But, importantly, in this low rate environment, investors want the confidence to go out and invest in the next best emerging manager(s), and in a way that avoids commingled risk and concentration risk.

**Ticking the boxes**

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.

And in that regard, the managed account structure ticks all the boxes.

“We are having discussions with a large institution who wants to optimise its allocation to emerging managers,” confirms Eric Bissonnier, CIO, Alternative Solutions, LumX Asset Management. “They don’t have to be dependent on what might be a small infrastructure that the manager is running. They can put that to one side; all they want is to access the manager’s trading skills.

The time to market to do this is very quick, once the investor has set up the platform structure.

“We have also had discussions with emerging managers who have come to us to discuss joining our platform but we haven’t implemented anything yet.”

As Bissonnier rightly states, if you can solve the transparency and risk monitoring issue for one hedge fund, you can solve it for pretty much any hedge fund (established or emerging). This has a lot of value.

“With regulatory requirements as they are, and reporting obligations being extended, you can’t just hide behind the complexity. You have to solve that complexity, and a managed account platform inherently achieves this,” he adds.

**Regulated funds provide even more reassurance**

The ability to access emerging managers in a managed account needn’t be reserved to those wishing to have dedicated mandates. Commingled platforms, such as those operated by Lyxor Asset Management and Gemini Alt, provide just as much control and transparency on the underlying manager(s), giving investors a managed account experience and the reassurances that there will be no undue operational risk.

Lyxor has pushed the innovation envelope recently, focusing on building out the Lyxor Alternative UCITS Platform to give access to managers (both established and new challengers) in a regulated fund format. There are currently 10 single-manager UCITS on the platform, with a further 10 scheduled to be added over the next year or two.

“We’ve been doing this since 1998,” says Daniele Spada, Head of Lyxor MAP. “Our model and the way we help our investors has evolved with their needs over time. We provide a lot of services to our investors in addition to the products we offer. We are able to help institutional investors do whatever they need from research, selection, advisory to infrastructure services, in order to help them with fund investments across different asset classes; everything is in compliance with their risk management policies and in line with what their investment committee is looking for. Every time there is a market dislocation, we help them understand what the risks are and if they need to take action.”

That is especially important within an emerging manager context. Even if the manager has a blip, and their strategy goes through a down period, managed account investors are insulated from the risks of other investors potentially redeeming en masse, in the offshore fund, in turn eroding performance gains.

“We really help investors from A to Z. We have structured the platform in a modular way so that they can pick the products or services they need to build their investment solution,” adds Spada.

Lyxor sees itself as much more than a fund selection platform. It is, says Spada, a

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**“With regulatory requirements as they are, and reporting obligations being extended, you can’t just hide behind the complexity. You have to solve that complexity, and a managed account platform inherently achieves this.”**

*Eric Bissonnier, LumX Asset Management*
BNY Mellon’s HedgeMark specializes in supporting institutional clients in the development and operation of their own private hedge fund dedicated managed account platforms.

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Private platforms –
The future of hedge fund investing

Interview with Andrew Lapkin & Joshua Kestler

Hedge fund managers often argue that taking on separately managed accounts can place an additional operational burden on their teams. As a result, many managers may resist investor requests for managed accounts.

A new breed of outsourced managed account solutions now exist which allow institutional investors to build their own private platforms while also reducing the operational burden on hedge fund managers. One of the leaders in this field is HedgeMark with its Dedicated Managed Account solution.

“We build and operate private platforms for our clients, independent of the hedge fund managers. The role of the managers is limited to trading the portfolio,” explains Andrew Lapkin, CEO of HedgeMark, a BNY Mellon company. “Historically, managed account platforms were used almost exclusively for more liquid strategies such as managed futures and equity long-short. Platforms were generally not equipped to operate complex strategies. As a result, many managers would refuse to offer a managed account because they felt that their strategies were too complex to be supported by the client or a managed account platform.”

“HedgeMark has designed our platform to solve this problem,” Lapkin further explains. “We operate many credit strategies, complex global macro and derivative-based strategies for clients. Many of our staff members have prior experience working on the operations and accounting teams at hedge funds and therefore, have the skills necessary to support complex hedge fund strategies. We have also developed proprietary operations technology to automate and scale the operations and accounting functions necessary to support managed accounts across varying strategies.”

“Our ability to operate a broad range of hedge fund strategies in a managed account helps our clients minimise manager concerns over whether their strategy is too complex for a managed account structure,” Lapkin argues.

This is good news for both asset managers and asset owners. Asset managers are using managed accounts to deliver more customised solutions to their client, thereby increasing their ability to raise capital. Asset owners such as pension plans now have a means to negotiate reduced fees and customise hedge fund strategies while investing in a controlled way, limiting the fear of fraud and eliminating co-investor risk.

HedgeMark continues to see an increase in the rate of adoption of dedicated managed account structures by large institutional investors. Discussing this, Joshua Kestler, HedgeMark’s President and COO, says that “asset owners aren’t necessarily getting a lot of bang for their buck when they use commingled funds”.

“With a managed account”, he says, “it allows them to negotiate reduced and custom fee structures and achieve greater transparency, among other benefits.”

Kestler also adds that, “in addition, there is currently a public and political stigma when a public plan invests in hedge funds. Public pension plans are therefore facing pressure because ‘hedge funds’ have increasingly become a political target.”

“The term ‘hedge fund’ really refers to an investment structure rather than an investment strategy,” Kestler states. “By using dedicated managed accounts, institutions can avoid certain flaws of the commingled investment structure and access a particular investment strategy in a more controlled manner. The investor takes control of the
investment structure and the manager is strictly hired to trade the strategy. The investor’s ability to reduce and customise fees also helps address a major issue which has become a political focus.”

“This is one of the reasons that pensions and other large institutions continue to adopt their own private platforms for hedge fund investing,” comments Kestler.

Asset managers, particularly Fund of Hedge Fund (FoHF) businesses, have been under a great deal pressure to evolve over the last decade. Much has been made of the high fees and low returns that broadly diversified FoHF products have served up, not to mention the lack of flexibility: investors don’t necessarily want an off-the-shelf product, they want customisation.

As investors increasingly demand custom solutions, FoHF have begun to develop their own private managed account platforms to deliver such solutions to their clients. The flexibility of a managed account structure allows FoHF to provide investors with custom strategies, increased liquidity, transparency to meet regulatory reporting or other needs and solve for other investor requests. Managed accounts have allowed FoHF to evolve their businesses to offer additional value to their clients.

“There’s generally been more urgency among the asset managers to utilise managed accounts as an investment tool than among asset owners. We would like to see more pensions develop their own platforms in the near term, but we do think that over the long term, the private managed account platform will become the standard model for large institutional investors to access hedge funds,” argues Kestler.

There are various drivers as to why an investor may wish to have their own private platform. Investment customisation is one key driver. For example, an investor may want to take advantage of a specific market or co-investment opportunity or they may want to explore carve-out opportunities with certain managers to tailor their return profile.

Fees are also a major driver for investors using managed accounts. “Everyone wants to lower fees and expenses as much as they can,” says Kestler, “but many investors are also looking for ways to restructure the fees to better align the investor’s interests with the manager. That could be anything from utilising hurdle rates to a performance or management fee-only model; we see investors negotiating a wide range of fee structures.”

Transparency is also a key driver to managed account adoption. Early users of managed accounts viewed the availability of daily transparency as a way to better manage risk. “Now,” says Kestler, “the transparency offered by a managed account is also becoming a portfolio management tool.”

“Investors are realising that managed accounts can improve their ability to manage a hedge fund portfolio, not only by enhancing manager oversight but also by allowing the investor to better analyse whether they are getting true alpha from a particular fund. Transparency allows large institutions to better understand, evaluate and challenge managers,” comments Kestler.

According to Lapkin: “Every manager should drive returns in isolation but you also want to look at it from a portfolio context. Certain funds provide even greater benefits when you factor in that they might not be using a lot of risk within the context of a portfolio (and the investor could then choose to dial up the risk, if they needed or wanted to).”

“Another transparency driver is the regulatory component. We are seeing that certain investors around the world, including insurance companies, need transparency on their hedge fund holdings if they are to continue allocating to the asset class,” explains Lapkin.

One final consideration that might explain the continued adoption of dedicated managed accounts is the control aspect. Investors want to remove the co-investor risk associated with investing in commingled funds. The last thing an institutional investor wants is to have their investment behaviour impacted by redemptions from other investors. At some point a manager might sell its more liquid positions or fire sale less liquid positions to meet redemptions, negatively impacting the fund’s liquidity profile and/or performance for remaining investors.

“By having your own managed account, you control the decision to redeem and the ultimate time horizon of your investment. If you want to be a long term investor, you don’t have to worry that other investors are going to force you to redeem,” concludes Kestler.
fully integrated centre of expertise, offering different types of strategy (offshore funds, Alt UCITS, traditional long-only funds) under a single roof. First, its fund analysts advise clients on the benefits of switching from one type to another.

“Second, our technological capabilities mean clients have access via our website to the latest performance and risk analytics. Third, our fund analysts can help clients analyse the sources of performance and can advise, for example, whether they are better off in a multi-strategy fund or in separate individual strategies.

“Fourth, our buying power helps us negotiate competitive fees for investors. Fifth, we incentivise top fund managers to offer their strategies in an Alt UCITS format as they know we can help them access clients. In summary, the platform gives clients access to different types of fund but it's also a research, advice, reporting and client servicing centre,” explains Spada.

**Operational risk is not a risk premia**

One could argue that irrespective of the 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 asset allocators 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.

Some in the industry believe it is not only beneficial to use managed account structures to access emerging managers; it is a necessity.

Jonathan Planté is Manager, Business Development & Investor Relations, Innocap. He says an institutional investor’s business is not to take operational risk.

“Operational risk is not a risk premia for which allocators are going to be compensated. By investing through a managed account, allocators remove most operational risk from their balance sheet. For this reason, MAPs are quite appealing for allocators seeking exposure to emerging managers. It enables their access to specific investment alpha while benefiting from
GEMINI ALTERNATIVE FUNDS

Gemini Alt continues to expand MAP capabilities

Interview with David Young

It has been a watershed year for Gemini Alternative Funds, LLC (Gemini Alt), as it continues to see interest among large allocators - pensions, endowments - that look at the managed account platform, and specifically Gemini’s Dedicated Managed Account (DMA) solution.

The DMA infrastructure is supported by Gemini Alt’s parent company, NorthStar Financial Services Group, LLC (NorthStar), which has more than USD685 billion in AUM. As well as the DMA platform, Gemini Alt operates the Galaxy Plus platform - a CFTC and NFA regulated platform - that provides a lower investment option to non-pension fund investors, and also the Galaxy Hedge platform, which gives investors access to a variety of hedge fund strategies to complement its CTA-focused platform.

“We are currently onboarding two household names onto our DMA platform and Galaxy Plus platform. Private banks have become more prominent with respect to their interest in using platforms like ours (to service their HNW clients),” explains David Young, President of Gemini Alt.

When Galaxy Plus was established in December 2014 it was designed to onboard CTAs to meet investor demand at the time. Things have evolved since, as asset allocators seek to use managed accounts for a wider range of hedge fund strategies.

“This year we’ve extended the Galaxy platform to onboard more hedged equity managers,” says Eddie Lund, SVP Business Development, NorthStar. “For 2018 we are already starting to vet some illiquid, PE-type strategies to reside on Galaxy. The idea is as we continue to grow we want to support investors in their investment choices. We are seeing those choices migrate towards hedged equity as well as private equity strategies.

“If the market pulls back, which people expect to happen at some point, managed futures could come back to the fore. Everything is cyclical. Money will probably flow back to CTAs and this might then prompt us to add more of those managers to Galaxy.”

With both the commingled Galaxy platform and the DMA platform, Gemini Alt is able to offer the investor marketplace both standard and customised exposure to hedge funds. Both platforms are able to provide operational efficiencies.

“Over the last 12 months, we’ve seen demand from investors for smaller, less established managers where they can have better third-party oversight and control of the operational elements; not because there’s an issue with the manager, the investor just wants greater operational comfort by using a platform,” adds Young.

The DMA business is approximately USD1.1 billion, confirms Young, adding that he is currently onboarding a number of mandates and expects AUM to double in the first six months of 2018 and triple by the end of 2018.

Gemini Alt’s team provides independent due diligence on the underlying advisors on an ongoing basis. “We monitor for any negative news and perform guideline monitoring on a daily basis to check what is going on in the portfolio. We make sure that the strategy remains in line with the investor’s expectations,” says Young.

Another element of good governance is standardisation of information; the ability to invest across a large number of advisors and pull all that information to one single location.

As Young concludes: “Having a focal point to pull everything together and provide a uniform view of the portfolio brings significant benefit to the investor and ensures that all the underlying managers are adhering to the investment guidelines.”
“Because of the transparency and the investment guideline controls that can come along with a managed account, investors may have more confidence in making an investment in an emerging manager.”

Andrew Lapkin, HedgeMark

“Because of the transparency and the investment guideline controls that can come along with a managed account, investors may have more confidence in making an investment in an emerging manager if they determine that the platform has the proper controls and oversight in place. We’ve had discussions with a few emerging managers about working with them to deliver managed account solutions. Investors are likely to see a benefit from having a managed account solution with BNY Mellon providing the infrastructure behind it. This approach may help emerging managers overcome one of the hurdles of capital raising.”

Joshua Kestler, President and COO of HedgeMark

An effective marketing tool

Moreover, as more large hedge funds hard close due to capacity constraints they don’t need to offer managed accounts whereas emerging managers are far more willing to do so. After all, many of them are still in asset gathering mode.

“It removes much of the operational due diligence focus that investors would otherwise have on those managers,” says Andrew Lapkin, CEO of HedgeMark.

“The institutional governance framework offered by well-established managed account platforms can be important for emerging managers, as some of them may not have the scale or resources for institutional infrastructure.

Expanding on the point made above by Planté regarding operational risk, Manos Chatiras, Head of Multi Asset Products at Deutsche Bank, offers a bank platform perspective. He says that many of Deutsche Bank’s institutional partners want to invest in emerging managers “but are only willing to do so through our managed account framework, precisely to mitigate any potential operational risk. The set-up benefits managers as well as investors – emerging managers can gain knowledge and experience while working with Deutsche Bank.”

One could argue that the managed account structure in a way frees the mind of the institution. For too long, allocations have gone to the top 100 hedge fund managers, largely to protect reputations and follow the herd. Why risk investing in a manager with a 1- or 2-year track record, even if he is posting impressive uncorrelated returns?

A managed account frees the shackles. It gives investors the confidence to strike out and access the best, most exciting trading strategies. They don’t have to worry about what the manager’s fund looks like, what their pricing policy is, how much AUM they have. Any risk is transferred from the fund to the platform itself.

An effective marketing tool

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