Managed Accounts

Taking back control?

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Managed accounts: taking back control?

The managed account industry has thrived since the 2008 crisis, as more and more investors have been attracted by the flexibility, cost-efficiency and customisation that managed accounts can provide. Initially seen as a way of enhancing transparency and liquidity, managed accounts are increasingly playing a key role in the broader reshaping of the hedge fund industry – in terms of alignment of interests, fees, alpha, improved governance and more customised approaches to investing – at a time when all investors and managers are under pressure to demonstrate value for money. In this special report, Philip Moore assesses the effects of the managed account boom for investors, managers, providers and platforms – and examines where the next areas for growth and innovation might be

The notion of taking back control may have become an overused political mantra over the last 12 to 18 months. But in the investment management universe, investors have been urged for several years to exercise stricter control over their allocation to alternatives. The need to do so was painfully exposed during the crisis, when hedge funds were shown in many cases to be opaque and illiquid, and in some well-documented instances, susceptible to mismanagement or even fraud.

KMPG explained in a 2015 report: “This led to increased demand from investors for greater transparency, liquidity and asset segregation, in order for them to better understand the investments hedge funds were making. It also led institutional investors to demand greater control over their hedge fund investments and not be subject to the liquidity provisions and co-investor risk of commingled structures.”

It was this demand that turbo-charged growth among managed accounts providers and platforms, which began to see their assets mushroom after the crisis. Since then, they have sent out a tub-thumping rallying cry aimed at enlightening institutional investors about the benefits of managed accounts designed to provide them with bespoke and cost-effective solutions for managing their exposure to hedge funds.

David Young, *president, Gemini Hedge Fund Services and Gemini Alternative Funds*

Those benefits are all associated with giving investors the flexibility and customisation they need to exercise more control over their investments, which is generally not available in co-mingled vehicles.

In that sense, managed accounts function like the next generation of fund administrators. This was explained in a recent update written by David Young, president of Gemini Hedge Fund Services and Gemini Alternative Funds (which together with Gemini Fund Services make up the Gemini Companies). These are wholly-owned subsidiaries of NorthStar Financial Services Group LLC (NorthStar), which has some $560 billion of assets under management and administration.

NorthStar’s dedicated managed account platform, Gemini Alternative Funds, was launched in November 2013. Currently, NorthStar’s managed account assets exceed $6 billion. “Historically, an administrator might be viewed as an alternative in providing many of the requirements needed by asset owners,” Young noted in the paper. “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."

More broadly, it is generally recognised that managed accounts give asset owners stronger governance over their exposure, together with enhanced transparency and, critically, enhanced liquidity, often with daily redemptions. They also generally offer institutions reduced fees on the underlying fund, as well as the benefits of notional funding, allowing them to leverage their investment.

The mechanics of what is generally known as a dedicated managed account (DMA) are straightforward enough, although they differ slightly on either side of the Atlantic. The US model generally allows an investor to open a made-to-measure account with a manager which is appointed to make and execute an investment strategy on its behalf, based on the investment objectives and restrictions determined by the investor.

Perhaps the simplest way of understanding the dedicated managed account model is the role it plays in separating investment and non-investment functions. "In the pure DMA model, the hedge fund manager's role is to trade the portfolio in the manner he or she has been contracted for, while the non-investment functions are handled by a managed account provider," says Andrew Lapkin, chief executive of HedgeMark.

Wholly owned since 2014 by BNY Mellon, HedgeMark is a specialist in structuring, oversight and risk monitoring of hedge fund investments. In 2016, HedgeMark saw its assets under management rise by 6.8%, from $8.8 billion to $9.4 billion, of which $5.8 billion was accounted for by DMAs.

"This separation of responsibilities means that all the non-investment functions, ranging from moving cash to accounting oversight, fund operations and co-ordination of audit and legal are handled by the managed account provider," adds Lapkin. "To us, the definition of a true managed account is where there is a complete shift in control from the hedge fund manager to the investor, which takes place via the managed account provider."

WHAT WE ARE DOING IS ENABLING THE MANAGER TO SPEND HIS TIME EXECUTING HIS INVESTMENT STRATEGY BY RELIEVING HIM OF THE BACK OFFICE PROCESSING ASSOCIATED WITH IT
KEVIN HESSELBIRG, GEMINI COMPANIES

Others agree. "We're not trying to supplant the investment manager in any shape or form," says Kevin Hesselbirg, CEO of the Gemini Companies. "What we are doing is enabling the manager to spend his time executing his investment strategy by relieving him of the back office processing associated with it."

VIVE LA DIFFERENCE?

In Europe, the managed account platform launched by Lyxor in 1998 differs slightly from its US counterparts, although it offers an almost identical end-result, giving investors enhanced control, liquidity and transparency. "The main difference between our platform and those in the US is that when we talk about managed accounts we are referring to funds," explains Daniele Spada, head of the managed account platform at Lyxor in Paris. AUM on the Lyxor platform rose from $7.44 billion in October 2016 to $11 billion in April 2017.

"In the US," Spada adds, "a managed or separately managed account refers to a trading account with a bank or broker which replicates the strategy that a given client requires. Those trading instructions will then be followed by the managed account platform which provides all the monitoring, reporting and analytical services on top."

"In our model, clients are investing in a Lyxor fund which is governed by a specific and well-defined regulatory framework which is clearly set out in the prospectus," Spada explains. "In the case of a UCITS this is generally Irish regulation, while for offshore funds it is mainly Jersey law. But in all cases the fund is monitored to ensure it remains compliant with the given regulatory framework."

Spada recognises that there are pros and cons associated with the models on either side of the Atlantic. "The US model may sometimes be quicker and easier to put in place, but large institutional clients generally prefer the protection and enhanced risk management offered by real funds." Although the bulk of Lyxor's institutional clients are in Europe, the platform has also attracted a significant number of large US institutions.

Spada says that the Lyxor platform offers exposure to co-mingled as well as dedicated, customised managed accounts, and that there can sometimes be an overlap between the two. "Our dedicated managed accounts are usually structured for a single investor," he explains. "Sometimes, however, the investor may agree to open the strategy to other investors, in which case we would issue the same strategy in the form of a separate share class."

The range of customised services provided by the platforms means that although DMAs are associated predominantly with hedge fund investment, there is no reason why they should not be applied to other strategies, says Jonathan Planté, manager of business development and investor relations at the Montreal-based Innocap's platform. Jointly owned by BNP Paribas and National Bank of Canada, Innocap has seen assets on its managed account platform climb past the $5 billion mark this year, and expects to see its assets double over the next three years, according to Planté.

"People believe that long-only strategies and long-biased private placements are easier to structure and monitor than hedge funds," he says. "I would question that assumption. When you invest in illiquid strategies, many of the services that managed account platforms can offer are as useful for these portfolios as they are for hedge funds."

Lyxor's Spada agrees that the idea that managed accounts are only relevant for alternative strategies is fast becoming outdated. "At the moment we don't offer managed accounts for long-only strategies," he says. "But we have started to provide research and selection advice on long-only funds in response to growing demand for integrated platform solutions."

"What convinced us to do this was the recognition that the growth of the market for alternative UCITS is driving a process of convergence between the traditional mutual fund world and the hedge fund universe," Spada explains. In this world, he adds, there is a clear symbiotic relationship between an investor's allocation to long-only and hedge fund strategies which is making the analysis of exposure to either asset class in isolation increasingly redundant.

AT THE MOMENT WE DON'T OFFER MANAGED ACCOUNTS FOR LONG-ONLY STRATEGIES. BUT WE HAVE STARTED TO PROVIDE RESEARCH AND SELECTION ADVICE ON LONG-ONLY FUNDS IN RESPONSE TO GROWING DEMAND FOR INTEGRATED PLATFORM SOLUTIONS
DANIELE SPADA, LYXOR

"It is essential to have an understanding of a client's overall needs, and to propose solutions based on those needs that are adapted to the prevailing market environment," Spada adds. "Because there is little value in looking for alpha strategies when markets are beta-driven, or vice versa, is it important to remain strategy-agnostic. This is why we believe that in order to be credible, over the longer term we should offer institutions a platform which provides a single entry point for long-only as well as hedge fund strategies."

RISING INSTITUTIONAL DEMAND

Although they have overwhelmingly been targeted at institutional accounts, with $100 million generally recognised as the minimum required in a single-investor hedge fund DMA, the concept of managed accounts need not be the exclusive preserve of the largest asset owners.

It was the perceived gap at the smaller end of the market that led in 2014 to the establishment by the Gemini Companies of Galaxy Plus. This is described by the Gemini Companies as an alternative strategy platform launched to provide investors, regardless of investment size, with an institutional-level investing experience in strategies ranging from managed futures to commodities, real estate, hedge funds, foreign equities and derivatives contracts.

"The Galaxy Plus platform was built with many of the same attributes as the DMA platform, but is targeted at smaller pension funds and endowments, as well as family offices and high net worth individuals," says Young. "So it is for investors looking to allocate as little as $100,000 or $1 million, rather than $50 million or $100 million."

Although Galaxy Plus is a welcome initiative in broadening their scope, the key driver of the recent rise in demand for managed accounts has been the recognition of their potential advantages by institutional investors. "Over the last 12 to 18 months, we have definitely seen more of an uptake among institutional investors embracing the concept of managed accounts and putting them to use," says Michelle McCloskey, who since March 2017 has been president of Man Group Americas and Man FRM.

Man had $88.7 billion of assets under management at the end of March 2017, of which around 80% was accounted for by institutional investors. Its global alternatives specialist, Man FRM, had $14.5 billion AUM at the same date, with $10.3 billion in its managed account platform, which was launched in 1998.

McCloskey says that strengthening institutional demand has been especially visible in the US recently. “If you look back to just after the crisis, it was largely the European institutions that began implementing strategies through managed accounts,” she says. “It took a little longer for the majority of institutions in North America to take on board how managed accounts could assist them in their hedge fund investments in a variety of different ways.”

Although managed accounts have grown in popularity in recent years, platform operators recognise that there is plenty of room for further expansion and innovation. When Kevin Hesselbirg was appointed CEO of the Gemini Companies in April 2017, his predecessor was quoted as saying that Hesselbirg shared the group’s “commitment to partnering with clients to achieve their goals and challenge the status quo”.

Hesselbirg explains that this challenge to the status quo is on two levels. First, it is based on the creation of managed account services that differentiate themselves with existing products through integration and an open architecture. “Having been at two fintech companies before joining the Gemini Companies, I believe that there is scope for building a technology-enabled environment to change the way investors address the challenges they face,” he says.

Second, it is aimed at promoting increased institutional allocations to alternative strategies via managed accounts. “One of my fundamental questions is that if DMAs are as cost-efficient as we believe them to be, why aren’t more investors using them?” Hesselbirg asks.

This is one reason why NorthStar continues to channel substantial resources into distribution. “Most managed account platforms are focused on attracting new managers rather than new assets,” says Eddie Lund, senior vice president of business development at NorthStar Institutional Sales. “We believe the RIA community has been under-serviced in managed futures specifically, and in alternatives more generally. So we built a team aimed at leveraging the strength of our relationships with about 1000 RIAs to promote increased allocations to alternatives.”

Kevin Hesselbirg,
CEO, Gemini Companies

NORTHSTAR’S CORE STRENGTHS HAVE ALWAYS BEEN GATHERING AND RECONCILING DATA, AND REPORTING PERFORMANCE
DAVID YOUNG, GEMINI HEDGE FUND SERVICES AND GEMINI ALTERNATIVE FUNDS

VARYING DEFINITIONS

Precisely quantifying institutional allocations to hedge funds that are handled by managed accounts is notoriously tricky, for a number of reasons. One of these is that different end-investors describe their allocation to hedge funds in different ways. While some give a very granular breakdown of their exposure to each hedge fund strategy, others simply bracket their allocation within a broader alternatives category.

Another reason is that definitions of managed accounts can themselves be fuzzy, which HedgeMark’s president and chief operating officer, Joshua Kestler, describes as a serious problem for the industry.

“We’re in the dedicated managed account business, which means we’re creating and operating private platforms for institutional investors,” he says. “Our business model is different from many of the other solutions in the marketplace. Many of these are provided by fund of funds businesses and these firms typically offer more of an advisory service or investment product. Many providers rely heavily on the underlying hedge fund managers to continue to perform operational functions such as collateral and cash movements. Other firms merely offer data aggregation and reporting and present themselves to clients as managed account providers. Our business focuses exclusively on providing a comprehensive solution for asset owners and asset managers to outsource the non-investment functions associated with setting up and operating a private managed account platform. As a BNY Mellon company, we are uniquely positioned to scale this type of service with the necessary people, processes and technology.”

Kestler adds: “Because there are so many firms claiming to be managed account providers, a potential client can look at five or six providers which they believe offer a comparable service, but actually each offer a completely different set of services. This is in contrast to areas like custody and fund administration where services are fairly well-standardised and the differentiators between firms are the quality of their people, processes and technology. In the managed accounts space, there is still a tendency for consumers to assume that they are receiving the same product from all providers, which is problematic for the industry."

Confusion over definitions in the managed accounts universe has in part been created by products or services which share some of the features of managed accounts without providing the same overall level of control.

Take, for example, the Fund of One, which as Kestler explains, removes co-investor risk by being custom-made for single investors. That may look hunky-dory on paper, but as a structure it would have provided no safeguards against Madoff risk. "If you are investing through a Fund of One, the fund is generally still set up and controlled by the hedge fund manager, which will also choose and appoint its own service providers," says Kestler.

"Because you're still allowing the manager to control the cash and value the portfolio, you remain exposed to fraud risk and manager operational risk. Although co-investor liquidity risk is removed in a Fund of One, it is certainly not the best-in-class model. If a manager is incorrectly valuing a fund's assets, passing through unapproved expenses or misappropriating assets from the fund, a Fund of One investor might be none the wiser without an independent third party overseeing the operations of the fund."

Others agree that the sheer variety of models operating under the banner of managed platforms can create confusion. Innocap, for example, describes its mission as being "to generate structural alpha." This, says Planté, makes the Innocap model different from that of other types of platforms, which he breaks down into distributors, asset managers and project managers. Each of these, he says, has a different focus, and in some cases, outsource many of the infrastructural functions which

Eddie Lund,
senior vice president of business development, NorthStar Institutional Sales

Innocap provides. Legal work, for example, is an expertise internalised at Innocap. "We are really a utility provider," Planté says, "focusing on the structuring and operationalisation of managed accounts."

A key element of the utility service provided as part of this integrated offering, says Planté, is helping investors to lighten the load of their regulatory burden. "To me, one of the biggest challenges institutional investors face today is regulatory reporting, not just because it is jurisdiction-specific and constantly evolving, but because of the complexity it adds to strategies' implementation and operationalisation," he says.

"If you take the example of the UCITS framework, the prohibition on direct short selling means that managers need to adapt their equity strategy by using contracts for difference (CFDs), which work like swaps with a daily reset. At first glance, this might seem like a simple adjustment, but in reality it requires updating the fund's legal documentation, and more importantly, it triggers a modification of operational processes," says Planté. "This clearly demonstrates that beyond the increasing importance of data quality, a real need has emerged for flexible IT infrastructures able to collect information from various sources, to aggregate and to display it in very specific ways."

NorthStar says that it is the integrated open architecture of its model that differentiates its managed account offering from many of its competitors. Young says that NorthStar's pedigree as an administrator is also a key differentiator of its dedicated managed account platform. "NorthStar's core strengths have always been gathering and reconciling data, and reporting performance," he says. "On top of this, we are able to offer risk reporting and guideline monitoring, and because we are fully integrated we are able to provide a highly granular level of data for our clients in near real time."

SURVIVAL OF THE FITTEST?

The problem of definitions has been exacerbated over the last decade, because since the crisis there has been a proliferation in the number of managed account platforms (MAPs). The leading providers caution, however, that it is a mistake to assume there is inexhaustible room for more managed account platforms to join the party.

Sam Thompson, head of managed accounts at Man FRM in New York, points out that following a flurry of new platform launches after the financial crisis, there has been a gravitation towards the larger operators. "As the MAP industry has matured and become more institutionalised, some of the smaller, more boutique-style firms have fallen away and there are now a smaller number of larger players offering comprehensive managed account services," he says.

Thompson sees this trend continuing over the foreseeable future. "We believe that having the capacity to invest in new technologies and to deliver complex products globally will be essential for success in this business," he says. "Especially in the dedicated managed account or DMAP space, where we're setting up platforms for single asset owners with investments with managers located all over the world, having the scale and global footprint of a firm like Man is critical."

DIMINISHING RESERVATIONS

While some confusion may still exist about the definition of a managed account, and how it differs from a co-mingled vehicle or a Fund of One, industry practitioners say that growth has been underpinned by the progressive diminution of institutional investors' initial concerns about managed accounts.

Foremost among investors' misgivings in the early days of the managed accounts movement was selection bias, or the belief that no managers worth their salt would agree to share their fee with any third party. In particular, there was initially some scepticism that the best performing managers would be those that would be least likely to feel compelled to make themselves accessible to a wider range of investors via managed accounts. This is a concern that, in the case of a handful of managers, remains legitimate. "Not every hedge fund manager is prepared to offer managed accounts," says Kestler.

Sam Thompson, *head of managed accounts, Man FRM*

"Their natural preference is to retain complete control over their funds and to maximise their fees."

There have been other reasons for hedge fund managers' reluctance to open their doors to providers of managed accounts. One of these, given the tepid performance of many funds, is that some managers may have benefited from the perceived mystique of the hedge fund clique. In other words, some were able to dress up strategies that were essentially based on glorified beta as highly sophisticated, proprietary alpha vehicles fully meriting a 2+20 fee structure.

Managers of this kind will no doubt greet the transparency that managed accounts offer with horror. "One of the key benefits of managed accounts is that the enhanced transparency puts an investor in a stronger position to assess whether a manager is really generating alpha or charging alpha fees for beta performance," says Lapkin.

Less of a concern among managers is the requirement for transparency on strategies or algorithms that they may have regarded as proprietary. "I don't think most managers are overly concerned about releasing statements to platforms as this doesn't give away much proprietary information," says Maxwell Eagye, managing director at Coquest Inc, a commodity broker and advisor which is currently building a fund of funds that will be made accessible to investors via the NorthStar Galaxy Plus platform.

"The platform sees a daily statement from a clearing firm which details all the strategy's individual trades. But it would be very difficult to reverse-engineer a strategy from that information because the trades themselves are only an output of that strategy. They don't give any insight into the rationale behind the strategy, nor into the trigger points for the trade itself, nor the exit strategy of the trade in question. While all of this has a bearing on the performance of the CTA, it has no impact on the success or otherwise of the platform."

This is echoed by the platforms. "Many hedge fund managers are generally comfortable with the transparency of a managed account, but if necessary, it is possible to customise reporting to end-investors if there are certain elements that the manager needs to restrict," says Lapkin.

More generally, platforms report that reservations about managed accounts, among asset owners and managers alike, are much less widespread than they were two or three years ago. In part, this is a result of the work that firms like Man have done over recent years to reassure hedge fund managers that the disruptive impact of managed account platforms will be minimal.

"Even if managers are a little reticent at first about working in a managed account format, we explain that we have a tried and tested method which we have applied successfully more than 350 times," McCloskey says. "One of the first things we do when we meet a manager is explain to them that our preference is to replicate their operating environment and make it as easy as possible for them to work with us. We also reassure them that we do not want to hamstring their trading strategies in any way, as long as they trade in what we deem to be a risk-appropriate way."

Besides, in some cases, investors themselves are laying down the law to the hedge fund community, putting managers on notice that if they don't make their strategies accessible via managed accounts they will either remove them from their list of approved managers or – worse – divest existing holdings.

In a stand-off of that kind, there can only be one winner. "There is still some resistance to managed accounts," says Lapkin at HedgeMark. "But the majority of managers are recognising that if they want to attract or even retain assets from their core institutional base, they will have to offer managed accounts. Those that don't will likely see their assets stop growing or begin to shrink."

This has not been lost on hedge fund managers, especially those aiming to extend their international footprint. "There are plenty of managers who are looking to reach a wider range of investors," says Spada at Lyxor. "US managers who want to use the UCITS framework to raise assets are very open to discussions with our platform, for example."

Andrew Lapkin, *chief executive, HedgeMark*

NOT EVERY HEDGE FUND MANAGER IS PREPARED TO OFFER MANAGED ACCOUNTS. THEIR NATURAL PREFERENCE IS TO RETAIN COMPLETE CONTROL OVER THEIR FUNDS AND TO MAXIMISE THEIR FEES
JOSHUA KESTLER, HEDGEMARK

PENSIONS: FLEXING THEIR MUSCLES...

The fact that investors are increasingly able to dictate terms to managers is symptomatic of a broader industry trend which is that as a group, investors in hedge funds now enjoy more bargaining power than they have ever had. This is because the buyer base for hedge funds has changed conspicuously over the last decade or so, with institutional investors in general and pension funds in particular far more influential participants in alternative strategies.

According to the latest numbers published by Willis Towers Watson, assets under management in pension funds in the 22 countries in its review grew at a compound annual growth rate (CAGR) of 4% between 2006 and 2016, from $23.7 trillion to $36.4 trillion, which equates to 62% of those countries' aggregate GDP. More significant, from the perspective of the global hedge fund industry, is that between 1997 and 2016, while these funds' allocations to equities, bonds and cash declined, their exposure to 'other' asset classes (including alternatives) rose from 4% to 24%.

Much of that increase has been accounted for by increased institutional appetite for real estate and private equity. But globally, Deutsche Bank's 2016 alternative investment survey put pension funds' allocation to hedge funds at 8%. That may sound modest, but it is double their allocation in 2014, and means that pension funds now account for about two-thirds of hedge funds' assets, according to KMPG's analysis.

Rising allocations from pension funds is of course positive in that it provides a bedrock of big-ticket liquidity for hedge funds. After all, when CalPERS originally announced its plans to expand its investment horizons in 1999, it indicated that it would allocate as much as $11.25 billion to hedge fund strategies.

In the event, the Californian public employees' pension fund never came close to allocating this much. But at the time, it was an unimaginably large chunk of money for an industry that had traditionally relied chiefly on family offices and high net worth individuals.

Since then, state retirement schemes across the US have adopted very different approaches to hedge fund investment. At one extreme stand schemes such as the Public Employees' Retirement System of Nevada (PERS), which reports that it emphasises a "simple, low-cost structure that relies primarily on intelligent asset allocation and rebalancing."

With short selling and leverage prohibited for the Nevada scheme, as of the end of March 2017 43.6% of the $37.4 billion fund was invested in domestic equities, with 19% in overseas equities and 28% in US bonds. This left 9.1% in "private markets", which are divided more or less equally between real estate and private equity. According to its latest investment review, PERS' annual return over the last 10 years net of fees has been 5.9% - bang in line with market returns.

At the other end of the extreme are funds that are increasing their exposure to hedge funds, such as the State Employees' Retirement System (SERS) in Pennsylvania. SERS had an 8% exposure to hedge funds at the end of June 2015 and its strategic asset allocation policy for 2016-17 specifies a target of 12%. Elsewhere, the Wisconsin State Investment Board approved more than $400 million in commitments to hedge funds as recently as the first quarter of 2017.

....BUT OVER-PAYING?

For hedge fund managers, the downside of increased pension fund participation in their strategies is that they have exposed the industry to a degree of uncompromising public scrutiny, especially on the thorny topic of the costs involved of investment in alternative strategies.

Over the last year, there has been graphic evidence from either side of the Atlantic of just how focused institutional investors have become on this count, with a number of public retirement schemes in the US becoming increasingly vocal on the subject.

Perhaps the most extreme illustration of how prickly pension fund overseers have become about the fees paid by retirement schemes in the US is the scathing report written by the Department of Financial Services (DFS) about the fees paid by the New York State Comptroller for the management (or perceived mismanagement) of its two retirement systems.

BASED ON OUR DISCUSSIONS WITH EXISTING AND PROSPECTIVE CLIENTS, WE BELIEVE THAT THE GROWTH OF THE MARKET IS STILL AT A VERY EARLY STAGE
ANDREW LAPKIN, HEDGEMARK

Written in October 2016, the unforgiving DFS report commented that "as state pension fund managers around the country have cut or eliminated exposure to overpriced and underperforming alternative investments, under the Comptroller's watch the State pension system has spent large amounts of pension system funds chasing returns and performance that has fallen far short for years."

More specifically, the report said that over the last eight years, the System had paid over $1 billion in "excess fees to hedge fund managers who underperformed to the tune of $2.8 billion." This, it added, amounted to "letting outside managers rake in millions of dollars in fees regardless of hedge fund performance."

The comparison of the fees paid by the New York retirement system to hedge fund managers versus their conventional counterparts does not make pretty reading. According to the DFS report, in the previous year the system had doled out $150 million for the management of an $8 billion portfolio of absolute return strategies, which accounted for 4.5% of its assets, equating to a fee of 1.87%.

By striking contrast, the system paid $59 million in management fees on its portfolio of domestic equities, which was worth $61.5 billion, or 34.5% of AUM. That equated to 0.096%, or "a less than 1/10th of 1% fee on assets under management." The Comptroller's damning conclusion was that "domestic equities have 7.7 times greater assets, but hedge funds cost 2.5 times more. When one combines both factors, the result is that the State pension system has been paying 19½ times more for hedge fund management than domestic equities."

The system's absolute return portfolio generated annualised returns in the five and 10 years to the end of March 2016 of a modest 3.69% and 3.23% respectively, compared with its overall returns in the same period of 7.25% and 5.69%. Slice and dice it any way you like, New York's experiment with hedge funds looks like a sorry indictment of the industry's performance relative to the fees it has historically charged.

HEDGEXIT?

A handful of US public pension systems have taken control over the increasingly highly charged debate about fees by either ditching their exposure to alternatives altogether or reducing it sharply. This is what the New York System has done, as it explained in a public statement issued soon after the release of the DFS report.

The State Comptroller announced that it was disappointed and shocked by the contents and timing of the document, which it said was distributed to the media five minutes after being sent to its office. "If the agency had reached out to our investment professionals," it said, "it would have known the aggressive steps that [the Comptroller has]...taken to reduce hedge fund investments and limit fees, including lowering the hedge fund allocation to 2% of assets from 3% and paying below average fees. In fact, the Fund has put no money into a hedge fund in well over a year."

New York is not alone in rethinking its policy on hedge funds. Since CalPERS famously announced its decision to bail out of hedge funds in 2014, several retirement schemes in the US have put managers on notice that they have run out of patience with strategies offering modest performance for disproportionately steep fees.

Last summer, for example, the New Jersey Investment Council said it was scaling back its exposure from 12.5% to 6%. "We have cut the target for our hedge fund exposure in half, and will seek out managers with solid track records who are willing to cut us a better deal on fees," the Council noted in its most recent annual report. In FY2016, New Jersey's $8.4 billion hedge fund portfolio generated a negative return of 5.13%, dragged lower chiefly by equity event-driven strategies.

More recently, in November 2016, the Kentucky Retirement Systems' Investment Committee said that it was continuing to wind down its 10% allocation to alternatives, to 6% by July 2017. Echoing other US pension schemes, it announced at the time that "the shift in pension fund allocations comes as KRS seeks to reduce its investment fee expenses and the complexity of its portfolio."

WE HAVE NOT SEEN INSTITUTIONAL INVESTORS FLEEING THE HEDGE FUND SPACE BY ANY STRETCH
MICHELLE MCCLOSKEY, MAN GROUP AMERICAS AND MAN FRM

How much of the reduction in some states' allocation to pension funds has been driven by sound portfolio management, and how much by political expedience, is an open question. After all, some appear to have responded to public dissatisfaction to the performance of hedge funds by reaching for the financial thesaurus and tiptoeing around using the term at all. "Some segments of the industry are moving towards looking at hedge funds simply as actively managed strategies rather than as a separate asset class," says Kestler at HedgeMark. "This makes sense, because 'hedge fund' is a misleading term which describes an investment structure rather than an investment strategy."

Others are more forthright, with some of the most vocal political vilification of hedge funds at a state level coming from surprising sources. Take the example of the former investment banker Philip Murphy, once president of Goldman Sachs in Asia and more recently Barack Obama's ambassador to Germany.

Poacher-turned-gamekeeper par excellence, Murphy is currently running for the governorship of New Jersey and has spent much of his campaign snarling at Wall Street. He has declared that if he is elected he will divest the hedge fund positions held by the state's pension fund, and reinvest the fees saved in public projects.

KEEPING THE FAITH

Announcements of this kind ought to be seen in perspective, because managed account providers say it would be a mistake to interpret them as a sign that institutional investors in general, and pension funds in particular, are abandoning hedge funds en masse. "We have not seen institutional investors fleeing the hedge fund space by any stretch," says McCloskey at Man.

Others agree. "We've come across very few investors in our meetings who say they no longer see value in hedge funds," says HedgeMark's Kestler. "We suspect that some of the investors that are pulling out of hedge fund strategies are doing so more because of the political pressure they are coming under rather than as a result of a revised investment thesis."

It is easy enough to see why this pressure has increased, given the disappointing performance that many strategies have delivered while keeping their fees high. That, says Kestler, has made hedge funds an easy target for politicians and the US media. "In many cases, their poor performance has become an unfairly politicised issue, and has been misrepresented in the media," he says. "For example, some journalists have made comparisons between hedge fund returns and the performance of the S&P, which is generally inappropriate."

On balance, however, there appears to be a reluctance among many public pension schemes in the US to throw the baby out with the bathwater by turning their back on alternatives altogether, for good reason. As the New Jersey Investment Council notes in its most recent annual report, hedge funds "can serve a valuable purpose. They can do well in good times, can do a lot to protect us in bad times, and tend to limit the overall volatility and risk in the portfolio."

"Many of the retirement systems in the US guaranteed returns to their members at a time when expected annual returns were 6% or 8%," adds Young at Gemini. "But generating an annual return of 8% is difficult when bonds are yielding 2% and investors are maintaining a traditional allocation model of 60% to equities and 40% to bonds. Maybe the model needs to change from 60/40 to 60/30/10, where the 10% is alternatives."

The reluctance on the part of some of the more progressive institutions to ditch alternatives perhaps reflects an acknowledgement among many institutions that hedge funds' fees are acceptable for managers capable of delivering consistently solid, risk-adjusted, uncorrelated returns. "We've seen no indication that institutions are unwilling to pay for real alpha," says McCloskey. "In the case of underlying managers that have performed well over several cycles and consistently delivered what they say on the tin, investors are still prepared to pay reasonable fees."

Joshua Kestler,
president and COO, HedgeMark

INSURERS TURN TO MANAGED ACCOUNTS

While pension funds on either side of the Atlantic are expected to make more use of managed accounts, so too are insurance companies. One driver of increased demand from insurers is Solvency II, the EU Directive which requires insurance companies to ensure that they have enough capital set aside to provide reserve funds to cover all claims.

One advantage of managed accounts for investors grappling with the challenges of Solvency II is that the position-level transparency which they provide gives insurers a clear picture of their exposure, allowing them to calculate their capital consumption more accurately.

Perhaps more important is that by accessing hedge fund strategies via managed account platforms, insurers providing full look-through on their assets are sometimes able to reduce capital charges. This can be as high as 49%, a punitive level that has already led some insurers to announce that they are pulling out of hedge funds altogether.

"Solvency II is an important challenge not just because of the reporting requirements," says Thompson at Man. "It can also have a meaningful impact on the amount of capital that insurance companies may have to set aside. In addition to streamlining reporting, setting aside capital against a single managed account platform rather than against a range of individual managers may help insurers reduce their capital requirements."

Managed accounts providers say they believe there is still plenty of room for more institutional use of their services, which they say remains curiously under-developed relative to their potential. "Based on our discussions with existing and prospective clients, we believe that the growth of the market is still at a very early stage," says HedgeMark's Lapkin.

"But we would like to see a more rapid adoption of the managed accounts model, especially across the public pension community," he adds. "While funds of funds have been quicker to adopt the use of managed accounts there has been a higher level of inertia among public pension funds, which is disappointing, given that managed accounts can address so many of the pressures they currently face in regards to investing in hedge funds."

UK PENSION FUNDS FEEL THE HEAT

There has also been an animated debate over fees paid by pension funds to investment managers in the UK, where efficiencies (or lack of them) in the administration of the local government pension scheme (LGPS) have become an increasingly sensitive issue.

It's easy to see why. According to a Centre for Policy Studies (CPS) update published at the end of 2016, and entitled "The LGPS: Unsustainable", in the six year period between 2009-10 and 2014-15, there was a "staggering 111% increase" in fund management costs per member. The CPS report is excoriating – pointing towards "a dangerous cocktail of dismally lax, ineffective (amateur) governance and a culture of non-accountability, opacity, incompetence and indifference."

Consolidation among the LGPS is addressing some of these inefficiencies, while managed accounts providers have also been helping to reduce their overall hedge fund investing costs. For example, Man FRM has won mandates from various pension schemes in Cornwall and the Welsh region of Clwyd to manage their hedge fund exposure via a fund of managed accounts. A key benefit of this platform is that it has been able to generate economies of scale by allowing the LGPS to share costs.

"We have created an innovative structure for LGPS clients, whereby total fees are calculated on the basis of a sliding management fee based on the collective assets in the portfolio," explains Thompson at Man FRM in New York. "While the LGPS clients are treated as a single investor with regard to the pricing of the managed account programme, each LGPS is treated individually in terms of investment objectives and delivered a customised investment portfolio solution."

USING MANAGED ACCOUNTS TO REDUCE FEES

In the US public pension market, few have been more outspoken about fees than Dale Folwell, who became treasurer of North Carolina in January, having made lower investment management fees for the state's $92 billion pension fund one of the pillars of his campaign.

***Michelle McCloskey,** president, Man Group Americas and Man FRM*

AS THE MAP INDUSTRY HAS MATURED AND BECOME MORE INSTITUTIONALISED, SOME OF THE SMALLER, MORE BOUTIQUE-STYLE FIRMS HAVE FALLEN AWAY AND THERE ARE NOW A SMALLER NUMBER OF LARGER PLAYERS OFFERING COMPREHENSIVE MANAGED ACCOUNT SERVICES
SAM THOMPSON, MAN FRM

Folwell has promised to reduce the fund's investment management fees by $100 million in his first term, and by the end of the first quarter of 2017 he was well on his way to achieving his target, cutting $25 million by conducting an exhaustive investigation into the fee structure and performance record of each of the scheme's investment managers.

North Carolina is one of a number of states that is exploring managed accounts as a way of ensuring that they can retain their exposure to alternative strategies while reducing their overall costs.

The best-documented example, however, has probably been the Massachusetts Pension Reserves Investment Board (Mass PRIM), which has indicated that it has no intention of reducing, let alone eliminating, its allocation to hedge funds. This represented 8.6% of its $60.7 billion of AUM as of June 2016, and its long-term policy target for hedge funds is 9%.

Mass PRIM comments in its latest annual report that one of the cost savings measures implemented in 2016 was "successfully [negotiating] all new hedge fund investments in managed account format with significant fee discounts."

Unsurprisingly, managed accounts providers say that the Mass PRIM model, which has been the subject of plenty of positive press coverage and conference chatter, is the benchmark that other pension funds should be encouraged to follow. Equally, however, they warn against looking to reduce fees even further by opting for alternative structures which, on paper, may look cheaper, such as Funds of One.

"One reason why some organisations have chosen to go down the Fund of One route is the perception that it is cheaper because they don't have to hire a third-party platform provider or additional internal staff," says Kestler at HedgeMark. "Even if you assume that the expenses associated with a Fund of One are lower than a managed account, which is not necessarily the case, we still believe it is worth paying some additional expense for the peace of mind of having a third party handle the core non-investment functions including independently maintaining control of and protecting your assets."

The heated debate over fees in the US and the UK suggests that it is the reduction in overall fees that is perhaps the most compelling driver of the migration of assets towards managed account platforms. The savings that managed account platforms say they can generate look very healthy in an environment where every basis point counts. "The pensions and endowment funds we have worked with have generated savings of 100bps and more through reduced management fees and through structural or operational alpha," says Gemini's Young.

There are several reasons why leading managed account platforms are able to drive a harder bargain on fees than co-mingled vehicles. Perhaps the most important of these is the economies of scale that their sheer size allows them to generate.

As an extreme example, take the formidable firepower that a firm like Man can deploy. "When a client hires us to structure a managed account for them, what they are utilizing is the purchasing power of almost $89 billion of Man Group assets," says McCloskey. "So when we go to the Street and negotiate the rates and fees at which our various service providers will be contracted, we're doing so on the strength of all of Man Group. The result is that the fees we utilise for our managed account platform are at rates that you would expect from a very large alternatives manager. We use this purchasing power and hand it back to the client in a highly transparent way."

Cost savings for clients are also generated, says McCloskey, by Man's internal expertise. "Taking the example of the legal work, we have a team of 30 international lawyers in 20-plus jurisdictions," she says. "The economies of scale arising from having an in-house legal team supporting client on-boarding as well as contract and service provider negotiations have been enormous."

"There are a number of expenses that a co-mingled fund investor might be required to take a pro rata share of, which would not be needed in a managed account, which is generally a much simpler structure," adds Man's Thompson. "Additionally, as there is usually only a single investor in a managed account, the amount of support they require from typical hedge fund service providers is generally lower than in a co-mingled fund. Administration and auditing is simpler, and there is seldom any need for a prime broker's capital introduction services, all of which creates cost savings which are passed on to the end investor."

Jonathan Planté, *manager of business development and investor relations, Innocap*

At Innocap, Planté firmly believes that the current pressure on fees in the hedge fund industry could and should be regarded as an opportunity for managers to re-attract investors' appetite in an environment where asset gathering has been difficult.

"The market has been talking for a decade about finding better ways to align investors' and asset managers' interests," he says. "I think we are finally reaching the point where those interests are being aligned."

One way in which those interests are being reconciled, says Planté, is in reaching common ground on manager fees, with managed account platforms such as Innocap's acting as the intermediary between the two. "By negotiating a more appealing management fee structure on behalf of the client, we are able to provide the manager with more opportunity to be rewarded for its true added value," he says.

Lyxor's Spada echoes the view that the 2+20 fee convention is fast disappearing. "Today the 2+20 model is much less valid, and in recent years we've seen managers agreeing to much lower fees than this," he says. "The aim for us is to find a fee structure that represents a fair compromise between what the manager deserves and what the client can accept in terms of management and performance fees."

Others agree that there has been a considerable improvement in the alignment of interests on fees between managers and investors. "Hedge fund investors have clearly been hit by fees which have remained high even when performance has deteriorated," says Lapkin at HedgeMark. "This is why we are seeing the reintroduction of performance hurdles, and more equitable arrangements being negotiated including changes to the performance fee crystallisation period as well as the introduction of fee clawbacks."

PLEASE SIR, I WANT SOME MORE (ALPHA)

As Man's McCloskey points out, however, it is not just the lower fees that explain the appeal of managed accounts; it is also the transparency of the fee structures. "If you look back 10 years, fee structures were opaque industry-wide," she says. "Today, there is an enormous amount of transparency and granularity around the fees paid by managed account platforms to service providers."

These fees form part of what is generally known as structural alpha, which is a critical contributor to the overall economics of managed accounts. "Structural alpha is an increasingly popular catch-all term which refers to the total savings that investors can generate as they migrate from co-mingled funds to dedicated managed accounts," says Lapkin at HedgeMark. "Reduced fees to administrators, legal advisors, auditors and in some cases even prime brokers all flow through to the bottom line, so the net return on the investment rises as the structure of the fund is improved." Hence the term structural alpha.

One important component of this structural alpha is cash-efficiency. "As an example, a pension fund allocating to a co-mingled fund wanting $100 million of exposure has to put up $100 million of cash," Lapkin explains. "Because many hedge fund strategies are so cash-efficient, in a managed account that same fund may only need to put up $50 million for the same exposure. The excess $50 million can then be used to generate a cash return to improve the overall performance of the portfolio, or it can be put to work for some other purpose within the pension fund."

Innocap's Planté agrees that cash efficiency plays a key role in the generation of structural alpha, and can be applicable to various strategies. "Obviously, systematic and derivative consuming strategies are a natural fit for notional funding," says Planté. "But negotiating more financing capacity with counterparties is not the only way to be cash efficient. It could also be achieved through a first loss structure

Daniele Spada,
head of the managed account platform, Lyxor

where the manager agrees to put capital alongside the investor, and leverage the total assets. As a compensation for absorbing the first x% of loss, the manager will have access to greater upside potential," he says. "This mechanism is also a true example of alignment of interests".

As well as driving harder bargains on fees and expenses, asset owners are also becoming pickier about where their money is invested, which Man's McCloskey identifies as another driver of increased demand for managed accounts. She says that these are especially helpful for any investor needing to screen a portfolio for exposures that they may wish to avoid, for environmental, social and governance (ESG) reasons, for example.

This is emblematic of one of the most visible trends in the managed accounts world over the last 12 to 18 months, which is the increasingly precise customisation that is taking place within the business. McCloskey says that this customisation is the product of a relationship between asset owners and managed account platforms which is based on a partnership driven by dialogue.

"As an asset management firm ourselves, originally developing our platform for our own use, we are very aware that investors may have a unique set of requirements and objectives," she says. "As a result, when we onboard a new investor we have a very detailed discussion with the client, oftentimes alongside their consultants, to understand in detail what the client needs from our platform and services. We have applied the same high touch approach to our platform clients as have with the 350-plus managed accounts that we have structured for our own portfolios at Man FRM."

The level of overlap between the provision of investment advice and other services varies from platform to platform. In the Lyxor model, for example, fund research is regarded as an essential part of the broader service. "As an asset manager, we aim to provide what we describe as an integrated but modular offering," says Spada at Lyxor in Paris. "This means that if clients have a very clear idea of which strategies and funds he wants to invest in, we can provide access to those products.

If not, we can do the research on the client's behalf and propose ideas, from which he can select the funds that are best suited to his global asset allocation targets. In other words, the platform gives clients access to a range of different funds, but also acts as a research, advice, reporting and client servicing centre."

Young at Gemini says large institutional clients using the NorthStar dedicated managed account platform generally have very clear asset allocation preferences. "Large asset owners are usually very well versed in the funds they want to select and the strategies they want to deploy," he says. "That being said, if any of our clients want more advice and research, this is something we can provide in conjunction with our affiliated companies."

At Man, McCloskey says that asset allocation and manager selection advice are not always part of the managed account services her firm provides. Clients interested in a dedicated managed account – or DMAP – generally come to Man FRM with a roster of investment managers they are looking to access in a managed account format.

"We don't sit down with our DMAP clients and tell them what sort of asset allocation they should be making," she says. "However, over the course of time the opportunity to provide a more differentiated range of services has arisen through the partnerships we have built with our DMAP clients. For example, we are now doing more extensive quantitative analysis on managers and helping clients to maintain or rebalance their exposures by monitoring their portfolio on a daily, weekly and monthly basis. But it is important to emphasise that this is at the operational level rather than at a portfolio management or top down asset allocation level."

This also applies to an area where McCloskey says Man is seeing growth, which is in the market for funds of managed accounts. "I think many investors have shied away from the co-mingled fund of funds model almost entirely," she says. "But we are seeing clients coming back to the fund of funds concept in a different format. These are funds of our managed accounts that we construct on behalf of our clients, in which we will deliver daily transparency to the investor's desktop, just as we would do for a DMAP client with their own managed accounts."

WE BELIEVE THE RIA COMMUNITY HAS BEEN UNDER-SERVICED IN MANAGED FUTURES SPECIFICALLY, AND IN ALTERNATIVES MORE GENERALLY. SO WE BUILT A TEAM AIMED AT LEVERAGING THE STRENGTH OF OUR RELATIONSHIPS WITH ABOUT 1000 RIAS TO PROMOTE INCREASED ALLOCATIONS TO ALTERNATIVES
EDDIE LUND, NORTHSTAR

Lyxor's platform has also developed a multi-manager UCITS managed account service, aimed at helping to reduce investors' total expense ratio. "This innovative structure gives investors access to different alternative strategies through a single UCITS investment vehicle," says Spada.

"This is a simple, transparent, liquid and cost-efficient version of the old fund of funds structure. Daily liquidity is possible and investors pay only one fee layer instead of two. As a result, the total expense ratio of a multi-manager fund is reduced, which is definitely valued by our investors. In the coming years, we will probably develop our range of alternative multi-manager funds even further, in new asset classes."

MANAGER DUE DILIGENCE

On the manager side, a key component of the work that managed account platforms undertake is exhaustive due diligence. As Galaxy Plus explains, "before being listed on our platform, every manager is thoroughly vetted and reviewed. We analyse, review, and identify manager strategies, abilities, and backgrounds, as well as relevant strengths and weaknesses. We only accept managers who meet our high standards for transparency and performance."

"Our due diligence doesn't stop once a manager is on the platform," Galaxy Plus adds. "We continue to monitor all of our managers to ensure that they stay within the established parameters of their investment strategy."

A by-product of the due diligence process is that platforms will sometimes find themselves acting almost as an operational consultant to managers. "If we identify weaknesses we will spend some time with the manager in order to make sure their standards are of the institutional quality that our clients demand," says McCloskey at Man.

Initially, this may not always go down well with managers. "Some managers may not welcome this input at first, because we may have to explain to them that they are not up to par," says McCloskey. "But ultimately most realise that the benefit of our operational requirements and consulting brings them up to an institutional standard and supports the growth of their business."

IT'S PROBABLY FAIR TO ASSUME THAT A YEAR FROM NOW AS MUCH AS 10% OF OUR PLATFORM ASSETS COULD BE DEDICATED TO EMERGING MANAGERS
JONATHAN PLANTÉ, INNOCAP

SUPPORTING EMERGING MANAGERS

This is especially applicable in the case of emerging managers, many of which have neither the time nor the resources to create the sort of operationally robust structures required by institutional investors. For these smaller operators, managed account platforms can be an ideal way for managers to increase their visibility by introducing their programmes to a whole new group of investors, says Esther Goodman.

She knows a thing or two about platforms and emerging managers, having set up the managed account platform at Kenmar, where she was chief operating officer from 1986 until 2014, when she co-founded the Conyers Group. "We spend a lot of time talking to emerging managers about using the Galaxy Plus managed account platform to start a fund," she says.

One of the main reasons is cost. "Setting up and administering a fund is incredibly expensive," says Goodman. "Even in the case of a straightforward fund structure and strategy, hiring a reputable attorney to draft an offering memorandum will cost at least $10,000, but will probably be closer to $15,000 or $20,000. We think a platform like Galaxy Plus is the ideal solution for emerging managers who are seeing growing interest from larger investors but are burdened by the inefficiencies of managing lots of managed accounts. Consolidating those accounts on Galaxy Plus instead of forming their own fund may free up more money for research, operations, compliance or marketing."

At Innocap, Planté believes that in today's environment, investing in emerging managers capable of taking more nimble positions is one area where the negotiation of more equitable fee structures is likely to benefit investors and managers alike. This is an area where Innocap has established a niche over the last 18 months, playing a structuring and co-ordinating role in the Quebec Emerging Manager Program (QEMP), which provides institutional investors with the opportunity to allocate capital to nine managers, in both hedge funds and long-only strategies.

Today, Planté says that Innocap is working on a number of other emerging manager programmes, with a view to helping large asset owners to deploy capital to small-size asset managers looking to access their first

Technology: opportunity or threat for MAPs?

Technology has been an important ally of managed account platforms over the last five years, underpinning their ability to provide highly detailed and customised data and analytics in a user-friendly format and to help present information to the regulator.

"Managed account platforms are a convenient option for investors confronted with additional reporting requirements," says Thompson at Man. "They allow investors to outsource the challenge of aggregating data from multiple managers by generating consolidated reports which can either be sent to the client or direct to the regulator on the client's behalf."

"The development of technology has played a key role in supporting the institutionalisation of managed account platforms by allowing them to analyse greater data loads coming from multiple managers and strategies, and providing consistent reporting," he adds. "Technological developments have made the platforms' job easier, which is positive because it makes the infrastructure more stable and drives down costs."

This represents quite a change from the way the industry used to function. As a recent note from Gemini explains, "investors are no longer satisfied receiving a statement at month-end telling them how the manager performed. Now, at the very least, platforms and fund managers have had to adapt and provide investors with functionality to view their investments on a daily basis. Platforms have looked to take this a step further by providing investors with a more granular look into their hedge fund portfolios. Platform investors are often able to see exposures and positions by manager, view aggregated data across their portfolio, and run advanced analytics on their portfolio."

Perversely, however, the technological progress that managed account platforms have so successfully exploited could also be a threat to their future, given the proliferation of fintech start-ups with the potential to disrupt the status quo by offering competitively priced data aggregation and other analytical tools.

As State Street puts it in a recent report on digital transformation, this is "driving a seismic shift in the investment industry. Both fintech start-ups and established investment firms are using emerging technologies – including predictive analytics and machine learning – to disrupt the industry, promising clients highly customised, hyper-convenient investment solutions."

institutional allocation. "It's probably fair to assume that a year from now as much as 10% of our platform assets could be dedicated to emerging managers," says Planté. "The rationale behind this is very simple. Given that performance in the hedge fund world has been sluggish over recent years, large asset allocators are increasingly looking for new ways to allocate to hedge fund managers. Notably in Canada, there is more and more appetite among institutional investors for new names."

Others agree about the appeal of emerging managers and the benefits of accessing them through managed accounts. "There is a common view that early-stage managers often outperform their later-stage counterparts, so there is often strong investor interest in the new funds being launched by managers spinning out of banks and large hedge funds," says Lapkin at HedgeMark.

"The problem that investors face is because these funds have less assets under management and often light infrastructure, it is very hard to get comfortable with accessing emerging managers on a stand-alone basis. The co-investment risk you take when investing in a small manager's fund is extremely high, and as a result, a managed account is a nice alternative as it can eliminate that core risk."

Esther Goodman,
co-founder,
Conyers Group

Planté says that allocating to emerging managers is comparable to acting as a private equity investor in the asset management industry, but he is quick to emphasise that Innocap's role is not to replicate that of sourcing or placing agent. "Our job is to provide an investment infrastructure which is up to institutional standards, because the biggest risk an investor faces with an emerging manager is first and foremost operational," he says.

He adds that identifying the best prospects among emerging managers is more of an art than a science, a key feature of which is negotiating an innovative fee arrangement. "The structure can be a bit different from established revenue-sharing practices," he says.

"By entering into an agreement whereby the manager agrees to reduce the management fee as the firm's assets grow above a predetermined level, you avoid a situation where the investor takes a double-long position by taking an equity stake in the manager. This creates a win-win situation, because it gives the asset owner access to an emerging strategy without going through a private equity transaction while avoiding ownership dilution on the manager's side."

Man's Thompson says he recognises the increased relevance of fintech firms. "There have been a number of start-ups in the fintech sector in recent years which are designed to support the hedge fund industry," he says. "Much of this is in response to the same dynamics that managed account platforms have responded to, including rising demand among institutional investors for greater transparency and more control over their investments. There are some fintech companies that are providing solutions for the analysis of counterparty data, risk analytics and operational functions such as cash payments and controls, which can be additive for managed account providers."

"Some of these products have been very helpful to us," adds Thompson. "We often find we are using the same fintech vendors that the underlying managers are using. For example, if you have a complex strategy trading with a wide range of counterparties, it can be challenging to standardise data across 10 different brokers, all sending files in slightly different format. When one of those brokers decides to update its fields, if there is a vendor that can fix your file-mapping efficiently and at a reasonable cost, it makes sense to use that service."

Lyxor's Spada agrees that it is important to keep an eye on innovations emerging from the fintech world. "We have been offering innovative web-based services together with analytical tools for many years, and up to now we have chosen to do all this technological development in-house, which has worked very well," he says. "This allows investors to manage and aggregate data both at the portfolio and the fund of funds level. But we are watching the evolution of the fintech space very closely, and we are not closed to the idea of partnering with or incubating fintech companies if the opportunity arises."

For the time being, managed account platforms are confident that they are well positioned to resist the competitive threat represented by fintech. "I agree that fintech is creating new competition," says Planté at Innocap. "But while fintech can provide technological innovation, it will neither be able to do the qualitative analysis of risk, nor the legal work that is necessary for structuring managed accounts. Nor can it help with the compliance challenge."

With about a quarter of Innocap's 45 staff accounted for by IT professionals effectively acting as an in-house fintech unit in any case, Planté says that he sees fintech being integrated into the development of managed account platforms, rather than competing directly with them.

Managed account platforms continue to overshadow their traditional FoHF peers/ By Siobhán Hallissey

As traditional commingled fund of hedge funds (FoHF) assets continued to lose ground in 2016, the story is dramatically different for managed account platform providers that have astutely changed their business structure in order to cater to investor demands for increased liquidity and transparency following the financial crisis.

While the split between traditional commingled funds and customised business lines was even at the beginning of 2016, assets shifted dramatically over the course of the year. Commingled fund assets fell by 24% last year, according to the figures submitted by InvestHedge Billion Dollar Club firms that provide a breakdown of assets under management. Customised or bespoke portfolio assets, meanwhile, grew by more than 11%.

Demand for customised solutions drove the 6.5% in collective growth of the managed account platform providers that participated in the 2016 InvestHedge Managed Account Platform Survey and has meant these platforms are edging ever closer to the $100 billion mark. This is despite the 6% asset outflow from the FoHFs industry.

What makes this survey unique is that it chronicles the assets of third-party providers as well as FoHFs offering managed account products. These third-party providers, such as InfraHedge and Hedgemark, may work with smaller FoHFs or with other institutional investors looking to set up managed accounts with specific hedge fund managers. This grouping of 16 firms provides an unparalleled glimpse of an evolving space in institutional asset management that is also at the heart of the great debate over excessive hedge fund fees charged by traditional limited partnership arrangements.

The firms reporting the most sizable growth in 2016 were: InfraHedge, with $7 billion in additional assets; Man FRM, with $900 million; and HedgeMark and Innocap, with $600 million in fresh assets each.

InfraHedge has retained its position at the top of the asset ranking of managed account platforms. InfraHedge reports its asset figures once a year and, as a result, the $26.3 billion figure listed in the table is as of June 2016. According to Bruce Keith, chief executive officer for InfraHedge, assets on the platform increased during the second half of 2016, despite the hedge fund industry's struggles with performance in the first half of the year and the heightened media scrutiny that came with it. "The period from September to November was strong, it eased off in December and we have seen a marked pick-up in allocations since January – to existing managers and new managers," he says.

Bruce Keith,
CEO, InfraHedge

Recent growth on the platform has stemmed primarily from InfraHedge's institutional investor clientele who are increasingly using the platform to improve the cost efficiencies of their hedged allocations. Its clients are large institutions and, as Keith highlights, there is a degree of public interest in how the money invested by these institutions is spent. "The whole issue of the cost of hedge fund investing is not going away and poor performance in the first half of last year shone a brighter light on it," he adds.

In Keith's view the hedge fund industry could do more to help itself, as the 2% and 20% fee structure that is so often referred to is not the reality. InfraHedge platform clients have customised their investments, so the cost of ownership of their managed accounts is less than if they were invested in a manager's commingled vehicle, even when considering the costs of setting up and running a managed account on an external platform, according to Keith.

Clients negotiate fees with managers and settle on a price that works for both parties. There are costs associated with investing in a commingled vehicle that are not required in a single vehicle, however. Therefore, he adds, a managed account has a different cost base and investors can be smarter in structuring to focus on total cost of ownership including both manager fees and other expenses.

Keith has also seen a trend building whereby clients are re-thinking the structures they use for their managed accounts to improve cost efficiencies. Historically, the accounts were all structured the same – most frequently Cayman umbrellas that looked similar and operated in the same way. More recently, InfraHedge clients are concluding that one structure doesn't necessarily fit all their needs and they are increasingly looking for platforms to provide multiple struc-

THE WHOLE ISSUE OF THE COST OF HEDGE FUND INVESTING IS NOT GOING AWAY AND POOR PERFORMANCE IN THE FIRST HALF OF LAST YEAR SHONE A BRIGHTER LIGHT ON IT
BRUCE KEITH, INFRAHEDGE

WE HAVE SPENT SIGNIFICANT RESOURCES ON BUILDING OPERATIONS AND RISK AND PERFORMANCE REPORTING TECHNOLOGY OVER THE COURSE OF OUR DEVELOPMENT WHICH WERE DESIGNED SPECIFICALLY TO SERVICE MANAGED ACCOUNTS
JOSHUA KESTLER, HEDGEMARK

tures, across a single programme, while still allowing them to manage it in a single place.

"Our clients are asset owners, sovereign wealth funds and institutional investors that use their scale to drive down costs and this seems to be where they have begun to focus their attention," Keith says. "I am seeing mandates coming through that are looking for the capabilities to run multiple structures and put it all together."

A more strategy-specific trend that Keith has seen in mandates coming from the US market is an increased interest in creating a basket of non-correlated strategies, such as CTA and risk premia that can run alongside treasuries or fixed-income.

"We are seeing a marked interest in crisis risk offset programmes," Keith says. "If I look at the market today there are a number of sizeable mandates for risk premia strategies, driven by a need for 'what if' protection."

InfraHedge's open-architecture approach can accommodate demand for these trends and Keith is optimistic about the platform's potential growth as a result. "Everything feels like it is aligning and starting to come to fruition. I think we are on the cusp of good things to come," he says.

Another non-FoHFs platform provider is HedgeMark, which saw its assets increase by 6.82% in 2016 from $8.8 billion to $9.4 billion. When we last published the managed account platform survey, as of June 2016, HedgeMark's assets had decreased by 7.8% and stood at $8.12 billion, which indicates that the platform grew by 16% in the second half of 2016, with inflows amounting to more than $1 billion.

According to Joshua Kestler, president and chief operating officer of HedgeMark, the firm benefited from continued growth from existing clients and an overall trend for outsourcing across private hedge fund platforms and the firm won new mandates from FoHFs firms and large financial institutions in 2016.

Kestler believes that industry budget constraints, speed to market and ease of implementation were key factors for clients selecting the HedgeMark platform to host their managed accounts. He says that getting the budget and internal approvals at a large financial institution to build and operate a managed account platform takes time and to insource is very people and technology intensive.

"HedgeMark's platform is an easier and more efficient path. We have a staff of more than 200 people to support our platform and service our clients. We have spent significant resources on building operations and risk and performance reporting technology over the course of our development which were designed specifically to service managed accounts," he says. "As a BNY Mellon business, which services many managed account platforms, we believe that we have the ability to scale more effectively than a single, stand-alone platform."

HedgeMark has grown significantly since it was acquired with $3 billion on the platform by BNY Mellon two and a half years ago. It runs 62 dedicated managed accounts today and Kestler expects that number to grow to 100 accounts by the end of 2017. "One of the benefits of being a BNY Mellon business is that we have the people, resources and scalability to efficiently support this type of growth," he says.

HedgeMark has offices in the US and India and leverages other BNY Mellon offices globally. The group launched its first AIFMD-compliant account for a client in 2016 and Kestler expects to do more business in Europe in the near future. Aside from the considerable asset growth, the group continues to grow its team, with more than 30 new staff members joining the firm last year alone.

As for FoHF managed account offerings, Man FRM's managed account platform grew by 10% in 2016 to reach $9.8

Managed account platforms: ranked by size

	AUM 31/12/16 Total $bn	AUM 01/01/16 Total $bn	Growth $bn	% growth
InfraHedge*	26.30	19.27	7.03	36.48%
Deutsche Bank*	11.10	12.10	-1.00	-8.26%
Man FRM[1] **	9.80	8.90	0.90	10.11%
HedgeMark	9.40	8.80	0.60	6.82%
Lyxor Asset Management[2]	8.40	8.40	0.00	0.00%
Lighthouse Partners[1]	7.60	7.50	0.10	1.33%
LGT Capital Partners[1]	5.05	4.71	0.35	7.35%
Innocap Investment Management	4.90	4.30	0.60	13.95%
EntrustPermal[1]	4.70	7.30	-2.60	-35.62%
Pacific Alternative Asset Mgmt. Co[1]	4.31	4.15	0.16	3.78%
Amundi Alternative Investments [2] *	2.20	2.63	-0.43	-16.35%
Private Advisors [1] *	2.12	2.12	0.00	0.00%
JP Morgan Alternative Asset Mgmt.[1]	0.58	0.45	0.13	29.82%
AllianceBernstein [1] *	0.56	0.55	0.01	1.82%
LumX Group Limited [1] † **	0.28	0.43	-0.15	-34.65%
UBS Hedge Fund Solutions[1]	0.26	n/a	0.26	n/a
Total	**97.56**	**91.61**	**5.96**	**6.50%**

[1] Assets included in Billion Dollar Club entry [2] Assets not included in Billion Dollar Club entry
**assets as of 30 June 2016 ** Assets as of 30 September 2016 † formerly Gottex Fund Management*

Source: InvestHedge

OUR MANAGED ACCOUNT PLATFORM HAS GROWN SIGNIFICANTLY OVER THE PAST FEW YEARS TO MORE THAN A THIRD OF MAN FRM'S TOTAL ASSETS TODAY
KEITH HAYDON, MAN FRM

billion as of September 2016. Ranked third by assets in our survey, new inflows to the platform came primarily from large investors in the US that wanted access to dedicated managed account services.

Man FRM provides the technology, people and processes and the clients pick and control their choice of hedge fund.

According to Keith Haydon, chief investment officer of Man FRM, the group has started to see a material interest in this offering and new assets are moving quite quickly into dedicated managed accounts that are hosted on the Man FRM platform.

"Our managed account platform has grown significantly over the past few years to more than a third of Man FRM's total assets today," Haydon says. "It is a good achievement for us. We wanted to establish a presence in the US and now we are working in full partnership with a number of substantial state plans in the region."

LGT Capital Partners' managed account platform assets increased by 7% to exceed $5 billion at the end of 2016. Innocap Investment Management's platform grew by 14% and PAAMCO's platform rose by 4%. JP Morgan Alternative Asset Management's platform, first featured in the rankings this time last year, reported asset growth of 340% in 2015. In 2016, assets increased by 30% to reach $600 million.

UBS Hedge Fund Solutions is a new addition to the managed account platform rankings this year. The $34 billion FoHF, which is ranked second in the InvestHedge Billion Dollar Club, has recently launched its own internal platform to enable it to fully customise its managed accounts.

Bill Ferri, head of products and solutions for UBS Asset Management, explains that the launch of the platform does not mean the group has entered the managed account platform business and it still plans to use vendors. "Vendors in the space are getting better and better and we aren't looking to compete with service providers," Ferri says. "What it means is that we are going to be using managed accounts as a tool more aggressively and we will be doing so in-house more than in the past to identify ways where we can add value to portfolios."

Ferri explains that the group will use the managed account platform when it wants to express its views in a more targeted way and where it believes it can add value through customisation. The primary catalysts for the launch of the platform have been client demand for more granular information and to better understand risk across the broader portfolio.

The UBS Hedge Fund Solutions in-house managed account platform will help the team analyse fees, particularly when accessing undifferentiated market returns. The group then aims to add value by using the platform to identify if there are more efficient ways to express their views in a more liquid and inexpensive fashion. "The platform will help us to ensure we are paying a fair price, both in terms of fees and liquidity, for smart market exposure," Ferri says.

Keith Haydon,
CIO, Man FRM

Bill Ferri,
head of products and solutions, UBS Asset Management

VENDORS IN THE SPACE ARE GETTING BETTER AND BETTER AND WE AREN'T LOOKING TO COMPETE WITH SERVICE PROVIDERS. WHAT IT MEANS IS THAT WE ARE GOING TO BE USING MANAGED ACCOUNTS AS A TOOL MORE AGGRESSIVELY AND WE WILL BE DOING SO IN-HOUSE MORE THAN IN THE PAST TO IDENTIFY WAYS WHERE WE CAN ADD VALUE TO PORTFOLIOS
BILL FERRI, UBS ASSET MANAGEMENT

Sponsor HedgeMark

HedgeMark, a BNY Mellon Company, specializes in supporting institutional clients in the development and operation of their own private hedge fund dedicated managed account platforms. HedgeMark's dedicated managed account services and position-level risk and performance analytics are aimed at institutional investors seeking increased customization, transparency, control and governance around their hedge fund investments. HedgeMark's team is led by well-established industry professionals with extensive experience in the structuring, operations, monitoring and oversight of hedge fund managed account structures.

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Sponsor Innocap

In the managed account platform industry since 1996, Innocap focuses on structuring and operating customized managed accounts solutions for sophisticated institutional investors across the globe. The firm's core business includes:

- Structure customized investment vehicles
- Perform due diligence and on-board external asset managers
- Supervise funds' daily operations
- Perform risk management
- Ensure compliance and independent fund governance

With the benefit of being owned by two large financial institutions, Innocap distinguishes itself in the managed account space through its dedicated in-house resources, unparalleled flexibility, and advanced technological infrastructure.

Focused on clients' evolving needs, and thanks to its multi-jurisdictional presence, Innocap has been able to provide asset owners, distributors and asset managers with tailor-made managed account solutions around the world.

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Sponsor Lyxor Asset Management Group

Lyxor Asset Management Group, wholly-owned directly or indirectly by Societe Generale and composed notably of two subsidiaries [(1)] [(2)], is a European asset management specialist, an expert in all investment styles, active, passive or alternative. From ETFs to multi-management, with EUR 122.3 billion* under management and advisory, Lyxor creates innovative investment solutions to meet the long-term challenges of managing savings. Thanks to its experts and its engineering tradition and research, Lyxor combines search for performance and risk management.

(1) *Lyxor Asset Management S.A.S. is approved by the «Autorité des marchés financiers» (French regulator) under the agreement # GP98019.*

(2) *Lyxor International Asset Management S.A.S. is approved by the «Autorité des marchés financiers» (French regulator) under the agreement # GP04024.*

* *Including EUR 15bn assets under advisory. Equivalent of USD 130.6bn in assets under management and advisory (including USD 16bn assets under advisory) at the end of March 2017*

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Sponsor Man FRM

Founded in 1991 and becoming a part of Man Group in 2012, Man FRM ('FRM') is a global alternatives investment specialist with USD 14.5 billion of assets under management and 56 professionals located in London, Guernsey, New York and Switzerland*. Today FRM is a leading provider of open architecture, full service hedge fund solutions. Working in partnership with institutional clients globally, FRM offers a flexible approach to implementing hedge fund solutions through a range of hedge fund and liquid alternative investment options in a number of formats, all enhanced by its investment driven USD 10.3 billion managed account platform.

**As of March 31 2017*

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Sponsor NorthStar

With more than 800 employees and over $560 billion in assets under management and administration as of April 30, 2017, NorthStar Financial Services Group, LLC (NorthStar) empowers its partners in the financial services industry through innovative tools, resources, and solutions. NorthStar has a foundation of innovation, expertise, and integrity. Upon that foundation sits a broader structure that gives us the ability to deliver results and build personal relationships with our clients.

The NorthStar companies work together to provide services, such as asset management, fund distribution, operational support for pooled investment solutions, and portfolio accounting for investment advisory firms, all under one roof. The collaborative effort among our organization's nine subsidiaries and the wide range of services they provide enables our partners to better serve their existing customers and reach new ones. NorthStar is a growing, talented, and diverse company.

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