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The rise and rise of managed accounts

Among all the big changes in the alternative asset management industry since the global financial crisis, one of the most significant has been the growth of managed accounts. Once disparaged as a mechanism suitable principally for lesser-quality managers and investors, managed accounts – and, in particular, managed account platforms – have come in recent years to occupy centre stage in the fast-evolving relationship between allocators, underlying managers and intermediaries. In terms of transparency, liquidity, cost-effectiveness, customisation, flexibility and control, managed accounts present numerous benefits to end investors and multi-managers alike – whilst there are now very few top-tier management firms that will not accept managed accounts. As Philip Moore outlines in this special HFM report, managed accounts have gone from being the poor relation of the co-mingled fund to becoming the preferred investing route for allocators across the spectrum of the alternatives world – offering the ‘Holy Grail’ of better returns at cheaper cost.

Are hedge funds out of the doghouse? Yes and no.

According to a recent survey published by BNY Mellon, alternative assets under management reached a record $7.7trn in 2017. That record is unlikely to stand for long. More than half (53%) of respondents to the BNY Mellon survey expect their allocations to increase over the next 12 months, up from 39% in the 2016 survey.

Perhaps more significant, for the longer term rehabilitation of the alternative investments industry, 59% of respondents to the survey indicated that they now have more confidence in hedge funds, while only 5% said they are now more negative.

Other surveys paint an equally upbeat picture of likely future demand. In its latest survey of the global hedge fund industry, Barclays’ Capital Solutions team advises that 49% of investors plan to boost their net allocations to hedge funds in 2018. “Given the positive backdrop,” says Barclays, “we expect the hedge fund industry to garner net inflows of about $40bn in 2018. We also forecast that gross allocations will be about $330bn and that most channels will be net allocators.”

The improved performance of hedge funds has, of course, worked wonders in helping investors to forgive the industry for many of the shortcomings that were exposed during the global financial crisis.

A study released in February by Preqin and the Alternative Investment Management Association (Aima) found that hedge funds had produced “more consistent and steadier returns than equities or bonds over both the short and the long term”. The same study found that about 32% of all hedge funds produced double-digit returns in 2017, up from about 23% the previous year.

Changing the rules of engagement

While investors may have forgiven the hedge fund industry for some of the failings of the past, they certainly have not forgotten them. The result is that while institutional alloca-
tions to alternative products are on the rise, the rules of engagement between hedge fund managers and investors have changed.

Institutions are increasingly insistent that these rising allocations are made on their terms, rather than on those of managers who were used to calling most of the shots prior to the financial crisis. As BNY Mellon puts it in its latest survey, “as alternative allocations have risen, so have investors’ voices”.

The increasingly vocal influence of institutional investors in the market for alternative products has been sending shockwaves through the hedge fund industry for several years. As well as pushing many managers into adopting a more open and communicative stance towards their investors, it is forcing most to compromise on their fee structures in a way that would have been unimaginable a decade or so ago.

According to industry data, average management fees were 1.4% in the first quarter of 2017, with performance fees slipping to an average of 17.1%. 82% of respondents to the BNY Mellon survey, meanwhile, expect fees to fall further over the next 12-18 months. 1.4 plus 17.1 may not trip off the tongue quite as alliteratively as 2 and 20, but hedge fund managers had better get used to the new reality, which is that fees are heading inexorably lower.

Nowhere has the institutional clamour for reduced fees across their investments been more deafening than among US public pension funds. State retirement schemes in particular have become increasingly preoccupied by management fees against the backdrop of an environment of low inflation, low yields, sometimes questionable performance and political pressure to minimise costs.

Conscious of the PR value associated with cutting costs, some of the US states have made very public pledges to stop lining the pockets of the investment management industry with taxpayer dollars. North Carolina is one of the more outspoken states on this count. “Treasurer [Dale] Folwell and the investment management team cut costs significantly in 2017 to provide more value to members of the pension plan,” the Department of the State Treasurer said in February. “During the first year of Folwell’s administration, fees paid to Wall Street investment managers were reduced by more than $600m for a projected saving of $240m over four years. That figure exceeds Folwell’s pledge to cut fees by $100m over four years.”

The Massachusetts Pension Reserves Investment Management Board (MassPRIM) has also been explicit about its commitment to reducing the fees paid by the Pension Reserves Investment Trust (PRIT), which had a net asset value of $71.6bn at the end of March 2018. “We value a basis point of cost reduction more than a basis point of return,” said chief investment officer Michael Trotsky in his February 2018 update on the fund’s performance. “Why? We can count on cost savings every year, but nobody ever really knows what the markets will deliver.”

THE SHIFT TO MANAGED ACCOUNTS
One of the most discernible by-products of the increasingly vocal institutional support for hedge funds has been the sharp increase in assets migrating towards managed accounts, and more specifically towards managed account platforms (MAPs), which saw their assets rise from $41bn in March 2010 to $112bn in March 2018.

This explosive growth reflects the fact that hand-in-hand with demanding more bang for their buck, deep-pocketed and influential institutional investors have also insisted on TLC, the catchy acronym for transparency, liquidity and control.

In a nutshell, managed accounts achieve this by effectively relieving managers of responsibility for all the day-to-day functions of managing a fund other than the investment or trading decisions that generate the alpha which is their raison d’être. Ben Browning, chief operating officer at Franklin Templeton’s K2 Advisors, describes these functions as the plumbing that is essential.

Given the positive backdrop, we expect the hedge fund industry to garner net inflows of about $40bn in 2018. We also forecast that gross allocations will be about $330bn and that most channels will be net allocators.

BARCLAYS CAPITAL SOLUTIONS
to ensure that funds are managed efficiently and transparently.

“The idea is that managed accounts take the onus of operational due diligence away from the manager,” Browning explains. “We simply ask the managers to implement their strategies consistent with the investment guidelines and objectives originally agreed. In other words, when they’ve executed their trades, the managers’ day is over. We take over, setting up counterparty agreements, establishing pricing policies, overseeing the administrators who calculate the net asset value (NAV) on our behalf, and so on.”

**OPERATIONAL BENEFITS**

Investors echo the view that MAPs provide significant operational advantages. “There are internal operational benefits from using a MAP,” says Marc Lorin, director of strategic relations at Coquest Advisors, a Dallas-based full-service brokerage firm focusing on executing commodity futures trades.

“It greatly simplifies our own operational requirements. Compared to separate managed accounts, we think of MAPs as an outsourced middle and back office solution, where the MAP provider does most of the day-to-day work and delivers the necessary reports and aggregated data for us to do our job.”

“But it does not stop at the day-to-day level,” adds Lorin. “MAPs also alleviate the structuring and fiduciary burdens associated with running managed accounts.”

The MAP service is especially well suited to investors with a very clear idea of their own strategic objectives, explains David Young. He is president of Gemini Hedge Fund Services and Gemini Alternative Funds, which specialises in providing financial institutions with access to multiple solutions for pooled investment products via its fast-growing MAP.

“Our offering is ideal for allocators who have their own conviction about the managers and strategies they want to allocate to,” he says. “We do not offer any investment advice. We provide the operational infrastructure to support those who already have an investment mandate or investment thesis.”

**A TREND THAT IS HERE TO STAY**

More broadly, data pointing towards rising demand for managed accounts is corroborated by a recent Credit Suisse survey which polled the views of more than 200 respondents worldwide from hedge funds and other investors, with aggregate assets under management (AuM) of about $765bn across a well-diversified range of strategies. This reports that over the last 12-18 months, more inflows were directed to non-traditional vehicles (52%) than co-mingled funds (48%). Managed accounts were the principal beneficiary of this movement, says Credit Suisse, accounting for 25% of all inflows.

Uptake of managed accounts is a trend that appears to be here to stay. “As hedge funds continue to be viewed as solutions providers and sophisticated investors look for tailored advice, we think interest in managed accounts will continue,” Credit Suisse comments.

“Therefore, industry participants (including those who feel managed accounts may not be a viable strategy) need to pay attention.”

Others agree. As with the total inflows into hedge funds, managed account assets are set to continue rising over the foreseeable future. According to the BNY Mellon survey, these are projected to rise from 17% of hedge fund allocations to 22% over the next 12 months.

If this turns out to be an accurate forecast, it will represent quite a change in institutional attitudes towards managed accounts over a relatively short period. As recently as 2014, a Towers Watson report on trends within the hedge fund industry acknowledged the benefits that managed accounts could provide in respect of control, ownership, liquidity, transparency and portfolio customisation.

But the same report appeared to be hesitant about giving a full-throated endorsement of the structure, cautioning that control was not always as complete as hoped for, that adverse selection bias was a potential problem, and that costs tended to be high.

The report concluded that “while managed accounts offer many potential advantages for investors...we believe the costs of the structures and the governance requirements of operating them outweigh the benefits for many investors”.

Managed accounts providers confirm that as recently as four or five years ago, evangelising among hedge funds – in particular – was an uphill battle. “Back in 2013, managers weren’t receptive at all to the idea of
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managed accounts,” says Browning at Franklin Templeton. “At the time, most hedge funds were still able to charge 2+20, and many of them asked us why they should participate in a program that would cannibalise their business.”

Since the publication of the Towers Watson report, many of hedge funds’ reservations about managed accounts appear to have melted away. In its 2014 report, Towers Watson identified adverse selection bias as one of the principal drawbacks of managed accounts, “There are still a large number of hedge funds that remain strongly against these structures, resulting in an adverse selection bias,” this noted. “In other words, investors will not be able to gain access to some of the best funds.”

Fast forward to today, and the number of hedge funds refusing to make their strategies accessible to investors in managed account format is nose-diving. In its survey, Credit Suisse reports that 60% of hedge funds have managed accounts, while 16% are intending to start them.

A recent EY report, meanwhile, finds that “over half of managers offer SMAs [separately managed accounts], and for those that do, they indicated that a quarter of their firm’s overall assets reside in these accounts. This is aligned with investors, of whom 55% said they invest using SMAs. Of those who do, nearly half of their hedge fund allocations reside in these accounts”.

IF YOU CAN’T BEAT THEM...

In one respect, this suggests that rising acceptance of managed accounts among hedge funds has become a self-fulfilling prophecy, with most managers now apparently observing the adage that if you can’t beat them, you should join them.

The upbeat findings of recent surveys, however, is not to suggest that hedge funds have dropped their objections to managed accounts altogether. Far from it. According to Credit Suisse, liquidity and fees top the list of reasons why some hedge funds remain queasy about making their strategies available via managed accounts, followed by operational complexity and system integration. Perhaps surprisingly, they appear to be less concerned about trading restrictions, portfolio disclosure and cannibalisation of their investor bases.

While hedge funds’ unease about managed accounts is clearly receding, this does not mean that the issue of adverse selection bias has entirely evaporated. “Negative selection bias is still a consideration,” says Sam Thompson, head of managed accounts at Man FRM. “But we’ve been able to on-board even some of the more reluctant organisations with enough explanation and a thought-out process allowing the manager to work within its preferred operating environment.”

“There are still funds that won’t run a managed account,” he adds. “However, in most cases this is because they are at or near full capacity and not looking to take in a significant amount of new capital. While we have found that some of the more quantitatively-driven managers may have concerns about intellectual property, this is becoming less of an issue.”

ARE SOME STRATEGIES LESS SUITABLE THAN OTHERS?

Investor misgivings about selection bias and related concerns have clearly diminished as hedge funds have warmed to the concept of managed accounts. 45% of respondents to Credit Suisse’s 2018 survey highlighted negative selection risk as their main concern associated with managed accounts, compared with 58% in 2009. Over the same period, those regarding the likelihood of tracking error as a worry fell from 41% to 24%.

Among investors, hand in hand with misgivings about adverse selection bias, a common concern about managed accounts was that they may not have lent themselves equally to all strategies. “Some strategies will
simply not be available,” Towers Watson cautioned in its 2014 report. It added that while it was relatively straightforward to offer CTAs in managed account format, strategies such as those investing in private debt or equity, those focused on less liquid assets and those looking to exert control over companies were less suitable. “This is because of the difficulty in valuing these positions, the inability to split allocations across different accounts and the required minimum deal sizes,” Towers Watson observed.

The argument that some strategies are less suitable for managed accounts than others remains valid today. “Managed accounts are most viable for strategies where liquidity is not a limitation, such as traditional long/short equity, global macro and some of the more liquid areas of the credit universe,” says Browning at Franklin Templeton.

“But there are two strategies that we regard as inappropriate for a managed account framework. One is high frequency trading strategies where the costs of implementation would be much higher in a managed account than in a traditional hedge fund. The second is some of the more private credit type strategies where, among other things, valuation is driven by the underlying manager rather than readily ascertainable market data.”

This does not necessarily mean that illiquid strategies and managed accounts need always be mutually exclusive. “Even in the case of highly illiquid strategies, there is an understanding that managed accounts are still possible,” says Charles Hill, European head of hedge fund sales at Societe Generale Prime Services. “Of course, investors may have to accept similar liquidity terms to the reference fund, and managers will need to consider the operational implications of having to split trades.”

TAKING BACK CONTROL

In the early post-crisis period, concerns about illiquidity were the main reason institutions started to look more favourably towards managed accounts, according to the Credit Suisse survey. In 2008, avoiding the risk of being gated was named by 78% of respondents to the survey as the primary reason for investing through managed accounts, followed by various other concerns related to liquidity.

These days, demand for managed accounts is being defined chiefly by an increased requirement for investors to exercise more control over their exposure, with transparency and customisation the main twin engines of demand.

While gating-phobia was regarded by 64% of investors to the 2018 Credit Suisse survey as the main reason for turning to managed accounts, this has now been trumped by transparency and customisation. Worries about liquidity slipped down the list in 2018, with transparency of portfolio composition and risk analytics named by 80% of investors as the main benefit of managed accounts, followed by clarity over how and where positions are held (68%) and customisation on fee amendment (65%).

These drivers are similar to those that have turbocharged the growth of the global market for Ucits and liquid alternatives. “Ucits have often become the preferred managed account investment structure for hedge fund investors in Europe,” says Andrew Lapkin, CEO of HedgeMark, the managed account and risk analytics specialist 100% owned by BNY Mellon.

“The dedicated managed account structure is still the preferred format in the US and Asia. But in Europe, the AIFMD structure has not been adopted as widely as many originally anticipated. Instead, European investors are moving towards the improved control, governance and transparency provided by alternative Ucits. On the HedgeMark platform, we now have over $5bn of assets that fall into the liquid alternatives category – either in the

Sam Thompson, head of managed accounts, Man FRM
form of UCITS or ‘40 Act mutual funds.”

Lapkin says that the customisation and flexibility built into the DNA of managed account structures has been an especially significant driver of their popularity among funds of hedge funds. This has in turn underpinned what Lapkin describes as a sea change in how alternative asset managers operate.

He says that far from collapsing, as many market observers believed they would, funds of hedge funds have begun to evolve from being product-driven to solutions-driven investment vehicles. “In other words, funds of funds are providing much more bespoke solutions, by identifying their clients’ specific needs and aiming to add more value than just manager selection,” says Lapkin. “Almost all the top fund of funds providers are now using managed accounts in some form, to create custom solutions for clients.”

HedgeMark’s president and COO, Joshua Kestler, says that a key component of this trend towards customisation is co-investment by funds of funds alongside their investors. “A co-investment opportunity often arises from the manager approaching the allocator with a specific, opportunistic investment idea,” he explains. “The allocator can obtain direct, concentrated exposure to a specific investment opportunity which meets its investment objectives and risk parameters.

“This industry evolution means that many funds of funds are becoming more like direct trading shops by investing in dedicated managed accounts,” he adds. “The value of investing through a dedicated managed account structure for funds of funds is the ability to materially improve both investment and risk oversight of portfolios. This is because they can monitor them down to the position-level on a daily-basis rather than monthly based on whatever limited information a manager provides to them. This new model is light years ahead of what was previously available to allocators and investors.”

This mirrors the broader trend across the hedge fund industry of managers recognising that they will need to become more responsive (and in some cases more proactive) to investors’ requirements if they are to survive.

This is especially important in an environment in which investors are increasingly demanding exposure that may be tailored to highly specific social or ideological requirements, as well as to performance, volatility and correlation targets.

For investors with strict parameters on compliance with ESG standards, for example, or for those with Islamic mandates, managed accounts may be an ideal way of filtering out inappropriate exposures embedded in a co-mingled vehicle.

**DAILY TRANSPARENCY**

Fundamental to this element of customisation is the daily transparency that is another important feature of managed accounts. “Daily transparency means that investors are much better positioned to monitor against style drift, and ensure that managers’ strategy implementation is consistent with their mandate,” says Lapkin.

“This goes further than simple customised investor solutions by looking at portfolios at a security level rather than a manager level and assessing the impact of consolidating fund positions;” he adds. “For example, by allowing investors to monitor their exposure on a daily basis, managed accounts give investors a more efficient way of assessing their exposure to beta in their hedge funds, which many investors think may be too high. We’ve seen some alternative investment managers using beta overlays, which allows them to gain access to managers’ talent and to the alpha embedded in their funds, whilst eliminating some of the excess beta in the strategy.”

Lapkin adds that an example of HedgeMark’s innovation in enhanced portfolio construction has been the roll-out of what it calls concentration and cancellation functionality. “The idea here is that investors can identify holdings of the same security across multiple portfolios and ensure that their net holdings meet their overall objectives,” Lapkin explains.
THE VALUE OF TRANSPARENT DATA

Among those bearing witness to the difference that managed accounts have made to the daily operations of funds of hedge funds is Rob Christian. He is head of research at K2, where he co-manages the Franklin K2 Alternative Strategies Fund, a multi-strategy product launched in 2014 which now has assets of some $3.2bn.

“From a research perspective, we get so much more information from a managed accounts platform,” he says. “The information we’re given on positioning, risk and leverage is all similar to what we would receive as an investor in a co-mingled fund. But the difference is that we get it 21 times a month and with much more granularity. This is extremely valuable when it comes to comparing and contrasting managers within the same peer group. Rather than just see that two managers each made 1% over a month, for example, transparent data gives us more of an insight into exactly how that return was generated.”

“Similarly, at the portfolio level, because we have position data we are able to follow changes in risk exposure as correlations shift or as volatility rises,” he adds. This, says Christian, has very notable benefits for investors in funds of funds. “The value for end-users is that instead of viewing hedge funds as separate allocations, they can think of their role within their portfolio in a more holistic way, and see much more clearly how they complement the risk elsewhere within the portfolio,” he explains.

Christian agrees that customisation supporting enhanced portfolio construction is another key attraction of managed accounts. This may involve cherry-picking the most successful components of individual managers’ strategies. “For example, in cases where hedge funds have found it difficult to make alpha on the short side of their book, or where the short exposure has been a drag on performance, we have been able to work with managers to carve out the liquid parts of their long book,” he says. “In other words, we have been able to extract the best skills of the manager and bring this to market in a liquid, lower-fee format.”

Others say that the transparency managed accounts offer investors is an example of a benefit that has evolved in recent years, greatly strengthening their appeal to investors and underlining the dynamism and flexibility of the managed account construct. “The core benefits of managed accounts have always been transparency and control,” says Man FRM’s Thompson. “But what has developed over the years is the extent to which investors and managed account platforms have been able to extract value from these benefits.

“In the case of transparency, for example, what has improved is our ability to analyse the data and report it both to our internal teams and to our clients in a way that helps them to make informed investment decisions,” Thompson adds. “This has been supported by our own investment in technology, which has helped us to consume and interpret data more quickly and more interactively.”

THE IMPORTANCE OF DIGESTING AND AGGREGATING DATA

The provision of unparalleled volumes of information sounds good on paper. In practice, says Franklin Templeton’s Christian, the challenge is aggregating, visualising and using the mountains of data now being made available through managed accounts.

This mirrors the broader challenge faced across the investment management community of marshalling data efficiently, which was highlighted in a survey of 86 investors published by State Street in May. This found that more than half (60%) of institutional investors surveyed plan partly or fully to outsource their data management over the next three years. “Currently,” State Street reports, “52% conduct all of their data management functions in house. However, by 2021, this is expected to fall to 36% with 15% aiming to fully outsource this function to an external partner.”

“In an environment of increasing regulatory requirements, and with low yields necessitating investors to look into alternative - and often more complex - sources of alpha, we have been able to extract the best skills of the manager and bring this to market in a liquid, lower-fee format.”

Rob Christian, head of research, K2 Advisors
it seems clear that institutional investors will continue to prioritise data management and analytics to make better investment decisions, meet regulatory requirements, and gain competitive advantage,” said David Pagliaro, head of State Street Global Exchange, EMEA, at the release of the survey. "It appears the natural and most effective next stage of this technological evolution is for institutional investors to partner with data and analytics specialists, allowing them to focus on their core competencies."

One reason for this, as Societe Generale’s Hill points out, is that information overload can have implications for institutions’ liabilities. “If you’re a pension plan allocating via a managed account and you’re not able to interpret or use the data available, you potentially face the danger of having too much information and making wrong decisions as a result,” he says. “The question is, are you set up, or equipped, to deal with this enhanced transparency?”

For the managed account platforms themselves, as well as for hedge funds, making sense of the cascade of information they are required to digest is one of the areas where a service like ENSO steps in. Part of NEX, ENSO is a treasury, cash, counterparty and portfolio finance management service catering to hedge funds, asset managers and other buyside institutions that has posted explosive growth in the buyside in recent years.

“ENSO was originally positioned to help hedge fund managers and alternative platforms aggregate their market exposure as well as their financing across their prime brokers, creating a technology community for like-minded treasurers, COOs and heads of operations,” says Paul Busby, head of analytics at NEX Optimisation. “Historically, hedge funds with three or four prime brokers would need to access several online prime broker portals in order to extract the proprietary

information and technology they needed. Either way, hedge funds still had to manage that data – normalising, aggregating and exporting information became increasingly difficult and costly to maintain.”

It was a cumbersome and operationally intensive process that was par for the course prior to the arrival of ENSO, says Busby. “As the market evolved, ENSO Core became the aggregation hub for the buy-side operational needs. We provided them with a holistic view of their counterparty exposure and financing management. Utilising third-party technology in place of internally built infrastructure creates a tremendous amount of efficiency,” he explains.

Demand from the alternative investment management community has been strong. “Fast forward a few years and we have over 130 clients on our platform globally,” says Busby. “These include some of the largest and most sophisticated hedge funds in the world. These clients represent strategies ranging from long/short equity to multi-strategy and quant funds, as well as many of the most successful managed account platforms.”

Busby points to a leading managed account platform as a good example of a client that has made very productive use of the seamless aggregation of data that the ENSO Core service provides. “By aggregating data from each of the managers on its platform, for example, we give this client a very transparent view on the counterparty exposure of all of those managers,” says Busby. “This helps them manage cost savings by providing a snapshot view into efficiencies in securities lending, margin, capital-use and financing.”

The economies that have been generated as a result are not to be sniffed at. “Providing an aggregated view of their stock borrow and their broader financing, we have helped our clients save millions of dollars, creating efficiencies which are ultimately passed down to their investors,” says Busby.

The successful evolution of ENSO’s service has developed in tandem with the growing importance of the treasury function within hedge funds. “Up until five or six years ago, the treasury role was generally deemed by hedge funds to be a relatively back office function,” says Busby. “Since then, the increased cost of liquidity and balance sheet, twinned with the rising

Paul Busby, head of analytics, NEX Optimisation

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cost of funding, has led hedge funds to pay much more attention to the role of treasury. The result is that some of the world’s most sophisticated hedge funds now employ very skilled treasury staff, and managed account platforms are looking to build a similar level of sophistication. This is quite a challenge, given that they have multiple hedge funds with multiple bank relationships to aggregate and understand, as well as multiple fund administrators to deal with.”

EVERY BASIS POINT COUNTS

The value of the savings generated by ENSO Core is especially meaningful at a time of low returns. As Elena Jakovleva, head of US client experience for NEX Optimisation says, “in this environment, every basis point counts. Returns have been lacklustre in recent years, so optimising and tightly managing financing costs really feeds through to the bottom line”.

This echoes the mantra from champions of managed accounts that a driver of their popularity has been their capacity to reduce costs. However, if the Credit Suisse survey is anything to go by, the costs associated with managed accounts are still not falling fast enough for investors’ liking. Asked to pinpoint their main concern about managed accounts, 59% of allocators named the expenses and fees of operating them. Surprisingly, this is up from 49% in 2009. “This is a concern regardless of the structure employed,” says Credit Suisse. “Internal platforms require greater resources and day-one costs, while MAPs have ongoing operating expenses/platform fees.”

HedgeMark’s Kestler says that the cost benefits of managed accounts apply across at several different levels. The first of these relate to what he describes as the operational alpha that can be generated through the reduced role of the manager in the day-to-day running of the fund. “Because managers are no longer responsible for functions such as NAV oversight and collateral management, they need fewer middle and back office resources, which makes it easier for them to reduce their fees,” he says.

Others agree that reduced management fees are probably the main cost benefit derived from using managed account structures. “Underlying manager fees are being compressed across the hedge fund industry,” says Franklin Templeton’s Christian. “But access fees are also important. On our platform, we don’t share revenues nor have any kind of rebate or captive brokerage relationship with the managers, as some of our competitors do.”

Another cost benefit arises from the economies of scale that managed accounts are able to leverage. “Managed account investors are often able to negotiate reduced, platform-wide rates with service providers, which can result in lower fund operating expenses and an improvement in the total return,” Kestler adds.

Gemini’s Young also emphasises that managed account platforms create multiple layers of cost savings, but he adds that the magnitude of these economies differs substantially depending on the platform’s structure. “Many platforms still outsource some services to third parties,” he says.

“Our platform is designed to offer a service which is completely integrated across the organisation. This means that it provides all the services required by the end-user, thereby reducing not just the costs that would be incurred by investing through a co-mingled fund, but also delivering a service that is more cost-effective than many other managed account platforms. Some of these charge separate platform and administration fees, which add up to more than double what we would charge for handling everything internally.”

MAPs backed by large asset management groups say that their bargaining power plays an especially important role in reducing costs. “We have $780bn under management and trade with virtually every major counterparty across the Street, which means we are able to use these relationships to keep costs down,” says Christian at Franklin Templeton. “Our scale also ensures that we can minimise legal, custody and administrative expenses. Although the reductions here may only be a handful of basis points, savings of 5bps or
6bps can add up to very meaningful amounts for large investors.”

The enhanced bargaining power that $780bn of AuM can provide is particularly applicable in managed accounts’ relationships with prime brokers. As Browning says, many prime brokers have already pared their operations and increased their fees in response to capital constraints arising from regulatory pressures which have risen in recent years. “At the same time, most of the banks have started to consolidate or rationalise their hedge fund relationships, and some will now only play ball with those that are generating a meaningful rate of return,” he says. “This means that the nature of our discussions with banks on areas like futures clearing and stock lending is meaningfully different to those that the prime brokers will have even with a $2bn manager.”

Thompson agrees that the economies of scale negotiated by large investment management groups such as Man FRM can and do generate very significant cost savings for investors. “We are continually looking to use our greater buying power to try and achieve improved fee reductions and discounts compared with co-mingled funds’ headline fees and expenses,” he says.

“Another component of the potential cost savings which is more specific to the managed accounts space is that we are able to construct simpler structures compared to the co-mingled alternatives,” Thompson adds. “When you’re launching an off-the-shelf co-mingled fund, you have to satisfy and support a wide range of different investors and investor types across a number of jurisdictions, each of which are subject to different regulatory regimes.”

This, he says, adds an entire layer of legal and structuring costs which may only be relevant for a handful of investors in a co-mingled strategy. The result may be that an onshore EU investor, for example, may find himself sharing the costs of reporting required only by US investors, and vice versa.

“In a managed account, you can slim down and refine the structure to meet the precise requirements of an individual investor, with obvious cost benefits,” says Thompson.

Investor resistance to the high costs associated with accessing alternative managers has opened the way for the establishment of new platforms which aim to challenge the status quo on fees. One example is the New York-based Blueprint Capital Advisors, a New York-based multi-manager platform launched in 2015, which insists on its website that “investment in alternatives doesn’t have to be expensive”.

“The Blueprint model was founded on a core value proposition – helping investors invest in the right alternatives at the right price,” says Jacob Walthour, Blueprint’s CEO. “Simply put, we are out to combat the dilutive impact of fees on net returns, and managed accounts provide the best means to this end.”

“The “one size fits all commingled fund pricing model” serves the manager,” he adds. “The sooner fiduciaries realise that, the better off their portfolios will be. Managed accounts provide the infrastructure and optionality to achieve lower fees and higher net returns. It’s a risk-neutral decision that they are making more and more each day.”

QUANTIFYING THE COST BENEFITS

In most cases, the cost savings generated by managed accounts are predictable, quantifiable and repeatable – in sharp contrast to the far more volatile returns that are a function of investment performance. “An important feature of these expense savings is that once negotiated, they are certain,” says Kestler at HedgeMark.

Because the costs associated with managed accounts are so immediately quantifiable, they dovetail with the broader transparency benefits offered by these structures. “Because we can measure and calculate the cost savings so accurately, it is very easy for us to report them back to our clients in whatever form they need the information for regulatory or fiduciary reasons,” says Christian at Franklin Templeton.

Another important cost consideration,
Kestler adds, arises from what he describes as the realignment of fees. “This is not always or only about reducing fees, but also about making certain that fees are commensurate with returns,” he explains. “By incorporating features such as hurdles and longer crystallisation periods, it is possible to improve the alignment of interest between the investor and the manager.”

In an environment in which every basis point counts, generating cash efficiency is another highly appealing feature of managed accounts, with investors only required to commit sufficient cash to allow for strategies to comply with their investment guidelines and meet its margin requirements. This has the advantage of freeing up excess cash for use elsewhere. “While there is nothing new about the potential cash efficiency generated by managed accounts, we are now seeing investors more rigorously scrutinising the amount of capital they need to commit in order to create a certain investment exposure,” says Thompson at Man FRM.

Gemini’s Young agrees. “It is essential to have a clear understanding of what your cash requirements are going to be on a daily basis,” he says. “A customised managed account allows you to sweep any excess cash and invest it productively, rather than leave it sitting in an account which will generate no return for you or your clients.”

In tandem with the quantifiable cost savings associated with using managed accounts, platform providers say that on-boarding new investor clients has now been streamlined to maximise the speed and efficiency of the process. “I believe there is sometimes a misconception about the complexity involved in using managed accounts, which is becoming easier every day,” says Young. “In the case of clients coming to us with funds they are ready to allocate and a clear conviction regarding their chosen managers, the entire service could be up and running within six to eight weeks.”

**MACs win support from prime brokers**

As the managed account ecosystem has expanded, flourished and accommodated an increasingly diverse range of managers and strategies, the leading prime brokers supporting hedge funds and managed account platforms (MAPs) have also adapted the way they service the sector.

Take the example of Societe Generale Prime Services, whose European hedge fund sales head Charles Hill describes managed accounts as being part of the DNA of the bank. “We were a pioneer in the managed accounts space through our legacy business, Newedge, which was originally built up around some of the early managed futures funds,” says Hill. “Many of these were launched with managed accounts,” says Hill.

“The result is that today, managed accounts as a concept we are very familiar with throughout the organisation,” he adds. “In the context of an increasingly complex regulatory environment, it is becoming more difficult to operate in this business without a very deep understanding of the risk, legal and compliance aspects of servicing managed accounts.”

While capital constraints that have led a number of banks to scale back their prime brokerage operations in recent years, Hill says that Societe Generale’s commitment to the business is reflected in the resources it has channelled – and continues to channel – into servicing managed accounts.

“The big change for us over the last three or four years has been the increased breadth of our platform, which we very much regard as complementing rather than competing with the managed account platforms,” he explains. “Societe Generale chose some years ago to invest in a fully cross-asset prime platform, which was an important strategic decision because managed accounts have attracted substantial asset flows across the board. As well as traditional managed futures, there has been growth in more complex and OTC-driven strategies which were traditionally reluctant to offer managed accounts.”

Against the backdrop of a managed accounts universe attracting a wide range of strategies, building a prime brokerage operation capable of catering to funds across all management styles has become critical, says Hill. “Being able to service big multi-strategy managers who require prime brokerage services across all asset classes has been a very powerful tool for us,” he says. “As soon as you lose the capacity to support one of those asset classes you weaken your ability to partner with them across their whole business.”

Hill is unsure about how many other banks are prepared to commit the resources necessary to offer a similarly comprehensive service. But he believes the retrenchment among prime brokers has now probably run its course. “Over the last few years we’ve been through a period of restructuring and reallocation of capital across the prime brokerage community,” he says. “But prime brokerage remains a key component of any investment bank, so while there may be some re-sizing in the industry, if anything I think we’ll see banks starting to reinvest.”
A Lifeline for Emerging Managers

The efficiency and ease with which managed accounts can be used to custom-build portfolios has been increasingly instrumental in providing investors with access to emerging managers.

As Lapkin explains, this is because the cornerstone of the managed account structure is that by ensuring that legal ownership remains either with the end investor or the managed account platform, it eliminates much of the operational risk (real or perceived) associated with investing in smaller managers. By allowing managers to focus exclusively on portfolio management and trading, it also strips out a panoply of administrative responsibilities that emerging managers may not have the financial, human or technological resources — nor the intellectual inclination — to manage on a day-to-day basis.

“Managed accounts allow investors to eliminate many of the operational due diligence concerns, such as daily cash control, net asset value (NAV) oversight, gating decisions and so on,” says Lapkin. “The managed account structure can allow investors to expand their investment horizon to managers which otherwise may have been screened out either for being too small or because they did not meet investors’ core operational due diligence requirements.”

At Man FRM, Thompson describes this phenomenon as positive selection bias, which he says can counterbalance the problem of adverse bias which has historically been cited as a factor slowing the advance of managed accounts. “Transferring boutique operational risk to an institutional managed account platform immediately opens up a whole new universe of managers that otherwise would have been excluded from investors’ selection process,” he says.

Franklin Templeton’s Browning agrees that managed accounts can and do act as an important gateway for emerging managers. “There have traditionally been two challenges facing investment in emerging managers,” he says. “The first is, how can you identify them? The second is that even if you can find them, do they have an institutional infrastructure that is sufficiently robust to allow for an investment by a firm like K2?”

Browning believes Franklin Templeton’s MAP has resolved both these conundrums. “Part of the day-to-day responsibility of our team of about 25 research analysts is finding talented emerging managers,” he says. “When those managers have launched, our platform ensures that they meet all the operational due diligence requirements of institutional investors.”

He adds that another reason why MAPs have become so important to emerging managers is bank regulation, which has had the effect of increasing prime brokers’ costs, and therefore exerted upward pressure on the costs of implementing hedge fund strategies. As Browning says, a number of surveys have already demonstrated that cost pressures are higher on managers with modest AuM, especially those depending on volatile incentive fees to pay their bills.

The provision of this additional support mechanism for emerging managers may have important implications for the performance of investors’ allocation to alternative strategies for two reasons. First, as Kestler says, recent precedent suggests that emerging managers have often outperformed larger household names in recent years.

“Investors are on the lookout for alternative ways to generate alpha, and it has been well-documented that early-stage managers who are less burdened either with too much capital or too much overhead often outperform later-stage managers,” he says. “But the challenge of accessing many of those managers has been the weakness in their operational infrastructure.”

Second, it may be that the successful use of managed accounts by emerging managers acts as a wake-up call for some of the longer-established managers that continue to be mistrustful of managed accounts. After all, if smaller newcomers can use managed...
accounts as a way of raising capital, the emerging managers of today may become the competitive threats of tomorrow. "Managed accounts definitely help managers in the asset-raising phase," says Kestler. "The costs of starting and operating a hedge fund are much higher barriers to entry than they were a decade or so ago."

Thompson agrees that managed accounts are playing a demonstrably more important role in bringing capital to embryonic managers. "We're seeing more and more managers starting life essentially through a seeded managed account," he says. "We have set up some managed accounts for managers even before they have launched their first co-mingled fund. These have allowed institutional investors to act as providers of seed capital not on a revenue-sharing basis but from the perspective of anchor investors. For the manager, the support of a large investor – especially if it is a brand-name investor – can provide an enormous boost when it comes to raising money for a co-mingled fund."

This process suggests that there is some overlap between managed account providers and the capital introduction function. "We're not trying to compete with them, but we certainly maintain a dialogue with the cap intro teams at prime brokers about what they are seeing in the market," says Thompson. "At the same time, cap intro teams are always interested to hear from us about new managers launching funds or spinning out from existing strategies. So there is a good two-way flow of information."

**PENSION FUNDS BECOME MORE RECEPTIVE**

According to Credit Suisse, demand among institutional investors for managed accounts reached a seven-year high in 2018, with 58% of investors in its survey indicating that they currently invest in managed accounts, and a further 29% saying that they plan to increase their allocations.

Over the last 12-18 months, according to Credit Suisse, managers have received the most increased requests for managed accounts from pension funds. This mirrors rising demand for exposure to alternatives from pension plans, which is expected to continue to gather momentum over the short to medium term.

In its recent outlook for the hedge fund sector, Barclays advises that it expects public and private pensions, sovereign wealth funds and private banks to be the largest allocators to hedge funds in 2018, accounting for about $10bn each. By contrast, it expects allocations from insurance companies and funds of hedge funds to be flat.

In spite of the demonstrable increase in institutional demand for managed accounts, some say that the take-up from pension funds in particular has perhaps not fully lived up to its potential. "I think it has been slower than anyone in the industry would have liked," says Kestler at HedgeMark. "This has been surprising, because we firmly believe that public retirement plans are the institutions that would have the most to gain from participating in alternatives via managed accounts."

Kestler believes that this is largely a reflection of inertia, rather than a rejection of the managed account concept among pension funds. "We very seldom hear pension plans saying that they don’t like the managed account structure, although some still question whether they can gain access to the top echelon of managers via managed accounts," he says. "But the main reason for the slow adoption rate among pension funds is that people are generally resistant to change."

This echoes a general consensus about the growing popularity of managed accounts among investors who have already tested the market. "There is sometimes an extended bedding-in period when you’re setting up a managed account, and the data you receive can sometimes be a little overwhelming compared with an NAV snapshot once a month," says Hill at Societe Generale. "But I can’t remember any investor who has moved from a co-mingled fund to a managed account reversing the process and going back to a co-mingled vehicle."

At Franklin Templeton, Christian says that investor inertia is often a by-product of stretched human resources in the institutional community. "There are three groupings within the institutional space – early adopters, slow adopters, and non-adopters," he says. "Among the slow adopters, many are attracted by the managed account structure, but it can be a huge job to identify the right partner to work with, and many institutions don’t have
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the resources to go through the due diligence process involved.”

That, says Kestler, is changing rapidly. “We have started to see a clear increase in interest among retirement plans in the US,” he says. “We are aware of five to 10 plans that are now seriously looking at using managed accounts for the first time. We have also noticed that the discussions we are having with these plans have changed in recent years. A few years ago, some plans did not even know what a dedicated managed account was. Now, it is more often a question of when rather than if they are going to start using this structure.”

Others attest to rising institutional demand for exposure to alternative strategies via MAPs. Young, for example, says he expects assets on the Gemini platform to rise from $1.4bn to at least $3bn this year, with a number of new clients now being on-boarded. These include investment advisory firms such as the Cincinnati-based Fund Evaluation Group (FEG), with others such as retirement schemes expected to follow.

“It’s an old saying that a penny saved is a penny earned, but in the case of pension funds and other institutions it is absolutely true,” says Young. “For institutions such as pension funds which have defined liabilities, the creation of structural alpha is critical, which is why we expect this to be a driver of new business for us in the future.”

**THE DIVERSIFICATION OF INSTITUTIONAL DEMAND**

It is not just retirement plans that are becoming more receptive to managed accounts. Browning says that Franklin Templeton’s MAP platform is now also seeing notable traction from an increasingly diverse community of institutional investors. He explains that when the platform was originally set up in 2013 it was principally driven by shifting demand patterns among retail investors.

“Following the acquisition of K2 by Franklin

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**Managed accounts – buy or build**

For investors choosing to allocate to alternatives via managed accounts, is it cheaper and more cost-effective to build their own infrastructure, or to use an external platform? This was the question that John Fidler posed in 2016 when he was appointed senior vice president and head of alternative investments at the Louisville, Kentucky-based Commonwealth Bank & Trust Company, which has some $2bn of client assets under management.

Prior to then, Fidler had worked for a family office that invested via its own internal platform. “We had a set of accounts at a variety of clearing houses that were cross-margined, maintained our own on-house monitoring and reconciliation software, and employed a couple of people on a full-time basis who worked exclusively on back-office monitoring,” says Fidler.

“When I joined Commonwealth to manage its exposure to alternatives, we had the choice of build or buy,” he adds. “We decided that there would be significant cost and operational benefits with using the Gemini managed accounts platform which had already invested in people and systems we could leverage off.”

“Additionally, our board and investment committee weren’t comfortable with the potentially unlimited liability aspect of investing directly via our own managed account,” says Fidler.

Fidler says that he has been delighted with the experience of allocating via the Gemini platform for several reasons, starting with costs. “The bottom line is that the costs of investing via a platform compare very favourably,” he says. “Our main objectives were to have access to our chosen managers and strategies with some fairly basic risk daily reporting, and we identified a number of platforms that were able to provide this for significantly less than it would have cost us to build an in-house platform. Originally, I assumed that as our exposure to alternatives grew we would eventually be able to run our own managed account, but we have found that the breakeven point at which we could transition to an in-house platform has risen, given the cost-effectiveness of the platform.”

Tracking error, says Fidler, has been minimal, while Commonwealth’s strategy of allocating to smaller managers has meant that adverse selection bias has not been an issue. “This has been less of a problem for us than for some investors because we tend to focus on emerging, niche or off-the-run managers with an average AuM of $500m,” says Fidler. “We also allocate to a number of smaller managers based in the UK or Europe, some of which don’t have a US fund vehicle. From their perspective a managed account platform serves as a cost-effective and efficient distribution channel to reach US-based fund investors such as us that they might not otherwise be able to access.”

While Fidler endorses the managed account platform route, he advises investors to choose their providers with care. “In some platforms investors may find that they are really accessing managers via a total return swap, which has meaningful drawbacks in terms of transparency and tax,” he cautions.
in 2012, one of the most important priorities was to deliver a product to Franklin’s retail distribution bailiwick in a format compatible both with Ucits and US 40 Act,” he explains. “As we thought about how to deliver a multi-manager product efficiently, we recognised that we needed to deliver daily liquidity as well as daily NAV. The most efficient way of doing this was by creating a managed account relationship with our underlying hedge fund managers.”

“The second priority was that on the US mutual fund side we needed to convince managers to deliver their strategies not on a 2+20 basis but with a reduced flat fee,” Browning adds.

Since being seeded with $100m in 2013, the Franklin Templeton platform has expanded rapidly, and now has combined mutual fund and Ucits assets of about $3.6bn, according to Browning. The institutional side of the platform, he adds, was launched at the end of 2014, and has also been expanding at an impressive clip, bringing total assets on the platform to more than $5.6bn.

Browning attributes the growth of institutional participation on the Franklin Templeton platform to two parallel trends that started to emerge towards the end of 2013. “What began to happen in 2013 and 2014 is that we saw large retirement schemes start to move their entire hedge fund programmes into managed account frameworks,” he says. “With large allocators moving $400m or $500m, this really started to move the needle.”

At the same time, says Browning, evidence of demand from retail as well as institutional accounts for exposure to alternatives via managed accounts forced hedge funds to sit up and take notice. “As players such as ourselves and Blackstone started to go down the managed account route, hedge funds recognised that we were able to provide them with a very powerful distribution channel, which has led to a significant uptake in new managers participating on these platforms,” he explains.

Browning says that at the last count, this dynamic had attracted 26 managers to Franklin Templeton’s institutional managed accounts platform, a total which he believes will continue to rise over the foreseeable future. “As we add more managers to the platform, we expect institutional assets to grow, from about $2.1bn to as much as $4bn by the end of our fiscal year,” he says.

Most of the early institutional traction on the platform, Browning says, came from public sector retirement plans as well as from the corporate sector, where there has been a notable focus on fees. “More recently, we have also seen rising interest from private banks,” he adds. “In particular, there has been a pick-up in interest from those that exited the hedge fund space after the global financial crisis, perhaps because they were burned by the Madoff scandal. Franklin’s distribution relationships and connectivity with private banks globally have helped us to make some inroads into the sector with those that have been thinking about jumping back into the alternatives space, but only with the right partner.”

While acceptance of managed accounts among other institutions has generally been slower to gather momentum, HedgeMark’s Kestler says that a regulatory environment which is demanding increasingly rigorous disclosure, transparency and governance standards can only support further growth in the managed account movement.

Equally significant, for managed accounts, is that regulatory change is also forcing investors to focus more intensively on controlling costs than ever before. “A global phenomenon is that in a low return environment, investors are under regulatory pressure to reduce costs,” says Christian at Franklin Templeton. “We have seen this in Australia with RG97 and in Europe with Mifid, and I would not be surprised if we see a similar regulatory mandate in the US as well.”

ROOM FOR SMALLER INVESTORS?
The rising use of managed accounts by pension funds is emblematic of a wider trend within the market, which is the increased concentration of managed accounts among larger investors. As Credit Suisse observes in its survey, “given the influx of institutional capital into the hedge fund industry, managers are now pursuing ever-larger tickets.”

Specifically, the Credit Suisse report finds that in 2009 only 27% of funds had a preference for a minimum investment of $50m. Today, this has risen to 75%.

HedgeMark’s Lapkin insists, however, that
this does not mean that smaller investors are denied access to managed accounts. “It would still be difficult for an investor with, say, $25m to open a dedicated managed account,” he says. “But it should certainly be possible for that investor to work with a fund of funds and co-invest alongside a handful of others with total capital of $200m, with each being entitled to many of the benefits of a managed account.”

More broadly, the consensus is that retail investors will continue to play an increasingly prominent role in the market for alternative products. This in turn will support further growth in the managed accounts space as providers look to generate the benefits of symbiosis between their retail and institutional businesses, blurring traditional demarcation lines between the two.

“We think the world is becoming more complicated from a distribution point of view,” says Browning at Franklin Templeton. “There will be more and more fee compression as hedge fund managers are forced to move away from incentive fees. As these managers come into the flat fee world, they will need either to build or to bolt on a retail component to their distribution capabilities, which is something that large managers such as Franklin Templeton already have. We believe that partnering with managers looking to diversify their investor base by exploring new distribution channels will be an important driver of our future growth.”

THE RAPID GROWTH OF MAPS

In its recent survey, Credit Suisse comments that “the path towards hedge funds utilising managed account platforms can trace its origins to the 1990s when the first alternative segregated accounts were formed.” More recently, the survey adds, if managed account platforms (MAPs) are taken as a proxy for the broader industry, the managed accounts space has expanded significantly since 2010, growing at a compound annual growth rate (CAGR) of 13%, versus a CAGR for the overall hedge fund industry of 9%.

This should not be taken to mean that investors exploring the potential of managed accounts will always opt to do so via platforms. “We have a few very large clients, such as sovereign-type entities, which have substantial internal back offices, accounting systems and risk monitoring capabilities, so they don’t necessarily need the additional layer of control that managed account platforms provide,” says Societe Generale’s Hill. “At the other end of the scale, some of the larger family offices may not see the need to pay the platforms for the enhanced transparency and liquidity they provide.”

Nevertheless, the proliferation of platforms in recent years has been such that comparisons of business models in the market are becoming close to meaningless. “In areas like fund administration, custody and prime brokerage it is fairly clear what services are being provided,” says Kestler at HedgeMark. “But when it comes to managed accounts, you will probably see six or seven completely different models among the top 10 providers.”

Gemini’s Young agrees that there are several different definitions of MAPs, which in turn explains the variance in fees charged by the platforms. “There are three different types of service providers,” he says. “The first is a reconfiguration of a fund of fund, where the platform itself makes the investment decision and allocates to the managers. It is understandable that their fees are generally higher because of the risk associated with taking responsibility for the investment decision.

“The second is a platform which provides a managed account-like experience,” says Young. “In this model, investors are co-mingled with others and given a basic managed account service. We have a platform in this space named Galaxy. I see this as a managed account-like offering for investors such as high-net-worth individuals and smaller pension funds or endowments which want exposure to alternatives but may not be large enough for a full service managed account.”

“The third platform type is what we call the dedicated managed account,” Young adds. “This is effectively a customised Fund of One for large allocators with assets of $50m-plus, which is what Gemini offers.”

In part, the co-existence of a diverse range of business models in the platform space reflects different nuances across geographies, with platforms run by European-owned players such as Lyxor operating slightly different models to those in the US. It is also a reflection of the different heritage
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-Andrew Lapkin, Chief Executive Officer of HedgeMark

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of the leading platforms, some of which were launched by banks, and others by asset management groups.

Clearly, there are strong competitive arguments in support of both models. Some of the bank-backed platforms argue, for example, that in the context of an industry that is increasingly dependent on technological innovation, being able to call upon the financial backbone of a large bank is a prerequisite.

“Although a handful of the largest alternative investment managers have implemented

MANAGED ACCOUNTS/2018

managed accounts themselves, most are now recognising the benefits of outsourcing these operations to players such as HedgeMark, rather than trying to do it themselves,” says Kestler. “HedgeMark has really excelled with this market segment because as a BNY Mellon company we have been able to make such extensive investments in the platform.”

Much of this investment is inevitably being channelled into a technology programme which Kestler says is split into two parts. “We invest millions of dollars a year on our

Crisis risk offset: Hawaii goes for protection

Morgan Stanley echoed the views of an increasingly broad spectrum of the investor community when it noted in a recent research bulletin that “while equity markets and other asset prices have generally retraced their declines in the years following the Global Financial Crisis, the fear of another sharp downturn à la 2008 has yet to subside.”

This fear, Morgan Stanley explained, had encouraged a growing number of investors to explore crisis alpha or crisis risk offset strategies designed to perform well in the event of an equity market collapse. In the immediate aftermath of the 2008 market shock, noted Morgan Stanley, tail risk funds generally composed of long equity index put strategies were popular defences against another severe downdraft.

But as the Morgan Stanley note added, “because the cost of buying and holding equity puts can be very expensive, the performance of many tail-risk hedging funds tends to be negative in between periods of steep equity market declines.” The result is that many tail-risk funds established after the collapse of 2008 have either closed or seen substantial outflows.

This explains why today, institutions eager to build a bulwark against a market crash of 1929 or 1987 dimensions have turned their attention to alternative strategies avoiding the high costs of using puts. In the case of the Hawaii Employees’ Retirement System (HIERS), this has taken the form of a crisis risk offset (CRO) programme, for which Man FRM launched a dedicated managed account (DMA) in April 2017. “The Crisis Risk Offset (CRO) portfolio is designed to invest in strategies and assets that are largely exposed to systematic market-based risk premiums that are expected to behave in a manner that is primarily distinct or counter to equity market beta,” explains Howard Hodel, chief risk officer and acting CIO at HIERS. “In other words, during a sustained bear markets in equities CRO should produce significant positive returns, while also producing a positive real return over the market cycle.”

Jens Foehrenbach, Man FRM’s chief investment officer, says that the CRO is based on three strategies which are structured

in a systematic fashion allowing them to adjust depending on the length and severity of a market crisis. The three components of the programme are long duration US Treasuries, managed futures and risk premium capture. “Managed futures have shown that they can deliver gains in a sustained bear market,” says Foehrenbach. “However, the strategy can be vulnerable to a change in market regime when established trends reverse. The duration component can then provide protection if there is a flight to quality.”

“The third component, risk premium, can provide a steady carry for the portfolio in order to try and absorb the smaller losses that may be incurred if markets are whipsawed,” Foehrenbach explains.

Hodel says that one of the key objectives of structuring the CRO investment portfolio was transparency. “We designed a suite of reports across a range of timeframes that Man FRM provides at various levels of aggregation,” he says. “This was critical to ensure our ability to monitor the investment class and report to our trustees.”

“Customisation was also very important for us,” adds Hodel. “This includes the flexibility to adjust risk levels for each manager, impose tailored risk limits, effectively manage cash, and reallocate capital quickly – especially during crises.”

Other notable objectives of the managed account format, says Hodel, were fiduciary oversight and the ability to adjust allocations to individual managers and strategies on a daily basis. Foehrenbach describes the use of a managed account format for an investor like HIERS as a game changer. “It creates meaningful efficiencies by reducing the amount of capital that needs to be consumed,” he says. “And from the perspective of a sophisticated public sector investor such as HIERS, which has no tolerance for surprises, it offers daily position-level and risk transparency which would be difficult to have with a co-mingled fund.”

Thompson at Man FRM, says that transparency was identified by HIERS as a top priority very early in the discussions between Hawaii and Man FRM. “HIERS made it very clear to us during the selection process that transparency was absolutely key for the investment team and for the board of trustees,” he says. “Our ability to demonstrate that we could design a tailored set of reports
in-house operational software,” he says. “We use our proprietary systems to support the oversight of the non-investment functions that move away from the manager in a HedgeMark Dedicated Managed Account structure, such as making OTC trade payments and collateral movements, completing daily reconciliations and reviewing and signing off on NAVs. Continuously enhancing that operational oversight over dozens or hundreds of accounts calls for a significant investment in technology.”

The second part of the HedgeMark technology investment programme, adds Kestler, is the client reporting side. “We have developed technology which leverages the transparency made available in a managed account to produce customised reports tailored to the clients’ requirements for risk exposure and performance reporting,” he says.

Technological investment and innovation supporting and enhancing the reporting function has also formed the cornerstone of development among the platforms operated

providing a continuous and consistent update on performance and risk across the programme was paramount. So too was our reassurance that there would be an independent platform manager overseeing the programme and acting as a fiduciary looking after the assets separately from the managers responsible for trading.”

Setting up the Hawaii managed account project began at the end of 2016 and continued throughout the first quarter of 2017. “It was an intensive three-month period in which we needed to design the platform and on-board the seven investment managers appointed to implement the portfolio,” says Thompson. “That was quite a challenge because it required that we launch all seven managed accounts simultaneously and ensure that the investment portfolio as a whole was put together in parallel.”

The challenges associated with setting up the programme explain why HIERS did not entertain the idea of managing it independently. “We don’t have the staff in place to run this platform properly ourselves,” says Hodel. “Man FRM was able to assist us in setting up the legal entities and negotiate all the contracts with the managers and service providers for the platform much more efficiently, quickly and consistently than we could have done ourselves. Having Man FRM involved from the beginning was key to getting the platform up and running on a very tight schedule. Taking on more of the platform responsibilities could eventually be an option for us.”

“We went through a very rigorous due diligence process to select Man FRM as the platform manager,” Hodel adds. “The most important factors for us in selecting a platform provider were operational due diligence capabilities, risk management, ongoing oversight of the managers, reporting, ability to process data daily for our risk system, expertise in systematic strategies and experience in operating a managed account platform. A strong middle and back office capability was one of the biggest factors in selecting Man FRM, in addition to the ability to execute a large complex project to a deadline.”

Market conditions have not yet put the resilience of Hawaii’s CRO project to the test, with Foehrenbach saying February’s correction in equity markets, featuring a one-day fall in the Dow of over 1,000 points, was not sufficiently cataclysmic to trigger the activation of the crisis offset strategy.

But Thompson says that over the last year or so, the managed account has tested many of the operational functions that would be needed in the event of a wholesale global markets collapse. “Scenarios calling for the rebalancing of the portfolio have occurred and all the reporting cycles have been tested, so from that perspective we have been very pleased with the platform to date,” he says.

The efficiency of the Hawaii managed account has been put to the test in other ways. “We have shown that we can – and do – intervene when a manager breaches the very specific guidelines that have been established for each investment, such as the value-at-risk limit being hit,” Foehrenbach explains. “In the case of Hawaii, this has happened once. Because of the transparency on overall risk levels, we also made the client and its consultant aware of the specific risks that had started to build up. In response, the crisis risk committee met to propose ways of addressing this.”

Hodel confirms that he has been very satisfied with the experience of investing via a managed account, and with the role played by Man FRM in building and managing the platform. “Having the input of an experienced investment practitioner has been an additional benefit of using Man FRM as our managed account platform provider,” he says. “For example, in helping design and implement rebalancing policies that take into account the complexity of the underlying investments or in creating stress tests and scenario analysis for the portfolio.”

“While Man FRM are not responsible for selecting the strategies or managers in our program, their experience in the marketplace has been valuable for us and our consultant (PCA),” Hodel adds. “We often solicit Man FRM’s view on different managers or markets as a reference point and to better assess what’s usual or unusual. For example, Man FRM helped us create a platform procedures manual, develop a set of crisis risk indicators to monitor, and design a rebalancing policy.”

Although the Hawaii CRO managed account is one of the first projects of its kind for a US retirement scheme, it is unlikely to be the last, with Foehrenbach reporting that there has been considerable interest from other investors. “Our advice to other investors embarking on a managed account platform investment would be to clearly establish their priorities, plan ahead and do their due diligence on their managers and service providers, particularly the platform manager. Picking the right partner is important,” Hodel advises.
by investment management groups, such as Man FRM. “We have channelled a lot of resources, time and effort into developing an online reporting portal that allows investors in dedicated managed accounts to log in and set up their own profile within this portal,” says Thompson. “This enables them to drill down into their portfolios and analyse their investments based on a very wide range of performance and risk metrics.”

The importance of improved reporting has been magnified by the tsunami of regulation calling for enhanced transparency at all levels of the investment management universe, which is an area where ENSO Core, for example, has played an increasingly prominent role. “We give investors and managed account platforms the tools they need to power their regulatory reporting,” says Jakovleva. “We have also worked directly with some of the platforms’ regulatory reporting teams, explaining and enhancing our data so they can leverage it more effectively in their regulatory filing.”

Within the highly competitive world of managed accounts platforms, those that have grown out of investment management groups say that their pedigree as investors gives them an edge. Take the example of Man FRM, which has been using managed accounts for 20 years, and has launched more than 380 managed accounts across all strategies, regions and maturity levels. “The origins of Man FRM’s managed account platform were to facilitate its own hedge fund investing programme, so the structure and operations of the platform were built from a hedge fund investor’s perspective,” says Thompson.

A notable by-product of that heritage, says Thompson, is the platform’s expertise in acting as a fiduciary. “One of the differentiating factors I see among platforms that have grown out of investment management or funds of funds is that their experience in investing clients’ capital means that they are comfortable acting in a fiduciary capacity,” he explains. “The result is that we are able to provide clients with fiduciary oversight on a daily basis at a level of granularity that may be difficult for them to generate themselves.”

**RIPE FOR CONSOLIDATION?**

A trend within the overall growth of platforms is that the largest players appear to be adding market share and extending their dominance. Lyxor Asset Management was the fastest growing platform in 2017, according to the HFM InvestHedge database, posting a rise in assets of almost 76%, from $8.3bn to $14.6bn, while HedgeMark saw its assets grow by 47.7%, with Man FRM and Innocap both registering increases in excess of 20%. The largest platform, InfraHedge, meanwhile, recorded a growth in the first half of 2017 of 14.9%, from $26.3bn to $30.2bn.

HedgeMark’s Lapkin believes that the next phase in the evolution of the managed account platform space will be one of consolidation. “Over time I think managed accounts will become similar to the custody space, with the emergence of a handful of dominant firms able to make the investment in the scale, technology and people necessary to offer a comprehensive range of services,” he says. “Most of the others will operate as niche players, offering more limited services.”

Franklin Templeton’s Browning agrees that consolidation among the platforms is likely over the coming few years. “Just as we are seeing consolidation across the broader investment management industry, I think platforms that aren’t part of larger asset management groups and have neither the economies of scale nor the capacity to invest in technology will be gobbled up,” he says. He points to some of the niche managed account platforms specialising in asset classes such as commodities as those that are most likely to be absorbed by larger platforms active across all asset classes and strategies.

Consolidation pressures are also likely to intensify as the platforms continue to grow in size and sophistication, especially in areas such as the management of counterparty relationships and capital optimisation. “It’s interesting to observe how the focus of managed accounts platforms has been expanding,” says ENSO’s Jakovleva.

“Three or four years ago, their main focus was often on monitoring re-hypothecation and counterparty exposure based on historical trends across brokers. Now their counterparty management extends well beyond simple monitoring and encompasses decision-making and active management of their exposure optimisation strategies and cost of carry management. It also includes understanding liquidity buffers and building portfolio financing functions.”
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The assets on managed account platforms increased by 23.3% in 2017, in the strongest year of growth since HFM InvestHedge began tracking the industry in 2012.

Having surpassed $100bn at the half-year point last year, the managed account platforms tracked by HFM InvestHedge grew by an additional $10.9bn between June and December, to bring total assets to $112.8bn.

InfraHedge, the largest managed account provider in our survey, estimates that the total AuM held in managed accounts could be close to $600bn, or 16% of total industry assets, based on research conducted by the Board of the International Organisation of Securities Commissions in 2016 as well as more recent findings from organisations such as Credit Suisse.

InfraHedge leads the rankings with $30.2bn, although this figure represents the assets on the platform as of June 2017, as the State Street subsidiary only reports its AuM numbers once a year.

In a report published earlier this year, Credit Suisse found that managed accounts attracted 25% of all inflows over the last 18 months, with over half of hedge fund allocations going into alternative structures.

The survey showed that managed accounts make up 48% of all inflows into non-traditional structures, which also included Ucits, ‘40 Act funds, long-only funds, and co-investments. Some 52% of all allocations are going into vehicles other than traditional master-feeders.

Many co-investments are also structured in managed accounts so the overall inflow figure is likely to be much higher than 25%. The research, which surveyed over 200 global investors and hedge funds, found co-investments attracted 9% of total inflows.

Some 42% of the respondents to the survey employed or invested in funds-of-one, 36% used proprietary platforms, while another 36% used third-party platforms. According to InfraHedge these research studies, along with the firm’s own experience of investor activity and preferences, indicate that the hedge fund managed account industry has reached a tipping point.

InfraHedge says that this is a great place for them to be. With only $100bn in assets on managed account platforms as it stands, the firm’s analysis suggests that there is approximately $500bn invested into hedge funds through managed accounts but not via a platform provider, so the opportunity is vast.

The growth figures of the managed account platforms featured in this survey is indicative of the conversations InfraHedge has had with hedge fund managers at industry events. In particular one manager, whose accounts had doubled to 40 in the space of 12 months, due to investor demand for managed accounts.

Larger institutions have made decisions around their passive and ETF investments and are starting to move staff from the equity and fixed-income books to focus on active investment, InfraHedge adds. These investors have bigger cheques to work with and demand transparency, oversight and flexibility around fees and investment terms, so the investments are typically allocated via a managed account.

The firm predicts that the next iteration of managed accounts, focusing on automation, are starting to form. This follows “version three”, which has largely been focused on customising allocations in terms of fees and strategy.

The individual growth of the managed account platforms was mixed.

Of the nine firms that provided full-year figures, six reported positive growth, including HedgeMark and FRM, which saw 12-month gains of 47.7% and 67.3% respectively. Florida-headquartered Lighthouse Partners saw assets rise by 22.4% last year from $7.6bn to $9.3bn. The six-month growth from June to December was 13.4% after hitting $8.2bn in June.

Lyxor Asset Management’s platform saw the largest increase on a percentage basis, owing to the onboarding of a significant client during the first half of last year as well as what the firm describes as a reclassification of assets. Assets on the platform grew by 75.9%, to finish the year with $14.6bn, up from $8.3bn in January.

HedgeMark’s platform assets increased by almost 50% to reach $13.9bn, up from $9.4bn in January, with new and...
existing clients contributing to the growth.

HedgeMark’s parent company, BNY Mellon, published a report in November 2017 which found that hedge fund investments had been revived by industry changes such as fee reductions and the development of new products. Technology is helping to hasten the evolution of these products and, according to the report, technology-enabled services are also part of the reason for the increase in expected allocations to managed accounts, which were anticipated to rise from 17% of hedge fund allocations to 22% over the next 12 months.

In addition to a desire by clients to drive down manager fees, Joshua Kestler, president & COO at HedgeMark, has also seen an increase in its existing clients using managed accounts to implement co-investments, such as topping up a manager’s trade idea. These co-investment opportunities can be long term, or exist for only a month or two.

New assets to the HedgeMark platform have continued to come from public pension plans and asset managers, the firm said. The industry uptake from public pension plans has been slower than Kestler would like, as the decision making and approval processes for these large investors takes time, but he expects to see a pick-up in activity in 2018.

Traditional FoHF firms have been significant contributors to growth as they transition to providing solutions, as well as products. “FoHF managers have realised they need managed account capabilities as a tool for their clients. Many of the largest groups have already built out these capabilities, either directly or through platforms like HedgeMark,” he says.

Innocap’s assets continued to rise in 2017, growing by 20% from $4.9bn to $5.9bn. It has been a busy 12 months for the Canada-headquartered group, which has seen a strong start to 2018.

The firm’s assets grew to $6.3bn by February 2018 and, according to Jonathan Planté, business development and investor relations manager, the group is aiming to onboard an extra $1.6bn in the coming months, which would take total assets close to $8bn.

The group recently won an emerging manager mandate from the $72bn Massachusetts Pension Reserves Investment Management Board (MassPrim), which will become the third North American pension plan to be onboarded in the past 12 months. Innocap will collaborate with NewAlpha Asset Management on this mandate. The French group will provide advisory services for the new emerging manager direct hedge fund programme and Innocap will provide managed account platform services.

In December 2017, La Caisse de dépôt et placement du Québec (La Caisse) entered into an agreement to purchase, along with Innocap’s management team, the shares held by the National Bank of Canada. La Caisse is one of the largest public pension plans in the world with $298.5bn in assets, as of 31 December 2017.

BNP Paribas, which has been a shareholder of the company since 2007, will retain its holding. As part of the transaction, La Caisse is in the process of onboarding some of its external hedge fund portfolio onto Innocap’s platform. The agreement is subject to usual closing conditions, including approval by relevant regulatory authorities, and is expected to close in the second quarter of 2018.

In Planté’s view, the recent inflows to the platform mark the beginning of the harvesting stage for Innocap, which was first featured in HFM InvestHedge’s MAP survey in 2012 with $2.2bn.

“Our success is the result of the hard work we have put in over the last five years to strengthen our overall capabilities,” he says.

Paamco’s managed account platform grew by 11% in 2017 to reach $4.5bn, which Carlos Ferreira, head of investment operations, attributes to four key trends: portfolio customisation, control of assets, capital efficiency and enhanced reporting.

Several managed account participants saw losses. Deutsche Bank’s total assets declined by 11.1%, from $9bn in January to $8bn in December, while fellow bank entrant JP Morgan saw a 35.2% decrease for the year.

JP Morgan’s managed account assets stood at $375m as of 31 December 2017, compared to $510m in June and $579m in January.

Private Advisors saw a 40% decline over the 12-month period, from $1bn in January to $617m at year-end, with its half-year total standing at $650m.

HFM InvestHedge was unable to obtain full-year figures for EnTrust Permal and Alliance Bernstein, which all saw double-digit asset decreases in the first half of the year, shedding 8.5% and 75%, respectively.

Managed account platforms: ranked by size

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<thead>
<tr>
<th>Platform Name</th>
<th>31/12/17 AuM Total $bn</th>
<th>01/01/17 AuM Total $bn</th>
<th>Growth $bn</th>
<th>% growth</th>
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<tr>
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¹ Data as of June 2017  
² Some assets also included in Billion Dollar Club entry  
³ Assets not included in Billion Dollar Club entry  
Source: HFM InvestHedge database
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