BNY MELLON

Issue 4

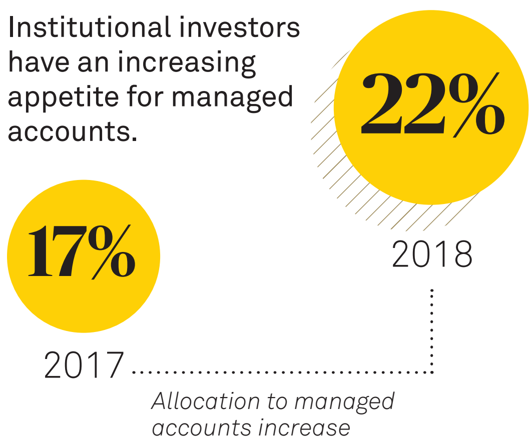
The Race for Assets

Dedicated Managed Accounts: Made to Measure for Smart Investors

By Andrew Lapkin, Chief Executive Officer, HedgeMark

"We are looking to managed accounts for hedge fund exposure because we are seeking high standards of transparency and governance."

Partner, Investment Manager, EMEA



The use of dedicated managed accounts in the hedge fund industry is rising as investors increasingly seek to reduce fees, improve transparency and gain control over their portfolios. In the fourth issue of our *Race for Assets* series, we investigate how this trend is changing the hedge fund landscape.

Institutional investors have an increasing appetite for managed accounts. Our *Race for Assets* survey found that 50% of respondents expected their allocation to managed accounts to increase by the fall of 2018, with the proportion of hedge fund allocations to this type of structure increasing from 17% at the end of 2017 to 22% by the fall of 2018.

And our survey also reveals that demand is being driven by larger investors with more significant assets to deploy: those with US$51bn+ AUM intend to invest up to 30% of their hedge fund allocation through managed accounts.

Product evolution brings an investor revolution

While hedge fund managed accounts have been available for some time now, the market has evolved rapidly over the last few years to make the dedicated managed account structure a desirable option for institutional investors. In the past, those interested in using a dedicated managed account had to build internal teams and take on many non-core operational functions. However, today's landscape is very different.

It's now possible to outsource the set-up and day-to-day operations of a managed account. A few managed account platform providers have emerged to meet the market demand for outsourced services. The largest institutional platform providers have invested significantly in the latest technology and benefit from economies of scale combined with specific operational expertise. These firms are able to offer the significant support needed to institutional hedge fund investors seeking to outsource the set-up and operations of managed accounts while also keeping costs low.

> **“We're seeking greater transparency and we plan to move some of our assets towards managed accounts, where risks are better contained and managed.”**
>
> Head of Investment, Investment Manager, EMEA

The investor viewpoint

The attractions for investors are clear. As the persistent low yield environment has put pressure on returns, many are now seeking ways of reducing the fees associated with hedge funds; 84% of those surveyed stated that they would search for lower management fees this year.

Fees come down Dedicated managed accounts provide investors with the opportunity to negotiate lower and more customized fee structures. Managed accounts are allowing investors to seek reduced management and performance fees (given the segregated nature of the investment, size of the investment and the lower operational costs for managers when a platform provider is involved). In addition, investors are implementing and setting features such as hurdle rates and longer performance fee crystallization periods. These factors could result in a better alignment of fees between the investor and the manager, with higher fees typically paid when returns are strong.

Control goes up Governance is another concern for investors that can be addressed through managed account structures. This is borne out by the difference in responses on the issue between our 2016 report and our most recent survey in 2017. Two years ago, only 31% said they would request improved governance in the next 12 months; this rose to 61% in the *Race for Assets* survey.

One of the key features of dedicated managed accounts is that investors retain ownership and control of the assets, with the manager hired as the trading advisor providing investment acumen. This approach is in direct contrast to a commingled vehicle or a fund of one structure, where the manager typically retains control over both governance and the underlying assets. Using a dedicated managed account, tasks such as operational oversight, valuation, expense payment and the movement of cash and securities are outsourced to third parties selected by the investor. This arrangement minimizes conflicts of interest and can reduce the risk of fraud and operational risks.

Reporting becomes clearer Dedicated managed accounts also have the potential to offer greater transparency for investors by offering them full access to the underlying portfolio positions, including daily reporting on asset performance, risk and exposure, as opposed to the more typical lagged monthly reporting offered by managers through commingled vehicles. Much like governance, respondents in our survey desired greater transparency from hedge funds—again, demonstrated by the difference in responses between our 2016 report and our most recent survey in 2017. In 2016, only 47% said they wanted more transparency; this rose to 70% in 2017.

While investors may not choose to monitor their hedge fund managed account exposure on a daily basis, the granularity of accessible information enables them to improve investment oversight and to manage risk more effectively. For example, daily monitoring seeks to ensure that exposures are in line with specific investment guidelines that the investor has agreed to with the fund manager. Access to daily information can also help investors more accurately assess the manager’s risk-adjusted return, as well as whether the manager is actually delivering alpha to the investor’s

> **“Hedge funds need to increase transparency. We plan on asking more questions and are going to become vocal about the way funds invest. We want better governance and are planning on increasing our allocations to managed accounts to make up for risks that we would be exposed to otherwise.”**
>
> CIO, Pension Fund, Asia-Pacific

portfolio. The enhanced transparency of dedicated managed accounts provides investors with key information needed to optimize their total portfolios through better diversification of managers and strategies. In so doing, investors are in a potentially better position to select the right managers and exposure levels to help them meet their long-term investment goals.

84% OF THOSE SURVEYED

are searching for lower management fees this year.

The manager perspective

The move towards managed accounts is now also being picked up by managers themselves. In our 2017 survey, over three quarters of managers (76%) said they were looking to offer managed accounts to investors. It seems as though some initial resistance among managers, who may have been concerned about fee reductions, loss of control and increased transparency, is starting to dissipate.

Do what you do best One of the major drivers for hedge funds is the need to continue to attract allocations from larger investors, who account for a disproportionate share of the capital that flows to the asset class and who are also the institutions increasingly seeking exposure through managed accounts.

Yet, as more managers become familiar with the way dedicated managed accounts operate, many are increasingly seeing that this route can offer benefits. With investors now opting to use managed account providers, fund managers can focus on their core skill—investing.

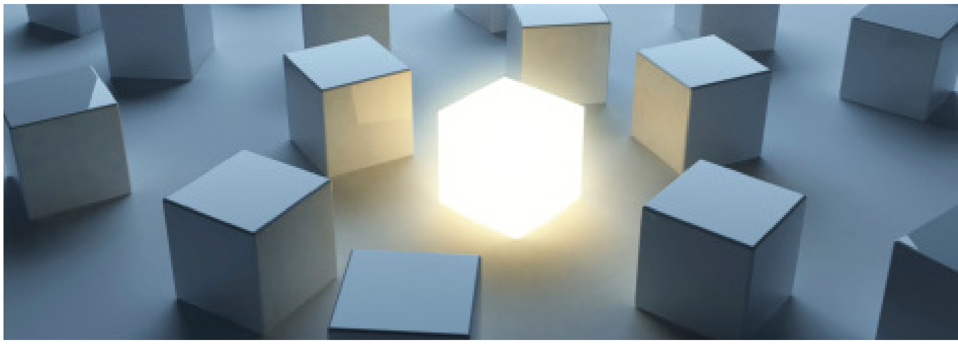
Indeed, offering managed accounts via a platform provider, removes much of the middle and back office burden for these investments, as managers are not required to sign off on net asset value (NAV) or provide governance and other operational oversight.

Build better relationships Over the longer term, dedicated managed accounts can also help hedge fund managers collaborate more effectively with their investors. The managed account offers the ability to customize investment strategies and exposures to an individual client's needs, including offering investors more co-investment opportunities.

Some of the best-performing managers are also recognizing that features of managed accounts, such as increased transparency and the ability to quantify alpha in a portfolio, can lead to increased future allocations because investors are able to identify who has generated high returns and how specific managers have added value.

Future developments

Dedicated managed accounts are increasingly being seen as one of the most attractive ways of accessing hedge fund strategies for larger investors—and for many, this is likely to be the future of investing in the asset class. Meanwhile, fund managers are warming up to offering investments via this structure. However, the question remains whether, and how, smaller investors can benefit from managed accounts.



These accounts are often only available for investments starting at US$50m for a single account, and for some managers and strategies, that threshold rises to US$200m or more.

It's clear that innovations will need to occur to allow smaller investors to access the benefits available to large investors. There is some evidence that this is starting to happen, with hedge fund of funds offering commingled managed accounts to smaller investors, and passing on many of the benefits, including fee savings and increased transparency. Yet there is still more development to come in what is fast becoming one of the most important evolutions in the hedge fund industry.

Words of wisdom

Three steps to success for alternative asset allocators

1 **Increased outsourcing enables the successful implementation of managed accounts.** Establishing and running dedicated managed accounts requires significant investment via technology and skilled staff. Investors seeking to invest in managed accounts should look to outsource to larger institutional platform providers that offer comprehensive managed account capabilities. This will help ensure a successful implementation and minimize internal costs and additional burdens on staff.

2 **Dedicated managed accounts overcome challenges.** Dedicated managed accounts allow investors to retain control of their investments and gain increased transparency—with exposures, risks and performance reported on a daily basis. Additionally, investors obtain greater negotiating power with managers over fees and structures.

3 **The market needs to evolve further.** Hedge funds are responding to this trend, with most looking to cater to managed account structures. Fund managers now need to look to the benefits—these structures can enhance their access to institutional capital, increase the "stickiness" of institutional investments and free up managers to focus on their core skill of investing. Managers less inclined to offer these structures may find their ability to attract capital from major institutions becoming more limited. Additionally, the market now needs to evolve so smaller investors can also start to take advantage of the benefits offered by managed accounts.

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