The evolution of Managed Account Platforms

Interview with Andrew Lapkin & Joshua Kestler

Please explain what you think is driving the continued increase in demand for hedge fund managed accounts?

Andrew Lapkin: Institutional investors are under increasing pressure for their portfolios to generate returns to meet their liabilities or other investment goals. This task has become even tougher in the current investment environment, especially given historically low interest rates. As a result, hedge funds are an attractive option on the basis of returns with an expected lower correlation to other more traditional strategies. A challenge for many institutional investors is that investments in traditional hedge fund structures create a number of issues including a lack of control, transparency and independent governance as well as co-investor risk.

Joshua Kestler: These issues with investing in commingled hedge funds were highlighted during the Financial Crisis of 2008 which resulted in increased investor focus on a solution. The use of managed account structures provides a key mechanism for investors to address many of their key concerns with legacy commingled hedge fund structures. As investors have become more focused on control, transparency, governance and investment customisation, the industry has seen an increase in the use of managed accounts as a means to achieve those objectives.

Can you discuss some of the ways that hedge fund managed account platforms have evolved over the past few years?

Andrew Lapkin: A growing trend in recent years has been the adoption of Dedicated Managed Accounts (DMAs) by institutional investors. DMAs are typically single-investor funds established for the exclusive use of an institutional investor. DMAs allow an investor to maintain greater control over their assets, receive full position-level transparency and customise the account structure as well as specific strategies. Large institutional investors such as public and private pension plans and insurance companies have been the most significant users of single-investor DMAs as this option is better suited for those investing $100m or more in each DMA.

Andrew Lapkin, Chief Executive Officer, BNY Mellon HedgeMark

Joshua Kestler, President & Chief Operating Officer, BNY Mellon HedgeMark

Joshua Kestler: Another trend that has been developing recently is the creation of customised managed account platforms or "multi-investor DMAs" by advisors and asset and wealth management firms. The first movers in this space were fund-of-fund managers who built customised managed account platforms which could be used to build portfolios exclusively for their clients. These multi-investor DMAs can be customised to meet the needs of particular clients or client segments. For example, DMAs can be structured onshore in an EU jurisdiction such as Ireland or Luxembourg to comply with AIFMD regulations or as a Cayman trust to appeal to the institutional Japanese marketplace. The use of DMAs also allows fund-of-fund managers to receive and provide a level of transparency across portfolios to meet clients' risk management and, in certain cases, regulatory requirements (i.e. Basel III and Solvency II). Fund-of-funds typically allow investors to access their managed account platforms either indirectly via investment in their fund-of-funds products or directly as part of a discretionary or non-discretionary advisory mandate to build a custom fund of fund portfolio. More recently, we have seen some fund of fund managers allowing investors direct access to particular managed accounts while leveraging their due diligence and manager oversight processes.

Andrew Lapkin: This approach of allowing direct access to underlying funds is a good model for both private banks and consultants building customised multi-investor DMAs for their client bases. These large asset managers, wealth managers and other advisors can achieve economies of scale, improve the investment and risk management process and provide improved investor reporting by pooling clients' assets to negotiate managed account arrangements with hedge fund managers.

The benefits of single-investor DMAs seem clear, but can you explain how mid-size and smaller investors benefit from multi-investor DMAs?

Joshua Kestler: Mid-size and smaller investors can potentially benefit from "multi-investor DMAs". Multi-investor DMAs are organised by a sponsor – for example, a fund-of-funds manager, wealth manager or consultant. The sponsor will typically serve as the investment manager of each fund and will hire each hedge fund manager as a sub-advisor of the relevant DMA fund. As the investment manager, the sponsor will perform initial and ongoing due diligence on the sub-advisors and will provide ongoing investment and risk oversight for each fund based on the availability of position level transparency. This model is particularly appealing to investors who may not have the resources or desire to perform these functions directly. Investors may also benefit from fee reductions negotiated by the sponsor with managers along with improved transparency and client reporting, lower minimum investment amounts and the overall ease and efficiency of investing through a single platform with consistent documents and processes.

Are multi-investor DMA platforms being built and operated in-house at asset and wealth management firms or are certain functions being outsourced to third-party providers?

Joshua Kestler: The early fund-of-funds firms that adopted multi-investor DMA models had to build and operate their platforms internally as there were really no specialised managed account service providers at that time to support them. Over the past five years, specialised service providers like HedgeMark have emerged to support institutional investors in the development and operation of their own customised DMA platforms. Today, it is less common for a firm to internally build and operate its own platform.

Andrew Lapkin: It really comes down to basic economics – launching and operating an institutional quality managed account platform requires customised technology as well as a significant number of specialised staff. The required infrastructure is expensive and therefore is less scalable and efficient for a single firm to build that infrastructure when they can outsource key non-investment functions to a third party service provider. In the end, by working with a managed account service provider, these investors will have their private platform up-and-running more quickly while leveraging existing technology and experienced, specialist staff, and generally at a lower cost than if they had to build the infrastructure themselves. ■