Dedicated managed accounts can overcome allocation concerns

Interview with Andrew Lapkin & Joshua Kestler

Large institutions face a Catch 22 when it comes to investing in hedge funds. On the one hand, despite performance having been muted for the last few years, institutions still broadly appreciate their importance as part of a diversified portfolio. On the other hand, negative media coverage that continuously compares hedge fund performance to the broader markets, not to mention continued questioning over exorbitant fees, means that institutions face external pressures to justify their allocations.

"What is interesting is that the major flows into hedge funds really seem to be driven by the super institutions such as public and private pension plans. Those are the same investors that are under immense pressure to justify the value of hedge funds in their portfolios" says Andrew Lapkin, CEO of HedgeMark, a BNY Mellon company. "These pressures are being driven more by political and emotional forces rather than rational investment analysis. The value of hedge funds is being questioned in part due to performance, but largely because of flaws in the traditional hedge fund investment structure including high fees, lack of control and lack of transparency."

The dedicated managed account structure really gets to the heart of these issues, shifting hedge fund assets into client-owned and controlled vehicles. The dedicated managed account structure allows investors to negotiate both the amount and structure of fees with managers. Helping clients setup and operate their own private managed account platform is what HedgeMark offers with its Dedicated Managed Account (DMA) solution.

"We feel that the DMA structure provides an opportunity for institutions to change the debate; to take control of their assets and demonstrate that they have a solution to specifically address the concerns that people are raising about hedge fund investments. Most institutions will say they don't mind paying the 20% performance fee when the fund exceeds an agreed benchmark return. However, investors are getting frustrated at paying these fees in situations where their funds are trailing expected return targets" added Lapkin.

Andrew Lapkin, CEO at HedgeMark

Joshua Kestler, President and COO at HedgeMark

"A dedicated managed account structure allows investors to restructure how performance fees are calculated, for example, by adding a hurdle rate. This structure limits the performance fee to a percentage of net gains in excess of an agreed rate of return – allowing the investor to only pay for outperformance," explains Joshua Kestler, HedgeMark's President and COO.

A recent CNBC article made a point of showing that New York State had paid hedge funds fees of USD1 billion over the past eight years. It added that New York State Department of Financial Services said hedge funds had been a "giant failure", resulting in USD2.8 billion of underperformance for the two state retirement systems.

Not to suggest that using managed accounts can alleviate performance issues but they can go a long way towards addressing these negative sentiments; justified or not as they may be.

Most public pension plans still believe that hedge funds play a valuable role in their portfolios, but they are bowing to broader political and media pressure, which is causing them to either cut their allocation or eliminate their hedge fund book altogether.

"We believe that the response to the issues raised with hedge fund investments should be to use managed account structures as a means of addressing these issues. Our clients have had significant success in terms of reducing fees and developing creative fee structures that better align the interest of the investor with those of the manager," confirms Lapkin.

That is only one part of the equation though. The other is that a lot of investors don't understand that there are operating expenses within hedge funds that lie outside of the 2/20 fee structure. Service providers such as fund administrators, auditors and lawyers also have to be paid and many managers charge business expenses such as research, technology, travel, etc, to their funds.

But as Kestler explains: "One of the tremendous benefits of managed accounts is that the investor has complete expense control and complete expense transparency. They know exactly what expenses they are paying and the manager is removed from the process by which expenses get approved and allocated to the managed account. The client only pays for expenses which they have agreed to pay."

Thanks to the transparency of its DMA solution, HedgeMark is able to provide its clients with daily performance information and performance attribution. Clients know exactly what's driving returns down to the position level. Arming investment professionals with the tools to evaluate hedge fund performance is critical in helping them improve their investment decisions as well as the quality of their ongoing discussions with managers.

"Historically, it's been extremely difficult to monitor and analyse managers," says Lapkin, "because all you've had to go on is a performance number at the end of the month. You don't necessarily know if the manager is really adding alpha. In the DMA structure, you can look at performance data every day and understand what the return drivers are, how a particular manager is correlated to other managers in the portfolio and so on. It takes hedge fund investing into a completely new realm of analysis."

Increasingly, investors seem to recognise the value in managed accounts. However, the adoption of using these dedicated structures has been slower than one might have expected given the value proposition, largely because of the amount of resources it requires at a firm to implement such a solution. The staff and technology demands are prohibitive for pension plans and most other institutional investors. This has led to an increased demand for outsourced solutions.

HedgeMark specialises in supporting institutional clients in the development and operation of their own private hedge fund dedicated managed account platforms by allowing clients to outsource these non-investment functions.

"The investor can focus on what they do best, which is building the portfolio, selecting managers, negotiating key terms and is able to outsource the handling of non-investment functions. The same applies to the hedge fund manager. They can focus on managing the investment strategy without dealing with setting up the managed accounts, oversight of the administrator, review and approval of the NAV, etc," Kestler added.

"Overall, outsourcing and the option it presents is key to the broader adoption of managed accounts and I think it will help the hedge fund industry because it empowers institutions to adopt a solution which addresses many of the issues with traditional hedge fund investments and changes the conversation back to the value add that hedge funds can bring to their portfolio," says Lapkin in conclusion. ■