Private platforms – The future of hedge fund investing

Interview with Andrew Lapkin & Joshua Kestler

Hedge fund managers often argue that taking on separately managed accounts can place an additional operational burden on their teams. As a result, many managers may resist investor requests for managed accounts.

A new breed of outsourced managed account solutions now exist which allow institutional investors to build their own private platforms while also reducing the operational burden on hedge fund managers. One of the leaders in this field is HedgeMark with its Dedicated Managed Account solution.

Andrew Lapkin, CEO at HedgeMark

Joshua Kestler, President and COO at HedgeMark

"We build and operate private platforms for our clients, independent of the hedge fund managers. The role of the managers is limited to trading the portfolio," explains Andrew Lapkin, CEO of HedgeMark, a BNY Mellon company. "Historically, managed account platforms were used almost exclusively for more liquid strategies such as managed futures and equity long-short. Platforms were generally not equipped to operate complex strategies. As a result, many managers would refuse to offer a managed account because they felt that their strategies were too complex to be supported by the client or a managed account platform."

"HedgeMark has designed our platform to solve this problem," Lapkin further explains. "We operate many credit strategies, complex global macro and derivative-based strategies for clients. Many of our staff members have prior experience working on the operations and accounting teams at hedge funds and therefore, have the skills necessary to support complex hedge fund strategies. We have also developed proprietary operations technology to automate and scale the operations and accounting functions necessary to support managed accounts across varying strategies."

"Our ability to operate a broad range of hedge fund strategies in a managed account helps our clients minimise manager concerns over whether their strategy is too complex for a managed account structure," Lapkin argues.

This is good news for both asset managers and asset owners. Asset managers are using managed accounts to deliver more customised solutions to their client, thereby increasing their ability to raise capital. Asset owners such as pension plans now have a means to negotiate reduced fees and customise hedge fund strategies while investing in a controlled way, limiting the fear of fraud and eliminating co-investor risk.

HedgeMark continues to see an increase in the rate of adoption of dedicated managed account structures by large institutional investors. Discussing this, Joshua Kestler, HedgeMark's President and COO, says that "asset owners aren't necessarily getting a lot of bang for their buck when they use commingled funds".

"With a managed account", he says, "it allows them to negotiate reduced and custom fee structures and achieve greater transparency, among other benefits."

Kestler also adds that, "in addition, there is currently a public and political stigma when a public plan invests in hedge funds. Public pension plans are therefore facing pressure because 'hedge funds' have increasingly become a political target."

"The term 'hedge fund' really refers to an investment structure rather than an investment strategy," Kestler states. "By using dedicated managed accounts, institutions can avoid certain flaws of the commingled investment structure and access a particular investment strategy in a more controlled manner. The investor takes control of the investment structure and the manager is strictly hired to trade the strategy. The investor's ability to reduce and customise fees also helps address a major issue which has become a political focus."

"This is one of the reasons that pensions and other large institutions continue to adopt their own private platforms for hedge fund investing," comments Kestler.

Asset managers, particularly Fund of Hedge Fund (FoHF) businesses, have been under a great deal pressure to evolve over the last decade. Much has been made of the high fees and low returns that broadly diversified FoHF products have served up, not to mention the lack of flexibility: investors don't necessarily want an off-the-shelf product, they want customisation.

As investors increasingly demand custom solutions, FoHF have begun to develop their own private managed account platforms to deliver such solutions to their clients. The flexibility of a managed account structure allows FoHF to provide investors with custom strategies, increased liquidity, transparency to meet regulatory reporting or other needs and solve for other investor requests. Managed accounts have allowed FoHF to evolve their businesses to offer additional value to their clients.

"There's generally been more urgency among the asset managers to utilise managed accounts as an investment tool than among asset owners. We would like to see more pensions develop their own platforms in the near term, but we do think that over the long term, the private managed account platform will become the standard model for large institutional investors to access hedge funds," argues Kestler.

There are various drivers as to why an investor may wish to have their own private platform. Investment customisation is one key driver. For example, an investor may want to take advantage of a specific market or co-investment opportunity or they may want to explore carve-out opportunities with certain managers to tailor their return profile.

Fees are also a major driver for investors using managed accounts. "Everyone wants to lower fees and expenses as much as they can," says Kestler, "but many investors are also looking for ways to restructure the fees to better align the investor's interests with the manager. That could be anything from utilising hurdle rates to a performance or management fee-only model; we see investors negotiating a wide range of fee structures."

Transparency is also a key driver to managed account adoption. Early users of managed accounts viewed the availability of daily transparency as a way to better manage risk. "Now," says Kestler, "the transparency offered by a managed account is also becoming a portfolio management tool."

"Investors are realising that managed accounts can improve their ability to manage a hedge fund portfolio, not only by enhancing manager oversight but also by allowing the investor to better analyse whether they are getting true alpha from a particular fund. Transparency allows large institutions to better understand, evaluate and challenge managers," comments Kestler.

According to Lapkin: "Every manager should drive returns in isolation but you also want to look at it from a portfolio context. Certain funds provide even greater benefits when you factor in that they might not be using a lot of risk within the context of a portfolio (and the investor could then choose to dial up the risk, if they needed or wanted to)."

"Another transparency driver is the regulatory component. We are seeing that certain investors around the world, including insurance companies, need transparency on their hedge fund holdings if they are to continue allocating to the asset class," explains Lapkin.

One final consideration that might explain the continued adoption of dedicated managed accounts is the control aspect. Investors want to remove the co-investor risk associated with investing in commingled funds. The last thing an institutional investor wants is to have their investment behaviour impacted by redemptions from other investors. At some point a manager might sell its more liquid positions or fire sale less liquid positions to meet redemptions, negatively impacting the fund's liquidity profile and/or performance for remaining investors.

"By having your own managed account, you control the decision to redeem and the ultimate time horizon of your investment. If you want to be a long term investor, you don't have to worry that other investors are going to force you to redeem," concludes Kestler. ■