WHY PUBLIC PENSION PLANS ARE EMBRACING MANAGED ACCOUNTS

JOSHUA KESTLER OF **HEDGEMARK** EXPLAINS WHY AN INCREASING NUMBER OF INSTITUTIONAL INVESTORS ARE LOOKING TO MANAGED ACCOUNT PLATFORMS

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Over the last several years, public pension plans have embarked on a strategic and evolutionary shift in the way that they access the hedge fund asset class. As public plans have become more comfortable with the asset class and more educated as investors, many plans have increasingly begun to invest directly in hedge funds.

Some plans have developed sophisticated in-house alternative investment teams to source hedge fund managers while others rely on advisers, fund of funds managers or consultants, but the ultimate investments are increasingly being made directly into hedge funds. The shift to a direct hedge fund investing model along with the general increase in alternative asset allocations have sharpened the focus of plan CIOs and boards of directors on obtaining increased control, customisation, transparency, and independent oversight for their hedge fund investments. This article highlights how managed accounts can help plans achieve these objectives.

SEGREGATION OF ASSETS, SEPARATION OF DUTIES AND ASSET CONTROL

Dedicated managed accounts can be a particularly effective investment structure for public plans. Dedicated managed accounts are typically single investor funds established for the exclusive use of an institutional investor, such as a public plan. A managed account platform provider, like HedgeMark, may be hired by the plan to provide certain critical aspects of the operational infrastructure, middle office services, managed account expertise and hedge fund risk monitoring and analytics to support the plan's managed account platform.

> "OVER THE LAST SEVERAL YEARS, PUBLIC PENSION PLANS HAVE EMBARKED ON A STRATEGIC AND EVOLUTIONARY SHIFT IN THE WAY THEY ACCESS THE HEDGE FUND ASSET CLASS"

The dedicated managed account structure segregates a plan's assets from other investors, removing co-investor liquidity risk and provides the plan with direct control over its assets. Managed accounts allow for the separation of operational and investment functions, thereby mitigating or eliminating certain risks of fraud as the hedge fund manager only has trading authority but not the ability to move cash or securities.

Further, since the assets are ultimately owned and controlled by the plan in a dedicated managed account structure, the hedge fund manager will have no ability to gate, suspend or side pocket the assets.

CUSTOMISATION

Dedicated managed account structures are designed to provide each public plan with the flexibility to tailor a structure to meet its specific needs and objectives. A managed account platform provider such as HedgeMark will work with the plan and its advisers to structure a custom and effective solution for the plan. The plan has the ability to customise all aspects of their dedicated managed account platform including the fund structure, governance model, hedge fund managers, service providers, counterparties, fee structures and investment guidelines.

The plan can often create customised investment strategies and structures to meet its particular needs and requirements (e.g. specific investment guidelines, restrictions or mandates and custom fee structures). For relevant strategies, a dedicated managed account can be structured to use notional funding as a means to achieving greater cash efficiency for the plan.

The customisation and flexibility afforded to plans through dedicated managed account structures create an extensive set of possibilities in terms of tailoring specific solutions to achieve the goals of the plan. There are highly specialised tax issues that must be considered by both US state plans as well as by non-US government sponsored plans when developing these custom structures.

FEE NEGOTIATION AND EXPENSE TRANSPARENCY AND CONTROL

The dedicated managed account structure provides the investor with an opportunity to negotiate a discounted and/or custom fee arrangement with each hedge fund manager. A dedicated managed account is a separate vehicle and can often have key differences from the commingled benchmark fund (e.g. reduced operational burden on the manager, differences in investment strategy and guidelines, etc.).

The use of a dedicated managed account structure combined with a significantly sized investment by the investor can and often does facilitate the ability to achieve a fee discount from the hedge fund manager.

Dedicated managed accounts also allow the plan to create custom fee structures with the hedge fund manager such as flat management fees, incentive fee hurdles, multi-year incentive fees and incentive fee claw-backs. These fee structures can work to better align the interests of the manager with those of the plan. The dedicated managed account structure also permits the public plan to approve or select each of the fund's service providers (fund administrator, auditors, etc.) and to negotiate specific fee arrangements with such service providers.

The dedicated managed account structure can provide the plan with complete expense transparency and the ability to control specific operating expenses that are charged to the funds.

> "THE POWER OF DAILY PERFORMANCE AND RISK TRANSPARENCY CANNOT BE UNDERESTIMATED IN TERMS OF BOTH PORTFOLIO MANAGEMENT AND RISK MANAGEMENT FOR A PUBLIC PLAN AND/OR ITS ADVISER"

INDEPENDENT VALUATION AND SERVICE PROVIDER OVERSIGHT

One of the core benefits of a managed account is the separation of duties maintained between the hedge fund manager and the platform provider. The hedge fund manager retains trading authority while the fund administrator and managed account platform provider are responsible for most day-to-day operational functions.

Operational tasks, such as valuation, accounting and cash and margin movements are performed independently of the hedge fund manager by a combination of the fund administrator and managed account platform provider. The platform provider is responsible for the day-to-day oversight of service providers (including the fund administrator) and provides various independent checks, middle office services and monitoring and reporting functions (e.g. NAV review and reconciliations, monitoring of investment guidelines, cash and margin movements, risk and performance reporting, etc.).

An example of the importance of separating the investment and operational functions is the determination of net asset value. In a dedicated managed account structure, the fund administrator would independently determine the net asset value of each fund using third party pricing sources and the implementation of the pricing policy would be overseen by the managed account platform provider. By using a managed account, a plan can ensure that the valuation of its assets is performed independently of the hedge fund manager whose performance compensation is linked to such valuation.

GUIDELINE MONITORING AND RISK REPORTING

A dedicated managed account structure provides the public plan with the ability to directly negotiate custom, written investment guidelines with each hedge fund manager to, among other things, help to ensure that the portfolio is managed in accordance with the objectives and expectations of the plan and to help prevent style drift and extreme concentrations.

In addition to guideline monitoring, the managed account structure generally allows the managed account platform provider to deliver the plan and/or its adviser with daily performance and risk transparency, often with underlying positions.

The frequency and granularity of this actionable data should allow the investor and/or its adviser to better and more efficiently manage their hedge fund portfolios. We believe that a public plan should select a managed account provider with technology capable of providing the plan with high quality, daily (T+1) risk and performance data. Reporting capabilities should include performance attribution, stress testing, scenario modelling, and value at risk (VaR) capabilities. Managed accounts also empower plans to monitor exposure to their counterparties, thereby allowing plans to mitigate or eliminate exposure to counterparty if a credit deterioration event occurs.

In comparison to the general opacity of most commingled hedge funds (which may provide some delayed monthly risk reporting, if at all), the power of daily performance and risk transparency cannot be underestimated in terms of both portfolio management and risk management for a public plan and/or its adviser.

CONCLUSION

As summarised above, there are extensive and material benefits for public plans to adopt the use of dedicated managed accounts as their preferred structure for making hedge fund investments. The customised nature of dedicated managed accounts along with the control and transparency afforded by such structures result in a superior hedge fund investment model for public plans as they continue to increase allocations to hedge funds.

The use of dedicated managed accounts can provide significant comfort to plan CIOs and boards of directors that they are meeting their fiduciary duties to plan beneficiaries by mitigating many of the investment and operational risks associated with hedge fund investing while increasing allocation to the asset class in an effort to achieve better risk-adjusted returns. Several public plans have either adopted the dedicated managed account structure or have announced an intention to do so.

We believe that this trend will continue and, in fact, accelerate in the coming months and years as plans look to take more control over their hedge fund investments and to further align these investments with the managed account model that plans have used for their traditional investments for many years. ■