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EVOLUTION OF INSTITUTIONAL INVESTING INTO ALTERNATIVES

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ALTERNATIVE HEDGE FUNDS ARE MORE POPULAR THAN EVER.

What used to be a vehicle for high net worth investors chasing big returns has evolved into one geared more toward institutions seeking diversification in order to reduce volatility. This new class of investors is also rightfully demanding transparency about how their assets are being invested, so gone are the days when funds' investment strategies and returns were closely-guarded secrets. In this report, NorthStar Financial Services Group, LLC ("NorthStar") explores the evolution of hedge funds in response to changing investor demand, from in-house reporting to mostly outsourced administration and from direct fund investments to today's managed account platforms.

MID-20TH CENTURY TO NOW: A CHANGING INVESTOR TYPE AND MINDSET

Many believe the modern day hedge fund can trace its roots back to 1949 when Alfred Winslow Jones pooled his money with four friends and invested $100,000 in a combination of long and short stock positions and significant debt. The fund – A.W. Jones & Co – earned 17.3% during the first year and outperformed every mutual fund by 87% over the next decade. Jones also devised the 20% manager's fee structure that remains in place in many hedge funds today.[1] Others believe the concept of a hedge fund was born in antiquity when philosopher Thales prospered from betting on an olive harvest.[1]

Though hedge funds in some form may have been around for thousands of years, the bulk of the growth for modern day funds came at the end of the 20th century, when assets surged from roughly $40 billion in the late 1980s to more than $650 billion in 2003.[2] During this time, most hedge fund investors were high net worth individuals chasing the excess return these types of funds appeared to be able to promise. Institutional investor inflows surged after 2002 after leading endowments, such as Yale University, which has one of the largest endowment funds in the country, significantly outperformed traditional 60% equity / 40% bond portfolios during the Tech Bubble by investing in hedge funds and other alternative instruments.3 In fact, most institutional investor flows into hedge funds began between 2003 and 2007, when they invested more than $1 trillion. Now, nearly $3 trillion in assets are invested in hedge funds, with institutional investors accounting for 65% of that capital.[3 4]

Institutional investors, such as endowments, pensions, and sovereign wealth, entered the alternatives market largely seeking risk-adjusted returns and the ability to reduce overall volatility in their portfolios. They were seeking diversification through investments that were uncorrelated with the rest of the investments in their portfolios. This differs from the objective of the "original" hedge fund investors – high net worth and family office investors, who are typically seeking outperformance and high returns. Over the last 15 years, many of the latter type of investors have exited hedge funds to seek better returns in other investment areas, but institutional investors have generally maintained and even extended their hedge fund allocations.[3]

AN EVOLVING STRUCTURE FOR ACCOUNTING AND INVESTMENT ACCESS

OUTSOURCING ADMINISTRATION

Prior to the 1990s, most hedge funds were self-administered, which gave the manager complete control over core processes and investor relations. They built and maintained their own back offices, bearing responsibility for hiring personnel for bookkeeping, investor registry maintenance, preparation of investor statements, and much more. As investment styles became more sophisticated and complex, so too did these back-office processes and the technology needed to support them. Still, investors generally had few issues with the fund being responsible for both generating and reporting performance. However, over time, managers became less inclined to invest in the infrastructure required for complex reconciliation and accounting, so the prospect of outsourcing to a third party administrator gained appeal.

Since hedge funds are only open to wealthy and institutional investors (generally those with more than $1 million in net worth) who can theoretically afford to take big risks, they were historically only required to offer the vaguest descriptions of their strategies, arguing that too much disclosure of their investment schemes could compromise their "edge." However, the 2008 financial crisis and Bernie Madoff investment fraud scandal pushed investors to demand greater transparency about how their assets were being invested. They called for managers to hire a reputable third party administrator to calculate Net Asset Value (NAV) and hold an independent set of books and records, which instilled confidence in the investor that NAV was being calculated using independent prices and transaction data sources. Before allocating money to any hedge fund or fund of hedge funds (FoHF), many institutional investors began conducting in-depth reviews of the manager's operational infrastructure, including evaluating the capabilities of the third party administrator. Institutional investors also began pushing heavily for lower management and incentive fees, which spurred hedge fund managers to look for ways to reduce expenses in the non-revenue generating parts of their businesses, such as administration. This led to more operational outsourcing.

Though some U.S. hedge fund managers are still self-administering (typically older funds that are closed to new investors), the vast majority of hedge funds entirely outsource to a third party administrator. In fact, by 2013, hedge fund administrators oversaw 81% of assets under management, compared to just 50% in 2006.[5] This careful release of fund information gives investors more confidence, while also providing hedge fund managers the opportunity to reduce and control costs, improve regulatory complexity, transfer operational risk, and improve time-to-market. Since the 1990s, third party hedge fund administrators have evolved to become experts in complex fund accounting, investor relations, and governance, as well as registrar and transfer agents.

TESTING THE HEDGE FUND WATERS THROUGH HEDGE FUNDS OF FUNDS

The early 2000s also saw a rise in FoHFs, which usually have lower minimums and provide broader diversification than single hedge funds. Some FoHFs invest in funds with a variety of strategies, while single strategy funds invest in a mix of funds with the same or similar strategies. FoHFs began booming in 2002 before significantly declining during the 2007-2008 financial crisis. The appeal of these types of funds is that, in exchange for an extra layer of fees, an experienced FoHF manager can vet hedge funds and place investor assets into suitable hedge funds that the investor would never be able to access on its own due to high initial investment minimums. The professional management a FoHF offers also allows institutional investors to sample hedge fund investing without having to tackle the challenge of individual hedge fund investing. Though they were paying an extra level of fees, institutional investors found investing in FoHFs easier and more sensible than hiring their own staff to research and invest in individual hedge funds. Since most institutional investors lacked the internal resources and familiarity with alternatives, they could leverage the FoHF's expertise and access to hedge fund managers. The expectation was that the FoHF manager would make moves in the portfolio as necessary to seek outperformance and ensure diversification.

Alas, the financial crisis beginning in 2008 hit FoHFs hard. During this time, many hedge funds had the same disappointing or calamitous performance as other types of investments, even though they had been promising absolute, not relative, returns. Additionally, the crisis exposed other flaws in the FoHF structure, as many investors were affected by liquidity restrictions imposed at the hedge fund and FoHF level and the irrational redemption behavior of their co-investors, as well as – in extreme cases – fraudulent acts (Bernie Madoff). The FoHF structure also allows the FoHF manager to charge its own fees and impose a layer of restrictions on investors on top of those being charged and imposed by each underlying hedge fund manager. These layered fee arrangements made FoHF prohibitively expensive to many. This costly and opaque arrangement drove out FoHF investors, who were concerned about the integrity and value add of these types of investments. Investors also began to demand more liquidity and transparency about the investments hedge funds were making and wanted more control over their assets in order to reduce co-investor risk. As their knowledge of the space grew, many institutional investors began investing directly in hedge funds to avoid the high fees inherent to the FoHF structure. Many began by placing a single allocation with a multi-strategy manager with the expectation that capital would be directed across a variety of approaches based on opportunities in the market. At the end of 2008, FoHF assets had dropped to about $600 billion from $800 billion at their peak in 2007. These types of funds continue to lose ground due to today's investors demanding lower fees, more transparency, and greater control and oversight into their investments.

PERCENTAGE OF HEDGE FUND ASSETS UNDER OUTSIDE ADMINISTRATION

2006	50%	2013	88%

LATE 2000s TO TODAY: INCREASED CONTROL & REDUCED COSTS THROUGH MANAGED ACCOUNTS

By the late 2000s, institutional investors' continued interest in accessing alternatives in a more flexible, liquid, transparent, and cost-effective manner led many to managed accounts – a structure that continues to thrive. In this arrangement, the institutional investor retains ownership and control over their assets yet delegates daily management of the account to an appointed hedge fund manager. Ultimately, this arrangement gives the investor more authority over its exposure than when investing directly in commingled funds or FoHFs, which are managed according to stated investment objectives rather than individual preferences. Hedge fund managed accounts also generally offer institutions reduced fees on the underlying funds, as well as notional funding, which allows for leveraging.

In contrast to hedge funds or FoHFs, which are professionally managed on behalf of many investors, managed accounts are personalized investment portfolios built to meet the specific needs of each institutional investor. The manager purchases shares of securities for the investor's account and them sells them whenever the investor desires. And, rather than being required to pay the standard hedge fund fees or multiple levels of fees inherent to the FoHF structure, managed accounts require managers and investors to pay only for what they need. Specifically, the managed account structure provides investors the following important benefits:

TRANSPARENCY AND CONTROL. Investors have full view of the managers' transactions, holdings, and asset values. They can also use segregated accounts with an independent broker or custodian bank rather than a pooled account with a broker that the hedge fund manager designates, which may reduce unwanted counterparty exposure. Investors may also require that a third party administrator perform portfolio valuations. Additionally, managed accounts allow institutional investors to see their positions and performance daily, thus providing more opportunity for more tactical account management.

CUSTOMIZATION. Managed accounts allow the manager and investor the flexibility to negotiate fees and terms without burdening the manager with excessive costs. Additionally, investors in FoHFs typically must accept the investment characteristics of the fund, whereas a managed account often allows the investor to set a specific investment mandate and therefore dictate investment targets, guidelines, and restrictions.

LIQUIDITY. In times of market stress, many hedge funds have been unwilling or unable to meet the surge of redemption requests. With a managed account, the investor is insulated from other investors' redemption activity since their assets are not commingled with other assets.

With a managed account, the investor and hedge fund are linked together only through an Investment Management Agreement. To change managers or reallocate assets, the investor simply needs to amend or terminate the agreement, whereas similar changes in a commingled fund arrangement would require disinvesting. Also, through a managed account, the investor can see activity on the underlying portfolio holdings whenever it is required.

RELIEVING THE BURDEN OF OPERATIONAL COMPLEXITY THROUGH MANAGED ACCOUNT PLATFORMS

Despite the indisputable benefits of individual managed accounts, they do carry a significant administrative burden for the institution which is responsible for setup of third party service providers. Ultimately, valuation, reconciliation, risk analysis, guideline monitoring, and even due diligence can all fall on the investor. It is prohibitively expensive for many asset owners to create the internal operational infrastructure needed to effectively administer and manage a portfolio of managed accounts. Many hedge fund managers have also pushed back against managed accounts because they feel burdened by the expense and operational complexity involved with managing a significant number of individual accounts, which can limit the manager's scalability. However, in the last 10 years, many operational infrastructure service providers have formed to handle most of the operations associated with a managed accounts structure, thereby alleviating this operational strain on hedge fund managers and institutional investors, while still meeting the institutional investor's need for independence. Essentially, these managed account platforms (MAPs) can be considered an evolution of fund administration, as they provide many of the fund's outsourced operational requirements that may not be part of the administrator's core service offering.

Through a MAP, an investor opens an account with a manager who then creates and executes an investment strategy on their behalf, based on the investor's specific investment objectives and restrictions. This allows for separation of investment and non-investment functions, as the hedge fund manager trades the portfolio according to the stated mandate and the managed account provider handles functions such as accounting oversight, fund operations, coordination of legal services, and much more. Essentially, through the managed account provider, there is a shift in control from the hedge fund manager to the institutional investor. MAPs provide access to hedge fund managers, but impose tighter investment controls around trading, investment allocation, and risk management than the manager would have to adhere to when managing direct investments in a pooled hedge fund.

MAPs provide tremendous depth and breadth of services, such as giving asset owners the ability to negotiate fees, maintain strong governance, and utilize risk and guideline monitoring tools, as well have complete transparency of data and processes and receive timely and comprehensive reporting. The platform provider is usually responsible for coordinating account setup, counterparty agreements and account openings, overseeing the third party administrator, auditing, performance reporting, and risk analysis. Some platforms also offer advisor due diligence and monitoring; legal support; trade collection, aggregation, reconciliation, and valuation; and portfolio rebalancing. The MAP is not designed to replace the hedge fund manager in any way; rather, it enables the manager to focus on executing the investment strategy without having to worry about back office processing.

ADDITIONAL CUSTOMIZATION FOR LARGE ACCOUNTS THROUGH DMAS

Dedicated Managed Account (DMA) platforms – typically available to institutional investors with investments in excess of $100 million – provide institutional investors an extra level of control, service, and the reporting needed to manage their investment decisions. In the DMA structure, the institution typically selects preferred trading advisors, custodian, clearing firm, and other service providers. The institutional investor ultimately owns and controls the account, which removes all co-investor risk and provides the investor more control and customization than with a commingled managed account. The DMA platform often provides granular details that support an investor's decisions, in addition to:

- Extensive due diligence on trading advisors and counterparties
- Legal structure of an appropriate investment vehicle
- Account setup with futures commission merchants (FCMs) and prime brokers (PBs)
- Performance reporting and trading activity
- Strategy rebalancing
- Position level transparency
- Daily liquidity
- Guideline monitoring on predetermined requirements, including markets traded
- Data aggregation and custom reporting
- Notional funding capabilities

A DMA platform also typically takes responsibility for exhaustive due diligence on managers available on the platform. Most DMA platform providers analyze, review, and identify manager strategies, abilities, backgrounds, and strengths/weaknesses, and only accept managers willing to offer complete transparency. Once on the DMA platform, the provider monitors the manager to ensure it is meeting performance standards and the manager is staying within the parameters of its stated investment strategy.

MANAGED ACCOUNT PLATFORMS

BENEFITS TO INSTITUTIONS

- Fee negotiation
- Strong governance
- Risk and guideline monitoring tools
- Complete transparency of data and processes
- Timely and comprehensive reporting

PLATFORM PROVIDE SERVICES:

- Coordination of account setup, counterparty agreements, and account openings
- Overseeing of third party administrator
- Auditing
- Performance reporting
- Risk analysis

CONTINUED EXPANSION TO IMPROVE RETURNS & MEET INVESTOR DEMANDS

These MAP services all come at a fee typically lower than what the institution would pay when investing directly with a hedge fund manager. Additionally, fees are transparent and granular. By paying less for administration, legal services, and auditing, investors may see improved net return on their investment. By providing the services that both hedge fund managers and institutions require, MAPs reduce the overall cost of investing while delivering greater control to institutional investors.

Though the structure of managed account platforms is continually evolving to better meet the requirements of institutional investors, what's apparent is that investors' need for investment transparency, control, cost-effectiveness is not abating. The fund servicing industry as a whole has changed greatly since hedge funds came to prominence 30+ years ago and continues to expand and innovate to meet changing investor demands.

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