An Introduction to Alternative Hedge Fund Structures

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1. Introduction

The hedge fund industry has evolved considerably in this millennium. These changes have included the due diligence of hedge funds. In 2000, industry best practices on conducting due diligence on hedge funds primarily focused on ***investment due diligence***. By 2005, leading industry best practices on due diligence had added ***operational due diligence*** as an important dimension. Operational due diligence, included everything non-investment – including background checks, quality of service providers, counter-party risk, internal controls, governance, and business viability.

Since the financial crisis of 2008, there has been more emphasis on governance, transparency, and liquidity. This has led to an increase of different types of structures to access hedge funds (separate managed accounts, fund of one, managed account platforms, 40-Act funds, UCITs, etc.).

The corollary of this development is a new dimension of the due diligence process – ***structural due diligence***. More specifically, once it has been determined that a certain hedge fund investment should be invested in since it is believed to be a value-add to the overall portfolio, the question arises – ***what is the best way structurally to access this hedge fund investment***? There is no universal, Holy Grail solution to this question. The answer depends on the specific investment and the specific investor's needs and capabilities.

Once it is known that a specific hedge fund should be added to the portfolio, the question becomes:

What is the best way structurally to access this hedge fund investment – through the manager's flagship fund, or one of its variant programs (such as a 40-ACT or UCITS), a fund of one, a separate managed account, a managed account platform, or a customized solution?

Investment Due Diligence + Operational Due Diligence + Structural Due Diligence

2. Investing in the Hedge Fund's Program directly

2.1 Investing directly in a Hedge Fund Manager's Fund Structure

Choosing to invest directly in a hedge fund manager's co-mingled structure, in general, usually has certain advantages and disadvantages:

Potential Advantages

+ Easiest in terms of minimum time to investment
+ Less "work" needed to do by investor
+ Lowest minimum needed for subscription
+ If the Fund has large AUM (in the Fund structure), then economies of scale are usually gained (i.e. lower expenses in terms of basis points per investor)
+ Less operations need to be done by the investor
+ No tracking difference
+ Limited liability

Potential Disadvantages

- Least amount of control for the investor
- No (or little) customization of investment
- Less transparency
- More vulnerable to strategy drift
- More vulnerable to style drift
- More vulnerable to concentration risk
- More vulnerable to fraud
- Less liquidity
- No cash efficiency
- Less governance
- One less layer of risk management / risk monitoring
- For hedge funds with low AUM in their fund structure, potentially more expensive (fees charged to the fund)
- Less transparency into expenses
- Potentially more counter-party risk
- Potential selection bias (cannot invest in some emerging hedge funds which may not quite meet operational standards).
- Less ability to adapt to changes in the capital and commodities markets at a total portfolio level

It should be noted, that in general, the less liquid the investments, the less the benefit of some of the features of a managed account solution (namely, cash efficiency becomes less likely, and some illiquid strategies, such as ABS, cannot be traded pari passu).

2.2 Investing in a Fund of One with the Hedge Fund Manager

Investing in a hedge fund manager's program via a fund of one, means that the investor is not co-mingled with other investors (the "one" is referring to the investor). Again, there are potential advantages and disadvantages in such an approach.

Potential Advantages

+ Allows for some customization
+ Less vulnerable to unwanted liquidity variation of co-mingled multi-strategy programs
+ Limited liability
+ Can usually leverage off of existing ISDA agreements of the manager

Potential Disadvantages

- Trading manager still retains control
- Somewhat time consuming in implementation
- Makes it expensive to redeem (since no portability of structuring)
- Limited cash efficiency (especially since one cannot add other hedge fund investments to this structure to cross-margin the investments).
- Size of investment needs to be large in order to keep expenses charged to the fund reasonable
- Less governance since HF retains control

In general, this structure may potentially be more valuable if there are many ISDA agreements and the ticket size of the investment is large.

2.3 Investing in Hedge Fund's Liquid Alternatives product (40-Act, ETF, UCITs, etc.)

The embarrassment of several institutional investors who had supposedly done "rigorous" due diligence being caught in Madoff-like "investments", coupled with investors not being allowed to redeem from investments due to gates, lock-ups, and side pockets, has led to increased demand for liquidity, transparency, and governance.

In addition to managed account solutions gaining in prominence since the financial meltdown, the area of "liquid alts" has also gained much traction. Since the financial crisis of 2008, one of the biggest developments has been the "collision of worlds" of long-only traditional investments, and hedge fund alternative investments. The 40-Act Alternative Mutual Funds in the USA has grown enormously the past few years, and it has changed the landscape of investing (and of the mindset of many hedge fund managers). The growth of 40-Acts in the US, and UCITs in Europe, has helped to increase the receptivity and experience of hedge fund managers towards granting managed accounts.

The 40-Act liquid alternative products are usually a "stripped down" or simplified version of the hedge fund manager's flagship program. In the USA, these products are typically accessible by a broader range of clients, since the property of "Qualified Eligible Person (QEP)" is typically not a necessary condition for these products [Mains].

Potential Advantages

+ Typically better liquidity conditions than the hedge fund manager's flagship program
+ Typically easy to invest in (in terms of time)
+ Often, this product is more closely regulated
+ Limited liability

Potential Disadvantages

- Typically more expensive in terms of overall fees (and layers of fees)
- Usually a "stripped down" version of the trading program with a less attractive statistical profile
- While the liquid alts space is growing rapidly, there are many hedge fund programs that do not currently have a liquid alternative product.

In general, this structure may potentially be a good way for an institutional investor to start gaining experience with alternative investments; one should pay careful attention with regards to the total fees and expenses of the product.

3. Investing in the Hedge Fund via a Managed Account Solution

3.1 Backdrop

The financial crisis of 2008 changed the hedge fund industry in a profound manner. Prior to the crisis, the balance of power was largely with the hedge fund managers. In addition to charging lofty fees, many hedge fund managers gave little or no transparency to the institutional investor. This was despite the fact that the hedge fund manager chose the route of taking outside investor money, as opposed to being a private proprietary trading firm which takes no outside capital. Institutional investors often have a fiduciary duty with respect to their investments; fulfilling this duty without proper transparency and reporting from their external hedge fund investments becomes extremely difficult, if not impossible. The offering memorandums of many hedge funds demonstrated the lopsidedness of the relationship, with the power of most items residing largely with the hedge fund.

During the height of the crisis, many hedge funds did not allow their investors to redeem – even those investors that had already lived through a lock-up period. Many hedge funds invoked gates and side pockets, infuriating institutional investors who were clamoring to redeem.

Almost in parallel, the multi-billion dollar fraud and Ponzi scheme of Bernie Madoff came to light. The Madoff debacle highlighted that so-called blue-chip pedigree and simply "trusting" was not sufficient in hedge fund decisions. Several fund of funds and large institutional investors were embarrassingly and sadly exposed to the Madoff fraud, largely for not doing proper and rigorous due diligence [Thorp].

The Madoff scandal was deplorable, and similar to the "cockroach theory", it was not isolated. There were other hedge fund frauds, such as Stanford Financial Group and Petters. Indeed, it is important for institutional investors not to have amnesia about these cases (http://www.hedgetracker.com/halloffraud.php).

The combination of institutional investors being gated, and some falling victim to fraudulent investments, led to an increase in popularity of managed accounts. Managed accounts, or separate managed accounts (SMA), were already somewhat common in the CTA space, which was one type of hedge fund strategy that did fare well during the financial crisis [Abrams – Bhaduri – Flores]. Somewhat ironically, systematic CTAs are mistakenly termed by some institutional investors as "black-box strategies" even though these CTAs typically will give full transparency via managed accounts. CTAs, compared to other hedge fund strategies, have had a history of granting managed accounts, at least partly due to the fact that the cash efficiency of CTAs is often sizeable, and hence a good benefit to the investor.

In going the managed account route, the three broad canonical choices for the institutional investor are:

(1) Take a separate managed account (SMA) in one's own name and do not utilize the services of a third party to handle back office operations and risk management.

(2) Invest in a customized solution via a dedicated managed account platform (D-MAP). The D-MAP is dedicated to a single institutional investor, and thus not co-mingled with other investors (unless this is a white-labeled for the single institutional investor – who is then fully controlling the channel of investors that may invest).

(3) Invest via an external managed account platform (E-MAP). The E-MAP is a co-mingled investment with potentially many different institutional investors.

The following sections of this paper look into some of the basic differences and ramifications of these choices. One common characteristic between these three basic approaches is, if done properly, it helps to lower the probability of strategy drift, style drift, or concentration risk. Strategy drift, style drift, or concentration risk can occur quickly, and investing in a hedge fund manager's flagship structure leaves the investor entirely vulnerable. Amaranth Advisors, was a bona-fide blue-chip multi-strategy hedge fund that deteriorated with style drift, strategy drift, and concentration risk that blew up with a multi-billion dollar loss in September 2006.

3.2 Separate Managed Account (SMA) with no MAP service provider

One of the main things about taking a separated managed account is having a strong operations and technology infrastructure. Transparency and technology go hand in hand, and advanced technology is needed in order to synthesize the positional and transactional information intelligently. Without proper operations and technology, having a separate managed account can create information over-load and potentially increase the liability.

When an investor takes a separate managed account, it empowers the investor, both from an operations and investment perspective. The investor is able to select the prime broker, auditor, custodian, and administrator. This allows the investor to better control the counter-party risk and the expenses associated with the hedge fund.

In addition to having management and performance fees, the hedge fund usually charges expenses to the fund, which is borne by the investors of the fund. These expenses usually include the costs of prime brokerage, administration, custodian, legal, and sometimes other items. The expenses that are charged to a fund can be non-trivial.

If the investor decides to go the managed account route, then there are additional choices that the investor has pertaining to the structuring. This may include selecting a certain jurisdiction (for example: Caymans or Dublin). In addition, if investing in more than one manager via a managed account, it may be possible to cross-margin these investments.

Potential Advantages of investing via a SMA (without using MAP)

+ Own the assets
+ Maximize control
+ Less probability of strategy drift, style drift, or concentration risk
+ Less probability of fraud
+ Cash efficiency
+ More control over counter-parties and expenses
+ Increases the scope of potential investments since one can invest in emerging managers which may not yet have institutional quality top-tier service providers and/or operations
+ Full transparency to transactions and positions helps to give deeper understanding of the trading program, which creates a positive feedback loop in ongoing due diligence
+ Increased ability to increase / decrease exposure

Potential Disadvantages of investing via a SMA (without using a MAP)

- Depending on how investment is structured, potentially more liability
- More back-office work
- More technology and operations required
- Larger minimum investment required
- Tracking difference

3.3 Customized Solution via a Dedicated Managed Account Platform (D-MAP)

A D-MAP has the business strategy of fully focusing on the institutional investor. In essence, a good D-MAP is "off-balance sheet employees" of the institutional investor, and provides expertise in back office, operations, technology, risk management, as well as being a valuable resource for manager research. A D-MAP is not comingled with other investors, and as such is truly customized for the institutional investor.

One commonality between the SMA and D-MAP is that the investor is in some ways creating a proprietary trading desk, except that its "traders" are hedge fund managers that might be situated anywhere in the world. The investor, either alone, or with a D-MAP service provider, is a centralized risk management, technology, and operations hub.

Potential Advantages of investing via a D-MAP

+ Maximize control (de-facto veto power)
+ Increased governance
+ Extra layer of risk management
+ Less probability of strategy drift, style drift, and concentration risk
+ Less probability of fraud.
+ Cash efficiency
+ Increases the scope of potential investments since can invest in emerging managers which may not yet have institutional quality top-tier service providers and/or operations
+ Full transparency to transactions and positions helps to give deeper understanding of the trading program, which creates a positive feedback loop in ongoing due diligence
+ Increased ability to increase / decrease exposure
+ More control over counter-parties and expenses
+ Less back-office and operations work to do in-house
+ Less expenses toward developing technology to monitor and track investments
+ Increased optionality in structuring choices (on balance sheet, or off balance sheet)
+ Gaining customized structure that can be utilized for the long-term (even if investments are changed)

Potential Disadvantages of investing via a D-MAP

- Larger minimum investment required
- Tracking difference
- Extra layer of fees to D-MAP
- Extra layer of due diligence necessary by investor (i.e. due diligence on D-MAP)

3.4 Customized Solution via an External Managed Account Platform (E-MAP)

The space of E-MAPs has grown considerably since the financial crisis. There are some E-MAPs that are bank-run, some which have stemmed from Fund of Funds and still have their Fund of Funds product, and some E-MAPs which are limited to CTAs only. It is possible that the E-MAP space will face some consolidation in the coming years.

The general premise of an E-MAP is to take a managed account from the hedge fund, and then wrap this into a fund structure. The E-MAP tries to have several hedge funds listings on their platform, and allows suitable investors to make investments into these listings. Done well, and properly, this is a value-add to the industry.

Some general remarks about E-MAPs:

1) "Managed Account" is somewhat of a misnomer, in that the institutional investor is investing into a co-mingled fund structure. Apart from the E-MAP fees, there will be expenses charged to the fund (administrator, prime brokerage, auditor, etc.). The E-MAP is selecting the service providers (administrator, prime broker, custodian, auditor, law firm, etc.), and typically the investor will not have a voice on these selections.

2) Most E-MAPs are trying to gain "market-share" of the hedge fund space (i.e. have a decent quantity of listings). The E-MAP is trying to act as a distribution channel for the hedge funds, and thus is not fully focused on the institutional investor.

3) In investing via a bank's E-MAP, the investor should be careful that they are not being exposed to concentrated counter-party risk of that bank, and if this is not avoidable, at least be aware of this risk.

4) In investing via a bank's E-MAP the investor should be careful that extra fees (the bank's prime broker or custody unit potentially charging more than market-rate or in the case of structuring via swaps, certain hidden costs). It is possible that a bank E-MAP gains certain efficiencies via their different business units, and passes this along to their clients. However, the client loses the ability to "shop" for different prices amongst different service providers.

5) Not all structures are equivalent. For instance SPCs (Segregated Portfolio Companies) have never fully been tested in court in terms of potential contamination. The institutional investor should confer with their own legal experts to fully understand the potential risks of any investment (whether in an E-MAP or elsewhere).

6) The E-MAP might not be familiar with the investor's regulatory jurisdiction and thus could potentially go off-side in an offering. For instance, a non-Canadian E-MAP (or non-Canadian D-MAP) may not be familiar with the National Instrument 31-103 Registration requirements that are part of the Ontario Securities Commission's regulations for entities based in Ontario that make hedge fund investments.

7) If the size of the investment is sufficient, it may be possible for the E-MAP to try and offer a customized "D-MAP" type of solution, but this further stretches their focus.

8) It is good to know the quality of the clients of a MAP (either D-MAP or E-MAP), as well as how long the MAP has been in business.

9) In general, utilizing an E-MAP as opposed to a D-MAP, might potentially be the better choice if the overall ticket size of the investment is not of a certain critical size, or if the investor plans to redeem entirely from the underlying trading manager in a short time period, and reinvest in a different trading manager. Otherwise, the D-MAP might potentially be the better choice than the E-MAP.

Potential Advantages of investing via an E-MAP

+ Extra layer of risk management
+ Increased governance
+ Less minimum investment needed than via a SMA or D-MAP
+ Easy to invest in
+ Limited liability
+ If seeding new program listing, then potential to negotiate lower platform fee
+ Some cash efficiency for CTA investments
+ Increases the scope of potential investments since one can invest in emerging managers which may not yet have institutional quality top-tier service providers and/or operations

Potential Disadvantages of investing via an E-MAP

- Less control than SMA or D-MAP
- Extra layer of fees of E-MAP
- Potentially high fund expenses
- No ability to cross-margin investments, so less cash efficiency
- No (or very little) customization in terms of service providers utilized (thus reducing ability to control counter-party risk)
- Extra layer of due diligence necessary by investor (i.e. due diligence on E-MAP)
- E-MAP is strategically not fully aligned with the investor
- If E-MAP has Fund of Funds product, could potentially compete with investor for capacity of a hedge fund
- E-MAP might be overstating their listings (i.e. include listings that have no assets) to try and give the impression that they are larger than they are.
- E-MAP might be limited to CTAs only, and not offering equity or other hedge fund strategies.

4. Conclusion

In general, an investor can turn to the hedge fund manager and invest via their fund structure, or potentially via a variant offering from the manager (40-ACT, or UCITs), or a fund of one (i.e. trading manager's fund, but not be co-mingled with other investors).

Alternatively, the investor might potentially go the managed account solution route, in which case there are three broad choices:

1) Take a managed account and do not use the services of a MAP (managed account platform)

2) Invest via a D-MAP (dedicated managed account platform), which is a customized solution (example: Sigma Analysis & Management)

3) Invest via an E-MAP (external managed account platform)

There is no universal solution, and this paper is meant to be introductory in helping to facilitate discussion towards the correct path. The potential for structural alpha via negotiating fees and an appropriate structure, is not being explored enough by many institutional investors.

References

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HedgeTracker Hall of Fraud: http://www.hedgetracker.com/halloffraud.php

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