



# **Separately Managed Accounts for Hedge Fund Investments:**

What institutional investors need to know

Capital Advisory Group

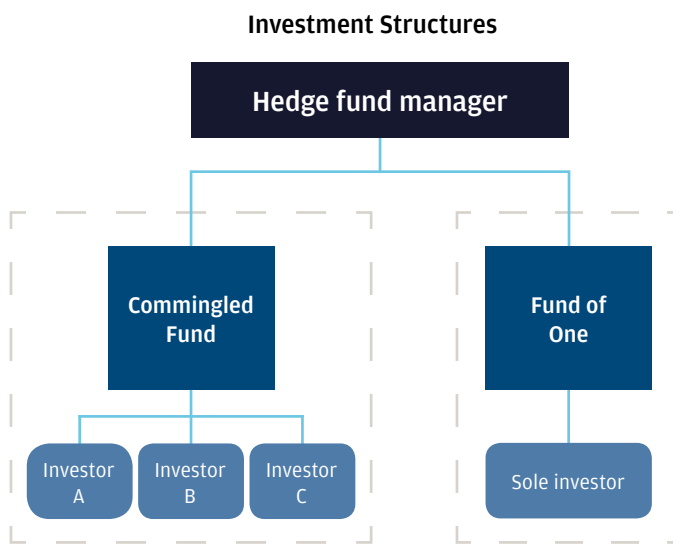
J.P.Morgan

Separately managed accounts for hedge fund investments are a concept that most investors have probably come across over the past several years. However, they continue to evolve and their popularity seems to be growing. This paper takes a closer look at the continued growth of hedge fund managed accounts, the types of investors using them, the benefits they can offer over other common fund structures available, implementation considerations and a comparison of the different managed account structures. Depending on an investor’s specific hedge fund portfolio characteristics and goals, managed accounts may offer compelling benefits.

## Defining the structures

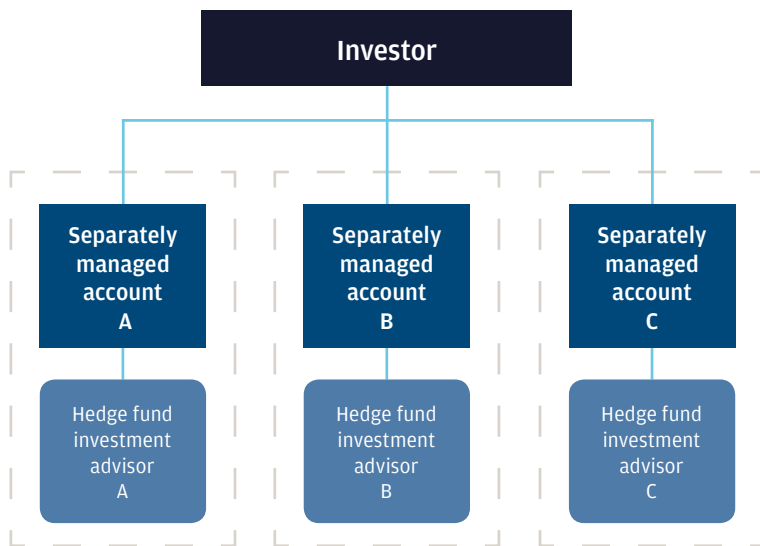
There are several ways to invest with a hedge fund manager, including:

- **Commingled fund:** an investment structure in which a hedge fund manager creates an investment vehicle and multiple investors can allocate to it.
- **Fund of one:** an investment structure where a hedge fund manager creates the investment vehicle for only one investor. This differs from the commingled fund because it may allow the sole investor to have more influence over the manager for that specific fund.



Source: J.P. Morgan Prime Finance

- **Separately managed account (SMA):** an investment structure where the investor creates its own investment vehicle, then appoints a hedge fund manager as an investment advisor. With an SMA, the investor owns the account, which is significantly different from the commingled fund and fund of one, both of which are created and controlled by the hedge fund manager and in which the investor is just a subscriber.

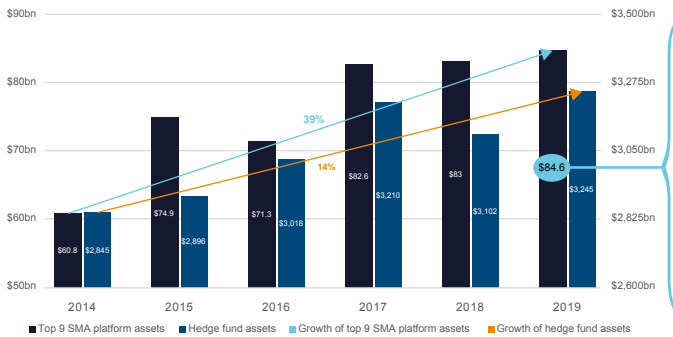


Source: J.P. Morgan Prime Finance

# Growth of hedge fund SMAs

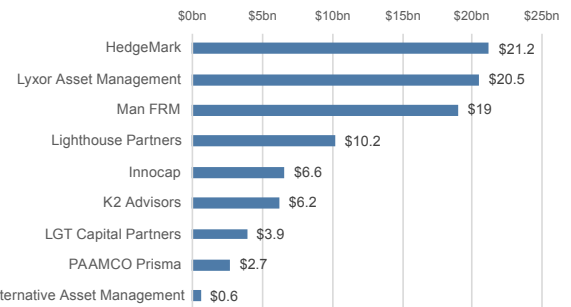
One of the simplest proxies for the size of the sector is to consider the growth of the largest hedge fund SMA platforms. These are the structures manufactured by asset managers or third-party service providers to house SMA investments. Data shows that these structures continue to attract assets; the top 9 platforms have grown 39% percent since December 2014 to \$84.6 billion<sup>1</sup>, compared with the hedge fund market as a whole, which has grown 14% to \$3.25 trillion<sup>2</sup> over the same period.

**Growth of Hedge Fund Industry Assets versus Top 9 SMA Platform Assets**



Sources: HFM Week report, December 2014 to June 2019, Hedge Fund Research, December 2014 to June 2019

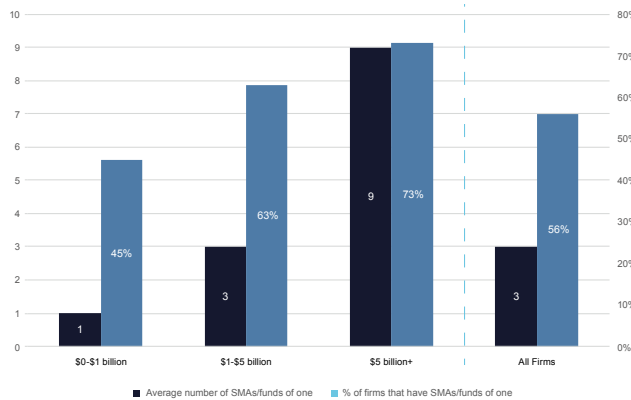
**2019 Top 9 SMA platform assets**



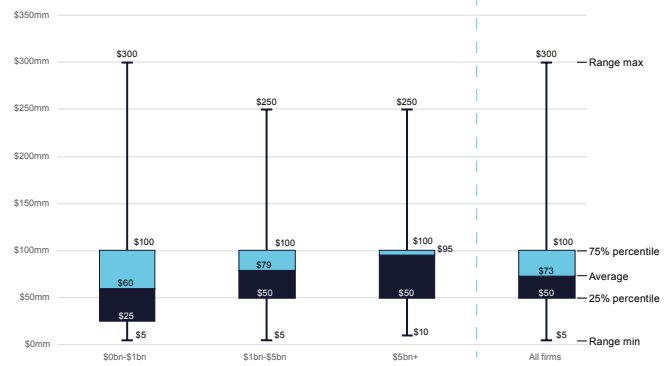
Source: HFM Week, October 2019

Hedge fund managers are also aware of the importance of offering SMAs to investors. The 2018 J.P. Morgan Capital Advisory Group Hedge Fund Benchmarking Study found that 56% of hedge fund managers have at least one SMA or fund of one.<sup>3</sup> Hedge fund managers dramatically increase the number of SMAs and funds of one as their firm assets grow. Firms with \$1 billion-\$5 billion in assets typically have an average of three SMAs or funds of one and that number increases to an average of nine for managers with assets of \$5 billion or more. The average minimum allocation size required by hedge fund managers to open an SMA or fund of one is \$73 million, with over two-thirds of the respondents requiring at least \$50 million.

**Hedge fund managers' use of SMAs or funds of one by firm AUM**



**Hedge fund managers' minimum allocation requirements by firm AUM**



Source: J.P. Morgan Capital Advisory Group Hedge Fund Benchmarking Study 2018

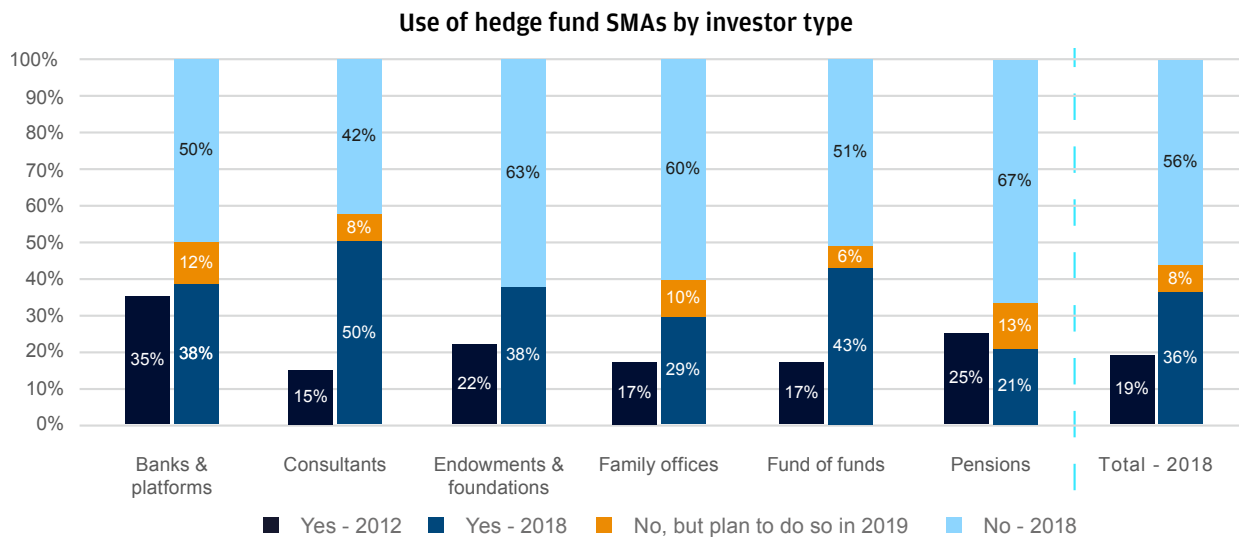
<sup>1</sup> Source: HFM Week report, December 2014 to June 2019  
<sup>2</sup> Source: Hedge Fund Research, period December 2014 to June 2019  
<sup>3</sup> Source: J.P. Morgan Capital Advisory Group Hedge Fund Benchmarking Study 2018

## Section highlights

- 56% of hedge fund managers have at least one SMA or fund of one.
- Hedge fund managers tend to have an average of three SMAs or funds of one, but that number grows to an average of nine for firms managing \$5 billion+.
- \$73 million is the average minimum allocation size required to open an SMA or fund of one, with over two-thirds requiring at least \$50 million.

## Who uses hedge fund SMAs?

The recent 2019 J.P. Morgan Capital Advisory Group Institutional Investor Survey revealed that the percentage of investors using hedge fund SMAs has grown in recent years, from just 19% in 2012 to 36% in 2018.<sup>4</sup>



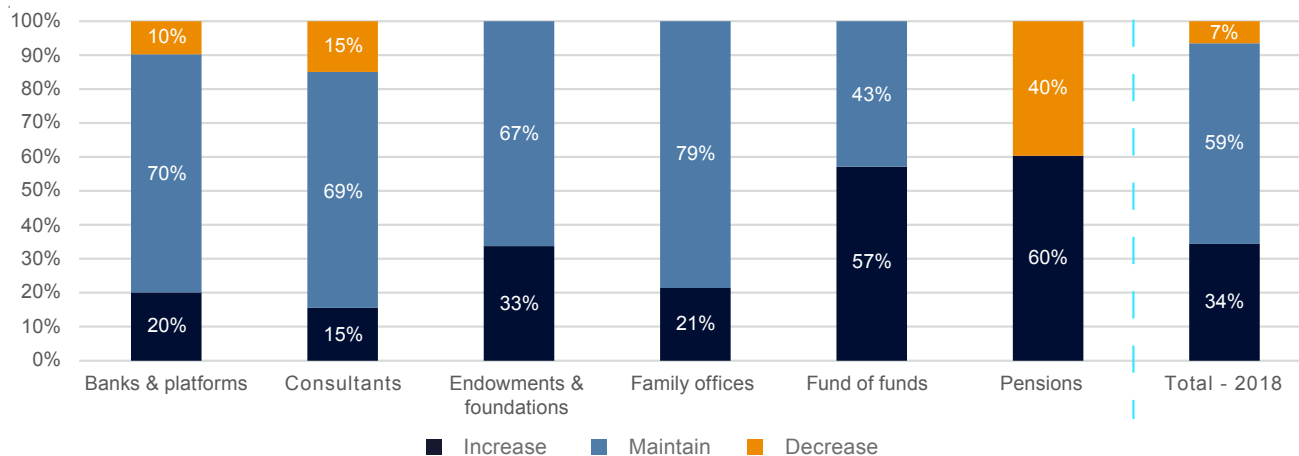
Source: J.P. Morgan Capital Advisory Group Institutional Investor Survey 2019

The survey shows that currently funds of funds, consultants, and private banks & wealth management platforms are the main types of investors that are using hedge fund SMAs. These types of investors are embracing the flexibility that the SMA structure offers as they have been keenly focused on evolving their business models with a particular emphasis on cost reduction and the ability to offer customized products.

Pensions are also growing users, with 60% planning to increase the number of hedge fund SMAs they use.

<sup>4</sup> Source: J.P. Morgan Capital Advisory Group Institutional Investor Survey 2019

### Expected change in use of hedge fund SMAs by investor type



Source: J.P. Morgan Capital Advisory Group Institutional Investor Survey 2019

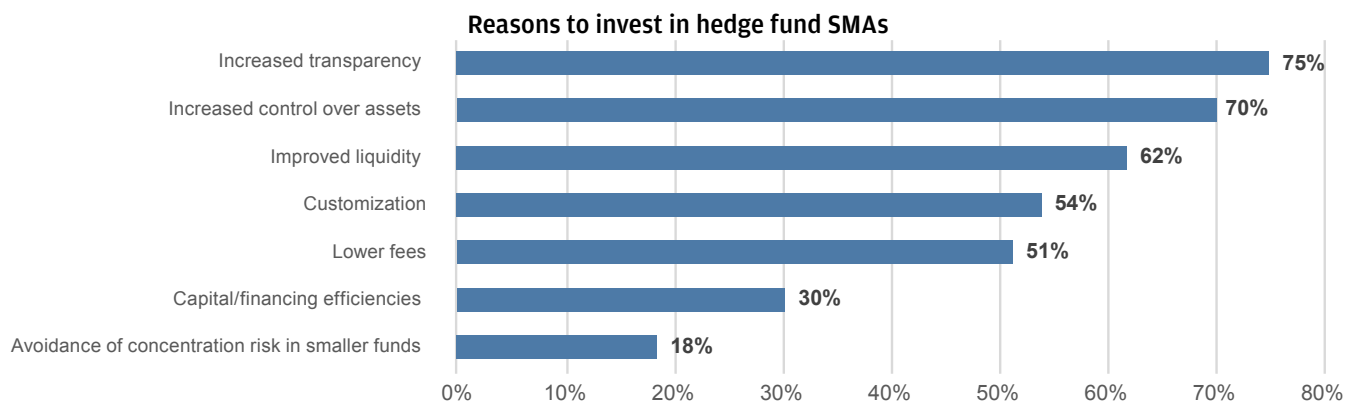
All investors must weigh the overall benefits of using hedge fund SMAs as it might relate to several important factors, such as total assets allocated to hedge funds, hedge fund manager selection preferences, strategy allocations and typical allocation size.

#### Section highlights

- 36% of investors use hedge fund SMAs compared with just 19% in 2012.
- 58% of consultants, 50% of private banks & wealth management platforms and 49% of funds of funds surveyed use, or plan to use, hedge fund SMAs.
- 60% of pensions and 57% of funds of funds surveyed plan to increase the number of hedge fund SMAs they use.

## Why are investors using hedge fund SMAs?

The institutional investor survey found that transparency, control, liquidity and customization are the most common reasons indicated for investing in hedge fund SMAs.<sup>5</sup>



Source: J.P. Morgan Capital Advisory Group Institutional Investor Survey 2019

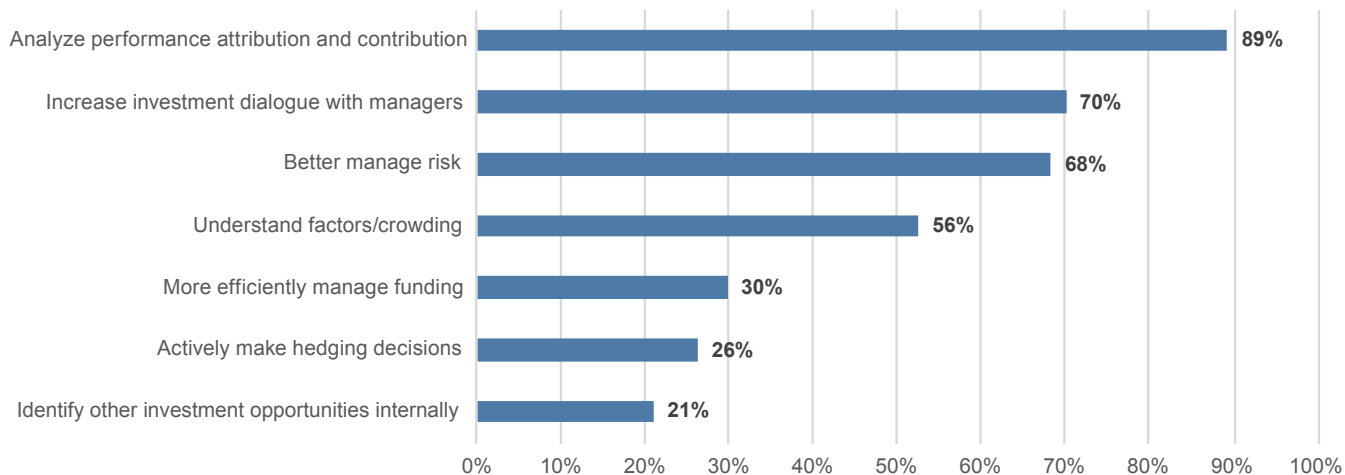
<sup>5</sup> Source: J.P. Morgan Capital Advisory Group Institutional Investor Survey 2019

The structure can provide several benefits to investors, including:

- **Transparency:** The investor, as the owner, has full transparency into the assets in the SMA.

Investors cited several ways they are able to use this incremental transparency to extract additional value, including the ability to better analyze performance, improve their investment dialogue with the hedge fund manager and better manage risk.

### Uses of the increased transparency from hedge fund SMAs



Source: J.P. Morgan Capital Advisory Group Institutional Investor Survey 2019

- **Structural comparison:** Investors in a commingled fund or a fund of one may be able to negotiate with hedge fund managers for more transparency, but unlike SMAs, the hedge fund manager ultimately decides the level of transparency that will be offered to their investors.
- **Control & liquidity:** The investor has full control over the assets in the SMA and has the right to dispose of any of the investments or terminate the Investment advisory agreement with the hedge fund manager at any time.
  - **Structural comparison:** With a commingled fund or a fund of one, investors are subject to the lock up and redemption terms of the fund.
- **Hedge fund fees:** Some investors find that the SMA structure allows them to better negotiate the fees they pay to their hedge fund managers.
  - **Structural comparison:** Fee negotiations may also work for investors in a commingled fund or a fund of one. In addition to a large allocation size, the willingness to lock up capital for a longer period can help with these negotiations.
- **Bespoke investments:** The investor can create a more customized portfolio with an SMA that might include strategy carve-outs, best ideas, co-investments, levered versions, or environmental, social and governance (ESG) mandates.

- **Structural comparison:** Customized strategies may also work well in a fund of one structure, but are more difficult to achieve in a commingled fund.
- **Leverage & financing efficiency:** Investors have the ability to apply leverage in an SMA, allowing for more efficient use of their capital.

Instead of fully funding the account with cash, the investor might be allowed to post less cash for margin purposes (“notionally funding”) and thereby free up excess cash for other purposes. Another potential option is to apply leverage synthetically by entering into a total return swap with a counterparty with respect to a hedge SMA investment. These leverage options might be particularly attractive to investors that are capital constrained and need to meet other funding obligations.

- **Structural comparison:** In a fund of one, an investor can potentially have a customized, levered version of the strategy as well, but this is more difficult to achieve in a commingled fund.
- **Structural cost reductions:** Services that are strictly associated with being an investor in a commingled fund or fund of one can be eliminated in an SMA, which might make the structure more cost effective.

These services include governance functions provided by outside fund directors, partnership accounting and reporting and other fund administration, legal, audit and tax costs. According to the study, the total costs passed along to their investors in non-SMA structures can range from 20 to 90 basis points (fund expense ratio).<sup>6</sup> Instead, with the SMA structure, most investors choose to negotiate the details in their investment management agreements, which include the expenses that will be charged to them by their hedge fund investment advisors.

- **Economies of scale:** Investors with large hedge fund portfolios can achieve significant scale, allowing them to potentially influence their pricing and additional resources offered from their service providers, such as prime brokers and administrators.

Those that invest with smaller hedge fund managers may find they have even more pricing power with their service providers than those smaller hedge fund managers might be able to obtain themselves. The investors and their hedge fund investment advisors may then be able to extract further value from their counterparties such as increased corporate access, research, banking and other resources.

- **Structural comparison:** With a commingled fund or a fund of one, any economies of scale are solely for the benefit of the hedge fund manager.
- **Concentration risk in smaller funds:** Some investors might not want their investment to be too high of a percentage of a commingled fund’s assets or might be concerned with the business risk of smaller and newer firms. With the SMA structure, investors do not have to worry about other investors’ actions, and they have complete control over the assets if the hedge fund investment advisor has any unexpected issues. This structure could allow an investor to more comfortably gain exposure to emerging hedge fund managers.
- **Structural comparison:** In a fund of one, investors also do not have to worry about other investors’ actions, but unlike SMAs, they do not control the assets in the account. In a commingled fund, allocations from all investors are pooled together.

<sup>6</sup> Source: J.P. Morgan Capital Advisory Group Hedge Fund Benchmarking Study 2018

## Comparison of structural benefits

	Commingled Fund	Fund of One	Managed Account
Transparency	▲	▲	■
Control & Liquidity	●	▲	■
Hedge Fund Fees	▲	▲	▲
Bespoke Investments	●	■	■
Financing Efficiency & Leverage	●	▲	■
Structural Costs	●	▲	■
Economies of Scale	●	●	■
Concentration Risk in Smaller Funds	●	▲	■
Investor Resource Commitment	■	▲	●
Hedge Fund Manager Selection	■	▲	●

### Benefit to the investor

■ Most → ▲ → ● Least

Source: J.P. Morgan Prime Finance

### Section highlights

- Transparency, control, liquidity and customization are the most common reasons cited for investing in hedge fund SMAs.
- Investors mostly use the increased transparency to better analyze performance, improve investment dialogue, and better manage risk.
- Benefits of financing efficiency, leverage, structural cost reductions and achieving economies of scale are more readily available to investors that invest in hedge fund SMAs.
- Investors can negotiate the details in their investment management agreements, which include the expenses that will be charged to them by their hedge fund investment advisors. The results may differ greatly from the typical fund expense ratio of 20-90bps for investors in a commingled fund or fund of one.

## Infrastructure: Build versus buy

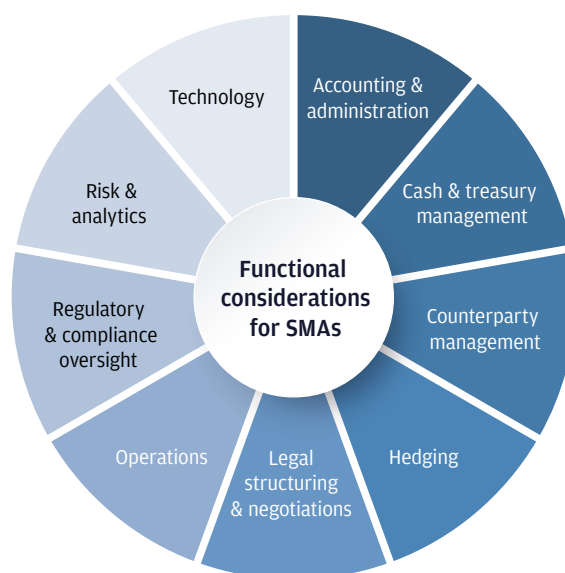
An important decision for investors is whether to create the SMAs themselves or to outsource to an SMA platform service provider. The decision will largely be driven by their resourcing, technology and expertise available because many additional functions are required in using hedge fund SMAs.

Investors that choose to build the hedge fund SMA platform in-house would have to assess in-house expertise in areas such as treasury management, portfolio financing, legal and operations. They would also have to confirm that their existing systems and technology (proprietary and/or outsourced) are able to provide the monitoring and risk management required.

Investors sometimes find that the operational complexity of creating and servicing SMAs can increase as the number of SMAs and service provider relationships also increase. Many investors are especially focused on making sure they are able to get the most out of their increased transparency.

As their program grows, they will need to continuously evaluate the opportunity costs of upgrading infrastructure and teams internally compared with the various outsourcing options available.

For these reasons, investors might choose to outsource a number of these functions to an SMA platform service provider that has the resources and expertise to scale hedge fund SMA programs.



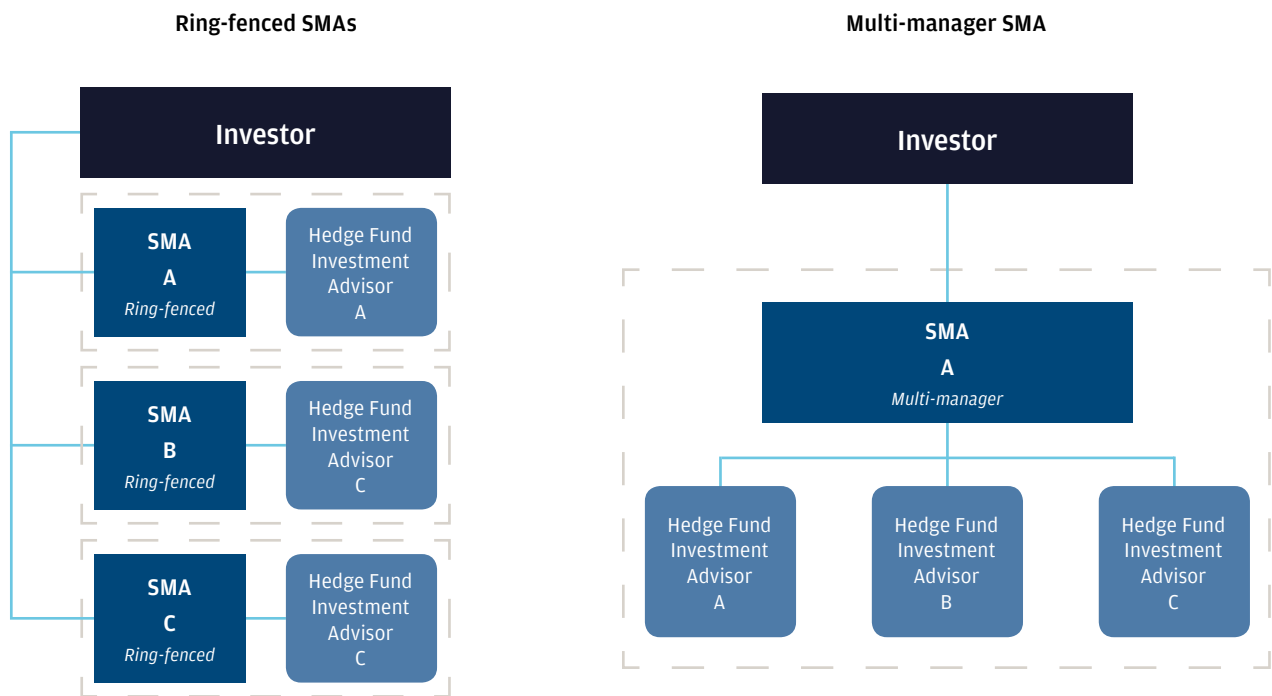
### Section highlights

- Investors that build their own hedge fund SMA platforms must have the staff, systems and technology for the functions required, including monitoring portfolios, risk management, treasury management, legal, operations and counterparty management.
- Many investors choose to outsource some or all of these functions to an SMA platform service provider.

## Structural decisions for SMAs: Ring-fenced or multi-manager

A further decision for investors is whether to structure their investments in individual ring-fenced SMAs or pool them in a multi-manager SMA. The latter option groups the allocations together in the same single legal entity, with the hedge fund managers acting as investment advisors to the combined asset pool.

### Managed Account Structures



Source: J.P. Morgan Prime Finance

For the ring-fenced SMA structure, each individual hedge fund investment is isolated from the others as they are legally and structurally separate.

- **Cross-liability protection:** This prevents potential issues with the portfolio of one hedge fund investment advisor contaminating any of the investor's portfolios managed by other hedge fund investment advisors.
- **Customized client mandates:** Businesses such as funds of funds, outsourced CIOs, and private banks & wealth management platforms catering to many clients can more easily customize their clients' hedge fund allocations by selecting different exposures to each managed account.
- **Attribution:** It is easier to attribute costs and performance to each underlying hedge fund investment advisor.

The multi-manager SMA structure differs in several key ways:

- **Financing costs & margining:** Investors have much greater flexibility over the financing and margining of the asset pool as their counterparties may be able to offer more efficient cross-margining and financing terms. This could result in a more favorable internal rate of return (IRR) across the portfolio as a whole.

According to J.P. Morgan Prime Finance’s calculations, in a \$2 billion hypothetical hedge fund portfolio allocated across diversified hedge fund strategies, an investor has the potential both to:

1. lower their financing costs by 22% because of a lower weighted average cost to finance the overall asset pool, and to
2. free up an additional 24% of cash due to a reduced blended margin requirement.

Several assumptions go into these calculations, which can vary and can be customized for investors looking to understand what these benefits might look like for their specific portfolio.

- **Implementation/onboarding:** Most legal negotiations happen upfront with a single SMA entity. Hiring each additional hedge fund investment advisor then becomes more streamlined from an onboarding perspective, because potentially fewer resources would be needed for legal negotiations and credit risk analysis as a new SMA is not being formed. This can be very important to investors that tend to invest in complex strategies, co-investments or short-term trade opportunities that require the ability to allocate quickly.
- **Structural cost reductions:** Operational costs such as audit, tax and reporting are limited to a single SMA, which may reduce the cost of services.

### Comparison of financing & margin requirements across SMA structures

Hypothetical hedge fund portfolio*	\$2bn	100%
Quant equity	\$400mm	20%
Equity long/short	\$200mm	10%
Event-driven	\$200mm	10%
Credit long/short	\$200mm	10%
Convertible arbitrage	\$300mm	15%
Distressed credit	\$300mm	15%
Macro/CTA	\$400mm	20%

Source: J.P. Morgan Prime Finance Calculations as of September 2019

	Ring-fenced SMAs	Multi-manager SMA	Differential
Financing charge	\$41mm	\$32mm	\$9mm <b>22%</b>
Margin requirement	\$1.388bn	\$1.049bn	\$339mm <b>24%</b>

Source: J.P. Morgan Prime Finance Calculations as of September 2019

\* Disclosure: This analysis is based off of hypothetical portfolios across multiple strategy allocations. Margin requirements, financing spreads and funding haircuts are indicative only and are subject to change based on a full review of the actual portfolio(s).

## Comparison of structural benefits

	Ring-Fenced SMAs	Multi-Manager SMA
Cross-Liability Protection	■	●
Customized Client Mandates	■	▲
Attribution	■	●
Financing Costs	▲	■
Margining	▲	■
Implementation /Onboarding	●	■
Structural Costs	●	■

Benefit to the investor

■ Most → ▲ → ● Least

### Section highlights

- Ring-fenced SMAs provide more protection and the ability to customize many client portfolios.
- In a hypothetical \$2 billion diversified hedge fund portfolio, the multi-manager SMA structure has the potential to lower financing costs by 22% and free up an additional 24% of capital, which could result in a more favorable IRR when compared to the ring-fenced SMA structure.

## Conclusion

The use of hedge fund SMAs has produced significant asset growth and continued interest. As a result, more investors are taking a closer look at the current value proposition of using such structures for their hedge fund portfolios. For many, the compelling benefits of transparency, liquidity, control, customization, leverage, financing efficiencies and potential economies of scale seem to outweigh the significant increase in work required to implement a hedge fund SMA program successfully.

J.P. Morgan has committed significant resources to assisting both hedge fund managers and investors that use, or are interested in using, hedge fund SMAs. By partnering with J.P. Morgan, investors that use hedge fund SMAs can gain access to a breadth of products and solutions across the franchise, including access to global resources, relationship-level pricing, streamlined managed account onboarding and dedicated relationship management. If you would like to learn more, please contact your Capital Advisory Group representative.

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