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# THE EVOLUTION OF INSTITUTIONAL INVESTMENT STRUCTURES: REVISITING MANAGED ACCOUNTS AND THE FUND-OF-ONE

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# The Evolution of Institutional Investment Structures

## Revisiting Managed Accounts and the Fund-of-One

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With the dawn of the financial crisis now over a decade behind us, it is important to look back and understand the evolution of institutional investment structures that has taken place. Manager-led products of the past are now often ignored in favour of more bespoke investment structures and customised, investor-driven solutions.

During the financial crisis, many institutional investors experienced a lack of transparency and control of their commingled investments as redemption pressures led to the imposition of gating provisions and compromised liquidity terms. This experience forced many institutional investors to reconsider their approach to investing in commingled funds. As a result, there has been a surge in structures including managed accounts and the fund-of-one. These have become popular alternatives that allow investors to tailor investment strategies to meet their specific targets, segregate their assets from other investors, and overall achieve a greater degree of oversight and flexibility not typically found with more traditional commingled funds.

Potentially facing a new set of challenging economic circumstances, institutional investors have continued to adopt alternative investment strategies to achieve a diversified return and risk profile. While implementing these often complex strategies has generally proven successful, investors continue to seek out optimal customised structures such as managed accounts and fund-of-ones that can afford them a greater

degree of control and transparency. Furthermore, the use of customised solutions fosters deeper partnerships between managers and investors and enables a more productive exchange of knowledge and information. Bespoke relationship agreements and structures have been used to create greater alignment of interest between the investor and manager which in turn has often led to improved risk adjusted performance and a higher probability of meeting specific risk and return goals.

According to a recent AIMA survey<sup>1</sup> of 118 hedge fund managers globally representing approximately US\$440 billion in assets under management, 53 percent of respondents agreed that offering customised solutions to asset owners is an important factor in aligning their interests with the investors. This is a significant increase from 2016 where only 14 percent of managers indicated the importance of customisation and an indication that this will continue

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<sup>1</sup> "In Harmony." The Alternative Investment Management Association. 2019.

to be a top priority as investment structures further evolve.

Ultimately, both managers and investors are operating in a complex and high pressure environment where both are challenged to produce optimal results. Customisation can be key to solidifying a long term relationship and achieving better alignment of interests. With managed accounts and the fund-of-one maturing in their implementation and investors now having the benefit of experience, we can better understand some of the reasoning behind these changes as well as the options available and how each approach actually works in practice.

## Managed Accounts

Historically, managed accounts have been the preferred structure for large, sophisticated institutional investors. The ability of institutional investors to create investment vehicles for the sole benefit of their participants or clients has enabled greater control of expenses, provides greater insight into the underlying portfolio of investments and overall performance, allows access to their own portfolio's liquidity without impact from fund liquidity provisions, and mitigates risks from other investors.

An off-balance sheet managed account, in particular, can be a prudent structuring option and offers a number of benefits over on-balance sheet managed accounts that may lack overall structure and governance and pose greater risks. These off-balance sheet managed account structures ensure that there is a blocker entity which mitigates against contagion risk including the risk of excess losses through the use of derivatives. In addition, an off-balance sheet managed account often benefits from a higher degree of oversight with regard to its operations. It also typically includes independence of net asset value calculations, investment valuation verification, independent management fee and performance calculations, as well as expense processing and monitoring of expenses for compliance with the investment management agreement. These features

all serve to strengthen the off-balance sheet managed account structure's governance.

These oversight capabilities and functions are generally not characteristic of on-balance sheet managed accounts that are held on the investor's balance sheet and serviced by their custodian. These traditional on-balance sheet managed accounts, however, still often make sense when the assets being managed are very liquid, easily priced in the market and performance fees are not being utilised.

Using managed accounts, institutions can select groups of managers with complementary strategies and delegate to them the authority to manage a specific pool of capital or assets with a specific investment mandate and risk and return targets in mind. A managed account can also provide significantly enhanced transparency, allowing for investment positions to be viewed on a regular basis. This can improve the investor's understanding on precisely how returns are being generated. Additionally, assets are held in the name of the investor, affording greater control and reducing exposure to other investors' investment decisions.

Overall assets among the top nine managed account platform providers stand at US\$85 billion, a 13 percent increase compared to US\$75 billion at the start of the year<sup>2</sup>. This growth is expected to continue as there has been increasing interest from a number of large allocators looking to build their own managed accounts platforms. However, there are a number of considerations that institutional investors should be aware of before building their own platforms. With the increased flexibility that a managed account affords there comes significant additional operational requirements and burden for investors. Frequently, assets are held in the name of the investor which means that the investor may be directly responsible for all losses incurred on an investment which, in some cases, may be more than the initial investment itself and may be catastrophic. Additionally, because the

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<sup>2</sup> "Top Managed Account Platforms 2019." HFMWeek. 9 October 2019.

institutional investor owns and controls the full infrastructure, they are responsible for ensuring smooth operations and contracting with the various service providers needed, including operational and investment due diligence providers, prime brokers, administrators, auditors, independent fiduciaries, reporting and monitoring services and legal counsel, a task that is often quite onerous and requires significant additional coordination and support.

Those who create managed account platforms directly often end up building out additional internal capabilities to oversee their platform's operations. Institutions who do not have sufficient internal resources to manage the contracting and legal requirements will often hire a full service platform provider who will coordinate all aspects of the managed account platform. Larger institutions with greater internal due diligence and contracting capabilities similarly will often choose to work with a specialist service provider, such as the Maples Group, who can provide platform specific services such as legal entity structuring, operational set-up, service provider coordination and oversight, manager on-boarding, day-to-day operational coordination, daily risk and performance reporting as well as guideline monitoring.

## The Fund-of-One Alternative

Increasingly, many investors who want to replicate the features of managed accounts without the operational and contracting burden have turned their attention to the more simplified fund-of-one structure. The fund-of-one is typically discussed in a similar context as managed accounts structures given that it is a structure set-up to cater for the specific needs of an investor. However, the key difference lies in the ownership and control of the assets and the operational requirements of the investor. While the assets are owned and controlled by the investor in a managed account, the fund-of-one structure is set up specifically for the investor with the underlying assets owned by the fund. However, the fund-of-one allows investors to capture almost all of the benefits of the managed account structure, including transparency,

liquidity, increased control, and enhanced risk management. The institutional investor is still able to customise the mandate and segregate its assets from other investors without the associated operational burden and contracting responsibility.

With the fund-of-one essentially being a single investor fund, the investment mandate and overall investment decision making process can be customised to specific requirements which can include leverage, concentration limits, sector and geographic limits, derivative exposure and asset types. In addition, these investment parameters can be incorporated into the governing terms which can be beneficial, particularly for certain institutional investors with strict investment restrictions or conversely for institutional investors seeking to invest into a more concentrated portfolio comprised of a manager's best ideas. In addition, the fund-of-one affords investors greater transparency and oversight with investors specifically able to obtain position-level information and more frequent and more detailed reporting. Investors may also have greater insight with respect to valuations and the calculation of fees.

The fund-of-one structure also offers an attractive combination of potentially improved performance along with reduced fees. Investors globally have become increasingly sensitive not just to the compensation fees to be paid to the manager, but also to the total costs associated with operating a fund. Fees for a fund-of-one are typically lower than for commingled funds since they can be negotiated between the investment manager and investors on a standalone basis. While these rates can vary based on a number of factors, not least of which is the amount of capital being invested and the investor's overall negotiating leverage, the expectation is that the fund-of-one is a more cost effective option.

The fund-of-one truly fosters better alignment, collaboration and consultation between investors and managers. Rather than focusing discussions primarily on a product or specific investment, both parties are able to take part in a constructive dialogue that clearly outlines the goals and objectives of the engagement

to determine what solutions are most appropriate. This approach can build mutual trust, strengthen the overall relationship and ensure both the manager and investor are better positioned to adapt as individual circumstances and/or market dynamics change.

Perhaps most importantly, the fund-of-one can offer the same benefits as a managed account (e.g. transparency, liquidity, control, protection from other investors, negotiated fee terms, expense caps and service provider selections) while reducing the burden on allocators to determine and manage the vehicle structuring and ongoing operations. The benefits of a fund-of-one can resemble those of a managed account but ongoing resource requirements from an allocator can be more akin to a commingled vehicle.

## **Outsourced Support: The Maples Group Solution**

Overall, the ability to customise investment vehicles fosters closer and more aligned partnerships between managers and investors. As the investor builds more knowledge about the manager, they gain a deeper understanding of how their investments may behave. The development of specialised product offerings such as managed accounts or a fund-of-one helps to solidify longer term relationships that can grow and evolve. This evolving relationship can mitigate the risk associated with more short term thinking that can sometimes be damaging to fund performance. Furthermore, the deepening partnership between the manager and investor enables the investor to take advantage of the manager's unique market insights and best ideas, benefitting their overall portfolio.

The Maples Group combines industry leading capabilities in legal and structuring, fiduciary services, operations, reporting and technology to provide highly customised, cost-efficient solutions to help both managers and investors looking to establish managed account platforms or fund-of-one structures. Given the increase of investor-driven structures and the expectation that this trend will continue, the Maples Group is uniquely positioned to support institutional investors in establishing the optimal operational

infrastructure to support the complexities of various investment structures. The Maples Group offering provides both managed accounts and fund-of-ones platforms with customised solutions including portfolio oversight and risk reporting solutions which aggregate data across the platforms. This expertise and customisation enables the delivery of improved portfolio transparency as well as enhanced risk management and governance which can ultimately lead to improved risk adjusted portfolio returns.

## **About the Authors**

### **James Perry**

James is the Head of Institutional Investor Solutions and is responsible for shaping the Maples Group's offerings and enhancing its service delivery to institutional investors. He brings more than 20 years of investment management experience, with 10 years serving in senior investment roles overseeing portfolios of public assets in California and Texas. In these roles, James played a pivotal role in the development of innovative industry solutions. He was a co-creator of the Managed Custody Account structure which has been embraced by both top-tier managers and sophisticated investors and is now taught at Harvard Law School. Leveraging this experience as an innovative allocator, James is committed to helping improve the relationships, structures and deal flow between allocators and asset managers. James is a recognised thought leader in the investment industry, as evidenced through a number of awards, including being named as one of the Top 30 Pension Fund Chief Investment Officers (Trusted Insight, 2016) and receiving the Investor Intelligence Award for Innovation (Institutional Investor, 2014). Previously, James served as Chief Investment Officer of the Dallas Police and Fire Pension System where he oversaw all investments in the system's portfolio. Prior to that, he served as Assistant Vice Chancellor and Assistant Chief Investment Officer for the Texas Tech University System, and was the Senior Investment Officer at San Bernardino County Employees' Retirement

Association. James also served as a Naval Officer and Aviator in the US Navy.

## Mark Weir

Mark is Regional Head of Fund Services – Americas and has oversight of the custom middle office services provided to our institutional investor and investment managers. In addition, he has oversight for the data management and information systems within the Maples Group's fund services business. He has significant experience in the development and execution of custom client processes leveraging best-of-breed technology platforms and product design and implementation. Drawing on this expertise and a client-driven approach, Mark provides external clients,

including hedge funds, private equity funds and institutional investors, with custom portfolio accounting, performance analytics, risk analytics and regulatory reporting solutions. He also supports the Maples Group's internal teams, providing data management, systems design and implementation and reporting solutions. Mark has authored several articles and has been asked to speak at various industry events on topics relating to institutionalising operations for various fund and investor types and how technology can support investment decision making. Previously, Mark worked in Citi's funds outsourcing department focusing on client specific solutions for institutional clients and, prior to that, he worked in fund administration at IBT.