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## Funding matters

AFSR has brought together a roundtable of hedge fund managers and third-party marketeers to discuss the state of capital raising and the best ways to get funding

The upturn of global equity markets means more people are looking to put capital to work. Money that was sat on the sidelines in cash or bonds is moving into more actively managed strategies. But how do managers get their hands on all this capital? AFSR's expert panel discusses the options:

AFSR: How would you describe the current state of hedge fund asset-raising?

Neal Berger (NB): Well, it's never easy, but thousands of hedge funds have found a way, so it's obviously possible. It tends to be a snowball effect – no-one wants to be the first, but if they see investors they know and respect they are far more likely to get involved. Some of our best leads come from our existing investors, so I play very aggressively with them to refer us to their friends. We also utilise third-party marketeers who have done a very good job for us. Personal contacts and attending conferences are good ways of getting your name out and attracting attention.

Mike Leverone (ML): The current rush into hedge funds makes raising capital easier, especially if you have a strategy that is in vogue. Hedge funds have to decide who they want to take capital from – hot money vs sticky money, fund of funds vs other institutions. It becomes an issue of client selection.

Alex Bentley (AB): So much money has come into the business that the big brand name funds close quickly, and if they do re-open they do so very much on their own terms. This means investors have to look for other ways of investing their money. Start-ups with talent are filling up quickly, although the very small managers with limited capacity are having a much harder time because the big investors need to put a large amount of money to work – they can't invest in a fund that has a total capacity of US\$50m.

AFSR: What are the most effective asset-raising techniques – how do you cut through all the noise?

AB: The same way as always – getting a manager and an investor together in a room to talk about what they do. You have to talk to people – it's the only way. Sending emails is virtually useless.

NB: In the initial stages you are so anxious to raise money you want virtually anyone as long as their money is green and clean. Institutional money is where you can ramp up the capital,

but they normally require a relatively high AUM before they look at you. That number is not set in stone, but is normally somewhere between US\$50-US\$100m plus a certain amount of infrastructure and time under your belt.

Joseph Sullivan (JS): There are many good ways to market yourselves to grow to the next stage, but most importantly you must promote and emphasise what your edge is – are you a fundamental stockpicker, or do you use a black box?

Create an identity and get your name out. Some firms create a sense of scarcity – get in now or never.

ML: The new manager must decide how to allocate their capacity to the various types of investors. If a manager has a US\$500m capacity for their strategy, then how much of that capacity do they want filled by fund of funds, family offices or high net worth individuals (HNWI) is an important decision to make. A manager does not want to regret taking money from an investor at some point in the future. New managers will always get a meeting at the large fund of funds as they cannot afford to miss new talent. But unless they have an established reputation from another shop, they will have difficulty distinguishing themselves in the institutional market.

AFSR: What realistic expectations should a hedge fund manager have of the success of a third-party marketeer and/or prime broker in raising assets?

Charles Currie (CC): In a market where there is little money about, marketeers are needed to find the firms willing to part with their resources. And when fund-raising is easy the solutions are abundant, but marketing is necessary to differentiate your fund from the rest.

AB: You have to look at the people involved and their experience and track record at raising money – it's that simple. You have to decide what type of approach you want – do you want a real hands-on firm for the long-term, or someone frantically running around for three months setting up meetings? Discuss your expectations with your service provider. They should be able to give you an idea of what to expect.

ML: Prime broker capital introduction has been very successful at getting a lot of managers out of the gate. But although having finger sandwiches over coffee is a good start, managers need someone to keep investors updated on AUM and the strategies' progress. That won't be communicated by your prime broker.

AB: Prime brokers are very good at setting up events and bringing lots of managers and investors together and letting what happens happen, although they tend to be the same established investors. But six months after this event will they still be involved, making follow-on calls? I think not.

NB: Both third-party marketeers and prime brokers like to raise money for people who don't really need the money. Normally these are funds that are relatively well capitalised, have a good track record and are not good at marketing and getting in front of the right people, and in that respect marketeers can be useful.

AFSR: What are the main issues when marketing to institutional investors?

AB: Most new funds should forget about institutions – they are not your day-one investor. HNWI, family offices and funds of funds have created programmes to invest in emerging managers.

CC: As institutions are getting more interested in hedge funds, the capital raising process is becoming more formalised. However, a beauty-parade situation requires a polished presentation because every detail will be examined all the way down to who answers your phone and how.

ML: In addition to a manager's ability to generate acceptable returns, institutions will look for evidence the manager knows to control the growth of their business with an eye to controlling the risks associated with rapid fund growth. The short history of hedge fund management is replete with examples of spectacular blow-ups from managers incapable of managing their firm's success.

AB: You need an infrastructure – a CFO, an appropriate number of analysts, back-up staff and tier one service providers. If you haven't, don't even waste your time. Managers are increasingly judged by the service providers they use.

NB: Being hard to pigeonhole can hurt you. We have a fairly unique multi-strategy quantitative approach, which can be a problem as many allocators like to put a square peg into a square hole. They have a need for a long/short manager and a convertible arbitrage manager and they want to fill the gaps.

AFSR: Once a hedge fund manager has become established, how does the asset raising approach change?

CC: Managers at US\$50m. with an intention to grow to US\$250m will soon reach the conclusion they have to either hire an in-house sales-person or third-party marketing firm. If you hire the latter it is important they are given a wide mandate to raise money. For example, don't bifurcate the marketing effort by saying 'I can cover the FOHF, you do the institutions' because plenty of useful marketing information comes back from every conversation. Unfortunately most hedge fund managers do not understand the marketing process.

AB: Helping firms realise their desire to reach the next level is a large task. They need more professional marketing materials to be able to tell their story in a more polished fashion. Smaller, sophisticated investors don't care about those types of things – they just want good returns. But institutions want more.

JS: Indeed, you must create an infrastructure, for example, we utilise hot disaster recovery sites and have annual SAS 70 internal control audits. These show institutional investors we're not just about alpha, but we are also serious about operations and controls.

AFSR: Will regulation change the nature of prime broker cap intro services?

NB: Prime brokers have a certain legal liability, because if that fund blows up the investor may say 'hey, you made an implicit endorsement of this manager by introducing us'. So for legal reasons prime brokers are beginning to shy away from being too involved. But I think prime brokers have already adjusted themselves, and they are doing a lot more due diligence before they take an account. Still, brokers must be careful they are objective which managers they push and how they do so.

AB: I don't believe the shape of capital introduction will change in the short term.

JS: I do. In the past, cap intro has become one of the main attractions of prime brokers. But now the SEC and particularly the NASD are questioning certain practices and raising concerns regarding general solicitation and it has become a thorny issue for them. Added to which, the current regulatory environment has the air of a witch-hunt. So prime brokers are looking at all the dinners and luncheons they're throwing and are worried they might be crossing the line and cause the regulators to monitor their cap intro practices more closely. By the end of 2004 I believe capital introduction will have changed considerably.

AFSR: What does 2004 hold for capital-raising?

JS: Interestingly, by permitting general solicitation in Section 3 C-7 regulators are opening up to the possibility of hedge funds advertising themselves in the public arena. If this had been suggested two years ago, you would have been laughed at. But it is changing as both the public and regulators realise when most investors in the US went into long-only mutual fund products they got devastated in the recent bear market. There are some good alternative absolute return products out there and there is a definite need for them.

NB: We have passed the point where most qualified managers who want to run hedge funds are currently doing so. As new managers come into the fray the quality is declining. People are jumping on the bandwagon with little or no qualifications— former brokers who have never traded anything in their life, even former tennis players. Everyone smells the dollars, but these guys aren't qualified to run hedge funds. This is advantageous for those guys who know what they are doing.

AB: Capital-raising will remain what it has always been about – great managers delivering great returns. That's what people are looking for and everything else is noise. If we can get those managers in front of the right people we can raise money.

ML: Hedge funds as a distinct asset class is now widely recognised. Many of the big players are closed. 2004 will be a great opportunity for emerging managers with good pedigrees and solid business plans. We are beginning to see some of our clients shying away from the larger players to seek new talent that comes to market.

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