Prime Brokerage & Hedge Fund Investor Survey 2013

Technology helps boutiques support smaller managers
Redefining the ‘mini-prime’ model for fund managers
The conundrum of investing in emerging managers
In this issue...

04 Technology helps boutiques support smaller managers
By James Williams

07 Focusing on diversification
Interview with Duncan Crawford, Newedge

09 Extending reach to the wider community
Interview with Jack Seibald, Concept Capital Markets LLC

11 Redefining the ‘mini-prime’ model
Interview with Robert O’Boyle & Julia Bronson, Liquid Holdings Group

12 Hedge Fund Investor Survey: The conundrum of investing in emerging managers
By Marianne Scordel

14 The right relationships are vital to success
Interview with Kevin LoPrimo, Global Prime Partners
Experience is our greatest asset. Jefferies offers a full-service integrated prime brokerage platform that includes execution, centralized custody, securities finance and capital introduction. By providing the unique combination of personal attention and leading-edge technology, we can accommodate the business requirements of the most sophisticated hedge funds.

Prime Brokerage. Our prime brokerage service enables clients to trade from anywhere in the world, while centralizing all clearance, settlement, financial and administrative services. We consolidate all transactions into one account and provide outstanding portfolio, attribution and risk reporting through our web-based platform.

Commodities & FX. Jefferies Bache is an industry leader specializing in exchange-traded futures & options, commodities and over the counter products including metals and foreign exchange. We deliver expert execution, clearing and customizable technology solutions to CTA’s, Hedge Funds, institutional investors, producers and commodity processors globally.

Futures. Our Futures Sales & Alternative Investment Services team provides a client-first approach. We deliver expert execution, clearing, capital introduction and flexible world class technology solutions to institutional investors worldwide with 24-hour coverage on all major markets.

For more information please contact:

Michael Hill
Senior Vice President
Prime Brokerage Services
michael.hill@jefferies.com

Richard Ryan
Vice President
Futures
rryan@jefferies.com
Technology helps boutiques support smaller managers

By James Williams

Given that around 90% of the hedge fund industry is dominated by smaller managers running between USD100million and USD1.5billion in AuM it is perhaps little surprise that smaller, boutique prime brokerage firms are holding their own against bulge bracket prime brokerages owned by European and US banks.

Banks are now under enormous pressure to strengthen their balance sheets under Basel III. As a result, their prime brokerage divisions are becoming ever more ruthless in terms of the size and quality of hedge fund managers they are willing to support. This is opening up a huge opportunity for younger non-bank owned primes like London-based Global Prime Partners whose modus operandi is serve the start-up and emerging manager market.

“In terms of total industry assets, 80 per cent are probably with the top 10 per cent of managers. That leaves 90 per cent of managers in the marketplace for us. From what I’m seeing, some of the bigger primes are moving even higher upstream and requiring higher minimum revenues and higher minimum sizes (in terms of AuM).”

“I’ve heard of two large primes who have
Prime brokerage is a massively expensive undertaking. Firms need to have significant skin in the game to ensure that they have the full suite of trade execution, margining, securities lending, clearing and custodial services in place, as well as non-commoditised services ranging from capital introduction to market research, regulatory consultancy etc. In effect, this requires a significant IT spend.

One trend that seems to be emerging in the US, in parallel with the rise of boutique primes in Europe, is that of technology solutions groups moving into the prime brokerage space. One such firm is recently established Liquid Holdings Group. The Liquid technology platform has been developed to support start-up and emerging managers not only from an execution standpoint via its EMS/OMS solution, but also to provide pre-trade compliance controls, real-time risk monitoring and even shadow accounting; all of which is delivered on a cloud-based platform.

What technology firms like Liquid are doing is effectively pushing forward the evolution of the ‘mini-prime’ model, which has proved hugely popular in the US but has, in the view of Robert O’Boyle, EVP of Sales & Solutions, been a limited model.

This is because until now mini-primes have focused almost exclusively on providing execution support to clients by acting as the introducing broker to more established primes like Credit Suisse, Goldman Sachs etc. What Liquid is doing with its technology platform is expanding the level of support; trade execution is just one element. Providing best-of-breed technology solutions is the real value-add.

“We offer clients the standard prime brokerage services such as custody, margining, securities lending,” says Julia Bronson, who heads up Liquid Prime Services, “but in addition we will be able to offer clients LiquidMetrics. This is our real-time risk management system and will enable us to provide enhanced risk, performance and P&L monitoring. Our intention is to become the top service provider in the start-up and emerging manager space.”

O’Boyle adds: “The advantage is we were born in the cloud so we are able to offer our solution from a technology standpoint at an extremely competitive price. Liquid Prime Services was born out of our belief that there needs to be a full-service offering from front to back across managed services, technology and excellent trade execution: offering all of those services on a cloud-based platform is effectively what the next generation of hedge funds need.”

For any new manager, the costs of setting up a hedge fund keep rising. Having the ability to keep the IT spend to a minimum yet still receive high-touch support and, at the same time, know that the fund’s assets are being cleared and kept in custody by tier-one institutions is a significant advantage.

For smaller primes like Liquid and Global Prime Partners, developing relationships is the name of the game. Indeed, the two firms themselves have joined forces, with GPP now using the Liquid platform to extend the suite of services – both during and after trade execution – to its clients in Europe.

LoPrimo confirms that GPP has broadened out its business by establishing clearing and custody relationships with BNY Mellon as well as Deutsche Bank, on top of existing relationships with Nomura and Kas Bank.

“Working with other service providers opens more doors for us and gives us more ammunition when we are targeting new managers or looking to open up other lines of business. A big way for us to get introductions to clients is via other service providers, including some of the primes themselves. We’re talking to a number of bigger primes right now who are doing their annual or bi-annual cull of the smaller end of their market and they’re saying to us ‘Here’s a handful of clients you should talk to because we’re offloading them’,” comments LoPrimo.

That aside, the firm has experienced extraordinary growth since it launched its prime services division three years ago. In year one GPP took on 10 clients only; this was intentional as the firm got up and running.

In the last two years, LoPrimo confirms that they’ve added a further 70 clients.

“Currently, we have between 35 and 45
Some see just another meeting.
We see connections, providing clients with the right introductions to further their strategies.

Newedge Prime Brokerage teams have more than 20 years’ experience of working with hedge fund managers, CTAs and investors. Through our proprietary database of funds and decades of market and strategy analysis, we offer opportunities to institutional investors to select and access hedge fund strategies. By sharing richer information and greater transparency, we help managers and investors achieve their strategic goals. newedge.com

NEWEDGE. NEW PERSPECTIVES.
French bank Societe Generale announced in early November that it was buying the 50 per cent stake held by Credit Agricole in leading derivatives broker Newedge and in doing so assume full control. Subject to regulatory approval the deal is expected to be completed before the end of 2013 and will, according to Duncan Crawford, Global Co-Head of Alternative Investment Solutions, Prime Clearing Services, be highly advantageous as Newedge looks to diversify its offering.

“Newedge is well known for supporting managers in the managed futures space but it’s by no means the only space we cover. Prior to 2008, investors knew very little about CTAs. Post-2008 that changed; for the last five years we’ve been talking to big institutional investors and educating them on what managed futures are and how they can help their portfolios. Now we are focused on diversification and growth, particularly in equities,” explains Crawford.

The Soc Gen deal should help facilitate this. Indeed, as an investment bank it will no doubt want Newedge to ramp up its mandates in equity long/short managers given that it has the CTA, fixed income and global macro markets well covered. According to Eurohedge figures for January 2013, Newedge was the leading broker – by number of mandates - across these three strategies, totaling 81 compared to 46 for Credit Suisse and 39 for JP Morgan.

Over the last couple of years Newedge has embarked on a serious mission to upgrade its service offering, precisely to support growth into other asset classes. In October 2012 it launched an enhanced FX prime brokerage platform to give clients even greater efficiencies in the market.

This has led to an increase in FX prime brokerage mandates, helped in particular by the fact that 50 per cent of Newedge’s business is in managed accounts.

“Managers that are housing their FX prime brokerage with us are saying to their managed account investors that they should move their prime brokerage requirements to us because we are able to tie everything together. Our expertise in managed accounts really sets us apart from the competition,” says Crawford.

As an agency broker, Newedge streams prices for its clients to avail themselves of the best price. “There tends to be a lot of money moving around and if you don’t manage that in an industrial fashion the costs build up very quickly. Our platform makes the most of available efficiencies, which directly benefits our clients,” explains Crawford, adding that cross-margining across asset classes is another core capability.

“If you are holding your FX trades with us in addition to futures, equities, fixed income then everything sits within one risk environment. That makes margining as efficient as possible. Most investment banks can cross-margin within one asset class – FX, for example – but not across asset classes as they tend to be organised in silos, whereas we can.”

That is particularly advantageous to global macro or equity long/short managers who might be employing different FX hedge overlays to their strategies.

As for fixed income, Crawford is excited by the potential growth opportunities of 2014 and beyond. This is because European regulation under EMIR will oblige managers to exchange-clear their derivatives.

“Being the biggest futures clearer in the world we are in a strong position to benefit from OTC clearing. The last couple of months have been encouraging; in November, for example, Aquila Capital appointed us as their OTC clearing firm. So we feel quite bullish about growing the fixed income part of the prime brokerage business too.”
clients in the pipeline; we have literally priced 18 clients in the last few weeks and there are still another 12 yet to be priced. It is busier than I've ever seen it with respect to start-ups."

What these boutique primes are doing is helping start-up managers achieve a degree of “investor and operational alpha” they would have no chance of achieving by going to a more established prime broker. And as O’Boyle says, it is not just about enabling execution for smaller hedge funds, it’s about offering a cost-effective one-stop-shop solution.

“If you look back at the mini-prime market it was all about enabling execution for smaller hedge funds and hopefully providing capital introduction. Today, with the evolution of the hedge fund marketplace, execution is no longer the endgame. It is about providing institutional-quality tools a hedge fund needs to grow their business in a scalable and reliable way.

“You can’t do that without changing the mini-prime model. We believe that being born in the cloud, providing best practices from a back-office standpoint in conjunction with prime services, is necessarily the new model because that allows us to fully support the rising demands of hedge funds in a cost-efficient way.”

Another US prime broker that is looking to leverage its existing capabilities and showcase them to a wider hedge fund manager audience, as opposed to only being associated with the start-up market as an introducing broker, is Concept Capital.

“We aren’t changing our capabilities but what we are doing is communicating that the capabilities we have are applicable to a much broader audience than the one that has historically been attracted to us,” emphasises Jack Seibald, managing member at Concept Capital.

These capabilities exist through its relationship with sister firm ConceptONE. Whereas Concept Capital Markets provides the standard prime brokerage services by connecting managers to tier-one institutions including JP Morgan, BNY Mellon and Merrill Lynch for clearing and custody, the focus of ConceptONE is on middle and back office work: portfolio and risk analytics, risk reporting on a T+1 basis and, increasingly, regulatory reporting solutions under Dodd-Frank and AIFMD.

As part of Concept’s evolution, therefore, the aim is to raise awareness among emerging and established managers that actually they can provide effective support for manager using multiple primes. Seibald explains: “If a manager is looking for a second or third prime, we’re probably an ideal solution for them. When they use different prime brokers they necessarily have to work with different systems unique to each prime. The issue becomes how to aggregate the portfolios and all of the trading activity into a single view from an intraday management standpoint, from a risk assessment standpoint, and from an aggregated reporting standpoint at end of day or on a T+1 basis.

“We can do two things for managers; firstly we can introduce them to one of our clearing partners as an introducing broker; secondly, and perhaps more importantly, we can do aggregation using our portfolio and risk monitoring systems. Let’s say you’ve already got a trading account with Goldman Sachs and you choose us as your second
Extending reach to the wider community

Interview with Jack Seibald

“As we’ve matured and the industry’s needs have grown, we’ve continued to make investments aimed at providing solutions to emerging and more established managers as opposed to solely supporting the start-up market,” explains Jack Seibald, managing member at Concept Capital Markets LLC. “Start-up managers remain a core pillar of our business. However, given the increasing regulatory requirements and the demands for greater transparency by investors a lot of the solutions we’ve built answer the needs of managers who might otherwise not have thought of us.”

The clearing and custodial relationships Concept Capital has with JP Morgan, Pershing/BNY Mellon, and Merrill Lynch are hugely important to start-up managers. But thanks in part to its relationship with sister firm, ConceptONE, Concept Capital is strategically extending its reach to do business with the wider hedge fund manager community.

“More managers are coming out of larger firms with teams of five or six people and launching funds with a higher initial AuM. We’ve started to engage with such managers in a variety of ways, even when they’ve chosen to go to one of the larger primes directly. That made us realise we don’t necessarily have to be the introducer of the account to one of our clearing partners. We can still provide a variety of services to them, be it outsourced trading or live aggregated portfolio and risk reporting,” says Seibald.

The additional services stem in part from the symbiotic relationship with ConceptONE, which provides portfolio and risk analytics and reporting, and increasingly regulatory reporting under the schemes implemented in the US and Europe. Some of the data aggregation and reporting technologies developed for these services have been repurposed by Concept Capital, which can make certain value-added services available to its prime brokerage clients.

“We want larger managers to see the value in using us for other things like outsourced trading, live portfolio and risk reporting, end of day portfolio reporting. It’s about taking the technology services we’ve already developed within the firm and extending the reach of those services to a different set of emerging managers and more established managers who are looking for a more efficient solution,” adds Seibald.

One example of this is the outsourced trading solution that Concept Capital offers. This year, it has won significant mandates from two large allocators to be the outsourced trading solution for a series of managers they are investing in via managed accounts.

“Our traders are functioning not just as the broker when they are trading with Concept Capital, but representing those managers when trading with other brokers on the Street. “We can do all of the consolidated reporting to those managers and the investors allocating to them. It opens up a whole new potential customer base that we’ve not previously reached out to.”

Offering this suite of additional services is one of Concept Capital’s key differentiators to the start-up market. After all, any ambitious manager will need to demonstrate that they have solid risk management and reporting capabilities to attract potential institutional investors.

“Start-up hedge fund managers tend to focus on capital introduction and execution and financing rates. We’re happy to engage with them on these terms, but in our minds it’s about offering the additional services discussed and partnering with managers as their operational needs become more complex,” concludes Seibald.
prime and we connect you to JP Morgan as the custodian.

“Every day we upload from those different accounts all the position activity and reconcile it in one system. All of the trade activity that the manager engages in during the day automatically feeds into the system and updates the portfolio in real time. This means the manager can view their portfolio from a risk and exposure standpoint in an aggregated fashion and, moreover, drill down to see exactly which assets are held with which custodian.”

Having a consolidated view, particularly when it comes to cross-margining, is something that other more established primes like Newedge are increasingly focusing on. This is particularly important given that Newedge is looking to diversify its expertise within the prime brokerage space – it has a long-standing reputation as the leading broker to CTAs – and support more equity, fixed income and FX managers.

“We have the ability to give them an aggregated view of their margining requirements both within the fixed income or futures part of the portfolio and beyond if they are trading other asset classes. Consolidated reporting is something managers are paying closer attention to,” comments Duncan Crawford, Global Co-Head of Alternative Investment Solutions, Prime Clearing Services at Newedge.

One of the keys to Newedge’s success, thus far, in Crawford’s opinion, has been the singular focus on each client. This might sound trivial but at the heart of every successful prime brokerage model is the commitment to relationship building.

“Managers have strong relationships with the team here at Newedge, we’re not a revolving door. From my perspective that’s a key strength of Newedge; when a client calls us they know we will bend over backwards to support them.

“Without that approach we wouldn’t have got to where we are today.”

Crawford says he is surprised that larger primes are culling their hedge fund clients, noting that “we can make money on smaller managers, even if they’ve only got USD20-30million in AuM.

“We built our prime brokerage platform on start-up managers and our consultative approach to those managers hopefully helped put them in the right direction to build a successful hedge fund. We speak to appropriately sized investors to help managers build their assets and reach critical mass to then take on institutional money.

“We’re not looking to make a quick buck from any of clients. We look to build a symbiotic relationship over the long-term.”

That’s not to say that Newedge is immune from regulatory pressures. Under Basel III, some strategies will need to be more closely assessed says Crawford, in particular certain fixed income, global macro and asset-backed security strategies “that are using a significant amount of OTC non-cleared trades”.

Trading, Reporting, Risk management: technology is helping smaller primes, who perhaps don’t have the same legacy issues as older and more established prime brokerages, connect more meaningfully and comprehensively to hedge fund managers. It is, perhaps, a sign of where the prime brokerage model is headed. But that’s not to say that people-driven solutions such as capital introduction will be overlooked.

As LoPrimo concludes: “We have family offices and FoHFs as well as some endowments coming to us saying, ‘We’re seeing some talent out there but we’re looking for more, what can you show us?’ and we’re providing the necessary introductions. We have, for example, established an agreement with a MAP provider where they are going to allocate to some of our managers and that will serve as an even greater incentive for new managers to come and join us.”
Redefining the ‘mini-prime’ model

Interview with Robert O’Boyle & Julia Bronson

For Liquid Holdings Group, a comprehensive technology and services firm that focuses on supporting small- to mid-sized hedge funds, the time has never been better to redefine the ‘mini-prime’ model with a stable environment for managers to generate investor and operational alpha.

Whereas mini-primes focus mainly on execution services, Liquid Holdings leads the discussion with its highly flexible platform, which supports managers beyond mere trade execution. The Liquid platform is cloud-based and combines managed back-office services with mission critical capabilities across order, execution, and risk management as well as portfolio management, compliance, investor reporting, and shadow NAV.

“This is a paradigm shift, as institutional quality capabilities, managed services, and prime solutions have not been available from a single source until now,” explains Robert O’Boyle, EVP of Sales & Solutions. “Hedge funds require a long operating runway to compete for and win new capital. Aside from showcasing performance, longer operating runways build investor confidence in the team and the processes in place to manage operations.”

Julia Bronson heads up Liquid Prime Services, the execution, clearing, and settlement facility that allows managers to avail themselves not just of first-class brokerage facilities but a complete technology framework.

Bronson explains: “The old prime brokerage model was built to service the largest hedge funds that required customised systems. However, for the new wave of emerging managers entering the market, these same systems were too expensive to maintain and could not evolve fast enough to meet their needs.

“Mini-primes emerged to service this new wave, offering inferior technology in exchange for introductions to bulge bracket brokers. Our approach is different. We have signed an agreement with Goldman Sachs Execution and Clearing, and they will be our clearing partner and custodian. We are also in advanced talks with a second major organisation that will also offer clearing services for us. I’m confident that these two premier providers will adequately meet our needs.”

Liquid Holdings’ objective is to be the top technology and services provider to start-up and emerging managers, using key partnerships to offer custody, marging, and securities lending services. In addition, says Bronson, “we can provide enhanced risk management using our platform’s real-time risk, performance, P&L, and NAV monitoring and reporting capabilities.”

In early October, Liquid Holdings announced a strategic partnership with London-based Global Prime Partners. GPP will use the Liquid platform to provide existing and new managers in Europe with the same additional front- to back-office tools that Liquid Prime Services now offers in the US, allowing Liquid Holdings to provide new managers with clearing and custody in both the US and the UK.

“If our team bumps into a manager six months down the line looking to launch a Europe-focused strategy, we have a natural introduction for them to GPP, and vice-versa,” says Bronson. Having strong execution, clearing, and custodial partnerships in place is essential for any prime broker as counterparty risk is one of the first things investors look at when doing due diligence.

“If a fund is currently using a prime broker at a particular bank, they want their second prime to be with a completely different bank to hedge out counterparty risk. We can provide that,” asserts Bronson. “Our custodians are going to be two different banks with different sorts of balance sheets and a different business mix.”

Robert O’Boyle, EVP of Sales & Solutions, Liquid Holdings

Julia Bronson, Head of Liquid Prime Services, Liquid Holdings
The conundrum of investing in emerging managers

By Marianne Scordel

A year ago, we explored what hedge fund investors might be looking to buy during the following twelve months, what their attitude towards managers at the smaller end of the spectrum was, and what investment strategies appealed the most.

This year, Bougeville Consulting and Global Prime Partners decided to team up in this survey produced for Hedgeweek to try and understand what has changed, whether plans have come to fruition, and what, in the light of recent events and as a result of more structural factors, would determine investors’ appetite towards emerging managers in the near future.

Global Prime Partners (GPP) is a boutique Prime Broker, focusing on servicing clients with AUM generally under $100m. It is important for GPP to understand the potential for success of the firm’s clients and potential clients, not just in terms of investment performance, but also as far as business development is concerned: AUM growth and stability of assets – mandates they are likely to win as well as those they are likely to lose, as a result of opportunity costs or early redemption.

Bougeville Consulting assists hedge fund managers with their business strategies. This consists in providing the ground...
The multi-faceted impact of the outsourcing of ODD

The investors surveyed manage or advise on asset allocation. Sizes at firm level range from $200 million to over $170 billion, with hedge fund investments of between $200 million and USD2.5 billion. The average size is $42 billion with hedge fund investments.
The right relationships are vital to success

Interview with Kevin LoPrimo

For award-winning boutique prime brokerage Global Prime Partners this year has seen the firm go from strength to strength, laying further foundations to their reputation as one of the hedge fund industry’s ‘go to’ service providers to small and medium sized hedge funds.

“It’s been an incredible year for us,” enthuses Kevin LoPrimo, Global Head of Hedge Fund Services at GPP. “Even before mid-2013 we had equaled all of last year’s revenue.”

Part of the reason behind GPP’s success is the quality of partnerships it is building within the marketplace. With counterparty risk high on the agendas of both managers and investors, the stronger the relationships in place the better: be they trading partners, custodians or technology firms. Just last month, for example, the firm appointed BNY Mellon as its global clearing and custody provider; a huge fillip for the smaller managers that Global Prime Partners supports.

GPP is a product of two business lines. Originally it was founded purely as a clearing firm. Four years ago LoPrimo joined and added the prime brokerage side of the business. “The BNY Mellon relationship is more around the clearing and custody side of our business but it could be used for either.

“We are doing some clearing and custody work with Deutsche Bank as well. In total we now have four financial institutions behind us: BNY Mellon, Deutsche Bank, Kas Bank and Nomura.”

Until now the technology platform that GPP had built internally to support the prime brokerage needs of its clients was centered on post-trade workflows. It was, as LoPrimo says, never their intention to build an execution platform but rather to look for the right partner.

This has led to a strategic partnership with New York-based technology firm Liquid Holdings Group.

“We had the technology in place to support everything after a trade has been placed. What Liquid has is the technology to facilitate the trade happening via EMS and OMS on the front end and real-time risk monitoring. Those are value-adds that we didn’t previously have,” explains LoPrimo.

GPP has provided demos to over a dozen of its clients who are now “hungry” to get the Liquid technology installed. This illustrates perfectly how the right relationships – be they custodian and clearing or technology-based reporting and risk monitoring – can work to the advantage of both the service provider firms and their clients.

“There’s no secret sauce behind the scenes. We just provide a high level of service and have good quality people supporting our clients. It’s a combination of technology and people and basically being attentive to managers who are not big enough to use bulge bracket brokers.

“If they did get in with a bigger prime they would be charged a lot more because almost all the larger firms have a minimum yearly revenue target of somewhere between USD250-500K. We don’t have that constraint. Smaller managers will also need to compete with managers many times their size if serviced by the larger primes. Someone running a USD10million fund is going to struggle to compete with multi-billion dollar funds for a return phone call or a stock borrow.”

Investors are increasingly targeting smaller hedge funds but the universal question they have is “How robust is the infrastructure of a USD50million fund?”

“That’s where we come into play, bringing in partners like Liquid Holdings, Nomura, Deutsche Bank, Kas Bank and BNY Mellon to provide a stable environment for smaller managers to operate in,” states LoPrimo.
ranging from 1.5% to 100% of total AUM. Like last year, investors surveyed are from the UK, the EU ex-UK (including Germany, Spain, Scandinavia and the Netherlands), the Americas, Switzerland and the Middle East.

While last year 70% of respondents said they were broadly in favour of emerging funds, this year only 25% adopted a similar view. Where does the drop in numbers come from?

We do not believe that the change in individual respondents within our sample explains such a dramatic change in the results. The sample mean has remained fairly similar – $42bn this year versus $40bn last year – and the diversity of respondents – a balanced mix between wealth managers, superannuation (pension) schemes, funds of funds, multimanager funds, and family offices – is broadly identical. The main difference this year is that respondents are more concentrated around the mean in terms of asset size, however this is unlikely to have a negative impact on investment in emerging funds for the following reasons:

- As the Chart shows, we have found that there is a weak correlation between AUM size and likelihood of investing in smaller funds.
- If anything, some of the largest investors are less likely to invest in smaller funds because their investment sizes would immediately make them the main investors, which they want to avoid – unless they do seeding and can take an equity stake into the management company also.

Among the respondents, 15% said they have “concentration limits”, as a result of which they cannot own more than a certain proportion of AUM – a 10% and a 20% limit were indicated as ceilings. The respondents who put forward that argument “against” investing in emerging managers were wealth managers, dealing both with wealthy individuals or endowments. With ticket sizes in the range of $10m to $30m, the ceilings could be reached fairly easily as far as the smallest managers are concerned. “We do not want to be caught with our pants down”, said one investor, to support his employer’s decision to avoid emerging managers, “so such an investment would be ok only if we believe a fund’s AUM will increase quickly”.

Investors with an increasing amount of AUM find investing in emerging hedge funds not so much dangerous as expensive: “Small funds make it difficult for us to achieve scale”, says one respondent.

- Conversely, some of the smallest investors tend to rely on the fund’s service providers for the purpose of Operational Due Diligence. Since smaller funds have less money to spend on outsourced functions – e.g. on a Prime Broker – the result is that smaller investors may tend to stay away from the space.

What explains the drop in numbers seems to be linked to that fact that this year, we asked the question in a more concrete way. Investors have not fundamentally changed their minds about emerging funds and overall still say they are open in principle. However, they pointed to a number of reasons as to why they are not planning to do so in practice. Most of those reasons have to do with the way emerging managers deal with the operating / business side of their ventures.

It can be argued that relying on service providers to perform ODD is a way of outsourcing that part of the investment process. Smaller investors tend to do this almost by default: they do not have enough resources to look into the (all important) details and, instead, tend to trust that a “big name” (e.g. in the Prime Brokerage
area) in itself means that a fund is fit for purpose. Those respondents who invest via managed accounts or into UCITS - funds of funds primarily - also tend to rely on platform providers, a process that is made even easier for those who recently built in-house platforms for outside managers. It has to be noted though that most of those surveyed do take the way managers outsource key functions into consideration - albeit to a greater or less extent and often in combination with other factors.

The most important points respondents made about emerging funds and their service providers are as follows, starting with views which are the most strongly-held and ending with those where comments did not constitute respondents’ primary concerns:

- **To outsource or not to outsource... is this really the question?** - The overall comment is that “small funds do not have the means to have solid, scalable infrastructure”. They have often recently come out of banks and are faced with the challenge of managing a business in addition to concentrating on their investment strategy; they find it hard to multitask and lack the expertise to deal with all the various areas relevant to their businesses; however, they often cannot afford hiring the talents required - whether to perform the work as a permanent member of staff or as an outsourced service provider.

- **Prime Brokers and Compliance** - These are the functions that seem to matter the most to investors, and some respondents say that these are “weaker at smaller funds than at larger funds, which, as far PB is concerned, can create a financing risk”. While some investors “prefer an outsourced compliance function”, which, at least gives some guarantees that the job is being done professionally, resource constraints result in investors passing on smaller funds because these two key functions are not dealt with appropriately.

- **Documentation and marketing material** - “Still a lot of people are using boilerplate documents, which allow managers to do anything”, says a respondent. While similar comments come up spontaneously after a few minutes of speaking with a few hedge fund investors, one respondent, whose operations fit into the higher end of the sample in terms of AUM, volunteers to say that “fact sheets and presentations are sometimes incomprehensible even for larger funds! The difference is that [the larger funds] listen to us because they have marketing personnel internally”. Smaller managers, who may be more likely to use third party marketers, find this exercise more difficult, and, according to another respondent who goes further in criticising funds’ information he regularly reviews: “Emerging managers have little to lose; we do not know to what extent we should rely on their presentation”. The nuance to this is the fact that documents
coming from more established funds are sometimes old and... outdated.

- Corporate governance – Some investors complain that they do not see enough board independence, with director oversight often qualified as “poor”.

- Conflicts of interest – “Larger firms have the resources to hire more back-office staff with segregation of roles and responsibilities, which is important in building appropriate checks and balances”, says one respondent.

- … and why sometimes it just does not matter – Finally, one respondent indicated that while back offices must be “appropriately funded”, they must first and foremost “have conviction about person”. They explained such an approach was in-keeping with their value and long term model, which result in a partnership with the investment target and hence they are prepared to accept that a fund’s operations will develop, grow and improve as the AUMs themselves also grow over time.

Additionally, some of the biggest investors, who also admit “ODD is not [their] strongest point”, have recourse to dedicated ODD service providers on which they rely for at least part of the process – with the remainder sometimes being done by their internal compliance teams. Based on our sample, the split among investor type is as follows:

- Family offices and funds of funds are the most reliant on external providers – either as providers they specifically mandate to do this job or via Prime Brokers’ introduction and implicit recommendations.

- Wealth managers tend to “mix and match”, trying to reach a balance between what is done in-house, on the one hand, and input from a specialist third party, on the other hand.

- The two pension funds interviewed are the only respondents saying they perform a very thorough ODD in-house, with dedicated teams working on this, which somehow confirms a point a fund of fund manager also made as part of this survey exercise: “The problem is that we are doing for our [pension fund] clients what they now know how to do”, thus highlighting the fact that several pension funds of large companies or organisation now have in-house alternatives teams that do everything, including in some instances more of the ODD that many funds of funds no longer really do.

The environment: how much is it costing? Investors say emerging funds may not have the appropriate level of resources to hire or to outsource properly, and this is compounded by the fact that the cost of doing business has increased over the recent period.

- AIFMD – Last year, the AIFMD was already on the cards, however it is not until late in the day that some of the players started to realise how expensive this would be. In addition to the direct cost of compliance comes the regulatory risk, and potential fines imposed by regulators, as a result of areas of uncertainty, such as those relating to marketing. Several respondents indicated that they are no longer sure as to what extent funds unknown to them – hence, many of the emerging funds – are allowed to approach them; some have taken the conservative approach that reverse enquiry might be preferable for now.

- UCITS – European conservatism really started with the beginning of the global financial crisis but was enhanced by the recent regulatory developments, which is paradoxical if one considers that one of the stated intentions of the AIFMD was to protect investors and restore confidence in financial markets. While US investors are still adventurous, the tendency for Europeans is to demand more of the UCITS type of structures, which is creating more costs and constraints on hedge fund managers.

- The “F... word” – At a time when, even in the best case scenario, capital is scarce, it appears the “fee question” is creating an additional hurdle for emerging managers: several respondents say they would only consider investing in smaller managers if they are offered lower fees. A respondent even said he wanted different fees at milestone AUM, starting very low and increasing as the manager becomes more successful.

- How small is small? – Finally, last year
we had not provided respondents with a definition of emerging managers, instead preferring to leave that door open to a qualitative discussion. In our conclusion, we had said that “several investors supportive of smaller funds say that they are now prepared to lower the minimum size of the funds into which they would invest. While this may sound like good news, the numbers provided ($100 and $200 million, both by private wealth managers) still seem rather high for a manager starting up”. Again this year, one of the respondents explained that “clear winners start with $200m anyway”, to justify he would not consider any fund with less than that amount in AUM.

**Timeframe and percentage of “skin in the game”**

While the above does not present an optimistic picture of the market for emerging managers, we did, throughout our investor survey, notice an interesting trend, namely the positive correlation between investment horizon and willingness to invest in emerging managers. The relationship is further strengthened when investors have a greater sense of ownership of the assets they manage.

Respondents made the following comments in relation to emerging funds and investment timeframe:

- “Long term viability of smaller funds may be a problem,” said an investor, adding that “two-third of the new hedge funds fail”. Yes, all agree that the potential returns are higher over time, provided one is prepared to stomach the risks involved: “we do not invest in emerging managers because of the huge level of uncertainty, however we are aware that we are missing out on alpha,” says a respondent, echoing one of his counterparts who says they are now doing some work internally to relax the concentration rules mentioned above, which, in some cases, prevent investors from owning too high a share of AUM.

- While long term investors managing a proprietary portfolio may be prepared to bear that risk, others, in charge of assets coming from a greater number of third parties are faced with the question of reporting on short term performance to clients who may be “less educated”

- This explains why 50% of the respondents say they want to increase their exposure to equity, which has performed well so far this year, while CTAs, who suffered this year in terms of performance, are not as much in favour as they were last year, with over 25% of the respondents planning to decrease their exposures to this strategy in the next twelve months. “This is very backward looking,” admits an investor – even though those buying equity include investors committed to specific strategies, such as event-driven, rather than to the asset class itself.

- Finally, as a point of methodology, it should be noted that last year’s sample included two seeders, which, by definition, do invest in emerging managers and do have a vested interest in the business, due to the equity stake. This year, these investors are no longer in the sample, however they have been replaced by another type of investor who does not have an equity stake but, instead, has adopted a “partnership approach” with the managers in whose fund they invest. Participating in the growth of a fund is no doubt rewarding, requires striking the right balance between proactive support and inhibiting interference, and takes, well, time...

The landscape for emerging funds does not look as rosy as one might like, past the initial enthusiasm that comes quite naturally with novelty. The one optimistic note though is that the investors committed to smaller managers look at the long term and, thus, provide a stable and strong base from which to grow.

Marianne Scordel founded Bougeville Consulting to assist alternative fund managers with their business strategy. This includes providing assistance to hedge fund managers in finding cost effective solutions to compulsory changes (e.g. those pertaining to the regulatory environment) and in enhancing commercial opportunities – adapting products, structures, or the marketing thereof. Prior to this, she worked for Nomura and for Barclays Capital. She is an Alumna of St Antony’s College, Oxford.