In at the ground floor

Even if the performance benefits of early-stage managers might be contested, Lynn Strongin Dodds identifies further positives in the form of negotiated fees, revenue sharing and direct-ownership opportunities

Early Stage Hedge Funds

It is no surprise that seekers of hedge funds have become more demanding over the past few years. Markets have been volatile, returns have been weak and regulation is ever tightening. As a result, investors are looking to be fully compensated for the risks they are taking. But the potential spoils are persuasive. While there are certainly issues with survivorship and backfill bias in the data that is used, numerous studies indicate that fledgling hedge fund managers are typically outperforming their larger brethren. One of the latest studies, from PerTrac, found that young funds outperformed both ‘middle-aged’ and ‘older’ funds in 13 out of the last 15 years, consistently beating their larger counterparts.

Hedge funds with less than $100m under management returned 13.94% in 2010 compared with 11.14% from mid-size funds and 10.9% from funds with over $500m in assets. Young funds, defined by PerTrac as less than two years old, gained 13.2% in 2010, versus 12.65% for middle-aged funds and 11.77% for 'tenured' funds (older than four years).

"One theory explaining this outperformance is that emerging managers are more nimble," suggests Jeff Maitl, head of European investments
for fund of hedge funds at Neuberger Berman. “There may be an emotional element at play: smaller managers are much more dependent on returns for the success of their business. A larger manager can generate average returns and live comfortably on the management fee.”

Lisa Fridman, head of European Research at fund of funds manager PAAMCO, points out that even firms set up by experienced individuals have to prove that they can succeed on their own as a new business. “As a result they may be more motivated to focus on performance and therefore better aligned with investors,” she argues. Even if performance is stellar, investors still worry that emerging funds lack the liquidity buffers to soften blows from volatile markets. “Sixty to seventy percent of start-up hedge funds fail to gain momentum in terms of gathering assets or performance,” says CAI Edgar Kohler, head of hedge fund advisory group Fundesa, which specialises in emerging managers. “Finding tomorrow’s stars is not that easy.”

While regulation and investor demand have dramatically increased—it is not possible for two professionals to set up a boutique with just a Bloomberg terminal any more—that has not stopped emerging managers from throwing their hat into the ring. Ironically, new rules such as the 1.14% fee and Volcker Rule have prompted a mini boom, as traders spin out of banks and large incumbents. In 2010 there were 1,144 hedge funds, down from 2,009, and in 2011 there were 1,100, despite the euro-zone crisis, according to Hedge Fund Research. But in the present environment, size also seems to matter. Those at the upper end of the spectrum are garnering the most attention, according to a new report from Credit Suisse, ‘Finding Direction in Uncertain Terrain’. The study, which polled 600 respondents managing around $250 billion in total, found that 68% were interested in funds with AUM of $500m to $2bn, while 63% would consider an AUM down to $100m. By contrast, only 34% were attracted to funds with AUM of less than $100m, dropping to 24% interested in funds with AUM under $50m.

Managers tend to be more flexible on terms if they want to attract stable capital,” says Fridman. “It is a much more challenging asset raising environment than it was several years ago and we are seeing investors looking for discounts on management and performance fees if they invest early and in size.”

A recent study by Citi Prime Finance, ‘The Day One & Early Stage Investor Allocation to Hedge Funds’, found that, on average, investors were seeking a 62 basis point discount on the standard 2% management fee and 20% performance fee. US investors were the most exacting, with 38% of those surveyed seeking a 75 basis point discount on management fees—twice the number of those in the EMEA and Asia Pacific regions.

Several studies have found that allocations can wield more influence than is the most dominant players, accounting for 62% of the universe of day-one and early-stage allocators. They also commit nearly three times more capital to start-up hedge funds than European groups and make early-stage investments that are, on average, 56% bigger than those from European investors. However, the Europeans are following the US lead at the bargaining table.

“We are able to negotiate a discount of about 25% on performance and management fees,” says William Benjamin, global head of research at HSBC Alternative Investments, which recently launched the HSBC Next Generation Fund covering early-stage emerging managers. “They do not take the stake or have a revenue-sharing agreement but, instead, build long-term investments with emerging managers. At this stage they are satellite-like positions but can become core over time.”

The Citi research on early-stage allocators, which canvassed 90 managers and day-one and early-stage investors globally, excluded allocations by seed investors that negotiate an ownership stake or an equity-sharing arrangement with the fund manager in exchange for start-up capital. Majit believes that the main distinction between taking an equity stake or a revenue share versus being a straightforward limited partner in an emerging fund is that there is less liquidity: LPs can usually get all their money out in any one month, with 60-90 days’ notice; it will be much more difficult to find a buyer for equity in a non-listed fund management company.

Equity investors need a longer time horizon and face economics tied not only to fund perfor–
MQuabator: giving talent a push

Capitalised in January 2009 with €250m from the Netherlands' G following the recommendation of a working group from the iiland Financial Centre, MQuabator intermediates the allocation of seed and operational capital from third-party institutional investors to early-stage boutiques. Martin Steward spoke to founder and CEO Jeroen Tielman about the business model.

You are not really a fund of hedge funds. It you really a private equity fund specialises in asset management businesses.

We are similar to private equity, but with a ten-year horizon of 3-5 years. I expect that at the end of this year we will begin preparations for a second fund.

Over time and effort we devote to monitoring the team is of a different dimension from that of a hedge fund. We typically can’t select a portfolio even on a single track record, so we have to consider investment processes. We do so at four levels: investment management, risk management, and team dynamics. We default to standard due diligence questions as well as careful online interviews. Once we invest, we involve CIOs to keep an eye on the progress and to help with the decision to sell.

We are well aware that the main causes of asset cancellations are operational or business performance. We charge 1% plus 25% performance on the underlying funds. This is 1% per annum and 25% for performance. We would pay for a private equity fund. If investors invest in MQuabator with a 25% stake, what is the necessary to help on our investment committees, they get an option on €100m of direct capital with each underlying fund at the same fee as MQuabator but without the IMQ fees. They are getting our guidance and monitoring.

If you find any model that is better for some, let me know.

If you do not have these talents managed?

JT: The key is to create a low-volatility fund. This means being broad and accessible — any proprietary artwork creates potential blue, so we encourage everyone to apply through our online entry form, which automatically feeds into our database and gives everyone the same opportunity to be evaluated. People started applying, based on some criteria, but even if MQuabator had such an application at the beginning. But by the summer of 2009, the majority were coming from abroad.

Today, it’s 60-95%; still mainly from within Europe but increasingly from Asia.

If you do ask for a preparedness to establish the business ‘centre of gravity’ in the Netherlands. Indeed, you prefer they not share a single office building, but a single floor. Doesn’t that limit you somewhat?

JT: This is not about Dutch preferences. Physical proximity enables us to guide and monitor managers. On the other hand, we want to reach out to the best talent there is, on the other, don’t we want a portfolio of managers dispersed between New York, Amsterdam and Hong Kong. So we need to reorganize for the first one to three years when the risks are highest.

As an example, Carenah, based in Singapore, came over to Amsterdam in 2010. At the little one of their trades happened to be in the US timezone, but after a few months, trading activity switched back towards Asia, and the traders started work at one in the morning and went home at 3.30pm. They didn’t complain, but after a year we concluded that this wasn’t sustainable.

Should pension funds want to be involved in the business of hedge funds? It is perhaps not so different from being involved in any of the other businesses that they hold in their broader early-stage private equity allocations. It can turn asset-gathering into a potential benefit, as well as a potential risk, and also adds participation in fee revenue. But it also turns what was a clean hedge fund-strategy exposure into a mix of hedge fund, private equity risk — both investment risk and liability risk. Investors must decide whether the benefits outweigh those risks, and also the practical difficulties that mixing the two things together introduces.

IMQ: Are there three basic models for investing with early-stage managers: the straightforward LP relationship; the LP relationship with a negotiated revenue share; and direct ownership stakes. Why has IMQ chosen the third?

JT: We are looking to establish a 3-5-year relationship with the managers and, while it might be tempting to take a share of the gross revenue, it

is not really consistent with our long-term objectives. We give them enough seed money to get them on the map and build a track record — but, as an encouraging push in the back, we don’t give them enough to break even. It could not be consistent with what we are trying to do.

We are still waiting for the break-even point.

It works the other way too, of course: most costs for an early-stage asset manager are salaries, and we want those partners to have skin in the game and part of that is delivering salaries. Teams typically include three key persons who have been financially successful in the past and can afford to defer salaries.

IMQ: How do you find these talented managers?

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