Special Report
Boutique Asset Managers

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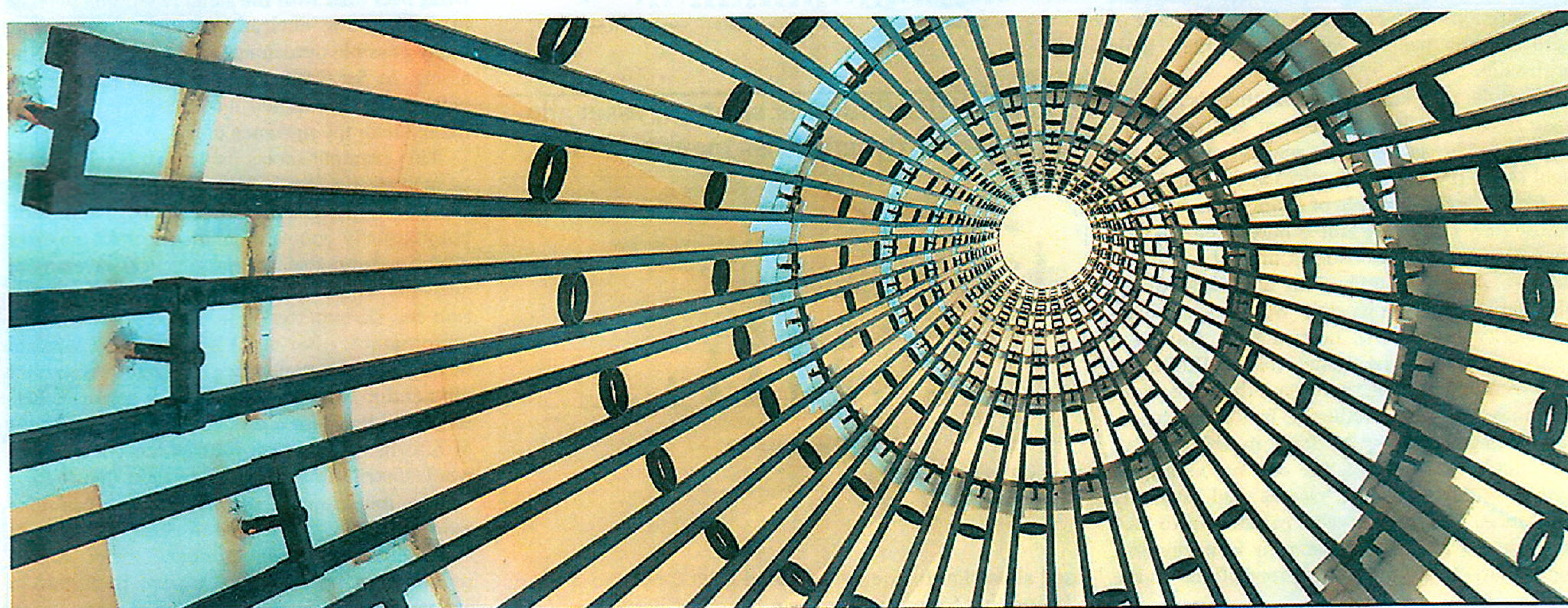


In at the ground floor

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 seeders 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 outshining 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 13.04% 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 13.25% 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 Majit, head of European investments

for fund of hedge funds at Neuberger Berman. "There may also be a psychological 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. "Ninety-five percent of start-up hedge funds fail to gain momentum in terms of gathering assets or performance," says Cédric Kohler, head of hedge fund advisory group Fundana, which specialises in emerging managers. "Finding tomorrow's stars is not that easy."

While regulation and investor demands 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 Dodd-Frank Act and Volcker Rule have prompted a mini boom, as traders spin out of banks and large incumbents. In 2010 there were 1,184 debuts, a 51% hike from 2009, and in 2011 there were 1,100 launches, 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 $28trn in total, found that 86% 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 Allocations to Hedge Funds', revealed that, on average, investors were seeking a 62 basis point discount on the standard 2% management fee, and a 502 basis point cut on the typical 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.

Part of the reason that the US institutions can wield more influence is that they are the most dominant players, accounting for 63% 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 comprising 10-15 emerging managers. "We do not take a stake or have a revenue-sharing agreement but, instead, build long-term investments with emerging managers. At this stage they are satellite positions but can become core over time."

The Citi research on early-stage alocators, which canvassed 90 managers and day-one and early-stage investors globally, excluded allocations by seed investors that negotiate an ownership stake or fee-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- ►

A Golden Age for boutiques

ANTHONY HARRINGTON

We are in something of a golden era for new asset management boutiques. A new regulatory regime is pushing banks away from proprietary trading, bringing talented managers to market at the same time as institutional fund managers increase their allocations to alternative assets. For the first time, all the back office and compliance functions and infrastructure can be outsourced via a range of providers at very reasonable prices.

"That makes it so much easier for the intellectual capital at big institutions to leave and set up on their own," says James Barber, senior portfolio manager at Russell Investments. "They see very clearly that their operations need no longer be dependent on huge, capital-intensive infrastructure."

Barber also makes the point that firms like Russell, which find good start-ups and point their big institutional clients towards them, have effectively disintermediated big-client distribution channels. By helping to provide distribution to the boutiques, Russell's service, and that of other advisers, makes it much more attractive for top managers to leave and set up their own shops.

The attractions of boutiques for institutional clients, particularly early-stage boutiques, are easily stated: scale tends to be the enemy of alpha and there is generally greater alignment of interest – boutiques are still hungry to succeed – and investors tend to get much more direct contact with the partners managing just a few hundred million dollars. "The analysis and macro resources we have available are vastly larger than those available to a boutique so we are a very useful resource for them," Barber explains. "With managers operating billion-dollar-plus funds, you just don't have that kind of dialogue on a regular basis."

Thanks to these plus points, Tommason Mancuso, a partner and head of research at Hermes BPK Partners, says that he has heard of a number of new start-ups that have attracted substantial seed funding with little difficulty. Russell, for example, recently provided one boutique start-up with $100m of seed funding. A few years ago a start-up would have been lucky to get $10m in seeding.

Hermes itself has a platform that specifically targets boutiques once they have moved past the immediate, seed-funding stage, a partnership with Northern Life aimed squarely at boosting the AUM of boutiques, and making them "institutionally ready" through operational advice. Investors will benefit both from the returns of the underlying managers and from revenue sharing.

For Mancuso, the distinction between seed capital and accelerator capital is that seed capital basically refers to a boutique's first $25-50m of AUM. Accelerator capital targets firms that are past this threshold, and can boost AUM to a level appealing to institutional investors.

Once they have found a boutique that they are prepared to back, Hermes and Northern Life will lock the money up for three years. In exchange, Mancuso says investors enjoy stronger alignment with the managers, which makes it particularly attractive to pension funds. (Hermes itself is wholly-owned by the UK's BT Pension Scheme).

After three years, the fund withdraws its accelerator capital, by which time the boutique should have attracted sufficient outside investment not to feel the loss. However, the revenue share goes on for four more years.

Pacific Alternative Asset Management Co (PAAMCO) is at the other end of the scale from Hermes and Northern Life in the view it takes on liquidity. "For us, liquidity is absolutely key when we invest in boutiques," says partner Alper Ince. "Although our clients tend to be pension funds, sovereign wealth funds and institutions with a long time horizon, the slice these clients allocate to boutiques is very much part of their liquid investment."

The question of how much importance should be assigned either to a portfolio manager's or boutique's track record is a complex one. There is plenty of evidence that the mainstream investment criterion of betting on an 'established' manager's track record does not necessarily pay dividends in a boutique context, and funds of funds want boutique partners to be fresh, new and keen, which doesn't square with a demand for history. Even when the manager does have a solid track record, by definition it will have been earned in a different context, running funds that were on a different scale.

Given the difficulties that come with increased scale, at least for many of the propositions run by boutiques, it is easy to see that success brings its own dangers. Funding follows success so the boutique's AUM swells and out-performance becomes that much more difficult. But the fact that fund advisers are alive to the idea that emerging boutique managers do better than their more established counterparts, makes them that much warmer towards start-ups. This, in turn, is playing an important role in making it easier for new launches to get off the ground.

mance but to the success the manager enjoys in growing assets.

"The upside to investors associated with this asset growth can be material," says Majit. "As an LP, however, this asset growth is less consequential."

Indeed, asset growth might be one reason why early-stage outperformance eventually turns into later-stage underperformance – as volume of money starts to drag on flexibility of alpha generation. Taking an equity stake or revenue share could be seen as one way to hedge the asset-gatherer risk to which a straightforward LP is exposed.

Overall, the majority of seed deals are via revenue-share agreements. "We believe in this model because it provides a much better alignment of interests between our investors and the manager," says Patric de Gentile-Williams, chief operating officer of FCA, the seeding division of fund of hedge funds FRM. "The incremental return from revenue sharing can double the potential returns. We do not like equity stakes, because there is the issue of the exit route. The most likely sale will be back to the management team because I think an IPO or M&A in the sector will be very difficult for the foreseeable future."

Equity stakes are popular in certain quarters, however. Seonaid Mackenzie, founder of Sturgeon Ventures, a regulatory incubator, notes that family offices prefer this route. "Many familes have built their own businesses," he observes. "As a result, they want to have some control and like to be involved in the business. Early-stage managers, of course, like this type of investment because it is seen as sticky money."

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 offers participation in fee revenue. But it also turns what was a clean hedge fund-strategy exposure into a mix of hedge fund and private equity risk – both investment risk and liquidity risk. Investors must decide whether the benefits outweigh those risks, and also the practical difficulties that mixing the two things together introduces.

MQubator: giving talent a push

pitalised in January 2009 with €250m from the Netherlands' G following the recommendation of a working group from the lland Financial Centre, IMQubator intermediates the allocan of seeding and operational capital from third-party institunal investors to early-stage boutiques. Martin Steward spoke founder and CEO Jeroen Tielman about the business model

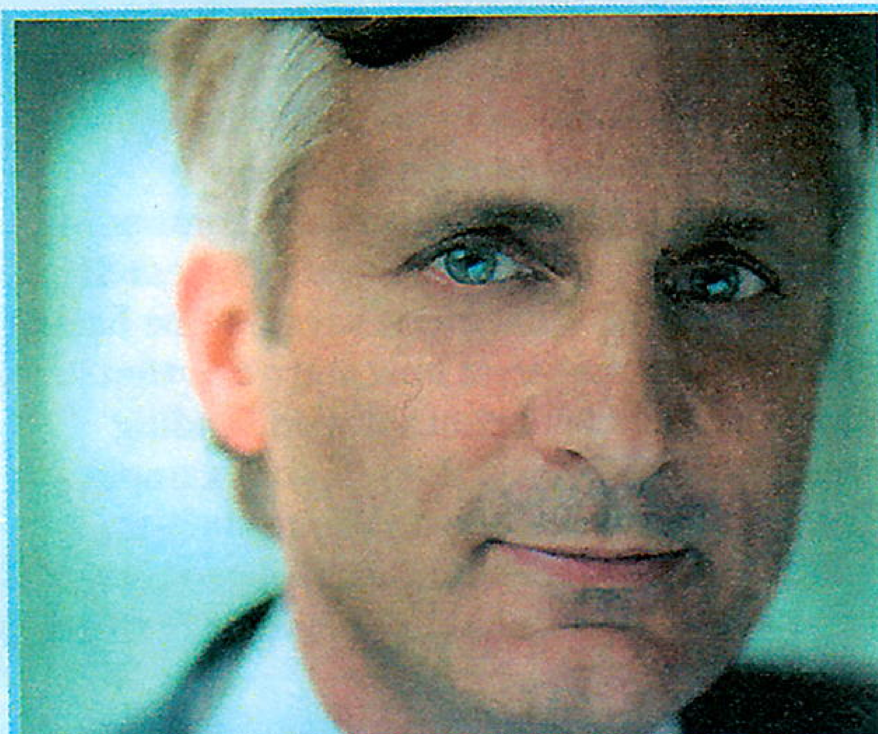
terview IMQubator

You are not really a fund of hedge funds. 't you really a private equity fund specialisn asset management businesses?

We are similar to private equity, but with a ter time horizon of 3-5 years. I expect that e end of this year we will begin preparations ise a second fund.

he time and effort we devote to monitoring teams is of a different dimension from that und of hedge funds. We typically can't select d on a past track record, so we have to coninvestment process alone. We do so at four rent levels – investment management, risk agement, operations and team dynamics – d on standard due diligence questions as well tensive interviews. Once we invest, we have -to-CIO meetings at least once a week and se close guidance and monitoring on opera-, risk management and business develop-t: we are well aware that the main causes of -stage casualties is operational or business lopment failure.

n fees, we charge 1% plus a 5% performance The underlying funds are paid 1% plus 15%. these up and it is slightly less than the ic 2-and-20 you would pay for a private ty fund. If investors join IMQubator with ast €25m, which is what is necessary to a seat on our investment committee, they get an option on €100m of direct capacvith each underlying fund at the same fee s as IMQubator but without the IMQ fees ereby getting our guidance and monitoring free. If you find any model that is better e for money, let me know.



JEROEN TIELMAN
CEO, IMQ Investment Management
- **2006-2008 – managing director, commerce, strategy & innovation, Cordares**
- **2000-2006 – founder and CEO, FundPartners**
- **1986-2000 – various roles, including global head product development, ABN Amro Asset Management**

IPE: There are 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 seeding 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 would not be consistent for us to say: 'If and when the next investor joins, we'd like to take 25% of the top line', because that would simply extend 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 these partners to have skin in the game and part of that is deferring salaries. Teams typically include three key persons who have been financially successful in the past and can afford to defer salaries.

IPE: How do you find these talented managers?

JT: The key is to create a level playing field. That means being broadly visible and accessible – any proprietary network creates potential bias, 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 rumour, even before IMQubator really existed, and that resulted in a tilt towards Dutch applications at the beginning. But by the summer of 2009, the majority were coming from abroad. Today, it's 90-95%; still mainly from within Europe but increasingly from Asia.

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

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

As an example, Cavenagh, based in Singapore, came over to Amsterdam in 2010. At the time most 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 long-term: we were confident in the way they were managing their operations, and advised them to move back to Singapore. We appointed