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Hedge Fund Start-Up Guide

In partnership with AIMA (Alternative Investment Management Association)

Welcome to the Hedge Fund Start-Up Guide.

Read on for an introduction and explore the report contents and topics.

Contents

We would like to express our sincere gratitude to the writers and groups of managers, including the AIMA Next Generation Manager Forum, that participated in the various roundtables and one-to-one meetings to come up with the topics and structure of this guide.

Introduction

In every industry, start-ups face a battle to gain a foothold and differentiate themselves from the crowd. In the hedge fund industry around 10% of firms manage close to 90% of the assets, and much attention is focused on this exclusive club and firms vying to join it.

But what about the other 90% of the industry – most notably the new funds taking their first steps?

This Hedge Fund Start-Up Guide is designed to help fill the gap. Drawing on advice from both investors and managers, it provides practical advice for all emerging and start-up managers on how to build a solid foundation and set your fund on the right path – whether your goal is to build a billion-dollar business or not.

We hope you find it of use and encourage you to get in touch to learn more about how Bloomberg's technology can help you start your fund or grow it to the next level.

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AIMA
THE ALTERNATIVE INVESTMENT MANAGEMENT ASSOCIATION

Drafting a business plan.

The importance of a robust business plan in managing process and risk.

By Malcolm Goddard, COO, Zetland.

A robust business plan is a critical tool for managing the process and the risk involved in what is an expensive undertaking. Your business plan must consider, in addition to cost budgeting, a myriad of other factors – not least of which is timing.

Main takeaway:

You must consider many things when starting a new venture. However, having a robust and flexible business plan, with the strategy at its core, is the key to mitigating risk, keeping costs controlled, and having and applying the right resources at a sensitive stage.

Setting up an alternative fund is not an easy undertaking

It's easy to spend in excess of $1m (example, any fund investment) to set the venture up before any revenue comes in the opposite way.

The actual amount initially expended will vary depending on the strategy.

For example, quant-led high-frequency strategies will use far more technology than value-led, event-driven strategies – although the latter may need a much greater level of staffing.

Remember, also, that in most cases, the principal will not have significant experience with non-trading aspects and there can be an emotional element, resulting in wasted time and money. This is known as "learning money." Infrastructure is expensive; a robust business plan is fundamental to keeping costs controlled.

A business plan should lay out all aspects of the business that are necessary to achieve objectives and offer a realistic assessment of what is affordable. While not necessarily a road map to certain success, a business plan can reduce the risk and potential cost of failure.

> **Start-up resources and pain thresholds are finite, but a well thought through and tested plan can offer the principal an ongoing view and measure of what is feasible within these constraints, thus affording them the flexibility to add or mitigate risk as circumstances dictate.**
>
> Malcolm Goddard, COO, Zetland

A plan is also necessary for seed investors and regulators to help them assess where the start-up is succeeding and where it might be going-astray.

Starting point

A brief assessment of what is needed (rather than desired) and how it will be paid for. Investors will want to see a resourced operation if they are to invest – but they need to invest to pay for this operation long term. So, this conundrum must be dealt with.

Next steps

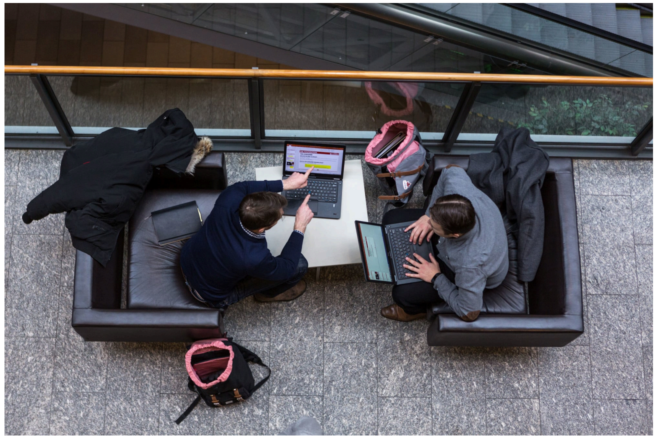
The next step is an assessment of and the timing of fee income. What is the nature of the start-up? Is it a spin-off with an existing team and track-record? Is there a track-record? If not, how can it be developed? Is there a seed? Where are potential investors based (this bears on fund structure, documentation, costs and regulatory environment)? What will it cost to raise this money (placement agents, pay-aways, etc.)?

Fund costs

I have deliberately not commented on issues like fund administration, establishment and legal costs associated with setting up the fund – these are normal fund costs and the outsourced model is standard. That is, if a fund is successful. If not, the costs revert to the principal. So, be certain that the marketing legwork has been done and reviewed before commissioning.

In addition, there is the manager's contribution to the fund. While it's certainly reasonable to point out that almost no start-up will have endless money, there still has to be a contribution. This must be discussed with investors – both this and any expense cap must be agreed to with the first investors as it potentially closes these points and gives a clearer vision of what is left.

Establishing all of this determines what infrastructure is needed to support the offering – fundamentally this is the basis of viability and what can be afforded at the start.



Raising money is the hard part. Although confidence is necessary to starting a business, overconfidence is a danger. A good guide: unless the fees are guaranteed, take a 30% haircut. If things are not viable at this point, move on.

Cost base

Having determined the revenues, the next step is to determine the cost base. Above the base requirement, this is what can be afforded against the timing of revenues and the principal's contribution. This must be limited to must-haves rather than nice-to-haves – the latter can wait until the business is sustainable.

On the following page are six strategies to keep a lid on fixed overheads and to divert resources to their maximum benefit – usually people and systems.

1. Outsource where possible

The more staff directly employed, the greater the cost – in both direct and indirect terms (office space, supplies, management, etc.). Using external resources, although somewhat costly, negates the need to hire expensive staff to perform these functions and also eliminates the need for software licenses and a tail on staff costs.

Accounting, payroll, compliance monitoring, etc., are as standard as IT, depending on the complexity of the requirement. Also note: this is a standard model, so will generally pass operational due diligence (ODD).

2. Use free stuff

There is plenty of free advice out there if you know where to look. Prime broker consultants are an obvious starting point (subject to the points below). Further, there is an active network containing plenty of free advice.

Use your initial meeting with potential suppliers to gather information. If you use the comps, they should be enough to point you in the right direction without the need for expensive commissioning studies.

3. Remember, suppliers can be homogenous

Prime broking consultants are a useful source of contacts although I would note that the smart suppliers have done their homework and have long-term relationships with the prime brokers.

It's amazing how you see the same names on the roster or sponsoring conferences. Is this an indication of quality or an indication that these suppliers have figured out the best way into this marketplace?

In the first instance recognize what you need to pay for and what is homogenous. Is a lawyer, accountant, compliance consultant, etc., providing a differentiated product or service? Unlikely. Recognize this and either set them against each other or go off-script. At least see what deals are out there. Recognize what you need to pay for and challenge the rest.

4. Don't own it

The key is flexibility. If it's possible to lease, do so rather than buy.

For example, serviced offices work fine for a start-up. Plenty to choose from at varying quality and price points. Most will offer packages that include telecoms and internet. The good ones also have tested BCPs, thus will have policies that will pass regulatory and ODD muster. IT can also be leased.

Most serviced offices can readily accommodate expansion or contraction, have no long-term contracts to inhibit future actions and you pay just for what you use, thus avoiding the tendency to over-order.

5. Share the risk

Capped fees (particularly among those who charge by the hour) are difficult to get, but plenty of suppliers will do a catch-up (a period of time with a reduced charge with a "catch-up" later on) if asked. Such an arrangement is useful, particularly in the early days when cash will be at its tightest. Equally, if looking at corporate structure, do you trade salary for equity? Can you pass the partnership tests for tax authorities? Do you use consultancy arrangements? If you don't ask, you don't get.

6. Hire an experienced COO

As principals are generally playing with their own money, it is essential to have somebody who understands and is experienced with how this works. Taking on an experienced COO can be a difficult step for a principal who is emotionally attached to what is their "baby." The COO may be perceived as a threat. Indeed, a good COO will challenge certain assumptions, strategies and goals; such questioning may be difficult for a principal to hear and, inevitably, time will be needed for trust to build.

However, this is no place for an amateur. An experienced COO will save both time and money; will have the necessary connections and will recognize where the bear-traps are. Having another person take on COO responsibilities frees up bandwidth to focus on marketing and portfolio management; so, if you get the right person, it will be the best money you'll have spent. Running a hedge fund is completely different from running infrastructure in a bank and this goes way beyond doing recs.

A robust, flexible business plan is key

You must consider many things when starting up a venture. However, having a robust and flexible plan with the strategy at its core is the key to mitigating risk and having and applying the right resources at a sensitive stage. It also can be the blueprint for building out, once breakeven has been reached.

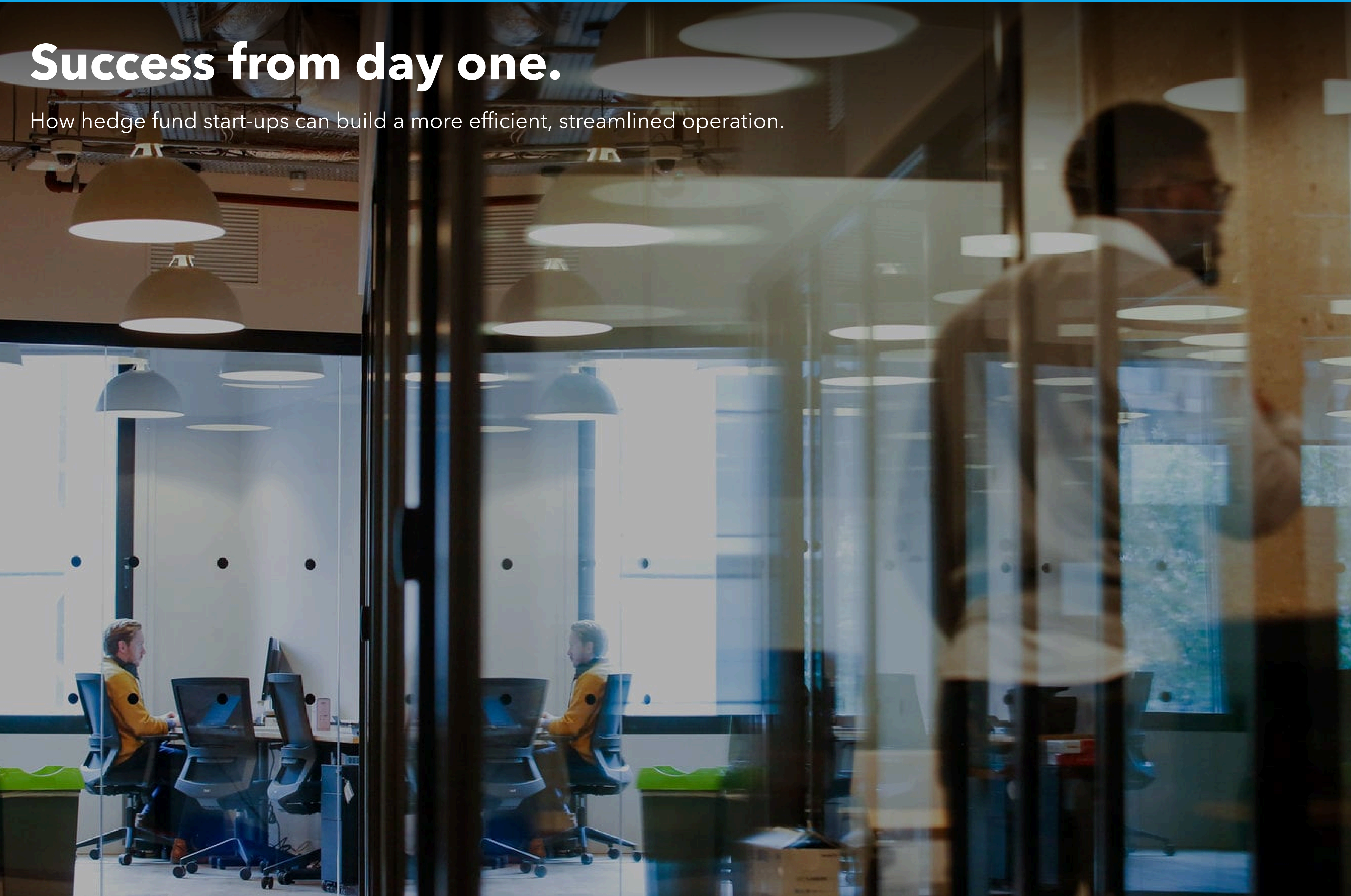
But in starting, the keys are what is needed – as opposed to desired – to promote the strategy and how, when and from what cash flows is it paid for. When does the venture wash its face? The rest can wait.

About the contributor

Malcolm Goddard is presently COO of Zetland; a first-time manager specialising in distressed opportunities in Europe. He has been involved in developing financial services businesses on the buy and sell side since the early 1990s. He spent 10 years as COO of an award winning hedge fund and has also consulted to a number of new managers.

Success from day one.

How hedge fund start-ups can build a more efficient, streamlined operation.



By Mush Ali, Founder, One Ten Associates.

In this report, a hedge fund industry expert explores best practices for assembling the right people, processes, and technology to succeed in the first year of operation and beyond.

Main takeaways:

1. The most important part of any business is its people. Make sure you assemble a core team that has a balance of investment, operational, and marketing expertise.
2. The majority of year-one costs should involve funding a combination of salaries, outsourced partners and technology.

One year, one million

Launching a hedge fund requires a tremendous commitment from the core team in terms of time, capital, and patience. Many start-ups are exceptionally skilled at investment strategy, but relatively few have built a business from the ground up.

The most important part of any business is the people. The core management team needs a balance of investment, operational, and marketing expertise; the majority of year-one costs should involve funding a combination of salaries and outsourced partners.

For example, a standard equity long/short fund, which is not very operationally intensive, typically incurs start-up costs of approximately one million dollars or one million pounds sterling in the first year.

According to Mush Ali, founder of One Ten Associates, a fund management recruitment firm that specializes in strategic non-investment hires for the hedge fund industry, this cost reflects the essential people businesses need to compete effectively.

“Most hedge funds have their front office team in mind,” he said. “When we help them find the right COO, that salary ranges from $150 to $200k. The CFO will need one junior support staff, assuming the strategy is straightforward. For more complex strategies, you may need a technical accountant or more non-investment support to help with valuation. After that, many successful businesses also hire a marketing specialist.”

Even if the principals forgo payment in year one, which is common, investment analyst, operational, and support staff salaries represent the bulk of the budget. From here, the list goes on to include the basics: legal, regulatory and compliance costs for management company setup, office space, insurance, payroll and benefits, accounting, and tax, as well as branding and travel costs for marketing.

Even the initial marketing presentation needs to

$1M Start-up costs for a standard, not operationally intensive, equity long/short fund

$130-$190K COO salary range

$2M Start-up costs for complex credit and systematic funds

go through a legal and compliance review. It requires the minimum disclaimers and guidelines on marketing requirements by investor type to avoid violating private placement rules in the relevant jurisdictions.

Businesses operating in the UK are regulated from day one, which is another monthly cost and required level of business formality that must exist before any revenue is generated.

In addition, very little revenue is likely to be generated during the first year. This is because of the time that elapses from the moment the core team decides to start a business until the first dollar enters the fund. Start-ups should expect this period to last between six and 12 months.

Traditionally, large institutions had more freedom to take risks. Now, because of poor returns, they spend more time on the initial evaluation and are more reluctant to become a day-one investor.

It often doesn't matter if a portfolio manager is very well-known. Institutional investors have extremely meticulous processes and competition is intense.

Specifically, there is a cadence of events that is difficult to compress. Even if the analyst is convinced of the fund's approach, they need to:

1. Get buy-in from their own investment committee.
2. Depending on the nature of the investor – they may also need to persuade individual portfolio managers or their own clients to allocate capital.

Varying levels of due diligence and background checks are then undertaken, which can take longer than expected if the business is not prepared for this or hasn't set up the business and fund in a way that the investor deems acceptable.

Once all teams have given their approval, the investor has to generate the capital to invest. Investors aren't typically sitting on cash, so the timing must align. To be sure, timelines are longer than they were five or ten years ago.

Assembling the core team

None of these timelines can begin, however, until the core management team comes together. While the roles will vary from business to business and strategy to strategy, Ali emphasizes that a great deal depends on how much the COO chooses to outsource.

"The current trend is outsourcing as much as possible, more than in previous years," he said. "The team can be quite simple in these cases. It's the investment team, the COO and their support person, a marketing expert, and occasionally an office manager. The technology outsourcing providers are more reliable, and they hire talent who understand the hedge fund space very well. Investors have no issue with it."

One key point to remember is that the core management team's skills should complement one another. In other words, a portfolio manager who knows the investor landscape very well may benefit more from hiring an operationally focused COO, while a PM who has never pitched to investors may be better served hiring a COO with a business development background.
If each person in the core team has the same skills and knowledge areas, it can raise the risk of infighting as they try to justify their own positions.

One of the risks start-ups may not account for is that of losing a member of the core management team within the first year.

Often, the hedge fund is the first business any partner has started. There is no existing framework to fit into, which makes it difficult to anticipate how each partner will react to the situation. Sometimes businesses simply hire the wrong people and disagreements arise. Other times, partners realize they are not cut out for the uncertainty that all start-ups must endure.

According to Ali, finding the right COO can be a make-or-break decision. While the CIO focuses on the investment strategy, the COO functions as the project manager. He or she interviews, selects, and then works with the lawyers, prime brokers, accountants, tax, compliance, and technology professionals to set up the business and fund. "The biggest risk is not having the right COO in place," Ali said.

> **"If you don't have an experienced COO, it can cause real issues. The COO is the person who figures out how it all hangs together and what the critical risks are. The earlier this gets figured out, the smoother the transition is to launch, and the more efficient operations will be."**
>
> Mush Ali, founder of One Ten Associates

Hedge Fund Solution Suite

In today's environment, it is increasingly common for hedge funds to focus on streamlining their operations model by outsourcing their technology systems to providers like Bloomberg so they can just focus on generating alpha . Wherever your hedge fund is in its life cycle, Bloomberg has the data, solutions and industry network to take you to the next level. Our Hedge Fund Solution Suite lays out a framework of practical solutions that can help you make smarter, more informed financial technology decisions.

Download information on our Hedge Fund Solution Suite.

Building out essential technology

While all of these decisions are being made, businesses must also think about technology. Like the core team, infrastructure depends on strategy.

More complex credit and systematic funds, for example, may cost closer to $2 million to start due to the level of technology integration, salary demands for the skill sets involved, and the manual processes necessitated by OTC trading.

Systems:

Systems are the biggest decision, one that the CIO and COO should make together. Building out complete systems in-house allows for a full-shadow NAV, but this may be unrealistic for businesses with tighter budgets.

Outsourcing middle and back office operations and related technology to a third-party provider, typically the fund administrator or a market specialist, has become a more common solution.

> **"Conventional wisdom says to outsource what you don’t know and keep what you do know, But really, it’s the opposite. You can control what you’re outsourcing better if you understand it."**
> Mush Ali, founder of One Ten Associates

Outsourcing:

But, in fact, it is rare to fully outsource front office solutions. Usually, businesses seek to purchase solutions that combine order management and portfolio management with connectivity for electronic execution.

“Much of this is driven by the experience of the team,” Ali said. “The more experience they have, the more likely it is they know what technology they need. Quant and CTA futures strategies are more technologically intense, for example, and so the investment team naturally will be more technically minded.”

Ali also explains that there is usually a constant debate about how much technology the business should outsource. On one hand, there is a desire to maintain control by keeping systems in-house. On the other hand, there is a need to not overspend or take on too large of an IT management burden.

Compliance is a great example. If you don’t know compliance, you are less able to assess whether your service provider is providing high-quality assistance.”

In general, the first two years are spent building an efficient if imperfect operation. At that point, when revenues are coming in, businesses can step back, reassess, and fine-tune. Furthermore, they will be in a better position to determine if more activities should be outsourced to the fund administrator, or if the business should add more systems to automate and handle higher trading volumes.

Most important of all, businesses can ask themselves: if we were building this from scratch, would we make the same decisions?

About the contributor

Mush Ali founded One Ten Associates in 2011.

Since 2004, Ali has focused on recruiting across the hedge fund space and has had great success identifying CFO/COO profiles for hedge funds in London as well as supporting his clients with non-investment hiring across operations, compliance, and sales/marketing/IR.

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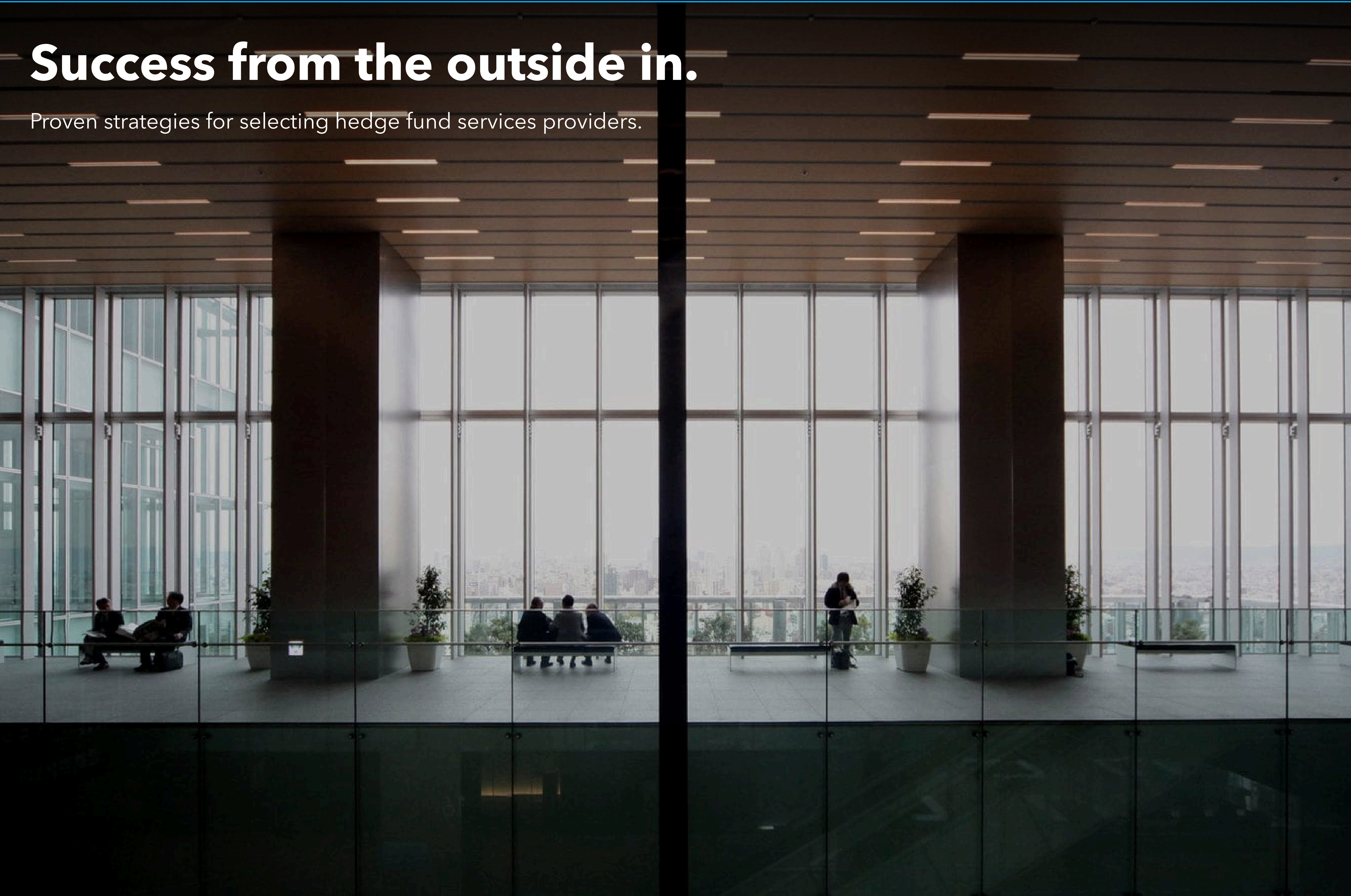
Success from the outside in.

Proven strategies for selecting hedge fund services providers.



By Ian Bickerstaffe, Founding Partner and COO, Rye Bay Capital LLP.

In this report, a hedge fund industry expert provides thoughtful advice on how to evaluate service providers and make more-informed decisions.

Main takeaways:

1. Due diligence is key - service providers should be assessed on the basis of reputation, expertise and growth.
2. Legal representation is first priority, as they will help set up the business, fund structure and negotiate contracts with other providers.
3. Prime brokers are the second priority and an equally important choice, the right broker will help turn prospects into investors.

First things first

After the core management team is finalized, the next step for a start-up hedge fund is selecting the service providers that will turn your strategy into a fully operational business. These choices are anything but simple, and play a greater role in the success of the business than many realize.

Ian Bickerstaffe uses a simple acronym for how start-ups should assess service providers:

REG, which stands for reputation, expertise, and growth.

Assessing providers:

"The reputation of the provider is critical, because if investors aren't familiar with them it could be an issue," he said. "Expertise means asking whether the provider retains the specific expertise your business requires. Do they have a track record in your strategy? Have they worked with other successful start-ups? And, finally, can the provider grow with you? You're not going to be a start-up forever, and you don't want to have to redo all your due diligence two years later."

Legal representation:

The order in which you choose providers is also important. Legal representation is typically the first priority, because this individual will set up the fund structure and negotiate contracts with other providers as well as offer advice on how to set up the business.

While much of the initial legal work is commoditized, strategy does play a role in selection. For many funds, choosing a "tier one" law firm is the most straightforward approach. But an esoteric credit strategy with more sensitive regulatory and tax implications, or a business regulated by UCITS with additional compliance concerns, may require more specialized advice.

After applying the REG test, businesses can narrow down their choices by establishing personal rapport.

“Ideally, you want people who are on your wavelength, so you can work with them effectively,” Bickerstaffe said. “The downside of the tier one firms is they are expensive, but these costs will in all likelihood be amortized, so it pays to go best of breed. Investors expect to see law firms they recognize and are well-known in your strategic space.”

> **"You need to find out how your prime brokers benefits from working with you and how much it will cost them to do so. The pricing you’re offered will help you get a feel for who is excited to work with your business and who is not."**
>
> Ian Bickerstaffe, Chief Operating Officer at Rye Bay Capital LLP

Picking a prime broker

After choosing legal representation, picking a prime broker comes next. The choice is extremely important, because the broker’s reputation helps turn prospects into investors. In other words, who you use reflects the quality of your business. It is ideal to work with a bulge bracket bank that knows the asset classes your business is trading. Typically, the portfolio manager will know which broker offers the right pricing, services, and financing for your strategy.

The decision, however, is more complex than it first appears. A prime broker, for example, may accept your business as a matter of course but have a stronger internal preference for other types of strategies. It is up to you to determine whether your relationship with the broker is one of convenience or true connection.

“It’s important to have a transparent conversation with your prime broker to understand how they view your strategy,” Bickerstaffe added.

Consultant & cap intro teams:

Keep in mind, the relationship with a prime broker goes both ways. Brokers offer a wide variety of services in addition to execution, including trading services, financing services, research, consulting, and capital introduction. The last two can be particularly valuable to start-ups.

Consultants provide seasoned advice about business setup, while the cap intro team serves as a bridge between new businesses and potential investors.

“You should understand the benefits of cap intro as well as its limitations,” Bickerstaffe said. “It’s a service. You get the introduction, but that’s it. It’s not a commitment to allocate capital.”

By the same token, you should expect to help the prime broker meet its revenue targets. The point is to think beyond execution and understand that the prime broker relationship works best when it works equally well for both parties.

Finding a fund administrator

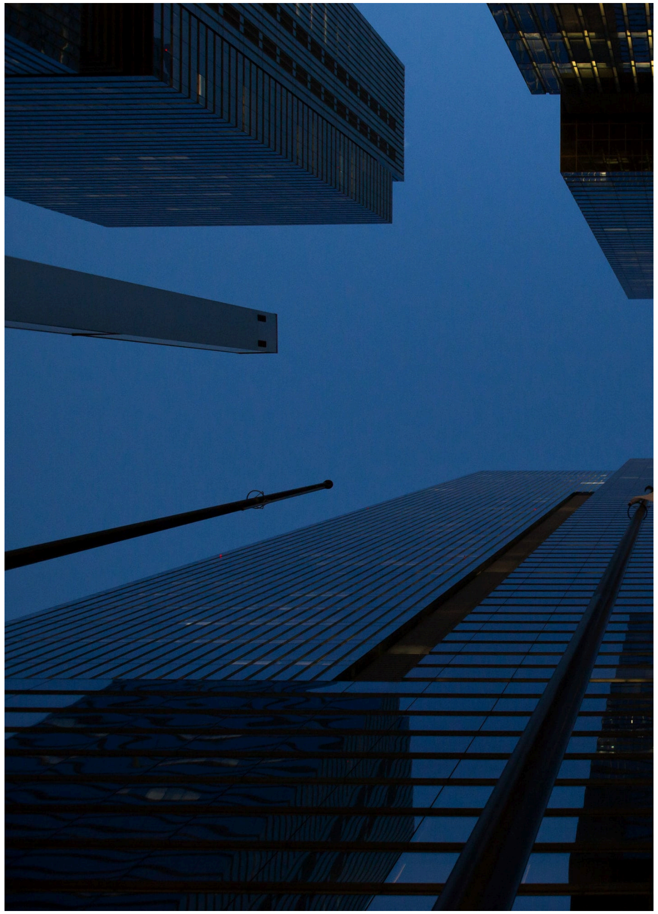
One service the prime broker consulting team can provide is helping compile a short list of fund administrators for your strategy and facilitating the introduction. Not every administrator wants to work with start-ups, and some strategies require administrators with more specialization. Of course, if you have a high-pedigree team and are positioned to raise a lot of capital, your business will be more attractive to the fund administrator.

Generally speaking, it is critical to find a fund administrator that is reputable, well-recognized, and can provide proper controls. Most important, however, is finding the right fit between your needs and the fund administrator's capabilities.

"It's imperative for start-ups to figure out what they really need," Bickerstaffe said. "In the last number of years, we've seen a shift towards outsourcing. Traditionally, the fund admin would cut the NAV once a month, send out your investor statements, and that was it. Today, they might also handle trade settlement, matching, and a variety of other trade support services."

Again, strategy may be a determining factor. A complex debt strategy could require your business to keep more middle office functions in-house. Simpler strategies, however, can use outsourcing to keep overhead low.

"Once you have your needs figured out, you can start looking for a fund administrator with a proven track record with start-ups," Bickerstaffe said. "You don't want to get a year into the relationship and have to replace them because they gave you a great deal for the first 12 months but now you can't afford the service."



"The first conversation needs to cover your expectations – and theirs, this will help you judge which firms have capacity to serve you and are interested in a relationship and which ones want to put you at the back of the line and charge you for the privilege."

Ian Bickerstaffe, Chief Operating Officer at Rye Bay Capital LLP

Assessing audit and tax

Much like legal services, audit and tax services for hedge funds are somewhat commoditized. Businesses can't go wrong by choosing one of the "big four" firms.

However, Bickerstaffe draws an important distinction between the audit side and the tax side. "Tax and audit are often the same provider, but not always," he said.

> **"Audit is a more straightforward decision. But you need a tax perspective on how your business is structured, and you need it early, whether you are doing a Delaware L.P. or an offshore Cayman vehicle. It's important to make sure there is nothing that will cause a roadblock for investors down the line."**
>
> Ian Bickerstaffe, Chief Operating Officer at Rye Bay Capital LLP

In other words, remember REG. A global equity fund trading in numerous jurisdictions needs a tax advisor that understands these markets – not one that knows one country very well but isn't comfortable outside it.

In fact, where the tax advisor's office is located can come into play. Because you are not just selecting the provider. You're selecting the office to call when you need help.

If you're trading in Asia, for example, you need support from an office in Asia. It won't work if you only have a two-hour window when you can communicate.

Bickerstaffe warns that choosing a big four firm doesn't necessarily mean you get the same treatment as everyone else. Start-ups may be a lower priority for a big-name firm, resulting in a headache when you need end-of-year statements by March but the auditor can't schedule you until June.

Fielding a solid team

Ironically, if you make all the right choices and surround your business with helpful, collaborative, competent providers, nobody notices. The business simply operates as expected.

"If everything is running smoothly, you can rest assured you've done your job," Bickerstaffe said. "On the other hand, if you're seeing cracks in the operation after a few months, that's worrying. The good news is, you can mitigate this risk with a rigorous due diligence process."

Ideally, the person conducting the due diligence should be a COO with sufficient experience to make informed decisions, and should be involved as early as possible.

If the COO comes in after providers are in place, it can be a bad omen – especially if up-front costs have been prioritized over long-term value. Again, proper due diligence can help start-ups avoid the trap of having unreliable service providers and, at the same time, wanting to avoid replacing them.

From the investor's point of view, a switch in any area is a red flag. The decision will need to be explained in detail, including why you selected the provider in the first place and how you discovered your mistake. If you replace your legal counsel, auditor, and fund administrator in the first year, that is evidence of poor due diligence.

Investors themselves are a key source of information when it comes to choosing the right service providers. Making these decisions collaboratively typically leads to better results. For example, one of the most helpful things any business can do is ask early investors for feedback.

At the end of the day, the investor is paying the fees, so it makes sense that they should have input. If they make a valuable suggestion and help your business avoid a pitfall, it pays off for everyone in the end.

About the contributor

Ian Bickerstaffe is a founding partner and COO of Rye Bay Capital LLP, a London-based long/short equity manager.

He has more than 20 years of relevant financial services experience and is a member of the Institute of Chartered Accountants in Ireland.

Taxation guidance.

Structures and key tax considerations for a new venture.

Moonir Kazi, UK Hedge Funds Tax Leader, PwC.

At a high level, we have sought to address the typical structures and key tax considerations for a new venture.

Basic hedge fund structures

When starting a hedge fund there are two key areas of focus: the fund and the manager. As well as consideration from a regulatory and a legal standpoint, the structuring and activity of these two areas of the hedge fund and management business involve consideration of the tax issues that can arise when setting up a new business. Most hedge funds take on one of the following four organizational structures.

1. Master/feeder fund (page 2)
2. Fund of funds (page 3)
3. Parallel funds (page 3)
4. Hedge funds with side pockets (page 4)

Many hedge fund managers also operate managed accounts on behalf of investors. These accounts may reside with the hedge fund's prime broker (rather than in the legal vehicle of the fund) but will be invested by the hedge fund manager similar to the fund's assets.

Funds are established for their own particular purpose based on the strategy, track record and reputation of the manager and the makeup of the investor group. These factors will all influence the final necessary structure of a fund range.

Where it is constituted as a corporate entity, the fund will have a board of directors to make decisions on behalf of the fund but will typically have no or few direct employees and no assets other than its investment portfolio and cash. The directors of the fund employ a number of outsourced providers to deliver the activities of the fund, these typically include:

1. The administrator
2. The prime broker
3. The investment manager (the investment portfolio is managed by the investment manager)

Transparent vehicles such as limited partnerships are principally used to structure hedge funds aimed at U.S. taxable investors, as the investors typically want a tax-transparent treatment from such a design.

Main takeaways:

1. The structuring and activity around a hedge fund and its manager involve consideration of tax depending on the fund's purpose.
2. The factors that influence the final structure of a fund range are strategy, track record and reputation of the manager as well as the the makeup of the investor group.

The general partner of the limited partnership may be the investment manager or, more typically, an offshore entity.

Offshore corporate funds:

Offshore corporate funds are typically used for non-U.S. investors and U.S. tax-exempt investors as they prefer an opaque entry into the fund to manage the tax exposure and reduce U.S. tax filings.

Typically, hedge funds are set up in low-tax jurisdictions such as the Cayman Islands or Jersey, where access to treaty benefits is limited.

However, more hedge funds are considering using treaty platforms (e.g., Irish ICAV) to manage the risk of withholding taxes.

This has gotten increasing attention since the recent introduction of Section 871(m), which has resulted in certain dividend-equivalent payments, which were historically exempt, being subject to U.S. withholding tax.

Founder shares:

The investment manager will often acquire an interest in its managed fund through either an interest in the general partner (where the fund is structured as a limited partnership) or through what are referred to as “founder or management shares” in a corporate fund.

Founder shares typically have no economic rights and voting rights over only a limited range of issues, such as selection of the investment manager. The founder share rights are limited to ensure that it is the fund’s board that makes relevant controlling decisions. The board should be self-appointing and independent.

In order to try to achieve a low level of regulation, some hedge funds will list their shares on what can be referred to as regulation-light stock exchanges.The listing is done to try to attract capital from investors who may be required by their own regulatory restrictions to invest in listed entities. A fund listing should be viewed as distinct from the listing of shares in an investment manager.

1. Master/feeder fund

A master/feeder fund is a structure which is capable of attracting capital investment from U.S. taxable and tax-exempt investors as well as from other global non-U.S. investors.

With a wide attraction of capital, such a structure is very popular and widely used in the industry. There are typically two feeder vehicles from which investors acquire their interest.

First feeder:

One feeder is established for the U.S. taxable investors, which is commonly a U.S. limited partnership. It is also common to see feeders as limited partnerships incorporated in no-/low-tax jurisdictions or, to a lesser extent, established as a U.S. limited liability company (LLC).

Generally a transparent vehicle is used to manage interests subject to the U.S. Controlled Foreign Corporation (CFC) or Passive Foreign Investment Company (PFIC) regimes (which come into play where a U.S. shareholder holds an interest in a corporation) and to provide investors access to any benefit from losses in the fund.

The feeder will have a general partner which often provides little service to the fund other than oversight of the feeder vehicle and the collection of any incentive allocation. As mentioned above, the general partner generally contributes some capital to the fund to ensure they are treated as a partner in the partnership for tax purposes.

Second feeder:

The second feeder, often referred to as the offshore feeder (due to its location), can be a corporate vehicle (or a partnership which elects to be treated as a corporation for U.S. tax purposes) through which U.S. tax-exempts and global non-U.S. investors generally acquire their interest.

This entity is generally resident in a no-/low-tax jurisdiction, commonly the Cayman Islands, however, there are many low-tax jurisdictions which can be used to achieve the same result.

Both feeder vehicles will invest their deployable capital into the master fund; this is done through the feeders' acquisition of interests/equity in the master fund. The master fund can take the legal form of a limited partnership, a unit trust or a corporate vehicle (in a low-tax jurisdiction) which has "checked the box" for U.S. tax purposes to ensure it is treated as transparent for U.S. taxable investors.

Some countries also offer specialized vehicle types which may be used as master funds, such as Ireland's Irish Collective Asset-management Vehicle (ICAV) and Luxembourg's Reserved Alternative Investment Fund (RAIF), which may take the form of a partnership, corporation or contractual arrangement.

The master fund will contract with an investment manager to manage its portfolio of investments in return for payment of a management and performance/incentive fee.

2. Fund of funds: Multi-manager funds

There are many investors who would like access to more than one hedge fund or hedge fund manager. The difficulty with such a desire for a single investor is finding the time for research and/or the excessive capital commitment to be able to hold an interest in several differing funds.

Because of this market demand, the fund of funds was established. A fund of funds will typically take the legal form of a limited partnership.

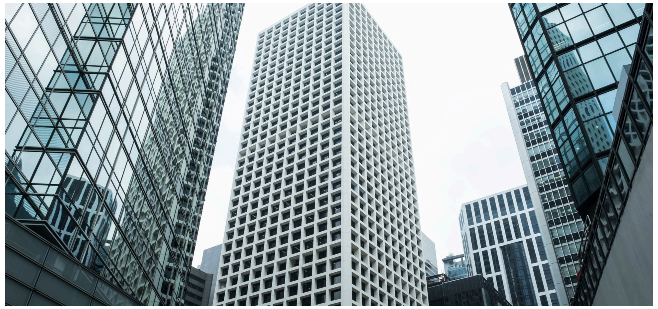
3. Parallel funds

At a high level, the parallel fund structure is a master/feeder structure with no master fund, such that the feeder vehicles become the direct investment-holding entities. The fund vehicles are chosen for U.S. taxable investors and U.S. tax-exempts or non-U.S. investors; these sister funds will directly invest together in the same financial instruments.

4. Hedge funds with side pockets

The use of side pockets to structure certain investments of a fund is a way for hedge funds to separate illiquid investments from the main liquid portfolio.

> **A fund of funds is a structure which invests in other hedge funds. The fund of funds has a widely diversified portfolio of unrelated hedge funds or, equally, can invest in a number of hedge funds with a similar focus such as by sector or geographic location.**



Management of hedge funds

Hedge fund management from the UK

With European hedge fund managers holding €587bn in assets at the end of March 2018 *(Source: FT)*, and many of these managers choosing the UK as their headquarters, the UK, and London in particular, continues to serve as the center of the European hedge fund industry.

There are many reasons why there is a thriving hedge fund industry based in London, ranging from the presence of a number of major global financial markets through to the existence of a wide-ranging multidiscipline talent pool.

In addition, the established tax framework in the UK has also contributed to the success of the hedge fund industry in London. The introduction and continued expansion of the UK "trading safe harbor" and the Investment Manager Exemption (IME) provided a framework for delivering a level of certainty of tax treatment for the funds which investors and sponsors require. It is therefore important that the degree of certainty which this framework delivers is maintained and continues to be supported by the UK tax authorities.

Typical UK management structure

A global hedge fund management structure will depend on whether the hedge fund manager is a U.S.- or European-led operation.

A U.S.-led operation will use a U.S.-domiciled entity such as a limited partnership or a limited liability company as its lead management vehicle, whereas a European-led operation will often use a lead manager or holding company structure based in a no-/low-tax jurisdiction such as the Cayman Islands or the Channel Islands.

Such a structure allows for the future expansion and growth of the investment manager to locations outside of the UK and may also suit the personal tax planning of the senior executives of the hedge fund manager if they are UK non-domiciled individuals.

The UK management business, however, will usually take one of two structural designs, irrespective of whether it is a European- or U.S.-led manager. A UK hedge fund manager will generally operate from either a UK limited company or a UK limited liability partnership (LLP) or a combination of the two.

The UK limited company

In any given UK management structure, the lead manager, be it a U.S. entity or a company in a low-tax jurisdiction, will hold all the equity in a UK limited company (UKco).

UKco will hold a sub-advisory agreement with the lead manager to perform designated management services.

In this situation, the UKco is the operational manager and it will most likely need to be a regulated entity with the Financial Conduct Authority (FCA) in the UK.

The UKco will be treated in the UK as a trading company and will be subject to UK corporation tax on its income, currently at **19%,** expected to fall to **17%** from 1 April 2020.

Use of UK limited liability partnerships (LLP)

Where a UK manager wishes to utilize a UK LLP, the lead manager will acquire all the entities of a UK limited company which will act as a service company (UK ServiceCo) to the LLP.

UK ServiceCo together with key UK persons (portfolio managers/senior analysts/senior executives) will establish a UK LLP. Typically. a UK ServiceCo will be the controlling member of the LLP. The LLP will hold a sub-advisory agreement direct with the lead manager to perform designated management services. The LLP in this case will be the operation manager (and not UK ServiceCo); as such, the LLP will most likely need to be the regulated entity with the FCA in the UK.

An LLP is treated as tax transparent in the UK and therefore it will be the members of the LLP who will be assessed for UK taxation based on their allocation of profits from the LLP.

Other UK key tax considerations

Changes to the taxation of LLP profits

In 2014, new targeted anti-avoidance legislation was introduced to prevent what the UK government deemed to be an abuse of the tax advantages afforded to an LLP structure.

The perceived mischief was, first, that any LLP profit share allocated to individual members would not attract the **13.8%** employer national insurance charge otherwise payable on ordinary salary and, second, that it was possible to indirectly stream LLP profits to individuals via the corporate member in the LLP – thereby avoiding a

1. The Salaried Member rules:
These rules, introduced in 2014, are designed to treat LLP members, for tax purposes, as employees, where the individuals are in substance employed by the business rather than leaders of the business (operationally or economically). If an LLP member fails any one of three conditions, they will be considered a true partner and will retain self-employed status for UK tax purposes and will not be treated as a salaried member.

2. The Mixed Member rules:
These rules seek to combat perceived abuse whereby profits of an LLP are allocated to non-individual members of the LLP (i.e., a company, another partnership or individuals acting in the capacity as trustees), while still earmarking those profits as, in substance, still belonging to the individual members.

charge to both income tax and national insurance altogether. The anti-avoidance legislation designed to catch this type of tax planning is referred to as "the Salaried Member rules" and "the Mixed Member rules," respectively.

Remuneration:

In the UK, most or all of the remuneration received by hedge fund managers is subject to income tax at 45%, either as employment income or trading profits. It is becoming increasingly difficult for individual hedge fund managers to achieve tax-efficient deferrals of their remuneration or to obtain the benefit of lower rates of tax on their remuneration.

Co-investment:

Hedge fund managers are often required to invest a specified minimum amount of their own money into the funds they manage (co-investment) – this is typically as a result of commitments given to external investors during the fund-raising process. Although there are many ways the co-investment may be structured, there are some specific features which are often seen in practice.

TP & BEPS:

The huge globalization of hedge fund managers has brought with it new tax risks and compliance obligations.

Transfer pricing is a key operational challenge for managers as they seek to identify the best strategy for correct remuneration of the core areas of their business. The operations of the investment manager are often priced using a revenue- or profit-split approach, calculated as the residual revenue of profit after rewarding the more routine business functions with a markup on their costs.

The 2015 BEPS Project was intended to address concerns over base erosion and profit shifting and the perceived flaws in international tax laws. The project introduced 15 workstreams which would be the focus of international leaders and finance ministers.

For portfolio managers looking to access the Asian emerging market, Hong Kong and Singapore have emerged as the top jurisdictions for fund asset management/capital-raising activities.

Hedge fund management from the U.S.

To the extent that the fund is managed from the U.S., consideration should be given to whether the fund may be considered to be engaged in a U.S. trade or business (USTB) for U.S. federal tax purposes (and therefore subject to U.S. tax/filing obligations).

The U.S. has a fairly broad trading safe harbor (U.S. TSH) with respect to trading in stocks or securities. A foreign corporation should not be engaged in a USTB if its activities in the U.S. are limited to those covered by the U.S. TSH.

However, certain types of activities could give rise to USTB. Among others, such activities include loan origination activities and investing in certain transparent entities such as master limited partnerships (MLPs) or publicly traded partnerships (PTPs).

In addition to federal taxation, there may also be state tax considerations for management companies as a result of undertaking activities in the U.S. To the extent that the fund manager is raising capital in some states, consideration should be given to whether such activities can create a state nexus.

For instance, in California nexus can be created even without having a physical presence in the state merely by having customers in California.

Hedge fund management from Hong Kong

Offshore funds managed from Hong Kong may be eligible for the Offshore Fund Tax Exemption (trading safe harbor).

Hong Kong has a trading safe harbor that can exempt offshore funds managed from Hong Kong from profits tax in Hong Kong provided that the fund meets certain specific criteria.

Under the Offshore Fund Tax Exemption, the profits of an offshore fund should be exempt from Hong Kong tax provided that certain requirements are met (e.g., among other items, the "central management and control" of the fund is outside Hong Kong and the fund does not carry on any other business in Hong Kong which is not a transaction covered by the exemption).

Given that the trading safe harbor is generally intended to benefit non-resident investors, Hong Kong law has certain anti-avoidance provisions known as "deeming provisions" which can result in

a Hong Kong resident being taxable in Hong Kong on their proportion of the underlying profits derived by the fund.

Hedge fund management from Singapore

Singapore is an attractive jurisdiction for investors given its investor-friendly regulatory and tax regimes. Two key tax incentive programs available to funds managed in Singapore include:

1. Offshore Fund Tax Incentive Scheme (Offshore Fund Scheme or S13CA scheme)
2. Enhanced-Tier Fund Tax Incentive Scheme (S13X scheme)

The main distinction between the two regimes is that S13CA is a self-administered regime and no formal approval from the Monetary Authority of Singapore (MAS) is required, whereas approval is required from MAS under the S13X and several other requirements, as discussed below, need to be satisfied.

Among other items, the S13CA has reporting obligations (e.g., report to the tax authorities/MAS where there are non-qualifying investors in the fund entity; annual statements containing certain standard information to investors) to be satisfied on an annual basis; however, this regime does not otherwise impose Singapore income tax filing obligation on the funds (or their partners in the case of limited partnerships) unless the funds or their respective partners derive any taxable income.

For completeness, note that the sunset clause for the Offshore Fund Scheme is currently set at March 31, 2019. All funds that continue to meet the conditions of the Offshore Fund Scheme on March 31, 2019. will continue to enjoy the tax exemption after March 31, 2019.

Under S13X, an approved fund is granted a tax exemption on "specified income" derived from "designated investments" managed by a "fund manager" in Singapore for the life of the fund and subject to meeting the ongoing conditions of the scheme. Except for the second condition, all the conditions have to be fulfilled by each fund throughout its life to obtain an annual income tax exemption. As previously noted, MAS approval is required under S13X. Among other requirements, under the S13X scheme the fund needs to incur at least SG 200,000 local business spending in a financial year.

In addition, assuming that certain requirements are met, under the Financial Sector Incentive – Fund Management program, fund managers managing a qualifying fund can qualify for a concessionary tax rate of 10% on income arising from such management.

About the contributor

Moonir Kazi is PwC's UK Hedge Funds Tax Leader and an experienced Director with over 17 years of experience, specialising in alternative investment fund structures and financial services taxation issues, with a focus on international tax.

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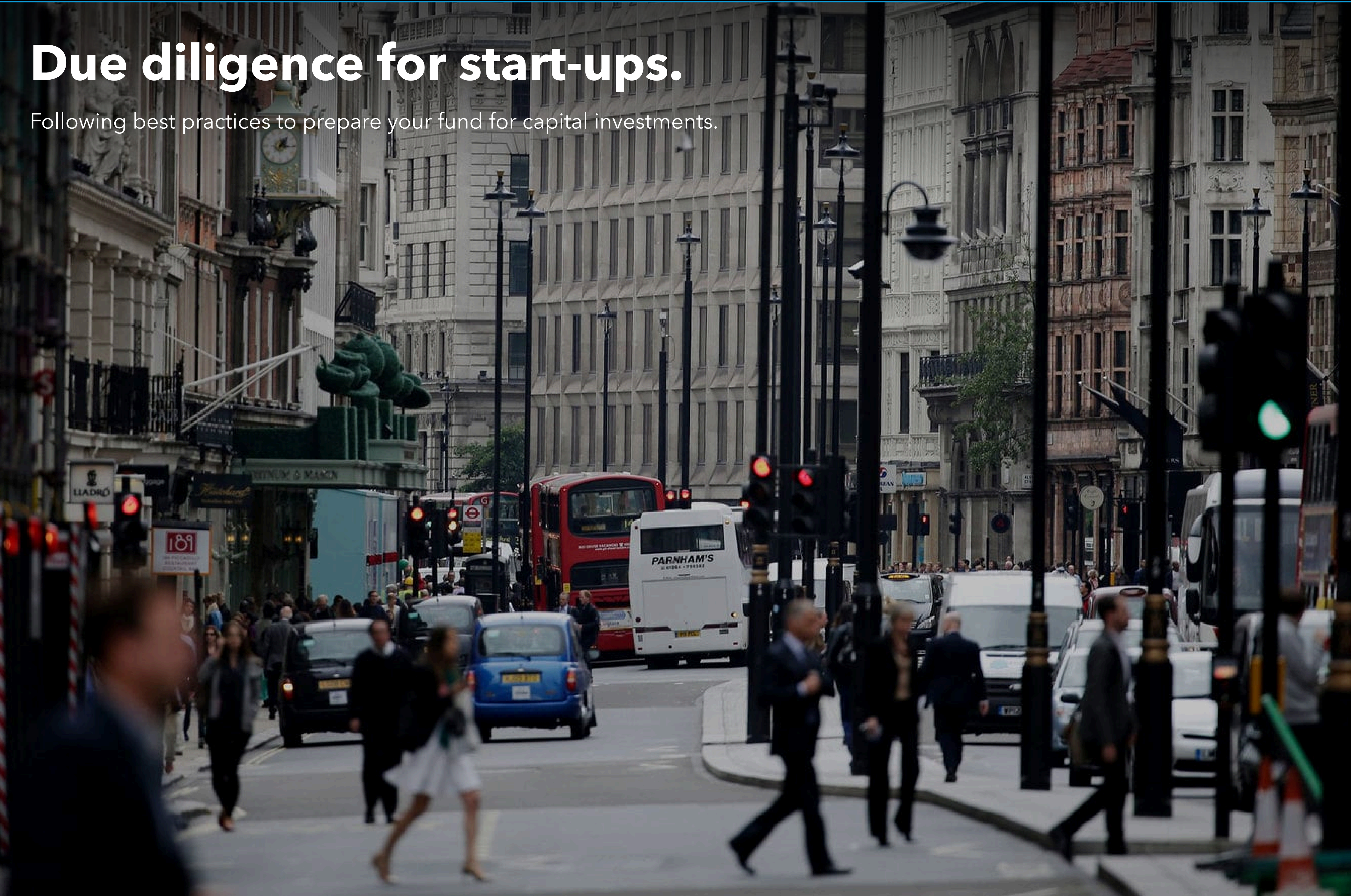
Due diligence for start-ups.

Following best practices to prepare your fund for capital investments.



Tom Kehoe, Global Head of Research and Communications, AIMA.

Understanding the due diligence process and following industry best practices are vital to prepare your fund for capital investment by institutional investors.

Main takeaways:

Today's alternative asset managers cannot afford to fall behind in their industry practice and need to make the due diligence process as easy as possible for potential investors. This is especially true for emerging and start-up managers.

What is due diligence for start-ups?

Although anyone thinking about investing in a start-up is likely to have a reasonable appetite for risk, prospective investors are unlikely to want to commit their capital investment to an entity that has an unnecessary exposure to risk.

Due diligence is the vetting process that everyone should perform before they make a new investment. This is true whether you are considering buying a car or a house to name just two everyday examples. Similarly, an investor will carry out due diligence where it might involve evaluating a potential fund investment or appraising an existing one.

Now, more than ever, to give your fund the best chance to receive fresh capital investment from institutional investors or retain an existing institutional investor's interest in your business, alternative asset managers must be able to highlight the strengths of their investment process and operational infrastructure.

Why is it important to your fund?

Different types of institutional investors may have different reasons for carrying out due diligence on a fund. These may range from wanting to better understand the investment process (for example, the rationale of the fund manager for a decision to make an investment), through to having an intimate understanding of the valuation process of the assets invested in the fund portfolio (as they may be extremely sensitive to valuation or counterparty risk associated with the same).

Others may want to have a thorough understanding of the nuts and bolts supporting the operational and organizational infrastructure of the fund itself to ensure that there are no weaknesses.

Start-ups and emerging alternative asset managers entering an increasingly competitive marketplace need to demonstrate to investors how they stand out from their peers, both in terms

The investor demographic of the alternative asset management industry is becoming increasingly heterogeneous, making the process of due diligence more complex and sophisticated.

of their investment and operations process.

Following industry sound practices in operations and the management of the business at the initial launch can help meet the demands of the current market and set the business apart when marketing to potential investors. Larger institutional investors are often beholden to the public or policy makers.

As a minimum requirement, they expect any managers in which they invest to adhere to industry standards. Such investors usually conduct months or, in some cases, years of due diligence before deciding to make an allocation.

Today's alternative asset managers cannot afford to fall behind in their industry practice and need to make the due diligence process as easy as possible for potential investors. This is especially true for emerging and start-up managers.

What are the hurdles managers face?

The process of sorting through all the legal and regulatory requirements for both establishing and managing an alternative investment fund is arguably one of the most time-consuming and daunting tasks for a would-be fund manager.

Investors are continuously on the lookout for any deviations (unwitting or otherwise) from industry practice: You do not want your fund to be the outlier when it comes to, say, sound industry practices when carrying out cybersecurity at your firm.

At a time when competition for assets is fierce, even the smallest quirk in your fund's management or operations could be enough to have you struck from an investor's list, or not even make it onto their list in the first instance.

Without taking the time to understand the goals and resources of each investor when performing a due diligence review, many alternative investment funds fail by either providing too much or too little relevant information to them.

It has often been observed that start-up and emerging fund managers place too much emphasis on managing their investment portfolio, but not enough on managing their business.

These pressures are particularly acute for prospective managers looking to establish themselves. Many of them will not have a long performance track record for their fund or will still be managing a relatively small amount of assets. Others might be pursuing a niche investment approach.

All of these are likely to attract intense scrutiny from a prospective institutional investor. The rigors of the due diligence process, combined with the increased competition for capital investment, means that firms have every incentive to smooth the due diligence process for potential institutional investors.

How can these hurdles be overcome?

Emerging managers can cope with these pressures by doing two things, they can adopt industry sound practices whenever and wherever possible to reassure existing and prospective investors that they are meeting their expectations. Or, they can use industry accepted due diligence questionnaires to allow investors to easily collate and compare the due diligence information that they gather on their investments.

The importance of due diligence and sound practices is widely recognized by industry bodies such as the AIMA, which provides tools to assist investors when selecting or appraising an alternative asset manager for their portfolio.

Alternative Investment Management Association (AIMA) first produced its hedge fund manager due diligence questionnaire (DDQ) 21 years ago in response to investor requests for a standardized questionnaire to help them compare various submissions regarding RFP from multiple asset managers.

Last year the template was substantially updated to cover the investment managers' governance, operations and risk management processes – a reflection of the expanded due diligence process being undertaken by investors.

While such questionnaires can help you prepare your firm for due diligence requests from existing or prospective investors, it is important that they be used to support your due diligence process, not replace it. Investors can use the information gleaned from managers who complete the DDQ to develop areas of focus for further questions and discussion with managers.

Industry bodies can also support alternative asset managers trying to identify what constitutes industry sound practice. AIMA's comprehensive resources include its Guides to Sound Practices, produced by its sound practices committee, which includes representatives from different organizations and countries across the world; including leading law firms, accountancy firms, alternative asset managers, prime brokers, fund service providers, fund directors and investors.

By drawing on up-to-date industry expertise, start-ups can implement sound business practices and due diligence processes, ensure they comply with new regulations affecting their business, and give themselves every chance of success when seeking capital investment.

About the contributor

Tom Kehoe is AIMA's global head of research and communications. In this capacity he has authored over 50 research and thought leadership pieces, and these have been mentioned widely across the trade and business press as well as commented on radio and TV. Tom has been involved with hedge funds for 14 years and is a Chartered Alternative Investment Analyst member.

To learn more about AIMA's Due Diligence Questionnaires and Guides to Sound Practice, visit AIMA.org or email info@aima.org

Routes to the market place.

What start-up hedge funds need to know about raising capital.

By Kevin Packford, Head of Business Development, Engadine Partners LLP.

The hedge fund management industry continually evolves and changes. As Sir Paul Ruddock, founder of Lansdowne Partners, once noted, these changes are most often driven by one of two forces – regulators or investors.

Main takeaways:

1. The hedge fund industry has two routes to market for the aspiring manager – via a platform or as a sole entity.
2. You need to build a team with core competencies around investment, operations and client service. The most important aspect a seasoned investor assesses is human capital.

What routes are available to aspiring managers?

Platform vs sole entity

With barriers to entry steadily rising in recent years, the hedge fund industry has become bifurcated into two routes to market for the aspiring manager – either via:

- A platform, where operational infrastructure, regulatory registration and compliance oversight are provided for the individual portfolio manager.
- As a sole entity, where the portfolio manager is not just captain of a portfolio, but is also responsible for building a firm with its own infrastructure, identity and culture.

Reaching out on your own requires an entrepreneurial spirit – and plenty of working capital.

Typically, this capital comes in the form of wealth built in a prior role by the manager or via a "seed" deal with an external investor.

If you choose the latter route, pursuing a specialized seeding deal (Blackstone Alternative Asset Management, Goldman Sachs Asset Management, Reservoir Capital and Stable Asset Management, among others, are active parties in the space) comes with benefits and caveats.

In addition to providing working capital for the management entity, seeders can be sizable day one investors into the fund itself, which ensures a critical mass to the venture and increases chances of success.

However, many seed deals do not typically achieve an "alignment of interests" between the general partner (GP) and the limited partner (LP), because the deal tends to favor the seeder as opposed to future LPs that invest at a later stage.

For this reason, some investors tend to avoid managers that have secured a seed deal.

Your fund may also be expected to make concessions in fee structure for the seeder. However, most seeders do not take a fee discount in the fund because doing so can create most-favored nation (MFN) issues for the manager in the future.

Instead, seeders may structure a deal to receive a revenue share of GP income, which effectively reduces the seed investor's fee load without legally triggering MFN issues within the funds. Finally, keep in mind that very few start-ups (less than 5%) receive seed capital.

If the seeding avenue fits your goals, the process can take anywhere from six to eighteen months to complete. The specific steps in the process vary per seeder, but expect to undergo thorough investment due diligence (IDD) and operational due diligence (ODD).

If you chose to start your own firm, you will need to build a team with core competencies around the three functional business units within all hedge fund management companies – investment, operations and client service.

Once your core team and service providers are in place, the next phase of starting a hedge fund involves raising capital. Navigating this experience can be more challenging than it seems, often because it requires skills that have very little to do with finance.

People and culture come first, product comes second

The most important aspect a seasoned investor assesses when looking at a new proposal is not the strategy nor the terms and conditions, it's the human capital.

"Ultimately, your value proposition is always people," said Kevin Packford, Head of Business Development for Engadine Partners LLP. "Investors will assess ability across the three verticals of investment, operations and client service. Does the investment team have pedigree and intellectual skill, do they exercise good emotional judgment? Does the operations team have the right experience to effectively manage legal, finance, compliance, as well as ensuring the middle and back office that support the investment team run smoothly on a daily basis? Does the client-facing team operate in a responsive, transparent, open and trustworthy fashion?"

The best investors – the top decile of hedge fund investors who consistently underwrite exceptional managers across a wide range of strategies – assess the people in the firm long before considering anything else.

> **"The failure rate for hedge funds is high – poor performance is often cited as the reason, but history shows us that even funds with good performance fail and tend to do so for personnel reasons."**
>
> Kevin Packford, Head of Business Development, Engadine Partners LLP

"Experienced investors spend their initial due diligence figuring out the people, as they understand the initial risk is business risk. Once business risk is assessed, then an assessment of the strategy can be undertaken," Packford said.

Many investors want to see that there are “alignment of interests.” This term most often refers to fee structures, however, it more broadly refers to the manager providing access, transparency, and operating with culture that ensures an investor’s interests are not subjugated to the managers.

Once investors have understood the business risk and assessed a manager’s skill, they will also need reassurance that the CIO is committed for the long term.

“Long-term investors want to understand your motive,” Packford said. “Some of the best track records in the industry have been created by managers who are very modest, live very simple lives and do not allow the financial benefits of success to distract them from the core requirement to compound client capital. Passion, curiosity, focus, intellectual honesty – these are observable and measurable human traits that are the soft factors behind alpha generation.”

Preparing the message

It is important to conduct market research to understand who your peers are and how your business, strategy, and product offering compare in terms of returns, volatility, gross and net exposure, and fees. This phase can be quite extensive but will eventually result in a more attractive product.

“In the four months prior to launch, we conducted more than 130 investor meetings,” Packford said. “Whilst we articulated a clear business plan and fund strategy, when it came to terms and fees, we didn’t dictate, we asked investors what was appropriate for the business we were developing. The feedback we got was direct, relevant, and actionable. Hence, we arrived at a term structure for the product that was completely appropriate as it was formulated from direct investor feedback. As a result, we’ve never had to negotiate on fees. Good investors are not focused on low fees, they are focused on fairness – the split of performance received by the investor vs. taken by the manager. If the investor is not getting at least 70% of the returns generated, the fee structure of the fund is likely wrong.”

Knowing your own proposal inside out is important, but so is knowing who you are speaking to.

Additional resources on alignment of interest

Several organizations have written extensively on the topic:

- Alignment of Interests Association
- Alternative Investment Management Association
- Standards Board for Alternative Investments

Packford said, “Before we contact a potential client, our priority is to undertake research from both public and private sources, to understand what the investor is looking to achieve, understand how they think, and get visibility on their track record of underwriting managers who deliver exceptional performance over the long term.

We look to build a partnership with our clients that is relational, not transactional. It is essential to understand that many investors have a responsibility, which has a very real social impact – for endowments and foundations, that responsibility may be to fund scholarships for underprivileged students, or it may be to fund research into cancer treatments.

These investors are selecting managers to deliver returns that help them achieve these aims. It’s a tremendous responsibility and privilege to run client capital and a manager should never lose sight of that reality.

Once we have a clear picture of what the investor requires, then we are able to clearly assess whether our people, our culture and our skills are relevant to help that investor achieve their aims.”

Delivering the message

Investors will expect to spend time with the investment team and CIO, but much of the heavy lifting of delivering the message should already have occurred by the time those meetings take place. Ultimately it is the responsibility of the client-facing function of the firm to source the right clients, field questions and ensure that the investment team is spending the vast majority of its time investing.

Packford said: “One mistake I see new managers make is failing to appreciate the time cost of sourcing and servicing high-quality client capital."

He continued, "Whilst it’s essential for the CIO to meet investors, there has to be a limit. On average, it takes 30+ hours of my time to work with an investor from initial contact to investment allocation, when you include all the questions via email, conference calls, face-to-face meetings, etc.

> **"Time is a scarce commodity and good investors want to see a manager spending his time and energy running capital, not sitting in a meeting room."**
>
> Kevin Packford, Head of Business Development, Engadine Partners LLP

It’s a red flag to investors if they see a CIO spend a disproportionate amount of time marketing vs. running money.”

If the message (content) is valid, the context (delivery) is equally important. Many good proposals have failed because of bad manners or poor preparation.

How do start-ups find the right prospects if they elect not to have a client function internally? There are a variety of routes to pursue, including:

- Introductions from prime brokers.
- Capital introduction conferences.
- Previous investors (as long as non-solicit

restrictions are not in play).

- Third-party marketers who make calls and set up meetings on your behalf.
- Online databases and client lists that can be purchased.

And, as Packford noted, having a marketing function is not always necessary, depending on the goals of the firm.

“There is a manager who started on their own with $2 million in their fund. The strategy was niche and capacity constrained to about $100 million. For three years, the fund compounded in the high teens. The firm did no marketing and met with no investors, just focused on building a world-class track record.

And then, after three years, they were approached by a U.S. endowment who’d seen the firm’s name on the shareholder register of a public company they had been tracking. After extensive due diligence, the endowment invested, taking all the remaining capacity in the fund and is the only external investor.

It’s a win/win for both the investor, who continues to get exceptional returns, and for the manager, who has a very profitable business with a small team, where all the operational infrastructure is outsourced to reliable third-party providers.

> **"The lesson is that if you really are good enough, the best investors will find you, no matter how modest your AUM ambitions."**
> Kevin Packford, Head of Business Development, Engadine Partners LLP

Dealing with operational due diligence

Investors perform varying levels of operational due diligence (ODD) on the management company and the fund to ensure that all staffing, systems, processes and controls are valid for the business and strategy. For some investors, ODD involves a single meeting or phone call, while the most thorough will spend dozens of hours liaising with managers to complete a variety of written forms before they conduct an on-site visit that can last a full day.

Investors will want to go through the business in a lot of detail, and the process can be intense. Topics covered during ODD include:

- The legal structure of the business
- Roles and responsibilities
- Internal controls
- Systems
- Execution
- Settlement
- Reconciliation

- Cash management
- NAV computation
- Valuation
- IT
- Cybersecurity
- Business continuity
- Compliance and regulation

All ODD meetings also include a discussion of all service providers and the investor will contact and assess each of the vendors a manager uses. The details matter a great deal, according to Packford. "Ultimately, investors want to see that the business is properly positioned and resourced to achieve its goals and that the vendors are appropriate."

About the contributor

Kevin Packford is Head of Business Development, a member of the Management Committee and a Partner at Engadine Partners LLP, an alternative investment manager (hedge fund) running a Europe-focused long/short equity strategy on behalf of institutional investors.

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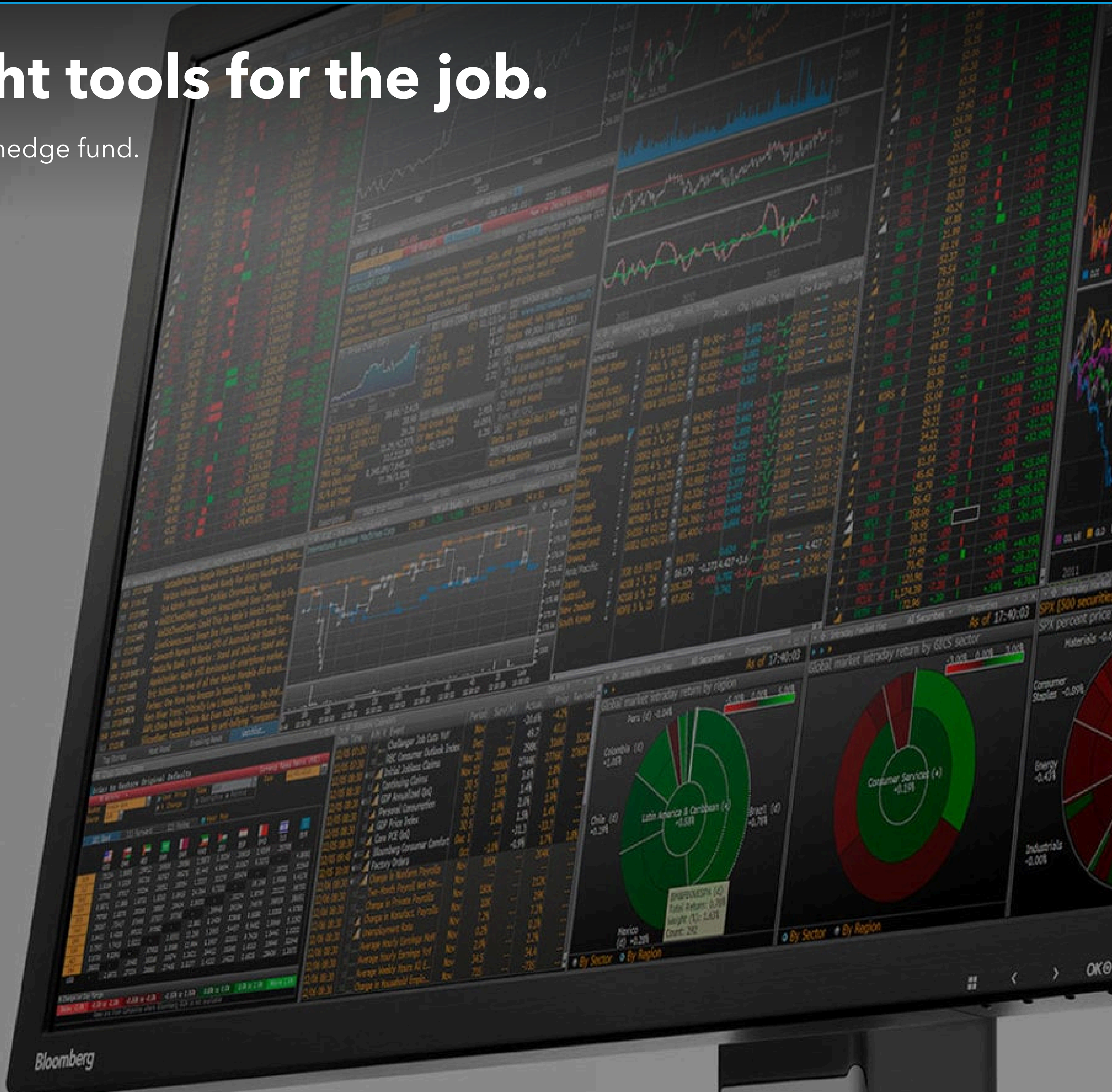
Choosing the right tools for the job.

Find the best technology to power your hedge fund.



The complete hedge-fund workflow

To compete with the top funds you need more than an inspired strategy – you need the right technology powering your asset management. At Bloomberg we employ 5,000 engineers dedicated to building new solutions, pioneering the use of new technology like machine learning, to solve problems unique to financial markets. Our commitment to staying ahead of the competition is exactly the same as yours. That's why we've built solutions, integrated on the Bloomberg Terminal, that connect the full hedge-fund workflow – seamlessly and completely – leaving you to focus on seeking alpha.

Portfolio management

Analytics
Decision support
Position management
Risk management

Trading

Order management
Electronic trading & execution
Multi-asset coverage
Multi-venue access

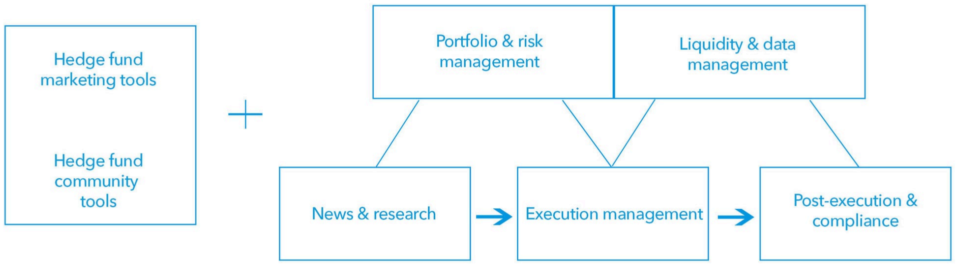
Compliance

Regulatory requirements
Investment & internal guidelines
Flexible template based rule construction
Centralized surveillance

Operations

Allocation & matching
Multi-asset trade settlement
Real-time connectivity & integration
Reconciliation
Trusted data

Bloomberg's Hedge Fund Solutions



Hedge Fund Start-up Guide