

FOCUS ON

# SMALL AND START-UP FUNDS

As more investors open up to the performance potential of smaller firms, *HFMWeek* talks to Custom House, IMS Group and Maxim Group about the strategies such funds can employ to ensure that they not only attract the necessary seed capital, but achieve the deftness and solid infrastructure necessary to flourish in a competitive capital-raising environment



## Dermot Butler

is chairman of Custom House Group. He is a frequent commentator, author and conference speaker on numerous aspects of alternative investing and assets servicing, a director of several fund companies and previous deputy chairman of the Alternative Investment Management Association (Aima).



## Jonathan Currie

is managing consultant of the Regulatory Transactions Team at The IMS Group. He has over 15 years' experience in compliance of the financial services industry, including assisting hedge funds in FSA authorisation, general compliance support and compliance monitoring.



## Steven Simmons

is head of prime services for Maxim Group, a full service broker dealer and investment bank. A 20-year industry veteran, Simmons was a 2009 recipient of *HFMWeek's* award for best capital introduction programme for small prime brokers.

**Q** **HFMWEEK (HFM): HOW CAN YOUR COMPANY HELP NEW HEDGE FUND BUSINESSES? WILL 2011 BE A GOOD YEAR FOR NEW FUNDS?**

**A** **DERMOT BUTLER (DB):** Since 2008 it has been increasingly difficult for start-up hedge funds to raise seed capital as institutional investors are not interested in funds of \$100m AuM. There has been a noticeable rekindling of interest in hedge funds by private high-net-worth investors and family offices, but it is likely that small start-up hedge fund managers are going to have to rely on 'family and friends financing.' With this in mind, we established the Nascent Fund as a Sicav in Malta and are in the final stages of introducing a US version of the Nascent Fund for US domestic investors.

The Nascent Fund is designed to enable start-up managers to establish a fund on a platform for a relatively small amount of capital and to operate that fund at reduced operational costs for a period of up to two years, after which the manager will set up his

own stand-alone fund and leave the Nascent umbrella platform.

I anticipate that 2011 will be a good year for new funds, as investors become more interested in hedge funds because of their performance, consistency and positive risk-profile.

**A** **JONATHAN CURRIE (JC):** We are a key go-to point for hedge fund managers who want to start up, as we assist firms in the asset management and securities industry, predominantly hedge funds, who want to obtain FSA and/or SEC authorisation. We have assisted thousands of firms in achieving FSA authorisation as we have the only specialist team in the UK dedicated solely to FSA applications. We also can help firms obtain SEC and/or dual registration through our New York office and in-house SEC expertise in London.

We help hedge funds before they become authorised businesses by allowing fund managers and advisors to use our hosted regulatory permissions under Mirabella Financial Services, which is authorised by the FSA. Firms can quickly operate under this regulatory licence, raising funds and, in some cases, managing them as well. This can be an excellent springboard for the application process as the hosted solution can run in tandem to the FSA application. Also, as part of the application process, we work hard with clients to make sure their operational and compliance infrastructure is in place when authorisation is achieved. We then continue to work with them on an ongoing basis by assisting them with their compliance needs.

We think that 2011 will be an excellent year for new funds as we are seeing a greater number of high-quality launches this year than of late and an unprecedented number of enquiries by managers wanting to use our start-up services.

**A** **STEVEN SIMMONS (SS):** Maxim Group LLC is a full service broker dealer, investment bank and prime broker that is uniquely focused upon the needs of smaller and middle-tier managers. We can level the playing field for funds by offering not only a robust capital introduction programme, but also highly regarded proprietary research and investment banking – the kind of services not typically afforded to these managers by the larger shops, and services that many other boutiques do not offer. With many institutional investors looking at 2011 as a banner year for investments in up-and-coming managers, Maxim Group is uniquely positioned to support these funds on numerous levels, allowing the funds to focus on their most important activity – creating alpha.

**Q** **HFM: HOW CAN SMALLER FUNDS MAKE AN IMPACT ON THE INDUSTRY?**

**A** **DB:** By producing steady, consistent returns and outperforming their peers, including larger managers utilising a similar strategy. This is difficult with a small amount of capital, because the overheads eat into returns, but nevertheless it is important that the returns should be above average, but no more. Lots of investors are nervous about stellar returns and take much more comfort in investing with managers who are consistently in the top quartile, but not necessarily at the very top of the pile.

**A** JC: There are far more smaller funds launching now than there were a few years ago. Smaller funds often find it hard to gather assets beyond their seeding amounts and so they need to do something to stand out from the crowd to succeed. Performance still sells and managers who have a strong performance track record will often succeed where a lesser-known name colleague will fail to gain traction. A smaller fund can make an impact though, by developing niche strategies and by innovating in areas that may be sub-optimal for funds that need to deploy larger amounts of capital. Smaller funds can also be fleet of foot, because the key decision makers are closer to the investment management process. They need employ high-quality service providers to give investor confidence in their controls. Of the smaller firms that we work with, they are typically niche specialist boutiques.

**A** SS: Without the bloated infrastructure of the larger firms, boutiques like Maxim Group have the opportunity to really understand the fund's underlying requirements, allowing us to provide custom-tailored solutions for their needs. This is especially important to the smaller and middle-tier funds who typically suffer from a lack of attention during the most critical stage of their growth. From front- to back-office, our clients always have a team dedicated to them, which is especially important as these funds are relying heavily on their service providers to help establish an institutional calibre infrastructure.

**Q** HFM: WHERE WILL THE INVESTMENT FOR START-UPS COME FROM? HOW CAN THESE BUSINESSES ATTRACT SEED CAPITAL?

**A** DB: Institutions will not invest in a fund worth less than \$100m and today a manager will find it very difficult to get to \$100m without the support of institutional investors. The reluctance to support the start-up manager is often based on the lack of a track record. There are some companies that are prepared to put up seed capital in exchange for a slice of the manager, which can be an expensive solution for the manager in the long run, but 75-80% of a large pie is very much better than 100% of an uneconomic, small pie. The alternative is raising capital from family and friends and for those people we stand by with Nascent.

**A** JC: The traditional sources of investment remain the same as they have ever been: high-net-worths, fund of hedge funds, and entrepreneurs etc. The industry also recognises star fund managers' performance and will reward previous success with seed investment. A track record accounts for everything in this industry and once beyond \$100m pension funds and institutions tend to take an interest.

**A** SS: There are a few key trends in 2011. Firstly, competition for seed and early-stage capital has never been greater, especially given the solid number of new launches with excellent pedigrees. Secondly, we have never seen such strong investor appetite for the smaller and middle-tier managers. Because of this, it has never been more important for managers to carefully craft a consistent message which they can convey concisely to investors. Their marketing plan



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NICHE STRATEGIES CAN WORK BETTER AT SMALLER CAPACITY BY BREAKING AWAY FROM THE CROWD AND DOING SOMETHING DIFFERENT THAT CAN GIVE INVESTORS A BETTER CHANCE OF RETURN  
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JASON SCHARFMAN, CORGENTUM CONSULTING

must be multi-faceted, including relying on their key service providers to refine their message and help spread it in terms of capital introduction. Now is not the time for service providers to be a bunch of cheerleaders or sycophants; our role should be that of devil's advocate and helping the funds navigate the potential minefields of the capital introduction / capital-raising world. At the same time, funds need to be tireless in their promotion, and need to recognise that the capital-raising cycle is longer than ever, which is one reason the funds need to also demonstrate their ability to strive and thrive while they are actively fund raising.

**Q** HFM: WHY SHOULD INVESTORS CHOOSE A START-UP OVER A LARGER, MORE ESTABLISHED FUND?

**A** DB: There is a widely held belief that start-up managers make more money, providing they don't fold in the first three years of their lives, than the



larger established managers. There are exceptions to this rule (Paulson, Bridgewater, Winton), but investors that believe this will often choose start-up managers in preference to the larger, more established funds, because they expect to get more out of them in the short term.

Additionally, the bigger you are, the more limited your scope. Larger managers have to concentrate on investment strategies in highly liquid assets if they are not to become too big for the market and hit the capacity wall. Smaller managers can chase inefficiencies in relatively small sectors of the market, which would be smothered by the larger players.

**A** **JC:** It is about the focus you get from smaller funds; start-ups are more focused on fundamentals. Niche strategies can work better at smaller capacity by breaking away from the crowd and doing something different that can give investors a better chance of return. Also, the way support services have developed means that smaller managers are now able to achieve a higher quality control framework that previously was only available to larger firms. If you combine excellent performance with a control framework, smaller managers now have very few disadvantages over larger more established hedge funds.

**A** **SS:** Smaller funds are typically much more nimble and focused upon creating alpha, as opposed to the larger funds, who are typically more concerned with retaining management fees. Numerous studies have shown smaller funds outperforming their relevant benchmarks over the first three years of a fund's life. The same train of thought applies to boutique service providers versus their larger counterparts. Boutique

firms are more inclined to provide better customer support and to be more responsive to the client's needs and less 'revenue driven'. Additionally, it is incumbent on the boutique service provider to offer a robust suite of services that can handle the various needs of the client. Our goal at Maxim Group is to build out a mutually beneficial relationship with our clients, so as they grow, we become a partner in their growth.

**Q** **HFM: HOW WILL ON-GOING REGULATORY CHANGE AFFECT START-UPS AND HOW CAN A SMALL FUND PRODUCE WORLD-CLASS OPERATIONAL STANDARDS?**

**A** **DB:** A noticeable trend over the past three years or so has been the outsourcing of a lot of the internal administration functions of managers, such as Anti money laundering (AML), accounting and compliance. Today, administrators are becoming more involved in fulfilling middle-office accounting functions for the manager, producing reports on behalf of the manager that comply with their regulatory requirements, carrying out all AML functions and generally enabling a small fund to produce world-class operational standards. It is clear that administrators (and auditors), will be instrumental in ensuring that both the manager and the fund complies with ongoing regulatory changes as they occur.

**A** **JC:** Global regulatory standards are continually evolving at a rapid pace, meaning that smaller firms will now not only have more obligations in their home state but also internationally. Examples of this include dual registration and expanding market disclosures across multiple jurisdictions. The first thing a start-up should do is hire an experienced COO. Investors demand the independence that a COO brings and like to see a split in responsibilities between portfolio managers and the control framework. They expect the COO to invest in high-quality technology and outsourced service providers, so that portfolio managers can focus on trading, while retaining overall control of operational risk. In Europe of course, independent fund administration is now standard, with objective fund valuation. Increasingly, we are seeing independent risk oversight as a requirement providing a challenge to the portfolio managers and supporting the fund directors.

**A** **SS:** This has been the biggest Catch-22 for small funds – without enough assets under management, they cannot build out the proper infrastructure; without the proper infrastructure, they cannot attract significant capital. Now more than ever, funds have to focus on the actual business of running the fund. As much as institutional investors want to put money to work, they need to mitigate risk in all forms, and poor infrastructure is the easiest way to ensure no asset inflows. Reputable, recognised service providers, institutional-calibre infrastructure, and a strong attention to the proper marketing and consistent conveyance of the fund's mission, is a very strong start. Boutique service providers like Maxim Group must offer a full suite of cost-effective services to be competitive among their larger peers; from an infrastructure and operations perspective, the ability to grow and keep pace as their underlying clients grow, is paramount to their success within the industry. ■