MercenaryTrader

Premium Report:

OPM 101: The Mercenary Hedge Fund Startup Guide

OPM 101: The Mercenary Hedge Fund Startup Guide

Table of Contents

OPM 101: The Mercenary Hedge Fund Startup Guide

…running a hedge fund can be an incredibly lucrative pursuit.

But first you have to start it…

For traders who have worked hard to hone their skill and create a successful trading program, running your own hedge fund can be an incredibly lucrative pursuit.

But of course, first you have to start it…

Consider the opportunity to trade for a living, generating attractive returns for your account as well as investors in your fund; and to participate in your investors' returns by collecting a percentage of their profits yourself.

If you truly are a successful trader, **starting a hedge fund is truly the best way to leverage your skill.**

For the sake of example, let's hypothetically assume you manage a fund with $2 million in outside assets, charging the standard 2% management fee and 20% incentive fee – and you are able to generate a gain of 20% in your first year.

In this case, your management fee and incentive allocation would amount to $120,000 in revenue. $40,000 would come from your 2% management fee, with $80,000 representing your portion of the capital gains.

And that's on top of the gains you are generating on your own capital.

Grow your fund to $10 million and the revenue gets closer to $600,000. And of course if you get a few institutional investors and beef up your fund to $25 million in assets, the profits grow exponentially.

… there are significant tax advantages to running a hedge fund.

The revenue model for managing a hedge fund is attractive enough on the surface, but dig a little deeper and you'll find there are also significant tax advantages to generating income by starting your own hedge fund.

Since the incentive fees are technically "allocations" of profit to your account, this capital is not categorized as ordinary income.

You – the hedge fund manager – are receiving an *allocation* of P&L from the fund, so that income is typically recorded under the capital gains category – and depending on your trading strategy, may be deferred or even booked as long-term gains.

Bottom line: If you're a successful trader; if you know how to generate profits from the markets; if you understand risk management and have confidence in your methodology; then **you should consider starting your own hedge fund**.

You must know how to start, manage, and grow from a business perspective.

Sure, not every great trader can be a successful hedge fund manager. To successfully run a fund, you have to not only trade well, but you have to know how to start, manage, and grow from a business perspective**.**

That's where we come in. We've been down this road. We've helped colleagues get off the ground, and we understand what it takes to get your fund up and running.

There is a systematic way of creating and growing a fund. A process, if you will, for taking a great trading program – and making it into a great business. That's what this report is all about: Creating a step-by-step guide to opening, managing, and growing your very own hedge fund.

So let's lay out the basic game plan and then we'll fill in the details along the way…

A Quick Word Regarding Methodology

You must know where your edge is, and be able to capitalize on it…

Of course, to have any success in trading (for a personal account or for outside investors), you need to have a well-defined methodology. Your approach to markets needs to be both profitable and repeatable. You need to know where your edge is, and be able to capitalize on that edge regularly.

You must be an excellent manager of risk, or you will not be in business for long. **Embarking on the course of launching a hedge fund assumes that you are already successful in your trading or investment approach**.

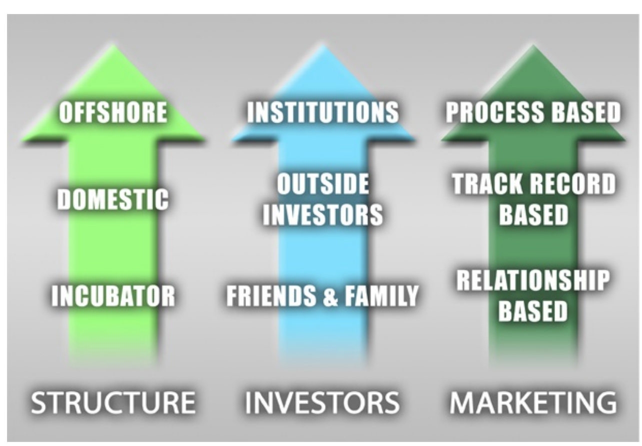
The issue of refining your methodology is another conversation altogether. We're assuming that you already know how to trade profitably and that is why you are interested in starting a hedge fund.

Anatomy Of A Hedge Fund

The term "hedge fund" covers a very wide range of operations… From individual traders managing capital for a few close associates, to multi-billion dollar funds operating on multiple continents. Hedge funds can manage publicly traded equities, derivatives, commodities, illiquid assets, intellectual property, or any number of "investable vehicles."

You're already familiar with the countless different investment approaches these funds can have. But what you may not realize is that the internal architecture can differ greatly from fund to fund.

…the internal architecture can differ greatly from fund to fund.



As you build out your new fund, it's important to understand the basic concepts behind how your fund will be structured, what type of investors you will be pursuing, and exactly how you will be marketing this fund…

Structure:

As an aspiring hedge fund manager, one of the first things you'll have to decide is how to legally structure your business.

In the world of hedge fund formation, "complexity" is synonymous with "expensive." Since you're going to want to keep as much of your capital as possible *in your trading account*, the key is to get your fund up and running in the most simple, efficient manner possible.

We'll cover the different structure choices you have available to you, identify which structures are advantageous for each stage of the business, and offer some guidance as to how to streamline the legal / regulatory process.

Investors:

…the key is to get up and running in the most simple, efficient manner possible.

Assuming you don't have $100 million committed from one of your Goldman Sachs buddies (*would you be reading this report if you did?*), you're going to need to solicit new investors for your fund.

While every hedge fund manager dreams of the 8-figure allocation from a pension fund or endowment, it's difficult to arrange that investment without already having a significant level of assets already in your fund.

This report will cover the traditional hierarchy of capital raising, along with some non-traditional routes for leapfrogging the tedious part of the process and moving quickly into the institutional realm of capital raising.

Marketing:

Your marketing will be most effective if it is tailored to the other two parts of your fund (your current structure, and your target investor). Depending on *who* you are marketing to, you will want to emphasize different key aspects of your fund – which also relate directly to the way your business is structured.

For example: Retail investors are much more relationship based, with an appreciation for a figurehead and strong personality at the helm. Institutional investors, on the other hand are more interested in the process, the metrics, and the operational aspects of your business.

You will want to emphasize different aspects, depending on who you're marketing to…

Adjusting marketing materials, and organizing presentations that address the key points your prospects are interested in can be the difference between a "*we'll keep in touch*" response, and a wire transfer directly into your fund.

Let's get started by breaking down these categories one by one, beginning with a conversation about your initial fund structure.

Begin By Creating An Incubator Fund

One of the most cost-effective and operationally efficient ways to begin your journey as a hedge fund manager is to start with an incubator fund.

One of the most cost-effective ways to begin is with an incubator fund.

An incubator fund has the basic framework of a fully functioning hedge fund, without the expensive offering documents and overhead items you will need for accepting outside capital.

Essentially, an incubator fund allows you to create a professional track record which you will then use to market to outside investors.

The cost of an incubator fund is only a fraction of the typical investment required to set up a full-fledged hedge fund.

The cost of an incubator fund is only a fraction of a full-fledged hedge fund.

From a logistical perspective, you can manage your trading or investment program just as you eventually will do for your full-fledged hedge fund. Even the legal entities are exactly the same (more on this shortly).

The only difference between an incubator fund and a full-fledged hedge fund **is the ability to accept outside capital and charge management & incentive fees.**

The incubator fund allows you to create a professional track, fully presentable track record at much lower cost.

Managers use incubator funds to **create a professional track record while soliciting interest** in the *actual* fund investors will be placing capital into. The key advantage is that **the manager doesn't have to make the material investment of opening a full-fledged fund** until he has received actual indications of interest from legitimate investors.

The idea of starting with an incubator fund is similar to the decision most managers will make for their initial office space.

Of course everyone *wants* to have the swank office digs on the 42nd floor with floor-to-ceiling windows and an incredible city skyline view. And you can even make a legitimate argument for the benefits of these digs (*client meetings, psychological equity, focus etc.*).

But you probably shouldn't start your business paying $6k per month for a posh office when you can get by for the first year or two subletting space for a fraction of the cost.

When starting your hedge fund, **it can similarly be a wasteful use of capital to roll out all the expenses associated with starting a full-fledged fund**, when it is going to take some time to develop a track record and begin networking with prospective investors.

…don't spend capital where you don't have to, before you need to spend it!

Once you have a 6-12 month track record, and a few key investors willing to put capital into your fund, then it makes a lot more sense to take some of your capital to open the fund to outside investors.

Logistics of an Incubator Fund

When you establish your fund, there are two key entities that must be created:

- **A Management Company** – As the name implies, the management company is the managing entity of the hedge fund. The management company can be owned by an individual or group of individuals and is typically a Limited Liability Corporation (LLC).

- **A Limited Partnership** – The Limited Partnership is truly the "fund" under which the capital will be traded. This Limited Partnership will accept contributions from the limited partners (investors), and gains and losses will compound within this legal entity.

Establishing these legal entities gives you a chance to build a legitimate track record that can be audited and presented to prospective investors.

...you need to establish your track record within a true professional legal entity.

It's important to note that you need to establish your track record within a true professional legal entity. Generating strong returns in a personal trading account may be helpful in verifying your methodology, **but there are very few investors who will put money in your fund based on a non-professional account**.

So if you generate excellent trading profits, but the returns are not in a legitimate investment entity, **your track record is essentially wasted**.

Unfortunately, no one really cares. You simply can't use the track record from a personal account to solicit outside investors…

On the other hand, if you go through the expense of creating a full-fledged hedge fund (complete with subscription documents, contracts with service providers, overhead expenses etc.) and have a poor first year, most of your expenses in setting up the fund will be wasted.

Interested in starting your own incubator fund and developing a professional track record? Or maybe you just want to get a little more information before deciding your next course of action.

Opening Traditional Bank Accounts

Once you have established the legal entities, you will want to open a bank account in the name of each entity.

For the management company (LLC), you will typically use a checking account to pay for expenses associated with the fund.

For the actual fund (Limited Partnership), you will use a checking account to receive contributions from investors, and to send distributions back to those investors.

Most brokerages also require the Limited Partnership to have an existing banking account before opening a trading account with the broker / dealer.

Choosing An Appropriate Prime Broker

Once you have the entities established and bank accounts opened, your next step will be to open a brokerage account in the name of the Limited Partnership. This is the account where you will actually trade the capital for your fund.

You will want to **open a Prime Brokerage Account with an institutional quality broker**. This is an important step and you need to carefully consider which brokerage you will use to develop your track record.

…carefully consider which brokerage firm you will use.

Below are some of the key issues you need to evaluate prior to opening the account:

- **Execution costs** – The importance of execution costs will vary depending on your trading approach… If you are an active swing trader with hundreds of transactions per year, low transaction costs will be at the top of your priority list. However, if you are a long-term trader or investor, you might be willing to accept higher transaction costs for other features that will be more beneficial.

- **Direct market access** – As a professional trader, you need to go with a broker that gives you quality execution features. Once again, the importance of your execution quality is determined by the type of trading you will be doing.

  Are you planning on moving large blocks of illiquid stocks? If so, then you need to research what algorithms are available to break up and hide your order size. Are you a quick scalper taking advantage of small price discrepancies? Then you need to make sure your order routing system is quick enough to allow you to hit the bids and asks efficiently and profitably.

- **Margin rates** – If your fund has the ability to use leverage and trade on margin, you will want to make sure that you are guaranteed an attractive margin interest rate. Even though we are currently in a low interest rate environment, brokers still charge a material amount for debit balances. And rates will not stay low forever…

  Negotiating a competitive margin interest rate today can help returns tomorrow.

  Margin interest rates are typically quoted as "Fed funds plus X" – so they will rise when the rate environment changes. Negotiating a competitive margin interest rate today when rates are low has the potential to help your returns significantly over the lifespan of your fund.

- **Rates on free credit balances** – For funds that hold significant balances, or even funds that only occasionally raise high levels of cash, the rate on free credit balances can be a very important factor.

  While today's interest rates are historically low (and you're unlikely to receive much by way of interest income), negotiating an attractive sliding scale attached to Fed funds could give you a healthy advantage once rates rebound. Many prime brokers also offer a "sweep" function that moves your credit balances into a higher-paying money market account automatically.

Remember, the compound effect of a handful of extra basis points each quarter can actually make a big difference in the performance of your fund. Spending a bit of effort to secure a competitive interest rate could actually end up providing enough additional profits to catch the eye of a key institutional investor.

…the compound effect of a few basis points can make a big difference.

- **Short rebate rates** – Long / short funds or trading approaches with a bearish bias need to pay careful attention to short rebate rates. (*When selling stock short, the proceeds from the short-sale are held in a sub-account and have historically generated interest income for managers.*)

  Granted, you are unlikely to receive a positive rate of return on this credit balance in today's environment, but you must read the fine print and ensure that brokers are not charging you a *negative* interest rate on the short credit balance in your account. In an early episode we were horrified to find out that a new account we had opened was charging US money to hold OUR credit balance(!)…

- **Stock lending capabilities** – Active short sellers need to be very careful to choose a broker with a strong short desk.

  Most institutional-grade prime brokers have agreements with retail brokers to give them access to a large pool of individual stock positions. So if you are interested in shorting a particular security, the stock is more likely to be available if they can borrow it from a wider body of both retail and institutional accounts.

  If your fund is an active short seller, it makes sense to have a conversation with the short desk and ask about several individual hard-to-borrow securities. You want to determine not only if the securities are available, but also see whether there is a carry charge or interest rate penalty for holding the short positions.

- **Capital introduction and other services** – Many prime brokers are set up to offer additional services or introductions to emerging managers. It is in the broker's interest to see your fund grow, so a number of prime brokerages offer capital introduction services once they are able to determine that you have a profitable strategy.

  You can also inquire about other services such as technology interfaces, office space, bookkeeping and administrative support. Depending on your fund's size and growth prospects, some prime brokers are willing to go the extra mile to help their clients build critical mass.

…a number of prime brokerages offer capital introduction services..

Negotiation skills can be very helpful when establishing a relationship with your prime broker. Depending on your fund structure, some of these features will be very important, while others may only be a marginal priority.

If your fund is very active, you may push harder for low execution costs, while accepting slightly less competitive interest rates. If you typically carry a high level of short exposure, the stock loan desk and short rebate categories will be particularly important.

In short, you need a **professional grade trading and brokerage platform**.

Building a fund track record while trading on a Schwab or ETrade platform doesn't only compromise your market access and execution costs, but it also sends the wrong message to prospective investors when you explain who you clear through.

Capitalizing Your Fund

If you need guidance in finding and selecting a Prime Broker, we can help…

The process for capitalizing your incubator fund is simple once you have the proper accounts opened. The investor(s) contribute to the fund by depositing capital (via check or wire) into the bank account for the Limited Partnership.

The majority of the capital is then wired to the same-name brokerage account where the funds will be available for immediate trading.

The car is now on the track and the engine is running! It's time to bring out your 'A' game and create that winning track record!!

Opening Your Full-Fledged Hedge Fund

Once you have established your incubator fund, put together a healthy 6 to 12 month track record, and begun to solicit interest from prospective investors, it's time to go ahead and transition your incubator fund into a fully-functioning hedge fund.

Bring out your 'A' game and crate that winning track record!!

With a track record in place, it's time to transition ….

Logistically, there are a few important issues that must be addressed in order for you to be able to accept capital from outside investors, charge a management fee and/or incentive allocation, and ensure proper liability protection for you as a manager.

One of the documents that you received when you created your incubator fund was a **Limited Partnership Agreement (LPA)**. This is the governing document which covers exactly how the partnership will be managed.

The LPA for an incubator fund is very broad, giving the manager discretion in terms of how the capital is managed, and it does not cover management fees or incentive allocation.

The first thing that you're going to need for your fully functional hedge fund is a revised LPA.

The updated Limited Partnership Agreement will include more specific details on how the capital will be invested or traded, how the fees and incentive allocations will be calculated and transferred, liquidity options for investors and so forth.

Before creating your new LPA, you'll need to consider a number of issues for your fund:

- **Management Fee** – The traditional hedge fund structure charges a management fee of 2%. Under this scenario, the General Partner (your LLC) typically uses this management fee to cover all of the expenses for the fund.

Other funds are structured to not charge a management fee, but instead to have the limited partnership (the actual fund) cover expenses such as bookkeeping, legal fees and other administrative costs.

As the hedge fund manager, you have flexibility in determining what management fee you will charge, balancing the stability of collecting a portion of assets to cover your expenses, with the marketability of a lower management fee to attract more investors.

Balance stability and marketability when determining your fund's management fee.

- **Incentive Allocation** – The LPA also dictates the incentive allocation that is due the manager, and the percentage of profits is typically annualized.

  Most hedge funds charge investors 20% of profits, and the profits are "allocated" to the General Partner as a pro-rata share of realized and unrealized gains, along with interest and dividend income. **This creates an attractive tax advantage for the General Partner** because the allocation is typically reported as investment income instead of regular W2 earnings.

- **Liquidity** – One of the most important issues covered in the LPA is the issue of liquidity. You can choose to offer your investors the chance to contribute capital or take distributions on a monthly, quarterly or annual basis. Some funds even require investors to commit to a multi-year period before they are eligible to withdraw capital.

Incentive allocations create an attractive tax advantage…

  From a capital raising standpoint, when you offer investors more liquidity (more frequent periods allowing them to withdraw capital), you typically make your fund more attractive with less perceived risk.

  But you also need to be careful to match liquidity with your trading style. If your fund invests in illiquid assets, you probably want to offer fewer windows where investors can withdraw capital, and require advanced written notice so that you have time to raise cash to cover the distributions.

- **Distribution Gates** – Another thing to think about is how to handle a situation where a significant amount of capital is being withdrawn at the same time.

  Some managers include "distribution gate" provisions within their LPA to restrict the amount of capital that can be pulled out in one quarterly or annual period.

  While some investors may look at these distribution gates as an impediment to keep them from withdrawing capital, **gates can actually work in favor of investors, allowing the manager more time to liquidate assets in an orderly fashion**.

Distribution gates protect existing investors as well as the fund manager.

  Depending on your trading style and the liquidity of the assets you are trading, you may want to consider a gate that kicks in if 30% or 50% of your capital is requested for distribution at any one time.

Assuming you are new to the business and have not managed a fund before, you may not know exactly how you want to arrange these particular details for your fund. There are a lot of variables, each of which could become very important when dealing with prospective investors.

This highlights the importance of having highly qualified legal counsel working with you on the process. You not only want to have a legal firm who is capable of setting up all the documentation, but also one who is willing to take the time to walk you through each important decision – giving you the information that you need to make a well-informed choice.

The other major set of documents that you need for your fully functioning hedge fund is a **Subscription Document Packet.**

Choose a legal firm that is willing to take the time to educate.

The subscription documents cover the entire scope of agreement between your management company and the individual investor. You and your investor will sign off on items such as how the fund will be managed, when and how the fees will be charged, how much capital will be invested, and when and how the investor can request distributions.

Most importantly, these documents include liability clauses which offer you – the manager - appropriate legal protection in your capacity as a manager of their assets.

In today's litigious society, it's important to have these documents prepared by a competent legal attorney specializing in investment law, and of course it is equally important for you as a manager to operate within the constraint of this framework.

…you'll want to be very familiar with these docs before presenting them for signatures.

Obviously, you'll want to be very familiar with these documents before presenting them to an investor for signatures. Our legal counsel takes time to walk managers through these documents carefully – explaining the different sections so you will be prepared to answer any questions that your investors have in the process of executing the documents.

Congratulations! You're now a full-fledged hedge fund manager, making a living by pulling money out of the markets for yourself – AND for your clients!

Offshore Entities & Special Arrangements

As your hedge fund develops a successful track record and you begin attracting interest from a wide body of prospective investors, you will eventually need to consider an offshore fund structure.

There are a number of instances where an offshore fund becomes logistically necessary. If you are a US manager and you have prospective investors who are not US citizens (or institutions), they will want to be able to invest in an offshore fund to avoid the US regulatory burden and tax consequences.

Most pension funds prefer (or even mandate) an offshore option.

Most pension funds also prefer (or mandate) that the funds they invest in offer an offshore option. An offshore arrangement allows them to invest in a fund that may use leverage – without running into sticky UBTI (Unrelated Business Taxable Income) issues.

Even if your fund does not use leverage, most institutional tax-exempt or tax-deferred investors will require an offshore formation as a precaution.

Typically, an offshore fund is set up in the Caribbean and British Virgin Islands, and can be established relatively easily.

Of course there are additional paperwork and administrative issues to cover, but a good hedge fund lawyer can help streamline the process and open the fund fairly seamlessly.

Once the offshore fund is established, your international or tax-exempt prospective investors can make contributions to your offshore fund in the same manner your domestic investors place capital into your traditional fund.

Running Multiple Funds Under a Master-Feeder Structure

Once your offshore entity is created, the process of running both your domestic fund and your offshore fund is fairly simple.

A "Master-Feeder" structure allows for trading of both vehicles like a single fund.

Every institutional-grade prime broker should be able to offer a *Master-Feeder* structure which allows the manager to efficiently trade both vehicles as if he were managing a single fund.

For example, assume a manager has a domestic fund with $300 million in assets, and an offshore fund with an additional $200 million.

The master fund would have the ability to trade based on a $500 million base. The manager would place all trades in the master account, and then at the end of the day, the trades would be automatically allocated to the "feeder funds" – meaning the domestic and the offshore fund.

In this simplistic example, 40% of the shares or contracts would be allocated to the offshore fund, with 60% sent to the domestic feeder fund. Depending on how the individual funds are set up, you may end up with different ratios (*if the offshore fund employs more leverage, or if the domestic fund has specific capital requirements*).

The key is setting up the automated rules ahead of time so that as the manager, you and your team can focus on the trading decisions, rather than wrestling with allocation issues.

Consider Separately Managed Accounts for Key Institutional Investors

In addition to the Master / Feeder structure, you might also want to consider the option of running separately managed accounts (SMAs) for specific investors.

Since separate accounts create additional complexity and additional administrative work, this shouldn't be an option for most of your investors. But there are times when a separately managed account for a particular institutional investor may be a great option.

A separately managed account option may win you a large allocation…

Offering a key institutional investor the SMA option may allow you to receive a large capital allocation that you would not have landed as part of your fund.

To the investor, there are two main advantages of the SMA route:

- **Control** – Your institution can allocate capital to the account at will, and can pull capital out whenever they please. You may have an agreement in terms of when the investor can and cannot pull capital out of the account, but the bottom line is that they hold the keys to the capital flow.

- **Transparency** – The institutional investor can also see exactly what is occurring within the account. They are able to see what securities are being traded, and typically which open orders are in place.

If you have a good working arrangement with your investor, neither of these issues should be a problem. You can have your investor sign a standard NDA (non-disclosure agreement) to protect your intellectual property and guard against your trades being shared or replicated.

If you have a good working relationship, SMA details shouldn't be a problem.

The benefit to you as a manager is obviously the large capital allocation. You can include the capital from this SMA as part of your firm's AUM, which in turn gives you more credibility when marketing your fund to other institutional investors (*more on that in a bit*).

A good prime broker can streamline the SMA management process.

Similar to a Master Feeder fund structure, a good prime broker can streamline the process of managing SMAs in conjunction with your actual fund.

Each of your trades can be sized based on the total amount of assets, with shares allocated automatically to the fund and SMA based on pre-determined rules.

Approaching The Right Investor At The Right Time

The decision of *who* to approach in regards to investing in your fund is an important consideration from the very beginning. You have to consider not only who is likely to invest in your fund, but also at what point you have the best shot at landing them as clients.

You only get one shot with many investors…

Keep in mind that for many of your prospective investors, you will only get one shot at convincing them to invest in your fund. If you make the solicitation too early, you may wind up blowing your opportunity because your fund is too small or new for them to feel comfortable allocating capital.

At the same time, you of course want to raise capital as quickly as possible to reach critical mass. The more effective you are in raising capital, the sooner you can increase revenue to cover overhead expenses and start generating true income.

For managers with a small shop (limited marketing or administrative staff), **it is especially important to manage the time commitment allocated to raising capital**. After all, you still need to maintain laser focus on your trading in order to continue to build an appealing track record.

Establishing a process to identify which investors to court at particular stages of your fund's lifecycle will go far towards increasing both the effectiveness (rate of conversion) of your marketing program, as well as the efficiency (getting the most capital for your effort) you need to consistently grow your business.

A Quick Word Regarding Marketing Regulations

Create a marketing process for maximum efficiency and effectiveness.

As a hedge fund manager, it is extremely important to be aware of the current regulations covering who you can market your fund to, and in what manner you can solicit investors.

At the current time of writing, managers are only allowed to solicit accredited investors for their fund, and may not display commentary or performance results publicly (as this material could be considered a public solicitation).

As part of the JOBS Act, hedge funds will have the ability to place marketing material in the public domain (although they still will be restricted to accepting capital only from accredited investors).

The SEC is currently writing new rules incorporating JOBS act stipulations. Hedge fund managers should continue to comply with old regulations until these are passed.

The JOBS Act opens up tremendous opportunity for new funds.

Once the new rules are clarified, there will be some tremendous opportunities for hedge fund managers to market their funds publicly through a variety of social media and in-person venues.

Raising Your First Two Million

Once you have set up your incubator fund and begun trading your own capital, you can begin to solicit interest from your inaugural investors. The goal at this point is to **establish a material base of capital**, typically bringing your AUM to a level near $2 million.

Unless you're a former VP at Goldman or Morgan with a rolodex full of accredited and institutional investors, you're likely to have to rely on close friends, colleagues, and family for your initial capital contributions.

The goal: Build a material AUM base.

While you certainly want to be able to show these investors a strong initial track record with your incubator fund, keep in mind that your primary connection with these investors is your longstanding relationship.

The relationship connection can be both an advantage, and a disadvantage in terms of raising capital and the long-term management of your fund.

On the positive side, capital from close relationships is typically "sticky money." As long as you treat these investors well, they are likely to stick with you – even through disappointing performance periods.

The disadvantage in raising capital from close friends, colleagues and family is twofold:

> First, there is a greater potential for **emotions to get in the way of investment decisions**. No one wants their investors to lose money, but it is even more difficult when you have to sit down to Thanksgiving dinner and explain why your fund is experiencing a drawdown.
>
> Second, investors who already have a close relationship with you can **become a major drain on your time and energy resources**. Friends and family investors can easily become "high-touch" investors – even down the road when they represent only a small portion of your assets.

Taking several calls a week from these charter investors can negatively affect your returns if it cuts into your research or trading process.

The Importance of Laying Ground Rules

With any investor, it is important to establish reasonable guidelines for what to expect as an investor in the fund.

Protect time and energy by laying ground rules for investors.

These guidelines should include not only the investment process and the range of expected returns, but also the manner and timeliness in which returns will be reported to investors, and what kind of communication investors can expect to receive from you as the manager.

Ground rules should be communicated before an investor makes the final decision to commit capital to your fund, and the communication is especially important for investors who are also close friends or family.

Ground rules should be communicated before the fund commitment is made.

Creating an arms-length business interaction – that is separate and distinct from your personal relationship – is important not just as a tool for protecting your relationship with these investors, but also as a tool for protecting your time and focus as a manager.

Ultimately, you want to make sure that you exit the "friends & family" stage of capital raising as quickly as possible, both from an efficiency standpoint (it takes a lot of small allocations to build a material amount of capital) and a peace of mind perspective.

Raising Capital From High-Net-Worth Individuals

Once you've established a reasonable base of capital (usually about $2 million), it's time to roll up your sleeves and start approaching the High-Net Worth (HNW) individual investor market.

As a general rule, **this class of investors is ideal for growing from $2 to $10 million in AUM.**

High-Net Worth investors are typically considered 'sticky money.'

Similar to investors in the friends & family category, HNW investors are typically considered "sticky money." With this class of investors, establishing a personal relationship with your investor will go far in creating a sense of loyalty.

The loyalty of HNW investors can be a tremendous asset.

That loyalty can be a tremendous asset, both in terms of raising initial capital, as well as retaining the capital through fluctuations in your returns.

Most HNW investors don't actively compare hedge fund managers on a quarterly or annual basis, so you're unlikely to lose an allocation from a loyal investor simply because another manager with your style has a stronger Sharpe Ratio.

As you build your network of HNW prospects, each potential allocation to your fund can vary dramatically (from less than $100k to several million). You can also expect some HNW investors to test the waters with a small allocation to begin with, and the intention of adding more capital after observing you for a few months or quarters.

Key issue: Balancing the need to raise capital with the true cost of that capital.

The key issue to keep in mind as you solicit investments from HNW investors, is to **balance your need to raise capital with the true cost of that capital you are bringing into your fund**.

The costs you need to consider are not only expenses such as marketing materials, dinners, and events. You also need to think about the operational costs of adding this investor, which can be especially taxing if your new investor turns out to be a high maintenance client.

Be careful not to limit future capacity by filling too many available slots.

Finally, consider the opportunity cost associated with the limited number of slots in your fund. Remember, most hedge fund structures only allow 99 slots for limited partners. So if you fill up the majority of these slots with investors who are only contributing a small amount of capital, you may be limiting your capacity farther down the road.

A good rule of thumb is to **require a minimum of at least $100k when your fund is below $5 million. Above $5 million, it is a good idea to boost your minimum to at least $250k**. And once your fund reaches $10 million in AUM, you'll have the ability to use much more discretion when accepting new investors.

Offering Concessions To Stimulate Asset Growth

Incentivize investors by offering lower fees for larger contributions.

With assets below $5 million, you may want to consider special arrangements with investors who have the ability to make a material difference in your AUM. Some managers offer a sliding scale for management fees or incentive allocations, depending on the amount of capital an investor places into the fund.

These arrangements can apply to all of the capital that an investor places into the fund (including future contributions) or only to the initial investment. Some managers agree to apply the discount indefinitely, while others cap the time period for a set number of years.

At this point in your funds growth cycle, the most important goal is to efficiently and quickly build assets. Once you get above $10 million in assets, you can start putting a plan together to start soliciting capital from institutional allocators.

Managing HNW Relationships Effectively

The advantage of courting HNW investors to help your fund reach critical mass is the fact that there are a LOT of eligible accredited investors out there. Investing in a private hedge fund can be a status symbol in many circles, so marketing your fund as an exclusive opportunity can be very effective.

Another great thing to keep in mind with HNW investors is the potential to raise a significant amount of capital through referrals. Accredited investors tend to be well connected with the ability to introduce you to other prospective investors.

Consider offering special fee arrangements for referrals.

Many managers are very successful soliciting referrals from current investors by regularly asking for introductions. You can even consider offering reduced management fees or incentive allocations for partners who introduce new investors to the fund.

While HNW individuals can help you build a great network of investors and prospective investors, there are also some challenges that are unique to this class of investors.

Individual accredited investors as a group tend to be "high-touch" investors that require a significant amount of maintenance to keep them satisfied. Even if you limit the number of office visits and one-on-one meetings, you are still likely to field several phone calls a week from your base of individual investors.

The key is to set limits for these high-maintenance clients and then firmly remind them if they are crossing the line. If Joe Smith calls to check on his account balance for the second time in a week, you need to clearly explain to him that he is detracting from the fund's performance by distracting you from trading. And if this becomes a regular occurrence, you may need to seriously think about returning Joe's capital in the interest of your long-term performance.

Raising capital from individual investors is very important in terms of building your asset base to a state of critical mass. This is because individual investors typically have a lower hurdle rate in terms of their expectations of your fund's current AUM and the length of your track record. For the capital, HNW individuals represent a broad pool of opportunity, but it takes a lot of effort to raise a material amount of assets from them.

Accelerate AUM Growth With Institutional Investors

Once you your fund is large enough to cover the majority of expenses through management fees from these HNW investors, it usually makes sense to start focusing more on the deep pockets of institutional investors.

If your fund trades liquid assets or otherwise has the capacity to manage a significant level of assets (over $100 million), then you will want to begin to approach institutional investors as soon as possible.

These are the investors with deep pockets who can make a substantial investment in your fund - often writing checks for several million dollars a pop.

Most institutional investors require managers to have at least $10 million under management.

The key is to work your way up the ladder…

Most institutional investors require emerging managers to have at least $10 million under management. Many require a minimum of $25 million, and some turn their nose up if you don't have $50 or $100 million in-house.

The key is to work your way up the ladder, while constantly demonstrating that your fund can remain profitable even while managing ever-growing levels of assets.

Institutional investors typically want to see at least one other institutional investor in your fund before they are willing to commit capital. Very few are willing to be the first major institution to take an interest – which leads to a chicken and egg issue (which comes first?).

We'll cover some strategies for breaking the institutional barrier in a moment...

Timing is extremely important when deciding which institutional invests to approach and how to structure your pitch. Most institutional investors have a pre-determined level of assets they require emerging managers to have before they will even spend time looking at the fund. That is why you want to have at least $10 million dollars under management before approaching this group.

You will want to begin with smaller institutions who focus on emerging managers. Then as you grow your assets, you will clear thresholds that will then allow you to start soliciting larger allocations from increasingly large institutions.

Types of Institutional Investors

Family offices focus on managing and preserving multi-generational wealth.

Institutional investors can be broken down into distinct categories, each of which have unique qualities in terms of what they are looking for from individual hedge funds.

Family Offices- these institutions may be in charge of managing the investment assets of a single affluent family, or a compilation of multiple families who are pooling resources.

Family offices typically keep a low profile, placing a high value on privacy and discretion. They are willing to place assets with small managers (less than $50 million), and place a high value on the relationship with the manager, along with the track record for the fund in question.

The lead time for receiving a contribution from these investors is typically longer than for individual investors. But the background checks and due diligence are fairly light compared to other institutional investors - assuming your fund fits with what they are looking for in another hedge fund investment.

~~~~~~~

The fund-of-funds structure is an entry level opportunity for new managers.

Fund-Of-Funds - the fund-of-funds structure is another "entry level" opportunity for hedge funds beginning to solicit investments from institutions.

Most fund-of-funds shops have a particular specialty in terms of their portfolio of individual hedge funds. They may focus on natural resources, managers who run mechanical trading systems, or on a class of funds such as emerging managers within a certain AUM band or within a particular time range in their life-cycle.

Your fund obviously stands a better chance of receiving an allocation if you fit within the specific niche, but you can also broaden your target market by highlighting special attributes that sync with the fund-of-funds’ strategy.

~~~~~~~

Registered Investment Advisories (RIAs) - while investment advisories have historically leaned more toward traditional investment strategies (mutual funds, long-term growth portfolios, and fixed income strategies) the industry has become increasingly receptive to alternative investments.

RIAs can be a high net worth investor gateway.

Developing relationships with RIAs can be very lucrative, as the advisor has the ability to put numerous investors into your fund, while serving as the point man for questions and hand-holding associated with the individual investors.

Similar to family offices and fund-of-funds, RIAs represent institutions that you can approach early in your growth stage. Having an AUM level between $10 million and $15 million is enough to begin discussions with a medium sized RIA.

You may want to consider offering a portion of your management fee or incentive allocation to RIAs who place investors into your fund.

The RIA can then determine whether to use that allocation to supplement the management at they charge their retail investors, or whether to keep the cash flow as additional income.

Either arrangement is perfectly acceptable, but to avoid a conflict of interest, all agreements should be disclosed to the actual retail investors who are being advised by the RIA.

~~~~~~~

Pension funds make larger allocations, but typically require more time.

Pension Funds - Moving up the institutional investor ladder, pension funds have the potential to make much larger allocations to your fund. The actual size of these funds can range from a few million dollars (for small business pension plans), to multi-billion-dollar allocators such as state and municipal pensions or blue chip corporate pension funds.

Pension funds typically have a regular schedule of liabilities as represented by distributions to beneficiaries. This means that the overall pension investment portfolio needs to be relatively conservative - ensuring that the fund's assets continue to grow in order to meet redemptions. But this doesn't necessarily mean that each hedge fund the pension allocates to needs to be a low-volatility fund.

Most pension fund models allow for investments in more volatile assets, provided the volatility is uncorrelated with the fund's primary portfolio (usually a mix of blue-chip equities and fixed income products). So even if your fund is a more aggressive vehicle, you should still consider pension funds as potential investors, provided your returns are not heavily correlated to broad market patterns.

Pension funds are notorious for dragging out the allocation process, sometimes taking several quarters or even years to decide on an allocation. But the flip side of this coin is that if you are able to convince a pension plan to make an allocation to your fund, you can expect to receive a very significant amount of capital, ranging from $10 million to several hundred million.

~~~~~~~

Both pension funds and endowments can be very demanding.

Endowments - Similar to pension funds, most endowments can be very lucrative in terms of the size of allocations they place with individual managers. At the same time, the vetting process for new managers can be long and tedious with some endowments taking a year or more to actually decide to place capital with a fund.

Both pension funds and endowments can also be very demanding in terms of performance. These funds have a fiduciary responsibility to generate growth while carefully protecting their capital. This doesn't mean that the board will instantly request a redemption if your fund has a material drawdown, but as a manager, you should be prepared to explain why the most recent drawdown fits within the range of expected returns, and be able to demonstrate that you have not strayed from your fund's methodology or trading strategy.

Significant Effort, Material Payoff

Institutional Investors represent the "big leagues" and require the caliber of such.

Attracting capital from institutional investors is hard work. In addition to manager meetings, due diligence questionnaires (DDQs), and process explanation, you will also be compared to other managers with similar strategies. This is essentially the "big leagues" of trading - and as such, you have to be able to prove that your fund is major league caliber.

Institutional allocators also have a reputation for being fickle investors. As one of the funds on their roster, you will consistently be compared to your peers (funds with a similar strategy to yours).

If you fall behind a benchmark, or a group of similar managers, you will need to be able to explain why your fund is underperforming, and why the institutional investor can expect you to make up the lost ground. Continue to underperform, and your allocation will likely be given to one of the stronger managers.

Style drift is a key risk factors for institutional investors…

Keep in mind, **this doesn't mean you have to have exceptional performance each quarter.** Institutional investors are professionals, and they realize that there will be volatility in your returns. The key is being able to demonstrate why a particular quarter was challenging, and also to assure your investors that you are sticking with your strategy.

It's important to note that even good performance can cause an institutional investor to fire you, if the good performance was generated outside of your fund's specialty. For instance, if you are a risk arbitrage fund and you generate a substantial portion of your returns by playing the IPO market, an institutional investor would see this as dangerous "style drift" and may choose to place their risk arbitrage capital with a fund that is more focused on that particular strategy.

While these sometimes demanding investors present unique challenges to hedge fund managers, **institutional investors also represent the strongest group of investors in terms of the opportunity to build a sustainable hedge fund business**.

Without institutional investors, it is more difficult to grow your assets to a level where your fund's income justifies the expenses and effort of managing that fund. If you are able to break the institutional barrier and begin building an established base of key institutional investors, your fund will ultimately be larger, more profitable, and have the longevity you are seeking in this new business you are building.

Breaking The Institutional Barrier

A capital matching program can help secure your first institutional investor.

The key to reaching critical mass and truly finding success as a hedge fund manager, is graduating to the point where you are able to solicit capital from institutional investors. These are the whales that are able to write a 7 figure check and take your fund from being an "emerging fund" with a modest level of assets, to a thriving business generating lucrative management fees and incentive allocations.

There are a few key ways to accelerate the asset raising process and enter the institutional arena more quickly.

Depending on your trading approach, your skill in risk management, and your return profile, your fund may qualify for an allocation from a **capital matching program**, geared specifically for emerging managers.

A manager puts up 10% risk capital, and the funding group puts up the other 90%

The manager's capital sits in a first-loss position, but also in a first-gain position on losses.

We have worked closely with one particular program which operates as a farm club for identifying and vetting talented traders. Their goal is to capitalize emerging managers through a capital matching arrangement. Through this process the allocator is able to evaluate managers in real time and determine whether to make a traditional investment in the manager's fund.

Under this program, an emerging manager puts up 10% of the risk capital, and the funding partner puts up the other 90%. On a monthly basis, the manager is paid 55% of the profits in the account, and the funding partner accepts 45% of the gains.

The manager's capital sits in a "first loss" position – meaning that if a manager loses a portion of the capital over the course of a month, the loss would be counted against the manager's capital account.

The manager also sits in a "first gain" position, so that if the next month the manager is profitable, all gains are applied back to the manager's capital account until he is made whole. Then any remaining profit is split between the manager and the allocator.

Let's use an example of a trader who puts up $250,000 in capital. The funding partner would put up an additional $2,250,000 in capital for an account of $2.5 million.

- If in the first month, the manager generates a 5% return ($125,000 in profit), the manager would receive $68,750 (55%) and the funding partner would receive $56,250 (45%). The account would reset and the manager enters the next month with $2.5 million in capital.

- If in the second month, the manager loses 3% ($75,000 in losses), the losses would apply directly to the manager's capital, leaving him with $175,000 in his capital account. It's important to note that the manager would still have the ability to trade $2.5 million in capital, so the size of the trading fund is not reduced.

- If in the third month, the manager has another 5% gain ($125,000 in profit), the first $75,000 in profit would go back to the manager. This brings the manager's capital account back up to $250,000. Then the remaining profit ($50,000) would be split between the manager (55%) and the funding partner (45%).

Capital matching lets you boost assets AND claim anchor institutional presence.

This first loss / first gain arrangement ensures that the funding partner's interests are aligned with the manager – as the partner does not receive any gain unless the manager is net profitable.

It's All About Building Relationships

The 55% profit split arrangement is certainly attractive for managers who want to leverage their ability to capture profits and manage risk, but the real benefit of the capital matching arrangement is the doors that it opens.

Successful managers can receive a multi-million dollar traditional allocation.

Many institutional investors won't even consider a fund (regardless of its track record) unless the fund crosses a material level of assets. That level could be $5 million - $10 million – or even $50 million (depending on the institution). There is also a tendency for institutional investors to avoid emerging managers unless there is already another institutional investor who has committed capital to the fund.

This capital matching program addresses both of these important issues…

An allocation from the capital matching partner can boost your AUM to a level where other institutions are willing to evaluate your fund. And because the capital matching partner is a well-respected institutional investor, you now have an institutional anchor which has committed capital to your fund.

Best of all, this matching partner has a mandate to act as an advisor to a multi-billion dollar investment firm. This firm uses the capital matching program to identify the best and brightest traders. If your fund catches their eye while you are in the capital matching program, you could receive a multi-million-dollar traditional allocation to your fund.

…tailor your approach to those you reach out to.

Note: While this capital matching program is one of the best ways to raise AUM for a new hedge fund, it is also available to individual trader.

Marketing Strategies For Different Investor Classes

To be effective at attracting and retaining enough outside capital to reach critical mass, you must tailor your marketing approach specifically towards the individual classes of prospective investors you are reaching out to.

Depending on which of your target investors you are currently pursuing (friends & family, HNW individuals, or institutional investors), you will want to focus your pitch to address the specific issues that are most important to your prospect.

There are three primary marketing perspectives to keep in mind when giving a presentation or even having a casual conversation with a potential investor.

- **Relationship-Based Marketing** relies on the personal friendship, or professional respect, between you and your investor.
- **Performance-Based Marketing** features the historical or expected returns for your investment or trading program.
- **Process-Based Marketing** focuses on the methodology you use to identify and capture profitable opportunities.

...focus should correlate directly with type of investor.

Each of these approaches can be extremely effective when matched with the right prospect. Knowing what your investor is looking for, and what features of your trading or investing style appeals most to this investor, will give you an advantage in choosing the right marketing approach to use.

Successfully choosing the appropriate marketing approach can dramatically increase your conversion rate (the number of prospective investors who actually make an allocation to your fund).

On the other hand, even the most well-articulated presentation can fall on deaf ears if it fails to address the issues that are most important to the particular investor in question.

As a general rule, your marketing focus should correlate directly with the type of investor that you are soliciting.

Close colleagues, friends and family will have interest in your fund primarily because of their relationship with you. High Net Worth investors will be much more interested in your historical or expected returns. And institutional investors will want to study your investment / trading process along with your operational setup.

Relationship-based marketing works best with those who know you.

Over the next few pages, we'll take a look at these three marketing approaches and cover the key elements for converting a prospect into an investor..

Relationship-Based Marketing

Since the majority of your initial capital will be raised from close friends, family and colleagues, your primary focus for raising assets as an early stage hedge fund needs to be built on relationship marketing.

Most retail investors are drawn to a "figurehead" when deciding where to place their investment capital. That figurehead may be a personable investment adviser, a broker for a major wirehouse, or even an actor they see in a Fidelity or T-Rowe Price commercial.

Instinctively, these investors want to have their money with someone trustworthy who can demonstrate competence as well as confidence.

With this in mind, your marketing material, and the direction of your conversation should **lean heavily towards building confidence in your ability to effectively grow investors' capital**. There are a few helpful ways to build this trust:

Instill confidence by highlighting designations or licenses.

Professional Credentials - While almost every successful trader will tell you that the school of hard knocks is a better teacher than any formal education program, individual investors still find professional designations attractive.

If you have a license or designation such as the CFP, CFA, CPA, CAIA, CHP, or even the Series 7 or 63 license, it is a good idea to highlight these designations and explain how the material covered in the process of acquiring these credentials applies to your investment approach.

Your trading history is a bond creating asset.

Licenses and designations from outside the financial services arena can also be helpful. Successful engineers or technology professionals often wind up creating profitable mechanical trading systems, and behavioral disciplines such as psychology and sociology disciplines can apply directly to trading styles based around behavioral finance.

~~~~~~~

Trading Background - Whether you gained your trading experience through managing money professionally, or built your approach through trading a personal account, your trading background is an important part of developing a relationship with your prospective investor.

Some managers cringe when it comes to discussing historical trading records, because of a black mark or major mistake that affects their track record. These experiences can actually be good opportunities to build credibility and a strong relationship with your prospective investor.

Consider using word pictures, anecdotes and metaphors.

By discussing your more painful investment experiences, and the lessons you learned through the process, you are able to demonstrate a trading or investing approach that has been refined and improved. The key is being able to show how your strategy has actually improved as a direct result of the challenging period.

~~~~~~~

Anecdotes or Stories - As hedge fund managers, we live, eat, breathe, and even sleep with markets on our minds. But to the average individual investor, the idea of professional trading or investing can be a bit of an esoteric concept.

Finding creative ways to explain how your fund generates returns can help your retail investors feel like they understand your approach a little better. Does your fund consistently "hit singles and doubles?" or are you the type of manager that "swings for the fences?" Maybe you assess the trading environment like a poker player sits down at a table and reads the personalities sitting across from him.

Details are less important than confidence and trust.

Of course you want to maintain a sense of professionalism, and no analogy will effectively describe all the characteristics of your trading or investment program. But finding a common point of interest, or visual reference point, can be effective in terms of engaging individual investors.

When you are focusing on relationship-based marketing, **the details of your investment strategy are much less important than the confidence and trust you are building**.

All too often, we as traders get excited about explaining the subtleties of our trading system - and don't realize that we have lost our prospective investor along the way. When dealing with individual retail investors, it is important to strike a balance, conveying the passion you have for the business of trading, but limiting the granularity in terms of your actual day-by-day trading process.

Find out what your prospective investor is looking for…

If your fund is more than a one-man shop, it can also be effective to discuss the different roles of your team members. Maybe one manager has expertise in the medical and technology sectors, while another has developed experience trading retail stocks. Or it could be that one partner is gifted at finding new investment ideas, while the other enjoys vetting those prospective investments by sifting through the details.

Communicating how your group works together as a team can help instill confidence, and also goes far towards convincing your investor to refer others to your operation.

Finally, relationship-based marketing should include questions... *a lot of questions!*

The more you know about your individual investor, the better you can communicate with them. You can understand whether your investor is worried about protection of capital, preservation of purchasing power, or if your investor is looking for a high-volatility / high-return investment.

Asking questions also helps to cement a feeling of trust, which significantly impacts how many of your close friends and family will actually pull the trigger and invest with you. It may sound cliché, but a genuine personality who strikes a connection with individual investors will be most successful in the relationship-based marketing stage of your fund growth.

As you can see, this level of marketing is relatively high-touch and time intensive. It is hard to grow a business through relationship marketing alone, because the time commitment for each individual investor can be significant. Once your fund passes the $2 million dollar mark, the next step is to begin focusing more on a track record based marketing program.

Performance-Based Marketing

Historical performance is critical for HNW investors.

As you move up the ladder in terms of prospective investors (from friends and family to HNW individuals), you will want to adjust your marketing strategy to highlight your track record.

This encompasses much more than simple historical returns.

This approach is more applicable to your second round of capital raising (after you have crossed the $2 million AUM hurdle) because you will now have more data to use in presenting your fund's returns.

Obviously, a performance-based marketing program appeals to a prospective investor's sense of greed, so you will want to highlight the strengths of your historical performance. But there is much more to this strategy than simply calculating and reporting your annualized returns.

You will want to include supporting information that highlights *how* your fund is able to generate profits, and why an investor can expect your fund to continue to be successful. At the same time, it is important to set realistic expectations so that the first time your new investor experiences a negative month or quarter, he or she is not caught off guard.

To be effective with a performance-based marketing approach, your presentation needs to include a number of different elements:

How does your fund compete with your benchmark? What sets it apart?

- **Average Returns** - The baseline for your presentation will be the returns your strategy has produced and the implied expectation that these gains can be reproduced as you continue to grow your fund. Some information about the capacity of your fund (how much capital can you effectively run with this strategy?) should be included in this discussion.

- **Benchmarks** - Your fund's returns can't be analyzed in a vacuum. Regardless of whether your fund is an absolute return vehicle (seeking to make positive profits in both up and down markets) or a relative return fund (rising and falling with markets, but outperforming over time), you can still use benchmarks to accentuate your performance data.

  It is often helpful to make comparisons to benchmarks *other* than the traditional S&P 500 or Dow Jones Industrial Average indices. If you are a merger arbitrage fund, you should consider presenting your returns next to similar funds. Long / short equity funds can be compared to an entire database of funds with similar strategies, risk measures etc.

  Using more applicable benchmarks gives you a chance to demonstrate a bit more sophistication to your HNW investor, and also allows you to point out the specific features of your investment strategy.

What level of drawdowns can investors expect? How does your risk-management protect them?

- **Drawdowns** - A discussion of historical and potential drawdowns will help set reasonable expectations for your prospective investor, which in turn can lead to better retention rates even when your fund experiences a challenging period.

  Both time and price are important considerations when analyzing historical drawdowns. In addition to the price magnitude (percent drop from peak to trough), it is also helpful to show the average amount of time it has taken to recoup losses, as well as the longest time period from the time the drawdown began until the loss was recovered.

  Investors may also appreciate additional commentary that you can offer for particular drawdown periods. For instance, a specific drawdown during a year where your fund had already accumulated significant profits may be less of a concern than a drawdown that jeopardized initial capital placed with your fund.

How do your returns stack up against your risk? How do you measure risk?

- **Metrics** - To give a more comprehensive view of your fund's performance, you need to view returns from the perspective of how much risk is taken to generate returns.

  The traditional industry-accepted metric for reward to risk has been the Sharpe Ratio. This ratio measures your fund's return above the risk-free rate, and divides it by the average volatility of the fund. We take exception with this measure (for reasons mentioned below), but there is another measure that may be more appropriate for analyzing returns in comparison with your fund's risk.

Give context for performance numbers – along with guidance for various environments.

  The Calmar Ratio actually compares a fund's returns to the *negative* volatility.

This metric avoids penalizing a manager for *positive* volatility but still accounts for the risk associated with historical drawdowns.

- **Environment** - Finally, your performance-based marketing approach should include commentary around the historical market environments for your fund. You need to be able to discuss what factors impact your performance, and how you position your fund to profit during advantageous time periods.

  Conversely, what about time periods where your strategy is less likely to perform well? How do you identify these periods early, and protect your investors against risk? What can your investors reasonably expect during times when risk is high and your strategy is less likely to outperform?

Performance-based marketing is much more complicated than simply showing a profit and loss table. Framing the information to give your investor a comprehensive picture of how your fund generates profits will be helpful not just in attracting new capital, but also in retaining that capital throughout the duration of your fund's lifespan.

Volatility As A Marketing Tool

From a traditional perspective, volatility is seen as a negative metric – something that traders and investors should minimize or avoid. The assumption is that volatility is a measure of risk, and obviously every investor wants to reduce the amount of risk in their program.

Volatility is NOT the same as risk.

However, traditional measures of volatility (standard deviation, the Sharpe ratio etc.), fail to differentiate between positive and negative volatility. Statistically, managers are punished for reporting gains that are significantly *above* their average period return, simply because this increases their standard deviation.

Looking at volatility from the perspective of an emerging manager, positive volatility actually represents opportunity. Traders need volatility to generate above-market returns, and volatility actually allows a manager who implements risk management to outperform his peers.

Academically, volatility is associated with risk as a convenience, because volatility is easily quantified and measured. But historically, low volatility managers have represented some of the riskiest investments.

Consider the Long Term Capital Management (LTCM) blowup. These brilliant statisticians developed a methodology for wringing small profits out of the market on a regular basis. Their strategy was the very definition of a low volatility money printing machine.

Historically, low vol strategies have carried significant underlying risk.

But because of the underlying leverage they used to generate the “stable” returns, the true risk to investors (and to the global financial economy) turned out to be monumental.

There are plenty of other low volatility examples (Bear Stearns High Grade Credit Opportunity Fund, Bernie Madoff etc.) that appeared stable on the surface, but represented significant underlying risk to investors.

On the other hand, funds with higher volatility profiles don't always represent higher risk strategies.

Harnessing Volatility For Stronger Returns

As an emerging manager with a manageable level of assets, you have the ability to enter and exit positions efficiently, varying your market exposure significantly without major liquidity concerns.

Emerging managers have edges that are not available to large funds.

A nimble approach to navigating markets gives emerging managers the ability to ramp up volatility significantly during times of high opportunity (capturing gains when the environment is supportive of the underlying strategy), while dialing back exposure during more challenging periods.

This type of positioning will by definition increase statistical measures of volatility because the high-magnitude gains will be well above the mean returns over the duration of the fund's track record.

But since this volatility is positive – and since the manager is cutting back on exposure during adverse time periods, the actual risk to capital is lower than for the manager who remains fully invested in the strategy regardless of the environment.

This approach to volatility can be a unique marketing point for an emerging manager, facilitated by the fact that the fund's asset levels are small enough to allow for efficient movement in and out of positions.

To quote the legendary Stanley Druckenmiller:

Volatility can present a unique marketing point.

> *"The way to attain truly superior long-term returns is to grind it out until you're up 30 or 40 percent, and then if you have the conviction, go for a 100 percent year. If you can put together a few near-100 percent years and avoid down years, then you can achieve really outstanding long-term returns."*

Incorporating Volatility Into Your Marketing Material

When discussing a non-traditional approach to volatility, it is important to be able to demonstrate exactly how your strategy actually embraces positive volatility while still effectively managing risk. There are a number of key concepts to cover here:

Dynamic position sizing facilitates opportunity maximization while still protecting base capital.

- **Position Sizing Parameters** – A trading strategy that allows for dynamic position sizing will be able to overweight opportunities when the reward-to-risk profile is healthy, and underweight positions when visibility is less clear.

  From a marketing perspective, you want to be able to communicate how your strategy determines when to adjust position sizing, and the magnitude to which position sizing can change based on individual trade parameters and the environment in which you are trading.

- **Total Portfolio Correlation** – There are both advantages and disadvantages to constructing a diversified portfolio. If the positions in your account are heavily correlated to each other, your fund's volatility will most likely increase. This can be positive when your positioning is correct, and can lead to significant drawdowns when all positions are moving against you.

Your marketing materials should include a discussion of how your fund manages the correlation of individual positions, and under what circumstances you seek to diversify versus taking a more high-conviction approach to a particular opportunity set.

High quality risk mitigation strategies are key.

- **Quarterly Allocation of Max Risk** – One way to manage risk to your investors' initial capital while still shooting for significant gains is to allocate a fixed number of basis points of max risk per period. You can use a quarterly, monthly or even annual time period for spreading out the risk.

  During challenging market environments, if your fund approaches this level of max risk, the key is to reduce position size so that your drawdown does not eclipse this line in the sand. On the other hand, when your returns are positive, your strategy has the ability to be more aggressive in compounding gains.

Unique approaches to position management can be an effective marketing tool.

- **Managing off the Zero Line** – A similar concept for embracing volatility while still managing risk, is to position trades based on whether your returns are positive or negative for a particular reporting period.

  Above the zero line, you can continue to increase your exposure, which results in your fund having larger positions when you are trading profitably. Conversely, your fund will have smaller positions during drawdown periods – protecting your investors from compounding losses.

  The return profiles for managers who effectively implement this strategy can be very attractive, with calendar-year losses kept to a minimum, while some years wind up being tremendously profitable. Communicating this approach to managing exposure off the zero line also sets your fund apart from the majority of managers you are competing against.

- **Tracking "NGR"** – **Net, Gross, and Reserves**. As you dynamically manage your fund's exposure to market swings, there are three key metrics worth tracking. Net exposure represents the value of your long versus short positions. Gross exposure is the total notional value of all positions (short and long) added together. And Reserves represents the amount of risk capital you can still commit to new positions.

  If you are marketing your fund based on the concept of embracing volatility, you will want to be able to explain how you track and manage all three of these metrics in order to cut off losses quickly, while leaving your fund free to capitalize on high-opportunity market situations.

Institutional Investors NEED Volatility

Using volatility as a marketing tool can be especially effective when marketing your emerging fund to an institutional investor.

Institutions expect – and even demand positive volatility from new managers.

The majority of institutional allocators are attempting to generate steady returns for their beneficiaries. But this doesn't mean that every investment they make will be with a "steady" investment manager.

Statistically speaking, a fund's overall return profile can actually become *less* volatile by adding a *high variance* asset to the portfolio. This is because a new asset (in this case, an allocation to a new hedge fund) can have a negative correlation to the existing portfolio.

So if the new fund has a strong year when more traditional investments are underperforming, that new volatile investment actually *decreases* the risk for the entire institutional fund.

New funds may be expected to have more volatility.

It's important to realize that this is how institutional allocators typically look at new hedge funds. The new fund is expected to have more volatility, and expected to produce above-market returns when the environment is right.

Keep in mind that any institutional investment in your fund carries risk to the allocator. From the institution's perspective, they are taking on the risk of fraud, operational risks, the risk of style drift, and the risk that you won't succeed as a manager

In order to justify this risk, **your fund MUST be able to demonstrate the ability to generate strong returns.** Steady money-market type rates simply aren't attractive to these investors because large funds such as Och Ziff have this market cornered.

To justify the risk, your fund MUST demonstrate strong return capability.

Using positive volatility as a marketing tool can set you far ahead of your competition in terms of winning institutional allocations for your growing hedge fund.

Process-Based Marketing

To effectively solicit institutional investors, emerging hedge funds need to be able to do more than simply produce superior returns.

…though it isn't just the returns, but also the PROCESS, that counts…

Institutional investors are typically fiduciaries with a responsibility to not only find investment opportunities with strong returns, but to also vet the operational soundness of the managers they place capital with.

A strong track record is just the first step.

When meeting with prospective institutional investors, your strong track record is just the first step in convincing them to place capital into your fund.

Both your investment or trading process (how your fund pulls gains out of the market) as well as your operational process (the organizational soundness of your business) should be included in your marketing material.

This added layer of information may take a bit more time to put together. It requires planning, standardization, and more organization than required for more traditional retail investors.

But the benefits of putting together a process-based marketing package can be tremendous. Remember, institutional investors are the allocators that often have the ability to increase current assets by an order of magnitude.
Land two or three institutional investors and your business can grow exponentially.

From a competition perspective, being proactive in presenting your fund's investment and organizational process can set you apart from other emerging funds. It is common for institutional investors to have to request this type of information from fund managers, and then wait several weeks while the information is put together.

Being proactive in process presentation can set your fund apart.

Having a process-based marketing package already put together shortens the time period required for an institutional prospect to perform due diligence, and improves the professional reputation of your fund.

Investment Process

An institutional-caliber presentation of your investment process should include a number of key elements:

Identifying Opportunities – How does your fund isolate the best trades or investments to include in your portfolio? Do you screen through stocks based on fundamental characteristics? Is there a technical overlay used to ensure prices are moving in your direction?

Offering specific details as part of your marketing approach helps solidify your reputation as a professional fund manager (as opposed to a shoot-from-the-hip speculator). The more granularity you can share – either in your printed material or during face-to-face meetings – the stronger your image will become.

~~~~~

Trade Execution – Once you have identified trade opportunities, how does your fund go about putting the positions on? Do you take a full position immediately or scale into the trade? What systems are in place to ensure that you receive the best execution?

When do you add more exposure? How do you continue to evaluate your trades?

Your discussion of trade execution should cover your brokerage relationships. In addition to execution costs, you can also discuss margin rates, platform capabilities, and other features you have negotiated with your prime broker.

~~~~~

Managing Trades – Once your fund has entered a position, what are the considerations for keeping that position in play? Does your fund have the ability to continue to add size to a successful position? What are the qualifications for this to occur?

Trade management should also include details on your process for risk management. Do you have individual risk points or stop orders for individual positions? Do you hedge exposure through derivative securities? What is your process for quantifying current portfolio risk – and what are acceptable levels of risk on a day to day basis?

~~~~~

Portfolio Construction – Institutional investors will want to see a process for how your individual positions work together to create a functioning portfolio for investors. Whether you are an investor holding long-term positions, or a trader with a very fluid portfolio, you need to be able to demonstrate a process for how you analyze the entire basket of positions.

How do the individual pieces of your portfolio work together?

A discussion of your portfolio construction process should include correlation considerations, guidelines for how individual positions are sized, maximum gross and net exposure, and other metrics that are specific to your strategy.

~~~~~

Post-Trade Analysis – Whether you have been in the business for several decades, or are just getting started as a professional money manager, there are always lessons to be learned from your trade history.

An honest assessment of past trades can offer tremendous insight.

As part of your investment or trading process discussion, consider including information about how often you and your team reviews trade history (Quarterly? Annually?) and what you look for in terms of tuition and adjustments for future trading methodology.

Some managers with proprietary trading systems are uncomfortable giving away too much information in the course of their process discussion. The concern is that the prospective investor could take the information and replicate the model, while short-circuiting the manager out of the process.

Of course if your fund is a fully mechanically-driven trading system, you won't want to give away the actual algorithms that drive your trading decisions. But there are still plenty of areas that you can cover to give an institutional investor confidence in the processes you have in place.

There are always plenty of process areas to cover.

Keep in mind that the majority of institutional investors aren't interested in managing their own funds. They are instead focused on finding the best funds and trading systems to allocate resources to.

A detailed explanation of your investment process helps to prove that your historical returns are repeatable and represent a strong investment opportunity for their family office, pension or endowment fund, or for the fund-of-funds that they manage.

Operational Process

In addition to your trading process, institutional investors want to know much more about the actual business that you run.

For institutional investors, the risk of an operational loss (through fraud, operational error, or the dissolution of your fund) is as significant as the potential for an investment loss. For small fund managers to have a shot at landing a significant institutional allocation, that fund must have a solid operational process documented and in place.

The scope of your operational process will likely grow as your fund assets increase, but there are a few areas that must be covered to be considered an institutional-grade fund:

Institutions fear operational loss as much as capital loss.

Fraud Prevention – In the wake of the Madoff scandal (along with any number of smaller less publicized situations), institutional investors are performing more due diligence to make sure that their assets are safe.

There are a number of ways you can demonstrate that your fund takes fraud prevention seriously. An annual audit by an independent third party is just one step. Offering a prospective institutional investor the ongoing ability to view your brokerage statements is also very helpful. You should consider allowing the investor to receive these statements directly from the brokerage to prove that you are not altering the statements in any way.

Fraud prevention is of heightened concern in the post-Madoff era.

If your shop has administrative help or other team members with access to trade platforms or customer funds, these members should have a background check performed and their activities monitored.

Hiring a third-party administrator (TPA) can also be helpful in that you as a manager would no longer have access to funds (except to trade securities), and the TPA would handle all contribution and withdraw requests.

The key is to demonstrate that your fund is actively managing your fraud risk, rather than simply asking an institutional investor to "trust" your ethics.

~~~~~

Errors & Omissions - Your fund should also have an operational handbook that covers how errors will be avoided, how they will be reported when found, and what remedies will be used to protect your investors' interests.

All traders will face an error at some point during the lifecycle of the fund. While these errors should be kept to a minimum, the key is to have processes in place to find these errors immediately and then to correct the mistakes before the damage becomes material.

Err on the side of openness and disclosure.

In many cases, a trade error will be charged to the General Partner (the management company), protecting the Limited Partners (investors) from losses when errors occur.

When your fund is ready to aggressively pursue institutional capital, it makes sense to have an errors & omissions insurance policy which will help with the marketability of your fund.

~~~~~

Disaster Recovery – In the event of a major power outage, a flood, or other catastrophic event, your fund needs to be able to maintain operations with minimal downtime and minimal risk to your investors.

Disaster recovery plans show you have thought thinks through.

A disaster recovery plan does not have to be expensive for startup funds. Your disaster recovery plan may be as simple as relocating the office to your personal residence, or to the offices of a colleague in another town.

Advanced technology makes it easier and less costly to set up a fully functioning disaster recovery plan. So make sure your fund has a logical plan documented, and make that plan available to prospective institutional investors.

~~~~~

How does your fund address 'key man risk?'

Succession Plan – Another concern that many institutional investors have is known as "key man risk." This is the risk that the principal of your fund steps in front of a bus or is otherwise indisposed.

From an institutional perspective, they don't want to spend the time and resources to vet a manager, only to have the fund shut down a year or two after they make an investment.

This is one of the reasons why your investment process is so important. If you can demonstrate that the fund can continue to operate even if something happens to the principal investor or trader, the fund will have a much better shot at landing an investment from the institution.

A succession plan should detail how the fund will remain operational through the transition process, who will maintain trading authority, how investors will be kept appraised of the situation etc.

Once again, if your fund is able to include an investment and operational process discussion as part of your marketing package for institutional investors, your odds of landing an eight-figure allocations will be dramatically increased.

The goal should be to run your fund as an institutional-grade business.

In order to solicit institutional capital, your goal should be to run your fund as an institutional-grade business rather than as a boutique trading shop.

The beauty of this approach is that you can incrementally add new layers of complexity, and graduate to new levels of marketing, as you steadily build your assets and corresponding revenue.

Additional Resources For Emerging Managers

As your business grows, with more capital under management and bigger investors on your prospect list, the complexity with running a fund will increase.

You will need to start thinking about additional service providers such as a bookkeeper, professional accountant, fund administrator, auditor, and potentially a third-party manager
~~~~~

The good news is that you can add these extra layers of complexity (and expense) one by one – and *only* after your fund assets have grown to where the overhead expenses are easily covered by the cash-flow from the fund.

Bookkeeping and Periodic Fund Statements

As you begin the process of trading your incubator fund, you'll want to create a set of periodic official records for your hedge fund.

Extra layers of complexity can be added after AUM increases.

While there are any number of different analytical reports that can be created from your trading data, there are three main reports that will be important to prospective investors, and that you will need to have for when you eventually want to audit your fund.

- **Balance Sheet** – Your fund's balance sheet shows exactly what assets were owned by the fund at the end of each monthly or quarterly period.

  Many funds decide not to list the individual positions owned by the fund for fear of giving the competition an opportunity to reverse engineer their trading process. You can determine whether to offer categories (listing positions by asset class or sector), or to present the actual detail on the positions your fund holds at the end of the period.

  From our perspective as emerging managers, it is likely more effective to err on the side of disclosure which makes your fund more transparent and attractive to a prospective investor.

- **Income Statement** – This statement can be fairly easily put together from brokerage account statements and your bank statements.

  The key is to classify income and loss based on proceeds from trading (long or short), interest income, dividend income, and any other items such as overhead expenses that are paid by the fund.

Better to reveal more rather than less.

- **Cash-Flow Statement** – The cash flow statement is particularly important if you are adding contributions to the fund or taking distributions along the way.

  The cash flow statement should tie back to the income statement, and include any capital changes that affect the net asset value (NAV) of your fund.

While the accounting statements are not necessarily a priority when it is only your own capital in the account, you will want to have these statements prepared before you begin soliciting outside investors.

If your trading strategy is fairly straightforward, there is a good chance that you can prepare these statements in-house, allocating a few weekend hours each month to create the reports in excel.

But as your fund grows, and especially as you incorporate outside investors, it is usually worth the expense to outsource a bookkeeper to prepare your accounting statements.

Unless your fund trades illiquid assets or makes excessive use of derivative strategies, any qualified CPA should be able to handle the job.

Year-End Tax Reports For Limited Partners

As you come to the end of your first calendar year managing capital for investors, your fund will need to prepare year-end tax reports for your investors.

Depending on the complexity of your trading approach, these reports may be very easy, or they may take more accounting expertise and time to prepare. The majority of funds which trade securities listed on US exchanges should fall well within the capability of a CPA who has a focus on tax or investment reporting.

Outsourcing accounting functions lets you focus on markets (not paperwork).

Prior to the end of the year, you should have a discussion with your accountant to determine when the annual reports (usually a K-1 for tax purposes) will be available to your limited partners. It can be helpful to communicate the timing of these reports with your investors so that they know when to expect documentation for their own tax preparation.

You may also wish to send your investors a schedule of realized and unrealized gains in your fund prior to the end of the year. This can help investors determine how to plan for their tax liabilities, and protect them from unpleasant surprises come April 15th.

If your fund trades less liquid securities that are difficult to price, or has a significant amount of foreign exposure, you may need to consider a more specialized CPA firm, with a branch that focuses specifically on hedge fund reporting.

Performing an Annual Audit

Make sure your investors know when to expect K-1's etc.

Once your fund exceeds the $5 million to $10 million level in AUM, you need to consider hiring an auditing firm to perform an annual assessment of your fund.

The annual audit is as much for the manager's well-being as it is for the investors' peace of mind. Annual audits can uncover key issues like operational risk – which can protect the manager against accusations farther down the road.

An audit provides peace of mind, and also helps identify hidden issues.

From a marketing perspective, an annual audit also gives prospective investors more confidence in your historical returns.

Hiring a Fund Administrator

As a new hedge fund manager, you will want to keep your overhead expenses light, and cover as many administrative tasks as possible in-house.

But once your asset base increases – and especially as you begin soliciting institutional investors – hiring a fund administrator can be a very worthwhile investment.

Fund administration can reduce grunt work and increase investor confidence.

Fund administrators typically cover the functions of processing contributions and distributions for limited partners. A reputable fund administrator reduces the risk of fraud, by giving the administrator exclusive access to the funds bank and brokerage accounts.

In this scenario, the manager still has trading authority over the account, and investors still communicate with the manager when they want to add capital to the fund or take a distribution. But the actual payments are processed by the administrator, thus protecting investors from the prospect of fraud, and giving the manager an extra layer of credibility.

Fund administrators can also be employed to cover expenses of the fund, writing checks to service providers, research providers, and other fund expenses. All of the payment records are kept by the administrator, leaving the manager with more free time to effectively manage the assets.

Carefully Evaluate Third Party Marketers

Third party marketers can be hit or miss - check credentials and ask for references.

One final category of service providers to consider is hiring a third party marketer.

Third party marketers often get a bad rap, and for good reason. The industry has a number of marketers who will require hedge funds to sign an exclusivity agreement, and then do little or no work in actually finding new investors.

Most third party marketers require an up-front payment along with a portion of management fees and incentive allocations for any investor that they introduce.

Use extreme caution when hiring one of these firms, and check out references of funds that have worked with the marketer carefully. Remember that all deals are negotiable, so if you aren't comfortable with the up-front payment or the cut of your management fee, you should be willing to walk away.

With that word of caution in mind, there ARE some legitimate marketers out there with great connections to HNW investors as well as institutional investors.

For managers who have little time for pursuing marketing opportunities, a third party marketer may be a good option. Just understand that once the marketer brings you a prospect, you will likely still need to spend a significant amount of time building a relationship with the prospective investor.

~~~~~~~~~~

In summary, starting your own hedge fund can be a tremendously rewarding (and lucrative) endeavor. There is a step-by-step process for launching your fund, growing your AUM, and building out the operational side of your business.

To your hedge fund success!
~~~~~~~~~~