ORIGINAL STRATEGIES

AS INCREASING INVESTOR SCRUTINY AND TIGHTER REGULATION BECOME A PART OF THE HEDGE FUND INDUSTRY'S OPERATING ENVIRONMENT, **PAUL GARVEY** OF **ALPS** DISCUSSES THE STRATEGIES THAT NEED TO BE TOP OF THE AGENDA FOR FUND MANAGERS

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As the US economy continues its recovery, the demand for emerging managers maintains its growth levels- being especially driven by an influx in institutional capital. But as start-up funds are presented with a number of opportunities, understanding the main challenges before considering structures, strategies and partnerships is key. *HFMWeek* sits down with Paul Garvey of ALPS to discuss the start-up space in the US and the most important business considerations for emerging managers.

HFMWeek (HFM): What key points should managers consider when starting a hedge fund from the US?

Paul Garvey (PG): Managers need to consider who their primary investor base will be, what type of structure would be most appropriate for those investors, and which service providers would be best suited to provide the proper offering to those investors and the chosen fund structure.

The vast majority of new US funds launch with assets under $100m. At those asset levels, fund expense loads have the potential of drastically eating away at performance. It is critical to align the infrastructure of the investment advisor and the services rendered to the fund with the current investor base. If the fund is starting out with mostly friends and family money, it may not be necessary to purchase a robust risk software suite. The fund may also be able to save costs by delaying NAV delivery by the administrator. Conversely, if the initial capital includes institutional investors, it may make sense to increase the services offered, such as engaging the administrator to provide daily P&L. In the end, the manager needs to assess the appropriate vendors and services with the actual needs of the fund.

> "MANAGERS NEED TO ENSURE THEIR FIRMS HAVE ROBUST INFRASTRUCTURE, NAME RECOGNITION AND SCALABILITY"

HFM: What should start up managers keep in mind when selecting the appropriate service providers, especially in the current environment of higher investor scrutiny and tighter regulation?

PG: Managers need to ensure their firms have robust infrastructure, name recognition within the industry, and scalability.

Investors are looking closer at service providers' internal controls and procedures. For example, an easy 'check-the-box' test of an administrator's internal controls is an annual SSAE-16 issued by a reputable accounting firm. This ensures the administrator has a proven set of procedures and systems when calculating fund NAVs. This goes hand-in-hand with tested and proven disaster recovery plans. Having a sound set of internal controls is meaningless if the service provider is unable to render services during a disaster.

Investors also want to see firms that are well-known within the industry. A good and easy test managers can follow is to ask the various service providers they are engaging or considering if they have worked with other firms they are speaking with. If the manager's auditor has never heard of or worked with the administrator, that could be a sign that the administrator is small or unknown. Another quick check is to see if the firm has received any industry-level service provider awards.

Scalability is extremely important. Whether the initial investors are mostly friends and family or composed of institutional capital, a new manager should engage service providers that have the ability to provide a full spectrum of services that would fit the fund at any asset level/investor base. If the fund is starting with mostly friends and family money, the manager should ensure that as the fund grows, the service providers will be able to scale with the growth of the fund.

HFM: What fee structures should managers consider and what role can the choice of appropriate structure play in the survival of a start-up hedge fund?

PG: The capital raising environment has become much more competitive over the past few years. The standard 'Two and 20' may not be acceptable any longer. We have seen many new funds becoming creative with their fees. There are more funds employing hurdles based on benchmarks and others that provide stair-step management fees based on invested assets. These are all creative methods that are utilised to make the investment that much more appealing.

One mistake we have seen over the years is when managers set fees that are not commensurate with fund style. For example, an incentive fee that crystalises quarterly may not make sense when the fund has a one year lock-up on new capital. The timing of fees should coincide with the investment style and any gates or lockups that may exist. If a fund is employing an absolute return strategy, then a hurdle based on the S&P 500 doesn't make much sense, but a flat 5% hurdle would seem more appropriate.

HFM: To what extent does the choice of US State play a role for a start-up firm and what recent initiatives at a State level are likely to influence this decision?

PG: For various tax reasons, Delaware is still the leading state for fund formation. The investment advisor will be subject to the regulations of their local jurisdiction regardless of the fund jurisdiction, but if they register with the SEC, the state becomes much less important.

The key is to have the appropriate attorneys and compliance professionals engaged to help managers navigate the various jurisdictions.

US managers that have an offshore component to their structure still favor Cayman as the primary jurisdiction, although we do see some BVI funds from time to time.

HFM: How can the US remain competitive in terms of hedge fund domiciliation choices, and what regions have been the most popular for start-up funds?

PG: The US will, in the long-term, remain a popular choice for domiciliation among managers that want access to US investors. The cost of setting up a US fund is relatively inexpensive and fairly quick, and the ongoing cost is extremely low. The low-cost environment, combined with the access of US investors, is a key driver for the growth of the industry in the US.

HFM: How has the hedge fund industry's investor base been changing and what implications is this having on a start-up firm's business model?

PG: Over the past few years more institutional money has been flooding into the industry. This has led to greater transparency requirements and shorter (or sometimes the elimination of) lock-ups. The due diligence of these investors has now extended well past the manager and heavily into the service providers. This has required investment advisors to build up their own infrastructure.

We have seen more dedicated CCOs with start-up firms and more investments into technology. There has also been a push to leverage the administrator with more of these requests. We have found ourselves more actively participating in the new investor due diligence process and have been building new reports to appease the growing transparency requests.

Besides institutional investors, we have found that high-net-worth investors have become much more savvy over the past few years. They are looking for more fee breaks when agreeing to longer lock-ups and they are looking for better risk-adjusted returns. This has greatly influenced start-up funds by making the act of raising capital much more competitive.

HFM: What can you see the next 12 months holding for US-based start-ups in terms of challenges and opportunities?

PG: There is going to be a lot of opportunity in the next year for managers with new or different strategies. If a 'typical' long/short equity fund launches, it will have a lot of competition from other existing managers. With that said, if the manager is doing something a little bit different, it can go a long way to attract capital.

The operational challenges are going to be derived from all the new regulations and investor expectations. Things like Form PF, which comes from the Dodd-Frank Act, are causing a lot of issues regarding cost and time. In addition, with the increase in investor demand for more transparent reporting, managers are going to have to invest in risk analytic software and/or service providers much sooner than in the past. Managers used to have a free pass for that level of reporting below $100m, but that has quickly changed. There is also more of a demand for some level of daily reporting. We are not necessarily seeing an increase in demand for full daily NAVs, but we are seeing an increase in portfolio transparency on a daily level and daily performance estimates.

These increased reporting requirements are driving up cost, which is creating a greater barrier of entry. Funds need to start at a higher asset level than was needed three years ago. Although those challenges may seem daunting, we've found that the majority of managers that have been launching new funds in this environment have been able to mitigate those issues with careful planning. ■