It's Still a Great Time to Start a Hedge Fund

Ten Things to Consider Before Launching a Fund in the New Era of Regulation

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Launching a Hedge Fund

There's no denying that the regulatory environment for hedge funds has become more complex and time consuming in recent years. While some in the industry view the regulatory landscape as a barrier to starting a fund, the reality is that the startup market is alive and well. In fact, it's thriving for those who go about it the right way.

With many of the largest hedge fund managers closing their funds to new investors, the opportunity for new funds is as strong as ever.

Hedge Fund Market Is Growing and Maturing

The hedge fund market is growing and maturing. Investors still need to meet their allocation targets or they're looking to replace managers. That means the capital is there for managers who can articulate their strategy and demonstrate the ability to build an institutional-quality infrastructure and suitable processes. However, doing those things requires a plan and, for many, a change in mindset.

Part of that mindset change is coming to grips with the reality that not every fund will – or needs to – launch with hundreds of millions of dollars. There are plenty of successful funds that launch with $40 million or even $10 - $20 million for that matter. The truth is many funds may never reach nine figures – and that's OK too.

Successful funds come in all shapes and sizes. It's simply a matter of how they define success. What's most important is that a fund:

- Has a clear understanding of that recognize and embrace it will be the ones that thrive in the future.
- Stays true to those goals as it operates

Some managers or would-be managers look at heightened regulation as a burden, but the reality is it can actually be a benefit. Heightened regulation can:

- Enhance the perception of the industry in the eyes of potential investors
- Demonstrate that protecting investors is paramount
- Create a new level of confidence for those who are considering investing

Heightened regulation is the new normal. Startups that recognize and embrace it will be the ones that thrive in the future.

Ten Tips for a Successful Launch

To help managers navigate the evolving startup landscape, Akram & Associates has developed a set of tips and considerations for successfully launching a fund in the new era of regulation.

1 | Build a Fund Like You're Building a Business – Because You Are

The "if I build it, they will come" mentality is no longer a viable option. Fund managers must take the time to create a real business plan with realistic projections of operational and cash flow needs. One way to do this is to get granular and make an itemized checklist of requirements and costs including, but not limited to:

- Staffing
- Office space
- Benefits
- IT infrastructure

The reality is that most funds don't fail because they make bad investment decisions. They fail because they make bad *business* decisions, or they don't take the time to think through critical operational components. For example, don't overbuild (or underbuild) your operations based on unrealistic capital projections.

Don't fall victim to the "set it and forget it" trap. Perform regular reviews of procedures, internal controls and compliance documents to make sure they match the fund's current reality. By planning relentlessly and projecting realistically, it's much more likely that your fund will be successful.

2 | Act "Institutional" From the Outset

"Institutional quality" has become a bit of an overused phrase, but the thought behind it is as meaningful as ever. The most successful funds build out their infrastructures with an eye for detail and a focus on quality that will pass muster with institutional investors from day one.

That doesn't mean buying the most expensive options or building out the biggest infrastructure. What it does mean is:

- Putting in place strong business practices, partners and processes that fit your needs today, and can scale as your fund grows in the future
- Taking a hard look at enterprise risk management, identifying exposures, and documenting processes that will help mitigate them

- Vetting partners and service providers, and having an understanding of their industry expertise and how they will add value to the process (as opposed to just checking a box)
- Safeguarding assets with a reputable custodian, establishing actionable internal controls, and creating an appropriate compliance manual, among other things – and then reviewing them regularly

This level of detail demands more effort, but acting institutional from the outset will pay regulatory dividends, attract higher quality investors, and set your fund up for long-term success.

> The startup market is alive and thriving for those who go about it the right way.

3 | Structure Your Fund Strategically

Contrary to some opinions, determining a fund's structure is a strategic exercise, not an administrative function. When considering what structure makes the most sense, managers have to take a hard look at their:

- Strategy
- Fee structure
- Trading frequency
- Liquidity profile

Whether that structure is a side-by-side, master feeder or segregated portfolio companies, managers should land on a structure that aligns operationally with their investment strategy and also makes the fund more attractive to targeted investors.

What's more, if hard-to-value securities make up more than half of a fund, the valuation process and the service providers that support it become critical.

Here are some questions you should ask yourself before choosing your fund structure:

- If your fund is less liquid, have you set up side pockets?
- Have you considered investor lock-ups, notice periods and redemption policies?
- Do you know what structure is more attractive to family offices, pensions and endowments, and high-net-worth individuals?

These are all important questions that demand well thought-out answers when a manager is making the fund structure decision. By approaching the processes strategically and seeking advice from trusted service providers, you will create a fund structure that will serve you and your investors better over the long haul.

4 | Consider the Tax Implications of Key Decisions

From estate planning to business structure to trading strategies, there are tax implications associated with nearly every key decision a fund makes. Whether it's structuring to maximize the tax efficiency of a management company or creating a trust for estate planning purposes before launch, fund managers need to be aware of all their options, and the costs and tax implications associated with them.

If you make the wrong decisions early, it can be very costly to make changes later. Therefore, it's important to partner with experts who can provide valuable insights and give you the full picture to make informed decisions. This will put the fund complex in the best position from both a tax and business standpoint, both today and in the future.

5 | Communicate Your Value Proposition Clearly

This is perhaps the most important – and often most overlooked – aspect of starting a fund. Whether you call it a value prop, elevator pitch or investing strategy, managers need to be able to tell a tangible and succinct story to investors about who they are, how they will generate alpha, and minimize risk.

We're talking about significant sums of money, and it's important for investors to understand how your fund is different from, and better than, other options. When developing your pitch, focus on coming up with *provable differentiators*, and position them in the context of competitive offerings.

Developing a flawless value prop is a process, so solicit feedback from trusted advisors and industry experts, and keep refining it to make your value prop tighter and clearer. What's more, that process should continue even after you begin actively soliciting capital.

Keep in mind that not every presentation will result in an investment. Don't take rejection personally. Be persistent, perfect your pitch, and you'll see the payoff.

6 | Control Your Capital Raising Process

It goes without saying that capital raising is a key part of any Fund's startup process, but that doesn't mean it's always carried out *strategically*. Funds need to look at what they're trying to accomplish from a business standpoint and align themselves with investors who share those goals.

There are a variety of potential funding sources – from friends and family to family offices, to institutions and seed capital. Accordingly, there are a seemingly endless number of questions fund managers need to ask themselves with regard to approaching potential investors and gathering capital, including:

- Should I use third-party marketers or cap intro groups of prime brokers?
- What are the right conferences to attend to find potential investors?
- What is the critical number I'm trying to achieve from a capital standpoint, and what am I willing to give up to get there?

Partner with experts who can provide valuable insight and give you the full picture to make informed decisions.

Seed capital could be a good option for some funds, but it comes with long-term implications. And to truly be credible with investors, managers need to have "skin in the game," because if they aren't willing to invest in themselves, why should anyone else? What's important is that fund managers understand the pros and cons of all their funding decisions, and they control the capital raising process so it makes the most sense for their business.

7 | Be Transparent

Transparency has become more than a buzzword; these days it's a key requirement for investors and should be embraced by fund managers. It's essential that you document and communicate your processes, and disseminate all offering materials, agreements, memoranda, advertisements, marketing materials, etc., with consistent messaging.

In addition, you will find that investing in state-of-the-art risk management tools will reassure potential investors of your commitment to transparency and to complying with securities laws and regulations. This investment will be well worth the cost.

8 | Outsource Strategically

The best fund managers know their limitations and aren't afraid to outsource areas outside of their expertise. That doesn't mean you should outsource everything, however; nor does it mean giving up oversight.

It's critical for funds to prioritize essential functions and determine what they need to keep in-house and what they can outsource. All funds are different and there's no one-size-fits-all answer. Some smaller firms may decide to outsource part of the chief financial officer (CFO) function; others may consolidate the CFO and chief operating officer (COO) roles and keep that in-house.

As the old saying goes, "you can outsource roles, but you can never outsource responsibility." By making smart decisions based on your firm's needs and maintaining strong oversight, you will maximize your operational dollars and build a better infrastructure.

9 | Tap Your Network for Knowledge

Don't be afraid to ask questions. Talk to friends, colleagues, experts or influencers who have been doing this for a while. Get the benefit of their successes and, equally important, their failures.

You'll find that people are more than happy to share their experiences and insights, and you'll probably find they wished they'd asked more questions when they started. Remember, knowledge is power. So put your pride aside, tap the power of your network, and put yourself in a stronger position to succeed.

10 | Make Sure Your Launch Timeline Is Realistic

It takes longer than some people realize to launch a fund. From identifying quality service providers, to preparing and filing the proper documentation, to raising capital, there are many resource and time-intensive steps to getting a fund up and running.

Take a hard look at how long you think it will take to complete those critical tasks and then add a little extra just in case. The more realistic you are on a launch timeline, the less likely you are to rush through key steps and create operational shortcomings that will plague the fund for a long time.

Closing Thoughts

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank) and increased regulatory scrutiny may have some potential hedge fund managers thinking twice about making the leap to launch a fund. This article was designed to shed some light on the subject and provide positive food for thought for aspiring managers.

The numbers don't lie; the landscape for hedge fund startups is as strong as ever. Success simply requires looking at things a little differently. Fund managers that can identify strong partners, build out institutional-quality infrastructures, articulate clear road maps for growth, and think about operational alpha as much as investing alpha will be the ones that attract the capital – and thrive in the new era of regulation.

Akram & Associates Is Your Trusted Adviser

Akram boasts deep industry experience spanning all Alternative Investment fund strategies and structures. From formation to capital accumulation to realization, our audit, tax and advisory professionals have the experience and insight you need. We work with you in a coordinated, collaborative fashion to ensure you are armed with a variety of perspectives to form the best courses of action for your fund.

Akram is often chosen as an alternative to Big 4 firms because of our exceptionally responsive and personalized service. As a boutique firm specializing in Alternative Investments, our highest priority is providing outstanding client service and establishing long-term relationships based on integrity, objectivity and open communication.

We have earned a reputation of trust in the marketplace through offering customized service and senior-led involvement. Our approach allows us to deliver the targeted services our clients require to run their fund operations efficiently and to make strategic decisions with confidence.

We understand the unique challenges faced by fund managers. From the beginning of our partnership, you can count on team continuity as well as the strength of long-term relationship building. We will be your trusted adviser.

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