A View from Both Sides: the Latest Trends in Capital Raising

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Executive Summary

Catalyst Financial Partners held its Alternative Investing Forum Spring 2010 conference in New York City on April 19, 2010. During the conference, we conducted a comparative/contrast study on investors and small/mid-size hedge fund managers to gain a better understanding of the insights and opinions from both sides of the Capital Raising equation. Similar studies by various organizations mostly focus on one side story, either the investor’s side, especially institutional investors, or the manager’s side only. More than 130 delegates attended the conference.

The conference attracted variety of investors, such as family offices; Pension funds; Endowments; Funds of Hedge funds; insurances companies; seed investors and investor advisors. On the fund manager side, the strategies include L/S Equity, CTAs, Event-driven, Credit/Debt, Energy, Merger arb, Convertible arb, Quantitative methods, etc.

Purpose

The purposes of this study were to identify:

- How investors use observable firm characteristics in their capital allocation and manager selection process.
- The perceptual gaps between Investors and hedge fund managers regarding capital allocation and manager selection process.
- The capital sources for small/mid-size hedge funds
- Post-financial-crisis and post-Madoff-scandal impacts on raising capital
- Obstacles in raising capital
- Channels of capital raising

13 firms were sampled in the study. In spite of small sample size, clear anecdotal evidence of behaviors emerged. As for the investors in the study, a typical first round capital allocation is $6.5million on average. The average AUM of hedge funds in the survey is $534million.

Industry Summary

The Hedge fund industry suffered dire losses during the financial crisis. Severe declines in capital markets and waves of redemptions forced an industry-wide consolidation and more than 2000 funds closed. The total AUM declined over $1trillion from its peak, with a net capital outflow of $330 billion in H1 2009. Since hedge funds mirrored broader market declines, investor’s confidence in hedge fund’s superiority in was shattered. The Lehman Bankruptcy and...
Madoff scandal led to calls for new regulations on hedge fund industry. Struggling with liquidity issues, hedge fund managers made a series of concessions on investor terms.

However, the managers that survived, and new managers, were able to take advantage of market dislocations created by the severe market downturn and the subsequent market rebound. HFN aggregate Index was near its all-time high by the end of Q1 2010. Half of the underwater funds reached their high-water Mark. Improved capital markets and better performance drawn back the investors, who forsook the hedge funds during the crisis. According to Hedgefund.net, the total AUM of the industry reached $2.267 trillion in Q1 2010, a 4.4% increase since the end of 2009. 20% of the increase ($95.13billion) came from the new capital.

**Survey Findings**

**Capital Allocation**

- **High Absolute Returns is the top reason investors allocate to hedge funds, and the primary criteria in selecting a hedge fund.** Going forward, it seems clear that hedge funds ability to attract capital flow, to a great extent, will be dependent on their ability to produce high returns. Among institutional investors, and particularly Pension Funds, Diversification was a noted desirable aspect of investing in hedge funds. Pension funds view hedge funds as an alternative source of return to traditional asset classes. In general, investors preferred constant, non-correlated returns over high risk-adjusted returns.

![Investor Responses](chart.png)

- **The current preferred strategy among investors is equity-related strategies.** Equity-related strategies, especially event-driven strategies, received the most attention in recent rounds of asset allocation. A good event-driven PM provides non-correlated returns throughout the business cycle and can be a valuable addition to a diversified investor.
Investors continue to see opportunities in fixed income and distressed debt from the market dislocation. Interests in CTA are waning. Investors are relatively neutral on Real Asset/Real Estate and Global Macro and show little interest in Quantitative/High frequency strategies.

**Manager selection Process**

- **Investors put the least emphasis on Firm Stewardship while in a fund manager’s mind, it is the top criterion.** Firm’s stewardship measures how committed a hedge fund firm to fund shareholders, or by Morningstar, whether “a firm takes its responsibility to fund shareholders seriously and actually puts their interests first”. It is surprising to find that investors put it last in its selection process while in a fund manager’s mind; it is at the top of the list.

Investors rank the importance of criterion in manager selection process as follows:

Hedge Fund Managers perceive the investors’ selection process as:

![Bar chart showing investor responses to various strategies](chart.png)
More weight on risk management by investors than managers. When evaluating a hedge fund firm’s risk/reward profile, Investors put more emphases on a fund firm’s risk control/risk management. Fund managers think that risk and rewards are the equally important integral part of investment process.

The impact of the financial crisis on decision times of capita allocation and management selection process is minimal. Current decision time is only 0.7 month longer than the one prior to the financial crisis.
Sources of capital

- **Traditional hedge fund clients are still the major sources of capital for small/mid-size hedge funds.** These Funds major sources of capital are; family office, followed by Fund of Funds, and Foundation/Endowments. For Small and Mid-size funds, Investor advisors and Pension funds, lag comparatively as a source of capital.

![Manager Responses Chart]

- **Pension Funds will be the driving force behind the future growth of hedge fund industry.** Although not part of study, during a telephone interview, Donald Steinbrugge, managing member of Agecroft Partners LLC and a Third Party Marketer, identified three changes in how Pension Plans allocate funds that could benefit Small/Mid-sized hedge funds:

  1. Pension plans intend to increase their allocation into hedge funds from the current 2% level to 5%. Small and Mid-size hedge funds will likely to see more allocations through Fund of Funds, the primary distribution channel for pension funds to invest in the hedge fund space.
  2. Pension plans start to go directly to mid-size hedge funds to seek alpha-generated returns.
  3. Pension funds begin to incorporate hedge funds into their overall portfolio allocation instead of viewing them as a separate asset class. This convergence of traditional-alternative asset classes will open more doors to many hedge fund managers.

With over $1trillion holdings, North American pension plans will represent the single largest source of new capital between 2010 and 2013¹.

¹ A study by Bank of New York Mellon and Casey Quirk.
Post-financial-crisis and post-Madoff-scandal impacts on raising capital

- Investors think “Institutionalization of hedge funds” can boost investors’ confidence in the industry.

- Investors are neutral on whether a new set of government regulations will increase their likelihood of investing in hedge funds in the near future.

- A reduced fee structure marginally helps investors’ decision on committing capital into a fund. Managed accounts offer relatively low value on capital commitment decision.
The Major Obstacles to Raising Capital

- **There is an expectation gap between investors and fund managers.** Both sides claim that they have hard time finding “appropriate” counterparts. As an industry going through a severe downturn and investors possibly full invested, more burdens are put on fund managers to reach out the investors. Managers have to closely align their business models to investors’ needs.

- **Lack of access to appropriate capital distribution channel, rather than lack of attractive products, is credited as the top obstacle in raising capital by hedge fund managers.** Once they are introduced to appropriate investors, they feel confident in their ability to fulfill all investment criteria and offer an attractive product.
Channels of Raising Capital

- **In-house marketing team has become the leading channel for raising capital.** Although the traditional rolodex of contacts is still high on the list, there is an increasing trend among funds to build their in-housing marketing and investor relations teams. A professional and dedicated marketing team, who can track down the capital sources, effectively differentiate the firm from its competitors and win investors’ mandates, can be invaluable.

- **Third-party Marketers are the least used channel in Capital Raising.**

### Managers: What are your channels of raising capital?

![Manager Responses (5=Max)](image)

**Conclusion**

In spite of the stellar performance and positive capital flow in 2009 and Q1 2010, the total AUMs of the hedge fund industry are still $670 billion below its peak in Q2 2008. As the industry rebounds, investors and fund managers seek each other to position themselves for the next stage of expansions.

Investors continue viewing hedge funds as a source of high absolute returns. Investors go through rigorous search processes to determine where and with whom to commit their money. In a nutshell, the manager selection process all boils down to a systematic evaluation of a hedge fund firm’s observable characteristics: risk/rewards profile, firm-specific characters, and stewardship. It is surprise that the investors in the survey rank the firm’s stewardship lowest.

On the other side, fund managers seek the opportunity to capture the capital redeemed during the crisis as well as the new capital coming from outside of their traditional customers. For hedge fund managers, the biggest challenge in raising capital is getting introduced to potential clients. To this end, fund managers increasingly rely on in-house marketing teams in their search for capital.