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## **Barriers To Allocating To Your Hedge Fund — That You Can Do Something About**



A 2024 emerging manager survey of both hedge fund managers and investors was recently released by Marex Prime Services and The Alternative Investment Management Association (AIMA).

Parts of the reporting that related to raising capital uncovered some barriers to investing and revealed how the investors' hunt for new managers and strategies runs differently from what many managers believe.

Let's take a look at the asset raising related findings in the survey, interpret what was reported and recommend what your hedge fund should do or consider as a result.

### **BARRIERS TO INVESTING**

The survey presented investors with multiple choice responses to choose from. The response choices often glommed together a range of important enough but unrelated issues. So, here, quoting verbatim, are the top three barriers to investing:

- Concerns regarding operational due diligence, poor administration standards and lack of fund transparency. [83% of polled investors]
- Investment style drift, too much illiquidity. [71% of polled investors]
- Unrealistic target, poor business plan or viability. [66% of polled investors]

Let's now look into each of these three with my observations and recommendations for hedge fund management firm owners.

## Investor response #1

- *Concerns regarding operational due diligence, poor administration standards and lack of fund transparency.* [83% of polled investors]

A structured, in place ODD management system, with expected documentation and staff delineation for oversight and management is a price of entry requirement for an investment firm to be considered by sophisticated institutional investors, from family offices to plan sponsors. Emerging manager hedge fund firms need to appreciate that if they intend to earn more than a brief glance from a sophisticated investor this is a cost of doing business that applies to them as well.

Your portfolio manager needs to be able to talk prospective investors through detail about how the organization is carrying out and overseeing reporting, compliance and operational risk management activities, and hand over this information in writing later in the due diligence vetting process.

Lack of fund transparency, however, is opaque in how the surveyors posed the question. Far fewer funds nowadays give no transparency into what their holdings are, and far fewer investors nowadays would consider allocating to a manager who claims the portfolio holdings must remain in their black box. This is why I believe it is a second, more likely interpretation that the investors gave to the phrase: lack of fund transparency really meant lack of sufficient communication about how the managers assemble and manage their baskets of holdings.

Investors need to be given a detailed enough explanation about a manager's investment process. Otherwise, investors will lack the ability to subjectively decide whether or not they believe it is a sensible enough approach to handling strategy implementation to warrant an allocation. Having trouble understanding and buying into a manager's investment process is a very significant barrier to investment. It is vital that fund managers put in the time and effort to craft and deliver this investment methodology information with consistency, both in print and verbally.

## Investor response #2

- *Investment style drift, too much illiquidity.* [71% of polled investors]

I've found the phrase 'investment style drift' to sometimes literally mean that, as in: the portfolio manager puts in writing the investments are in small cap stocks and now the portfolio holdings report shows a significant percentage of mid-cap stocks being held.

Other times, it is investors making a reference to a drift from a strategy's explained, intended risk exposure to something different.

This is why you should share with investors what characteristics they should expect to see in the portfolio. Also, give a sense of how these characteristics might shift under different market conditions where you might take some tactical actions in running your strategy. If you do not communicate this up front, before investors allocate, you may find yourself with some pretty disillusioned customers some time down the road if and when the risk/return of your basket of holdings changes enough to have them start calling you with questions.

As for the complaint about illiquidity it could be referring to one of two things. One is about ease of fund redemptions. The survey reported that short hard locks are acceptable by most, while long hard locks (e.g., 12 to 24 months respectively) turn off 40% and 48% of polled investors.

The other related consideration I have found sophisticated investors to have regards the liquidity of holdings, and therefore risk, in portfolios of publicly traded securities. It is the portfolio manager's job to educate prospects about how he or she takes illiquidity to mind in managing the sell discipline for the portfolio. One equity investing hedge fund client, for example, makes a point of explaining how whittling down what for him is an investable universe includes filtering out stocks that, based on their trading volume, would take more than two days to close the position. This gives prospective investors a sense of strategy implementation and risk management protocol as relates to illiquidity and how it might affect the portfolio they allocate to. Make sure your hedge fund lets prospective investors know your own liquidity requirements when selecting new holdings to add to your portfolio.

### **Investor response #3**

- *Unrealistic target, poor business plan or viability.* [66% of polled investors]

A hedge fund manager whose stated investment return objective sounds clearly unrealistic (e.g., too high) to experienced, skeptical, sophisticated investors won't win allocations. However, I believe it is the business plan and business viability issue that too many emerging managers do not properly appreciate.

As my 37-year-old financial communications and sales marketing consulting firm counsels its emerging manager clients, sophisticated investors recognize there are two barriers to investing they need to consider when conducting due diligence on you. One is strategy risk: What is the likelihood you will deliver the type of returns expected. The other is business risk. This is most applicable to emerging managers. Here is the worry as to whether the fund manager might be a good trader but lack the competency to run and grow a business.

This not only includes properly addressing the operational due diligence issues, it also includes how thoughtful and detailed the plans are for business development to grow AUM and increase the number of investors to the fund. The sooner the emerging manager firm grows its client base the sooner it reduces the added business risk exposure that early allocators face; and they take this serious point into consideration. I've known family office investors who liked a manager's returns but refused to allocate because the manager was demonstrating pennywise pound-foolish thinking as to when, and how much, resources would be dedicated to marketing outreach to most quickly grow the pool of investors.

Every emerging manager should be dedicating some of his or her initial meeting time with prospects to talk them through key elements of the firm's business plan, as well as plans about how future revenues will be reinvested in the business. For this, you first need to decide and then write out exactly what this would look like.

### **HOW INVESTORS ARE FINDING THE FUNDS THEY ALLOCATE TO**

Responding to the multiple-choice answers to choose from, a substantial 67% of polled investors said finding new hedge fund managers and strategies was from their *Personal Network*. Just 22% attributed it to *Capital Introduction From Prime Broker*. And then there is the particularly fascinating response: only 5% of investors chose *Referral From Third Party Marketer*. That should get the attention of emerging manager hedge fund firm owners who contemplate whether they might outsource their investor outreach efforts.

That miniscule five percent response for *Referral From Third Party Marketer* can convey a few possible scenarios combined. Among those to consider are these: A vast percentage of polled investors do not get, or else accept, hedge fund pitches from third party marketers. These investors do not know or have relationships with those third party marketers who may in fact be competent (there is not a high barrier to entry into the field). Finally, when it comes to emerging manager funds in particular, investors would much prefer having contact with the founder/portfolio manager/head of the business than with a proxy. For the young emerging manager firm, do not underestimate that last observation.

We believe *Personal Network* means the combination of people they know + fund performance reporting databases + industry networking events they attend + published content from portfolio managers that they find or get and read.

So, what should you do to make finding you and your hedge fund easier?

Your fund's performance reporting data should be posted and findable at the major online databases that offer this compiled information to investors.

You should look to attend and participate as a speaker at some of the industry networking conferences and events where investors and money managers are at the same place at the same time.

Set a goal of building a library of beyond-the-numbers content from your portfolio manager that delivers insights into how she or he thinks and that communicates and promotes the intellectual acumen of management at the hedge fund.

Make it easier for your prime broker's cap intro team to refer investors to you rather than similar sized, similar performing hedge funds they also have as clients. Following the recommended actions throughout this article and delivering the resulting information and documents to the cap intro team will set you apart from others and give your prime broker confidence that there is no reputational risk in introducing you to investors they know.

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### **About the author**

Bruce Frumerman is CEO of Frumerman & Nemeth Inc., a 37-year-old financial communications and sales marketing consultancy that helps financial services firms create brand identities for their organizations and develop and implement effective new marketing strategies and programs. Frumerman & Nemeth's work has helped money management firm clients attract over \$7 billion in new assets, yet they are *not* third-party marketers.

Frumerman & Nemeth is internationally recognized for its work in crafting for clients the beyond-the-numbers story of how they invest — content that investment committees actually discuss, debate and vote on behind closed doors when considering firms on a short list for potential investment. Importantly, this is required due diligence content that cannot be communicated in pitchbook format.

Frumerman & Nemeth's work also includes providing strategic consulting on product and strategy-specific branding, crafting the required strategy-specific content detail and designing and producing the marketing tools needed to make it through the two-month to two-year institutional selling cycle. Clients also employ Frumerman & Nemeth to help promote the intellectual acumen of management — helping them get speaking opportunities, write and give speeches as panelists or stand-alone speakers at industry conferences, and through media relations marketing services.

Mr. Frumerman can be reached at [info@frumerman.com](mailto:info@frumerman.com), or by visiting [www.frumerman.com](http://www.frumerman.com).