Anchin Alert

Anchin, Block & Anchin LLP
Accountants and Advisors

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How Can Hedge Funds Raise Capital More Effectively?

Raising capital for a hedge fund is a process. At a time when the industry has seen four straight quarters of capital outflows, it's more important than ever for fund managers to know how, where and why they will attract investors. By understanding the mindset of investors as well as their concerns, you can improve your fund raising results.

Top Regions for Raising Capital

While there have been net outflows overall for hedge funds, some regions remain good sources of capital. The United States is the clear frontrunner and accounts for about 70 to 80 percent of the assets raised in North America. In particular, there are strong mandates in the Western part of the country, from Texas through Northern California.

If your fund wishes to look abroad, Australia and the Middle East are showing the most interest. Japan is another country worthy of consideration, although investors there seem to be interested in investments with few restrictions on withdrawals.

Before you target an area, think about whether you're able to visit at least twice a year to meet with investors. Visiting Australia just once may not help your fund raise capital because investors expect consistency to establish a relationship which leads to investment.

European Marketing Strategies

Over the past four years, managers have put aside active marketing efforts in Europe and relied mainly on reverse solicitation. However, European activity is starting to pick up and may be worth reconsideration.

The UK, Switzerland, the Netherlands and Finland are generating significant deal flow while continental Europe, especially France, Spain and Italy still present challenges for raising capital due to government regulations.

It's important to look into the registration and notification requirements of each country. If your fund is established, and can qualify in an Undertakings for the Collective Investment in Transferable Securities (UCITS) environment, this can be another way to navigate European regulations. With that in mind, while Asian and North American funds are picking up registrations in Europe, reverse solicitation remains the main way to raise money here.

Types of Investors

The majority of hedge fund inflows still come from institutional investors: large sovereign wealth funds, corporate pension plans, public pension plans, funds of funds, etc.

However, interest is slowly picking up from family offices and high net worth individuals. With valuations at all-time highs for traditional equities, these investors want to take some of their profits off the table and redeploy them into a hedge fund that continues to deliver consistent returns.

Advisory firms are also starting to invest their clients' funds directly in hedge funds, rather than going through a fund of funds. The wealth management industry is consolidating as larger firms buy up smaller ones, resulting in these accounts growing in-size and becoming more significant sources of funding.

Finally, the hedge fund activity from the multifamily office market is also growing. They look to build their portfolios of 20 to 30 different hedge funds to give their clients variety while also creating some excess performance (Alpha) in their portfolios to offset the risk (Beta) from other assets.

Investor Concerns

With equity valuations currently high, investors are looking for funds that will continue to deliver performance in the future, even during a potential downturn. Capital preservation is particularly important for high net worth individuals and families, especially those in the second or third generation. They would prefer consistent returns in the high single or low double digits rather than deal with potential losses possible from chasing better returns.

When you meet with investors, they will also be weighing whether you're different from all the other funds out there. Are your ideas truly unique? What sets you apart from the competition? This is something you need to be ready to discuss convincingly.

For the first time in years, investors are not as concerned with liquidity. If a fund can demonstrate consistent returns, investors are more willing to give up liquidity in order to participate in the strategy.

In-Demand Strategies

Today, some hedge fund strategies are more in-demand than others. From a strategy agnostic point of view, if a fund can show that they've delivered a Sharpe ratio (excess of return over risk) of one with a low Beta relative to the market over the past three to five years, that will attract interest.

Investors are also looking for funds that specialize in a specific sector. There's interest in most industries outside of technology, media and telecom, and also in other niches like royalties, litigation finance, reinsurance or private credit. A fund that uses artificial intelligence or machine-based learning strategies could be attractive provided the fund has a successful track record of at least three years.

Funds that invest in China also have an advantage as investors are looking to add this region to their portfolio in a hedge fund capacity. As has been the case for years, there remains an ongoing supply/demand gap for Emerging Markets Macro strategies.

On the other hand, equity long-short has seen the most capital outflows, especially from North American markets. Commodity Trading Advisers are also seeing outflows as investors move into other lower priced risk premium products like private credit.

The Investment Cycle

Patience is the name of the game with raising capital. Expect to take, on average, 6 to 7 meetings to secure an investor: roughly two to -three with the investor themselves, then a due diligence meeting, then another two to three additional meetings after that. The fastest this process usually goes is six months, but the standard is typically 12-18 months, and that's if an investor is ready to take on another fund.

During this time, you should stay in touch without being pushy. One to two meetings per year is ideal. If an investor is interested, they'll reach out for more. Remember, the typical investor is contacted by 5,000 to 10,000 funds per year and meeting with several hundred. If they're slow to get back to you, it could be because they're feeling overwhelmed.

Building Relationships

In order to get more time with your prospects, visit conferences you know they will attend. That way you develop relationships in a low-stress environment and they'll be more likely to get back to you in the future. Another way to build rapport is by sending investors information throughout the year, such as articles about market conditions you think they will find helpful.

Through actions like these, you present yourself as a partner, thought leader and a fiduciary for an investor. While they may not have room in their portfolio for another fund at this moment, following these steps will put you in a strong position when they are ready to invest.

Researching Investors

Before meeting with any investor, to the extent that you can, get to know what's already in their portfolio. For example, by looking at a pension fund's annual filings you can see how to position your fund within their holdings.

When a client asks which existing fund yours is similar to, don't say you're completely unique. No fund is. While you may believe your fund does have an original approach, investors see so many other funds that say the same thing. Instead, research your peer group and competition so that you can specifically point out what your fund does differently during your presentation.

Presenting

Rushing into an investor meeting is one of the worst moves a fund manager can make. For example, you might seem ill-prepared if yours is a new launch and you schedule a meeting without having your presentation deck ready. You only get so many opportunities to meet investors and may not get a second chance. Remember, investors have long decision cycles. It's better to delay the meeting a couple of weeks so that you can show up completely prepared.

If you have a great product, but meetings just aren't leading to investors, it could be an issue with your pitch. Your presentation should be well-rehearsed and everyone in the meeting should know their part. You don't want fund members talking over each other during the meeting as this makes investors uncomfortable. Consider writing a script to keep everyone on track, and don't bring anyone to the meeting who doesn't have a role in communicating the message.

Ideally, the presentation should be an hour or less. Except in rare situations when the client is extremely interested, longer than that may be viewed as rambling.

Tips for Raising Capital in a Competitive Environment

As always, a hedge fund with good systems in place is more likely to raise money. You need to show that you have the right people to not only deliver Alpha, but also to run the ship during difficult stretches. When you have a process that is repeatable and you can explain how you're driving returns, capital starts to flow.

Still, in today's competitive environment hedge funds cannot rely on their legacy or word of mouth alone to raise capital. They need to invest in a sales and marketing process to get in front of investors and develop relationships.

Set priorities for where your managers will visit during the year. For an area to make your list, managers must be able to visit at least twice a year. For example, you may pick your top seven cities and then only visit other places if there's time leftover. As you put together your plan, consider visiting less-trafficked cities, especially in the United States. There will be less competition to get in front of investors.

Hiring a good marketer can help with this process as they understand how to stay in touch with investors and maintain relationships. This is important both before an allocation and after. When your investment starts to hit issues is when you need good communication most of all.

Long-Term Focus = Allocations

Raising capital requires a long-term focus, especially with institutional investors. They typically aren't holding 50% of their money in cash so you need to be prepared to wait for them to be seeking to change their portfolio. It may take two to three years before they are ready to revise an allocation and you need to build up your relationship before then. That way when they're ready to move, you're in position.

If you try a transactional mindset, targeting investors only when the news breaks and telling them that they're looking for your type of strategy, it may already be too late. They are going to be bombarded with calls. Who are they most likely to invest with? Someone they just met or a manager they've been speaking with for years?

Today, investors are looking for a partnership with their funds. They are more hands-on and want to spend more time with their managers developing strategies, especially since institutional investors have their own in-house talent with expertise. Prepare to be flexible with your strategy as investors may request changes. Don't expect a one-size-fits-all investment approach to work anymore.

While you can't control whether your fund fits an investor's goals or strategy, you can control whether they like you and your story. By following a disciplined process and avoiding common capital raising mistakes, you'll put yourself in the best possible position with investors.

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Anchin, Block & Anchin LLP
Accountants and Advisors
1375 Broadway, New York, NY 10018
212.840.3456 • www.anchin.com