

## The Spectrum of Hedge Fund Investors and a Roadmap to Effective Marketing

By Ron Suber, John Quartararo and Patrick McCurdy

**M**erlin has written a number of articles and papers this year about the changing nature of the hedge fund industry. Specifically, we have written about the various requirements that funds need to meet in order to attract and reach the right investors. What we have not addressed is who those target investors are and how managers can determine the appropriate investors for their specific fund. In fact, we feel that surprisingly little has been written about this topic in the post-crisis environment. Now more than ever, it is critical that hedge funds know their investors, know what those investors require, and understand how to tailor their marketing strategy accordingly.

The hedge fund industry is experiencing a period of unprecedented uncertainty. Many existing and established funds are struggling simply to keep moving forward against redemptions and perilous market conditions. Additionally, for many managers who have launched in the past several years, while their initial goals may have been clear – get the fund up and running, build a track record and grow to the target AUM goal – the financial crisis has knocked them off course.

Many investment managers made early infrastructure investments they felt were necessary to reach their goals: they bought advanced trading, reporting and risk technology products; took up expensive space; and hired top-tier talent. They built the foundation for a significant fund platform.

Then came the financial crisis and the ensuing turbulent market. The “ready” capital these managers expected to find early in their development was invested instead with larger, more established funds with better pedigrees and

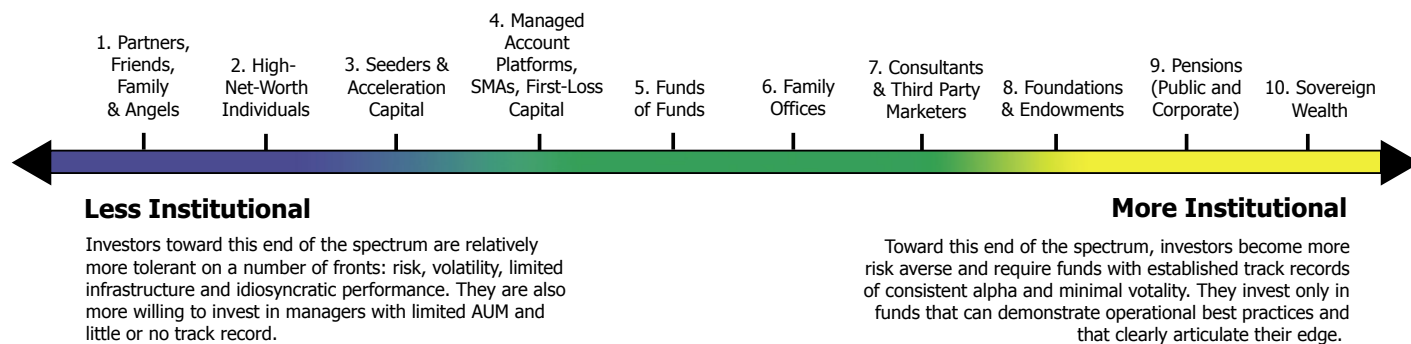
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longer operating histories. Additionally, the revenue they anticipated from their “2 and 20” compensation structure never materialized: the management fees suffered from smaller AUM, and performance fees suffered because the market has been difficult to navigate. Many of these funds are experiencing low single-digit returns and are still under or near their high-water marks.

For these managers – as well as other existing managers whose revenues are simply not sufficient to support their operating expenses – today’s climate necessitates difficult decisions both for the top- and bottom-lines. Critical questions that must be asked include: What expenses should be reduced? How can managers grow AUM in this environment? How can a fund meet its day-to-day obligations and pay top-tier talent when the revenues are not where they need to be?

These questions are – at their core – the most basic questions any business manager must ask. And while little good has come from the financial crisis, one positive

## The Spectrum of Hedge Fund Investors



development has been the realization among many hedge fund managers that they are not simply managing a fund – they are operating a business.

This concept, while seemingly straightforward, is the key to moving up through the various levels of potential investors.

### THE SPECTRUM OF HEDGE FUND INVESTORS

The spectrum of hedge fund investors is arranged, generally, in terms of how “institutional” each type of investor group tends to be. Regardless of whether these investors are in fact “institutions,” by “institutional” we are referring to the level of general requirements each investor group places on their hedge fund managers: assets, operational practices, risk management framework, track record, reporting and so forth.

Just as the spectrum goes from risk-tolerant to risk-averse, as a general rule of thumb, hedge funds can assume that if they are ill-equipped to meet the needs of one level of investor, they are unlikely to realistically be able to target any higher, more risk-averse levels further along the spectrum.

### A Closer Look at Each Level of the Spectrum

#### 1. Partners, Friends, Family & Angels

**Overview:** Friends and family members are the inner circle of investors. They have close relationships with the general partner(s) of the fund, including in many instances a prior investment relationship. General partners of a fund traditionally make significant investment of their own net

worth into the fund to demonstrate an alignment of interest with their limited partners.

**When to access:** Prior to Day 1. These investors often comprise a significant portion of a fund’s launch capital.

**Advantages:** The personal relationships that often exist among these investors may enable a manager to find capital without overcoming the institutional hurdle – i.e., without having a significantly developed infrastructure, team, track record and AUM. These investors will also likely require minimal due diligence and will stay with the fund through various market cycles as patient investment capital.

**Challenges/Limitations:** While these investors are helpful as first movers of capital, they typically make small investments. They may get a fund up and running, but they do not help achieve critical AUM – i.e., a level of assets that allows investors further up the spectrum to invest without becoming a significant portion of overall AUM.

#### 2. High-Net-Worth Individuals

**Overview:** As a non-institutional group of investors, high-net-worth (HNW) individuals are accredited investors or qualified purchasers as defined by the U.S. Securities and Exchange Commission. They have the ability to invest based on referrals from personal relationships. Managers may access HNW individuals by networking with friends and family, current and past investors, executives of the companies the fund covers, hedge fund databases, consultants and third-party marketers.

**When to access:** Prior to Day 1 and early in a fund’s development.

**Advantages:** Similar to the friends and family group, these investors are often willing to invest in managers

that do not satisfy the rigorous requirements of institutions and who have smaller AUMs. They should be longer term investors, typically.

**Challenges/Limitations:** Smaller check sizes, harder to source investors, potentially difficult to perform background and due diligence checks. Many HNW investors will require access to the portfolio management team, which can become a strain on PMs.

### 3. Seeders & Acceleration Capital

**Overview:** Investors who provide seed or acceleration capital receive compensation for their investment, often in the form of a revenue sharing agreement or equity ownership. These investors can provide Day 1 funding from \$5 to \$100+ million, and that capital is typically provided by one of the 20 traditional seed capital providers, other hedge fund managers, HNW individuals or private equity firms.

This capital is also often used to help spinout funds that are seeking to replicate their previous funds. Once a fund is able to secure this level of capital, they typically are at the first level of critical AUM for marketing to other investors. Acceleration capital is provided to managers who have already launched but are willing to enter into a partnership with an investor to quickly ramp up their AUM level.

**When to access:** Prior to Day 1, or anytime for acceleration capital.

**Advantages:** These investments, typically larger in size, enable a manager to reach critical AUM, which in turn opens the door to the first levels of institutional investors, especially those with lower AUM requirements.

**Challenges/Limitations:** While seeders are willing to invest early with managers, typically they require a revenue sharing agreement or an equity stake in the fund. Given their unique ability to invest significant capital with unproven managers, seeders are extremely sought after. They see many opportunities, but invest in few.

### 4. Managed Account Platforms, Separately Managed Accounts, First-Loss Capital

**Overview:** This group of investors requires that their investment be placed in an investor-owned account segregated from the commingled fund. The manager will act as the trading advisor to this account, and while most

often traded *pari passu*, in some cases investors will require additional strategy constraints or risk parameters be applied to the SMA. This source of capital has enjoyed a major surge in popularity by investors and acceptance by managers following the broad market redemptions and gating of 2008. Their popularity is due to the benefits they offer to investors, including transparency, ownership of the account and liquidity through control of assets. Other investors take these benefits one step further and require managers to put up capital into a separately managed account to serve as first-loss capital, thereby creating a principal-protected account.

**When to access:** SMAs provide liquidity and transparency and thereby enable investors to gain comfort at any stage of the fund's lifecycle.

**Advantages:** SMAs provide an additional revenue stream to support the business and help build out infrastructure. Taking capital into an SMA shows AUM growth and fund-raising momentum.

**Challenges/Limitations:** SMAs increase the operational complexity for a manager. The assets are not invested with the commingled funds and therefore do not assist in targeting larger investors who, because of their minimum investment size, are limited by the total fund size.

### 5. Funds of Funds

**Overview:** As the name suggests, FOFs invest capital across a range of hedge funds. Given today's competitive capital raising environment, and the fact that FOFs typically have a sophisticated investment team that conducts multiple layers of manager due diligence, FOFs can take 6 to 18 months to make an initial investment. Before engaging with a FOF, be sure that a true partnership relationship is possible.

**When to access:** Once a good source for Day 1 capital, since 2008 FOFs have been less likely to be early investors, preferring instead to look at more established managers with track records of producing alpha and a proven ability to manage their business. Newer managers will be monitored until an investment strategy can be verified by their performance metrics.

**Advantages:** FOFs are active allocators of capital and are most likely to invest if the fund's strategy is of current interest and the fund is performing well. However, this active allocation practice cuts both ways: underperforming managers or those managing out-of-favor strategies may suffer redemptions. FOFs have a general reputation

of having higher turnover rates than institutional investors further up the spectrum, but this must be taken on a case-by-case basis.

**Challenges/Limitations:** Managers need to perform due diligence on the FOF to understand who are their underlying investors. FOFs may have an unstable capital base and therefore be subject to underlying redemptions. That means they may be “hot money” – i.e., having to redeem capital from managers.

## 6. Family Offices

**Overview:** A family office is an organization built to manage a family’s wealth and can be administered by the family itself or by a team of investment professionals. Often incorrectly lumped into one bucket, family offices can vary significantly in terms of their level of investment expertise, sophistication, strategy interest and risk tolerance. Smaller family offices allow for closer access to the money, but allocations may be smaller (\$1–\$5 million) to start. Larger family offices often require as much due diligence as institutional investors and tend to allocate in larger sizes (\$5–\$25 million). This is particularly true of multifamily offices, which manage assets for a number of HNW individuals and families. The sophistication and expertise of multifamily offices is often at a level more consistent with larger institutions.

**When to access:** As family offices have varying mandates that enable them to be opportunistic, they can be accessed throughout a fund’s lifecycle.

**Advantages:** Family offices typically have flatter structures that allow managers to get closer to the decision makers and may lead to a shorter due diligence process.

**Challenges/Limitations:** Unsophisticated family offices may overweight AUM and name brand recognition in their due diligence process and therefore only allocate to the largest, most pedigreed hedge fund managers. Managers with smaller AUMs may find this unsophisticated group quite challenging to access.

## 7. Consultants & Third-Party Marketers

**Overview:** Putting together these two groups is more a function of the outsourced service they provide rather than the similarity of that service. Consultants often work in an advisory capacity to investors, while third-party marketers work as an extension of a fund’s marketing efforts. Fundamentally, what each group provides is “access.”

Many consultant relationships are set up in an advisory capacity for investors who have decided to outsource a portion of their investment process. Therefore, while consultants do not have discretion to invest capital, they do provide investment options to their underlying investor.

Third-party marketers act as an extension of a fund’s marketing efforts and enable the fund to reach a broader universe of investors. Some third-party marketers might focus on HNW individuals, others may provide access to institutions and some may have regional and global reach.

Understanding to whom consultants and third-party marketers are speaking enables managers to determine whether this relationship will be appropriate. Approval on one of these platforms can lead to rapid asset flows, so capacity and AUM targets must be clearly defined.

**When to access:** There is no set timeframe to begin reaching out to consultants and third-party marketers, but typically only after a fund has reached out to the previous levels of investors can these groups be accessed.

**Advantages:** These groups provide easy access to a broad and diverse investor base.

**Challenges/Limitations:** The biggest challenge with these groups is that the fund strategy must have capacity. Once approved, a fund may receive a steady flow of assets. While it may be costly to use a third-party marketer, especially if they are simply leveraging performance numbers, they can be of great benefit if they have real investor relationships.

## 8. Foundations & Endowments

**Overview:** Endowments and foundations are institutional investors that manage the assets of schools and nonprofit organizations. Because the organizations they represent are permanent, these groups invest with exceptionally long-term time horizons.

The longer time horizons translate into sticky capital – i.e., a lower turnover rate in the portfolio. However, that also means that there are fewer opportunities to be added to the portfolio and that the chances of receiving an allocation are proportionately decreased.

**When to access:** Foundations and endowments are essentially untouchable until a fund can demonstrate true institutional quality. There is no value in approaching these investors before the firm’s infrastructure has been built out and the fund has demonstrated staying power and a track record of producing alpha. Only funds in Stage 4 (see below for an explanation of the Stages of a Hedge Fund’s

Development) of their lifecycle need focus on these and subsequent investors.

**Advantages:** These groups can make significant investments of long-term capital.

**Challenges/Limitations:** The low turnover rates among these investors means less opportunity to be added.

## 9. Pensions (Public and Corporate)

**Overview:** Pension funds are responsible for preserving and growing capital for companies and governments which is used to support their employees upon retirement. There is a wide range of investment expertise represented by pensions. Some are staffed by highly experienced investment professionals, while others are managed by people with little financial experience. The former will invest in a wide range of strategies to produce a diversified portfolio of strategies, whereas the latter may disproportionately invest with blue chip, pedigreed managers or outsource their research process to consultants. Understanding the different types of pensions will help managers effectively navigate these investors.

**When to access:** Pension funds have the ability to invest with hedge fund managers at any point in their lifecycle, but given the long-term nature of these investments and their size, they typically spend the majority of their due diligence energy on established, blue-chip managers. With that said, many pensions can be opportunistic with their investments.

**Advantages:** These groups make significant investments and represent sticky capital.

**Challenges/Limitations:** Pensions vary widely in their sophistication. Pensions have ERISA considerations and need to have transparency into a manager's portfolio to understand leverage levels. They may require a separately managed account for transparency purposes.

## 10. Sovereign Wealth

**Overview:** Sovereign wealth funds are entities set up by governments to manage a country's wealth through long-term diversified investments. Wealth is often generated by capital account surpluses in natural resource rich countries. Because these funds are so large, capacity becomes one of the critical considerations; managers must be able to accept \$500 million to \$1 billion as a minimum investment size. Therefore sovereign wealth funds usually deal with only the largest hedge fund managers.

**When to access:** Managers must have a fully built-out infrastructure and the capacity in the fund to take in a large investment.

**Advantages:** Sovereign wealth funds have the ability to write very large checks and are fairly stable with their investments.

**Challenges/Limitations:** The strategy must have the capacity for large investments, and typically only funds with AUM of at least \$5 billion have the necessary infrastructure in place to take on such large allocations. Additionally, such larger investments mean that to maintain a liquid strategy managers will be forced up the market cap curve, which might constrain strategy. These investors are often costly to access and conduct extensive due diligence.

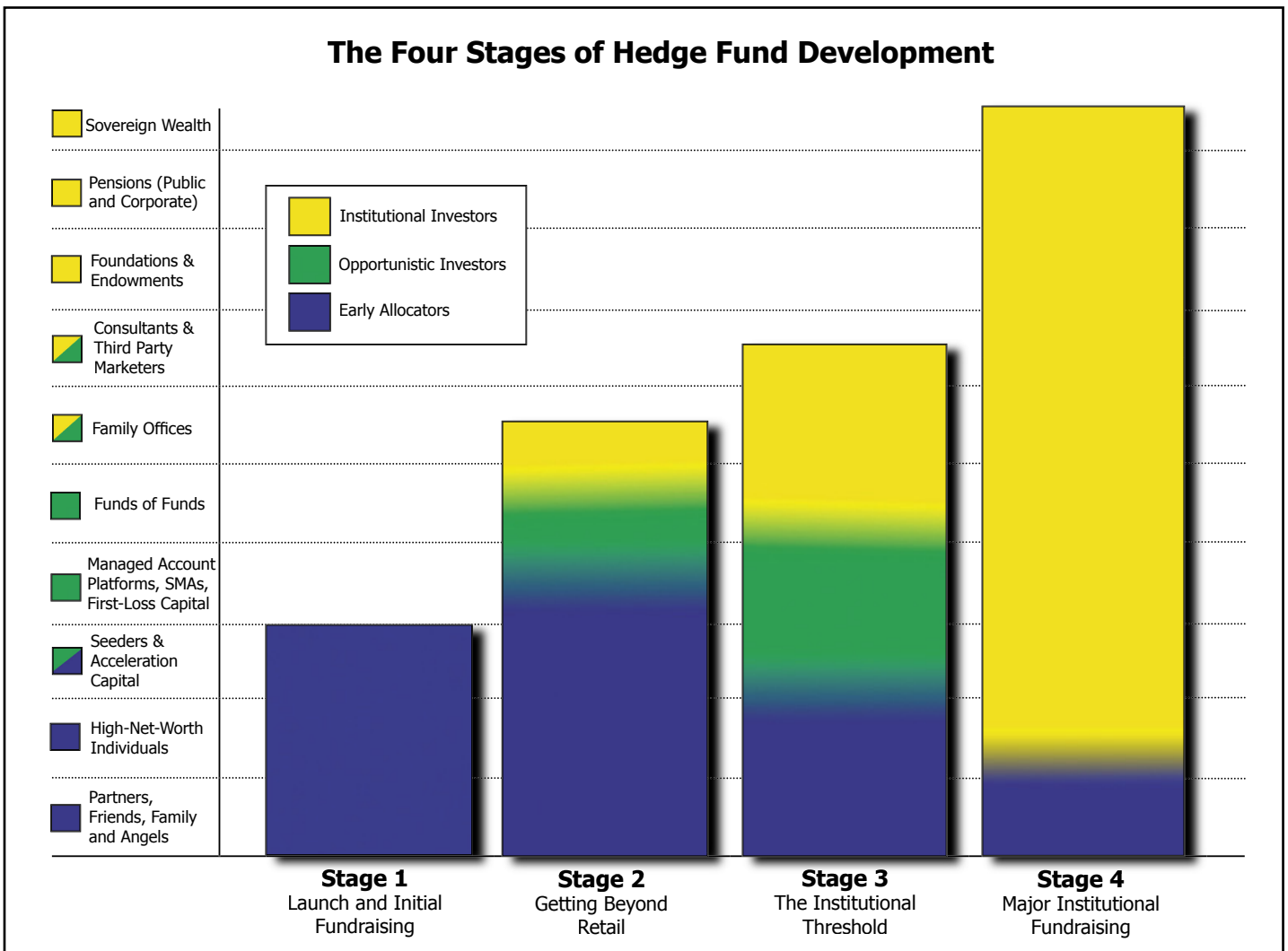
## PROGRESSING ALONG THE SPECTRUM — THE FOUR STAGES OF A HEDGE FUND'S DEVELOPMENT

Once hedge funds have a firm understanding of the various types of potential hedge fund investors, the next step is to tailor their marketing program to attract the types of investors most appropriate for their stage of growth, their size and their level of institutional preparedness – that is, the robustness of their platform in terms of operations, risk management, controls and so forth.

Hedge funds should approach their marketing program in roughly four stages, as highlighted in the diagram on the following page. These are not meant to represent unbending rules or firm boundaries, but rather to serve as a guideline to understanding how much attention a fund should be committing to attracting the right type of investors at the right times. Additionally, the stages should be used as a guide to help managers think about what aspects of their marketing program need to be ramped up as they move to each step of the spectrum.

**Stage 1, Launch and Initial Fundraising**, represents the very early days of a fund's development, including the prelaunch activities of securing initial investment capital. The types of investors are typically individuals known personally to the manager or seeders which require only a baseline of institutional preparedness.

**Stage 2, Getting Beyond Retail**, should also take place relatively early in a fund's lifecycle, should also take place relatively early in a fund's lifecycle, ideally within the first 180 days. At this stage, managers have established a groove, the fund is functioning well on a day-to-day basis, core personnel and systems are in place and the fund has



established clear marketing materials for targeting entry-level institutional investors.

**Stage 3, The Institutional Threshold**, represents a significant hurdle for most funds. At this stage, managers have successfully gotten several small institutional commitments, perhaps from family offices, consultants and third-party marketers. Now they are ready to break into institutional investors who will require significantly more. We have written extensively this year about the many requirements that come into play at this level.<sup>1</sup>

**Stage 4, Major Institutional Fundraising**, is only attainable once all of the aforementioned requirements that we have outlined this year are satisfied: the manager must be able to articulate their “edge,” adhere to best practices and demonstrate a significant track record of repeatable performance with minimal volatility. Even when all these conditions are met, getting institutional capital is difficult

and takes significant time. In today’s environment, institutions can take many months reviewing a small number of funds and ultimately pass on most of them. When they do commit, however, these investors typically bring very significant capital to the table.

It is critical that funds understand which stage of development and growth best describes them and that they then focus their efforts on the respective targets. Just as seeders are inappropriate targets for a \$10 billion fund, pensions are not the optimal target for a \$1 million startup fund without a track record. Time spent marketing is valuable and should be treated as such.

In order to advance through the four stages, managers need to demonstrate increasingly that their infrastructure is robust, the investment process and results are repeatable, and that the fund is truly running a business. A fund’s collective marketing efforts, outlined in the next

<sup>1</sup> See *The Necessary Nine: How to Raise and Retain Institutional Capital*, *The Big 12 Hedge Fund Best Practices*, and *The Quantitative and Three Qualitative Minimums for Hedge Funds*.

section, should reflect these criteria.

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## MARKETING ACROSS THE STAGES

First, some simple definitions. Marketing, sales and communications are three terms that are often interchanged, but they have distinct definitions:

- **Marketing** represents a firm's collective efforts to reinforce existing relationships and engage new opportunities. Marketing encompasses both sales and communications.
- **Sales** is the private introduction of the firm and its relevant product offerings.
- **Communications** is the public introduction of the firm's brand and range of products.

While sales and communications are different disciplines that produce different results, they are naturally symbiotic. When synchronized, they amplify each other and the overall marketing program.

As funds progress through the stages of their development, a number of marketing activities need to be ramped up at each stage. Examples of the types of sales and communications efforts that funds should think about as they move through the spectrum include:

### *Sales activities*

- Maintaining ongoing dialogue with existing clients for additional funding
- Encouraging existing clients to introduce new potential investors
- Consistent communication with strategic partners about business growth and fund performance

- Supporting foundations and charitable organizations and joining their boards (activities which, importantly, foster enormous personal growth as well)
- Maintaining connections with university endowment groups and alumni
- Developing relationships with the senior management of companies held in portfolio

### *Communications activities*

- Upgrading pitchbook content and design to reflect the fund's size and sophistication
- Refining and improving investor letters and broadening the distribution list
- Upgrading the website
- Getting membership to additional investor databases
- Speaking and attending investor conferences
- Creating and distributing white papers that demonstrate thought leadership
- Developing and fostering relationships with key industry media
- Attending prime broker capital development events

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## CONCLUSION

Clearly the landscape has changed dramatically for hedge fund managers and the investment community over the past several years. And so, too, have the investment approaches of each level of the spectrum changed. For hedge funds seeking to reach the next level of AUM, it is important to understand where the fund is in its lifecycle, which investors should be targeted and what each of those investors requires. Only then can a fund begin to organize its overall marketing strategy to meet the increasingly stringent investor requirements.

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