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Myriad of choice for start-up hedge fund managers

Whilst in London recently I attended an event focused on start-up hedge fund managers. Although the number of launches in 2016 was down on recent years, those at the cutting edge in London at least, are reporting an uptick in the number of funds launched towards the end of the year or which are otherwise in the pipeline. Opening discussions on the prospects for sector growth quickly turned to discussions on the cause of the lower numbers and the challenges facing new start-ups.

Prospective hedge fund managers face a myriad of choices when establishing a new hedge fund operation. This article highlights some of the key areas for consideration.

Internal operations

A good starting point is to consider the expectations of the target investor base. Is it necessary to build an institutional grade infrastructure with significant numbers of permanent staff, dedicated IT systems, prestigious office premises and the like or is a more modest operation sufficient? Whilst the days of a laptop, access to a trading system and a few spreadsheets are long gone, it is worth considering whether the core investment and risk management teams can be supported by individuals with specialist knowledge in the areas of accounting, finance, regulatory compliance and IT security on a part time or contract basis. There are clearly pros and cons of each approach, but if tight control of costs in the early years is an absolute priority - which in many cases it is likely to be – it is perhaps worth building a lower cost but scalable operation which can be expanded as AUM grows.

Stand-alone fund versus platform

It is not the purpose of this article to analyse in depth the merits of either option. A stand-alone fund is normally the goal of most start up hedge fund managers, given the increased flexibility and arguably prestige that such a vehicle offers. However the route of launching your first fund via a "fund platform" solution offers a cost effective way of bringing product to market. There is a wide choice of platform providers and most jurisdictions offer platform solutions is some shape or form. Such platforms are however not without drawbacks. They may lack a degree of flexibility or control otherwise desired by the manager and for those intending to use the platform product as a stepping stone to a standalone fund, one needs to factor in possible future issues for investors such as the potential crystallisation of tax liabilities when the time comes to migrate investors from the platform to a stand-alone fund.

Choice of domicile

Most potential hedge fund managers will already have a view on the likely domicile of their operations – and this will often be onshore. However it is worth considering whether all operations will be carried out onshore or whether there is scope to offshore part of the operation – effectively setting up an offshore AIFM. With increasing focus on the OECD's BEPS initiative, jurisdictions such as Guernsey offer an attractive and viable proposition in that expertise and other resources which offer true substance are readily available.

Choice of domicile for the fund itself should also be considered carefully. Traditionally the Cayman Islands have been the domicile of choice, particularly for funds oriented to a US investor base. Increasingly however Asian investors who are a significant potential target market are finding European offshore centres a credible alternative, particularly if the selected service providers are themselves based in Europe.

Service Provider selection

Perhaps going hand-in hand with choice of domicile for the fund is the challenge of selecting suitable service providers. These decisions generally focus on the choice of administrator, prime brokers and auditors.

Again it is not within the scope of this article to analyse in detail the options, suffice to say that decisions will be needed on whether to appoint one of the larger firms with a global reach who can provide a "one stop shop'" offering or whether to engage a combination of smaller independent providers who can deliver the required services in a coordinated manner. In the latter case, consideration will need to be given as to whether the provider can support the manager not just in the launch and immediate post launch phase but as the fund grows in size and potentially complexity. The selection decision should factor in the likely nature of the service delivery. Is the provider's output more akin to a "factory" or "commoditised" approach with potentially limited scope for a highly personalised service or is the service delivery more relationship based, as is more commonly seen in the private equity world where the provider may be able to offer an attentive highly customised service.

Investor preferences

As touched upon earlier, investor preferences are likely to be a significant influencing factor when setting up any new operation.

It is likely that most if not all investors will undertake a significant level of due diligence before committing capital to a new fund. As well as the usual checks on investment track record, financial viability, risk management processes, and the level of management's own investment into the fund, investors will ascertain that the new manager fully understands and accepts their fiduciary responsibilities and can demonstrate that it has in place robust governance of the new operation.

Different investor types will have different expectations. HNW individuals for example may feel more comfortable investing in a UCITS type fund which by their nature tend to be quite heavily regulated, although from the manager's perspective, such funds bring additional costs and may lack the flexibility of a non UCITS fund. Institutional investors generally do not have the same requirement for investor protection by the regulator and may be comfortable relying on a combination of the fact that the manager itself is appropriately licensed and their own ongoing monitoring.

Conclusion

This short article can do no more that skim the surface of a large topic. If one assumes that the likely timescale for bringing a start-up operation from inception to launch is the best part of 12 months, then there are plenty of decisions to be made by the prospective hedge fund manager from an operational perspective in a relatively short space quite apart from the need to deal with the portfolio management side of the business.

The good news is that there is plenty of support and advice available to new start-ups ranging from that provided by prime brokers and administrators to that offered by independent firms. New managers should not be fearful that they are setting out on their new venture single-handedly.

For more information about establishing a fund, please visit our website www.icorserv.com or email us at info@icorserv.com or call us on

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