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Merlin's Necessary Nine: How To Raise and Retain Institutional Capital

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Ron Suber: *This article is based on a presentation by Ron Suber at the Feb. 18th event* *Hedge Funds: Getting to the Next Level* *[1]By Ron Suber* -- Not long ago, pre-2008, hedge fund managers held relative power over investors. Because demand for their products was so high across a range of strategies, they controlled the terms, often with little transparency and very favorable gating provisions.

Recent market events and a general scarcity of investors has shifted the power to the investor. While raising and retaining institutional capital has always been challenging, in today's environment hedge fund managers must be more diligent than ever in clearly defining and explaining their process, controls and their differentiation. Worries about performance are now often eclipsed by other concerns such as volatility, liquidity, attribution, transparency and, of course, fraud.

The following checklist – we call it the Merlin Necessary Nine – is designed to help hedge fund managers understand and articulate their edge to institutional investors.

1. Convey how your process, performance and Alpha generation is repeatable. Institutions don't make decisions based on short-term performance, so if you have less than a 2-year track record be prepared to explain clearly and with great detail how your fund will perform throughout the full market cycle and under periods of unique economic duress and volatility. Needless to say, given the turbulence of the past few years, this is top-of-mind for institutions.

2. Showcase your portfolio's performance using the full range of quantitative measurements. Institutional investors are more advanced than ever, so be prepared to offer them the data and analysis of their choice. The numbers themselves are critically important to an investor's decision-making process, but so too is the fact that their managers are as diligent as they are at tracking, understanding and knowing what to do with those numbers. At a minimum, be able to provide the following:

- Risk (delta and beta, adjusted with implied volatilities)
- Daily exposure detail since inception
- Alpha over custom-blended benchmarks on your long and short positions
- Asset allocation versus stock selection criteria
- Concentration, liquidity and leverage statistics
- Volatility

- Attribution, both absolute and relative

3. Harmonize your team. If an investor speaks with four members of your team separately, how certain are you that all four members would articulate your fund's compelling edge similarly? Conversely, if you were an investor and met with four members of an investment team and received four inconsistent explanations of the fund, would that make you more or less likely to invest? Define your key messages in short-form (less than 1 minute) and longer form (about 3 minutes), and then drill your team periodically to ensure everyone is in harmony.

4. Operate in a multi-prime and multi-custodian environment. The days when a fund larger than $75 million could use only one prime broker or custodian are over. Institutional investors require, for good reason, that managers mitigate their counterparty risk by using multiple primes and custodians. Further, some institutions choose the prime broker and require that a true custody bank retain at least a portion of the cash and fully-paid-for assets under management.

5. Accept separately managed accounts. The demand for separately managed accounts continues to grow, and institutions want assurance that fund managers are operationally equipped to handle these structures. Of key importance, you must be able to demonstrate that your managed accounts perform consistently with your flagship strategy.

6. Provide institutional quality infrastructure. "Institutional quality" means, quite simply, that regardless of the size of your fund, it run in a manner that constantly adheres to all best practices. This includes having an empowered compliance consultant or internal CCO, retaining reputable third-party administrator and tax/audit firm, outsourcing your IT (complete with disaster recovery and multiple levels of redundancy) as well as defining and enforcing strong trading and operational policies and protocols.

7. Show sustainability with limited reliance on the founder or any single person. So often in asset management a "star" analyst, portfolio manager or trader becomes the face of a fund, a phenomenon that cuts both ways for funds. On the one hand, high-profile managers draw clients, but on the other hand institutions no longer accept "key man" risk. Showcase your players, but emphasize the team element.

8. Understand your shortcomings. Effective managers, no matter what business they are in, are keenly aware of their risks, shortcomings and exposures. When an institutional investor asks you this question – and they will ask it – they expect a response that demonstrates a full understanding of what those shortcomings are and how you control for them.

9. Know your competition. Understand that any institutional investor who is interested in your strategy has likely researched and talked to many of your competitors as well. Your competitors have explained why they are superior. You need to know – and articulate with multiple supporting facts – why you are the better choice, differentiated and truly unique.

Raising and retaining institutional capital without the ability to articulate and differentiate your business including all of the above makes is next to impossible. And the barrier is only going higher.

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***Note:** This article is based on a presentation by Ron Suber at Hedge Funds: Getting to the Next Level [3], hosted by FINalternatives and the Capital Markets Consortium on February 18, 2010.*