

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

*This article – which originally appeared in FINAlternatives – is based on a presentation that Ron Suber delivered to an industry conference, “Hedge Funds: Getting to the Next Level”, in mid-February. With the author’s permission, we reprint it here. We were so taken with the principles and recommended action steps outlined in this article, we sat down with Mr. Suber and discussed in greater detail how audiences can take “Merlin’s Necessary Nine” and put them to best use. That interview appears immediately following this article.*

### By Ron Suber

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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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## “It’s the Little Things that Count”

*With this issue of FOCUS we introduce a collection of tips and techniques to help you better your business life. We hope you find these ideas – themed, “It’s the Little Things that Count” – interesting and useful.*

### Building a Nimble Company

When faced with change, companies can choose to adapt or falter; to reinvent themselves or struggle to survive. Gary Hamel, Visiting Professor of Strategic and International Management at the London Business School, offers these tips to “build a nimble company”.

1. Embrace the idea of a ‘strategy re-boot’. Don’t fight change. Anticipate, adapt, excel.
2. Encourage colleagues to challenge the status quo. Standing still is falling behind.
3. Remove barriers to change. Don’t let structure or system keep you from redeploying talent or capital to new ideas.

*Source: “The Future of Management”, Gary Hamel with Bill Breen; Harvard Business School Publishing, 2007*

## Interview with Rob Suber

**FOCUS:** *While your article is themed, “The Necessary Nine”, are there one or two of your recommended actions that percolate to the top as being more essential than the others?*

**Ron Suber:**

The idea that I’ve probably been asked to talk about the most is number three:

“Harmonize Your Team”.

That notion

seems to resonate most strongly with hedge fund CEO’s and with funds’ end-investors.



Ron Suber

**FOCUS:** *How so?*

**RS:** Investors find it very frustrating when they speak with multiple parties at a particular fund – for example: a general partner, a trader, a portfolio manager, an analyst and an investor relations person – and get widely divergent points-of-view. The net effect is as if those individuals worked at wholly different firms, rather than at the same place. The core message about the fund, which should serve as the point of differentiation, is not harmonized among the speakers.

**FOCUS:** *So, the firm’s message – at a critical juncture – lacks cohesion.*

**RS:** That’s correct. And it’s a huge problem because, as they evaluate a variety of funds, investors are looking for clarity and coherence, so as to make an informed choice. While “Harmonize Your Team” is the most talked about of The Necessary Nine, the one that fund managers find most difficult to achieve seems to be

“Showcasing Your Portfolio’s Performance”.

**FOCUS:** *Why do you suppose that is?*

**RS:** Fund managers tend not to have the tools to aggregate all the assets and to synchronize daily such factors as asset allocation vs. stock selection, exposure over time as well as relative and absolute attribution. To illustrate the challenges of proper classification, think about this: is IBM a hardware company or a software company? For example, if your strategy involves a blend between European and companies in the S&P 500, who is going to create custom-blended benchmarks that allows you to clearly demonstrate your long and short Alpha over the unique benchmark? As a result, we’ve seen a lot of attention focused on the aspect of “Showcasing Your Portfolio’s Performance”, with the most frequently heard question: “How do I solve for it?” That’s really what our firm does. We help managers with \$1 billion or less in assets under management articulate what makes them different. We help them articulate and demonstrate their “edge” using all the quantitative measurements listed under the second of our “Necessary Nine”.

**FOCUS:** *Is it that fund managers don’t know what tools might be needed to create these measures? Or do many simply not have those tools on-hand?*

**RS:** They realize they don’t have the proper tools on-hand. Often, they try to solve with standard industry third-party vendors, their current prime brokers technology or in many cases manual spreadsheets and they simply can’t get their arms around the data as frequently as they need to or in a way that tackles that

complexity. For example, when an investor says “show me your exposure”, it’s very easy to take a snapshot today with Excel and deliver an exposure number. But if the request is for exposure during a particularly volatile timeframe in the past (let’s say, October 1 through October 11 last year), the simple spreadsheet isn’t robust enough to provide those data. That sort of time-series exposure is difficult to capture. Increasingly, however, that’s precisely the kind of question investors need to know and are asking these days. Our offering in this regard helps set us apart.

**FOCUS:** *The notion of separately managed accounts obviously has gained a great deal of attention of late. In your travels, are you seeing a growing desire for separately managed accounts? Do you observe more and more funds offering these?*

**RS:** We do. There are some very interesting new managed account platforms that have different fee structures and different risk policies. We’re seeing more and more assets come to these new structures. We’re also seeing some of the bigger managers accept them, providing they start with a minimum of \$50 million in assets on day one, with a commitment to grow those assets.

**FOCUS:** *In your “Necessary Nine” essay, you wrote about the importance of managers needing to acknowledge, rather than shy away from, their fund’s vulnerabilities. You noted that when presenting a firm’s story, managers often minimize or purposely steer clear of the fund’s shortcomings. Your counsel is that that fund managers need to be forthright about their funds’ flaws. When you advance this idea, do you get much push back from managers?*

**RS:** In the beginning, there's almost always some push back. However, as managers continue further into the conversation about investor due diligence, they come to understand not only what their particular vulnerabilities might be, but importantly how they should articulate their control over them. At the onset, it's difficult for managers to acknowledge such things as "I can't handle 24-hour trading" or "I can't handle futures". The natural tendency is to be defensive about things that can be perceived as flaws. But, when managers really think about what investors are seeking, they begin to display more comfort and confidence not only in addressing those areas, but in demonstrating how they've solved them.

**FOCUS:** *As you've pointed out, fund managers need to find something that confers specialness upon their offering or provides a competitive edge. What are you seeing currently as attempts to do just that?*

**RS:** I was in the Cayman Islands recently, speaking at the GAIM conference, and we talked about the alignment of credit and risk and the alignment of fees and lockups. So, we're beginning to see managers going to a 1½% management fee (down from 2%) but still getting the 20% and 25% performance fee. More importantly, they're aligning their gating or lockup provisions. Example: if you're in a liquid strategy, you're no longer able to get a one-year lockup. Now, you're really giving a 90-day lockup with 30-day notice periods. If you're in a less liquid, less transparent strategy (perhaps high yield or distress or bank debt, even convertibles), you are getting a longer notice period, a longer lockup – perhaps a year or 9 months with a 60-day notice period. You're seeing that word,

"alignment" more and more. But its chief applications seem to be in the areas of fees, transparency and what I'll call the term, or lockup.

**FOCUS:** *With whom does your firm chiefly work?*

**RS:** Merlin works with managers from \$25 million in assets to just under \$1 billion in assets. What we do is help them articulate their edge and operate as if they were over a billion in assets. We incorporate open architecture technology solutions and our multi-prime products because we clear and custody at Goldman Sachs Execution & Clearing, JP Morgan Clearing Corp and Northern Trust. So, we give our hedge fund clients three places, three custodians to house their assets with all of our technology reporting and middle office support on top.

**FOCUS:** *And whom do you most enjoy talking to in terms of making presentations and reaching out and spreading the word?*

**RS:** I really like to talk to the entrepreneurial managers who really have an institutional mindset. When you can help a manager go from \$25 million to \$150 million or \$50 million to \$500 million, it's extremely rewarding.

**FOCUS:** *That sounds a bit like waving a red flag in front of a bull.*

**RS:** It is. I spent a lot of time with the managed account platforms and the investors in Cayman talking about just where they're going. This helps us understand where the tides are going, which of course helps us help them how to get there.

**FOCUS:** *What are those entrepreneurial managers telling you about capital raising, asset gathering and the like? What is the climate like these days?*

**RS:** They're often having trouble finding hedge funds who hedge. They're finding the short exposure is elusive. Hedge funds' net exposure today is in the mid-40's, let's call it 43% roughly. We're almost at an all-time low in aggregate shorting. So, they're continuing to look for managers that are truly hedged that can operate in this – and any – environment. Most importantly, they're looking for a truly repeatable process that proves it wasn't a "one-off", or just a lucky asset allocation: for example, long gold vs. short financials. They're looking for that manager who has a repeatable process that's institutional, and they're finding it in the managers that are \$250 million to \$400 million. It's a struggle to find and identify that manager. They're really relying on firms like ours to help point those out to them.

**FOCUS:** *And that's another one of the services that your firm provides?*

**RS:** Yes. Our capital development team maintains proactive relationships with 175 institutional investors. We maintain this dialogue and provide feedback between our clients and the investor community. It's not the traditional cap intro, which historically includes a lot of cocktail parties and lots of investors in the room who may or may not be interested in many of those managers. When you find ways to minimize wasted effort and time, you're helping both manager and investor. In that sense, what we do is much more consultative and targeted. ■