Rocky Mountain Alternative Investment Summit Focuses on Challenges Facing Fund Managers

Few sectors of the American economy cover more diverse businesses than the financial sector. Investment vehicles within this sector range from low-risk U.S. Treasury securities and federally insured bank accounts to high-risk/high-return financial instruments and hedge funds whose significant potential benefits must be weighed carefully against the potential for loss. People who spend their careers working in financial services learn early on that the constant development of new products and investments demands continuous attention and ongoing education.

At Richey May & Co., we have served clients in the financial service sector for over 25 years. Not only do we provide top-notch assurance, tax and business advisory services to clients in this sector, but we also support financial professionals with education and networking events focused on significant trends in the marketplace. The firm recently hosted the Rocky Mountain Alternative Investment Summit, bringing together leaders from a variety of financial backgrounds to talk about challenges in the Emerging Manager segment of the market. The event consisted of two panel discussions about issues of interest to investors, fund managers, allocators and service providers who work primarily in this unique segment of the financial market.

According to Stephen Vlasak, Director of Business Development at Richey May & Co., “The reason we wanted to put on an event covering the topic of raising capital is because, whether we are talking with a one million dollar new launch or a fund that has a billion dollars under management, the questions that always come up are, ‘How do I raise capital?’ ‘What does the perfect pitchbook look like?’ and ‘How do I meet with money allocators?’ Richey May is a firm that prides ourselves on customer service, so we are always trying to bring value to our clients and friends in the industry. That’s why we helped to coordinate and co-sponsored this event.”

One issue that has grown in prominence in recent years is the practice of emerging fund managers leaving larger funds where they have built a reputation to start a smaller fund or funds under their own brand. Analysts vary in their opinion of how big a fund can get and still be classified in this category. Some argue that they pass beyond the “emerging” stage at $500 million in assets under management (AUM), while others suggest the threshold could be as high as $2 billion. These new funds face many challenges in attracting the capital needed to grow and thrive. The Summit’s first panel looked at this group and discussed some of the unique challenges they face and the opportunities they offer to investors.

Emerging Managers

Growth in this area has been driven by allocators who seek hedge funds that get away from mandates on specific types of investments and return to what one panelist described as “what hedge funds are good at” – finding idiosyncratic, asymmetric returns on the investments that they’re making. “Handcuffing a hedge fund manager to 7.5% or 10% of their portfolio when they have a really bullish idea is not allocating to their skillset.”

Allocators are now looking for more concentrated investment types, often executed through limited partnership (LP) strategies or special purpose vehicles (SPVs) that invest based on an emerging manager’s ideas. Panelists noted that it can be hard to gain an edge when so much money gets piled into particular stocks. Using these smaller, more concentrated funds to focus investments on one or two best ideas is more likely to generate the kind of returns that allocators are looking for.

One concern of investors that applies to all funds is the resistance to high fees, or at least a desire to understand the value being delivered in exchange for the fees. The panelists discussed how transparency about fees can help make them more palatable for investors. When institutional investors understand the strategy and the effort that warrants the fee, they tend to be more willing to accept a higher fee. The group noted that regulations in Europe require fund managers to disclose how fee revenue is spent. Many in the U.S. worry that similar rules could be imposed here.

The panel next offered suggestions on how emerging managers can make themselves more attractive to investors. Brett Yarkon, Head of Capital Introduction at Concept Capital Markets, described the example of an emerging manager with $5 million AUM and a 31% rate of return in his first four months of trading who couldn't understand why people weren't flocking to his fund. He explained that the manager's AUM was small enough that his fund hadn't made it onto people's radar yet. But more importantly, valuation of alternative investments focuses at least as much on the process that delivers the results as the results themselves.

Brian Sanborn of the Ned Davis Research Group noted that performance is important but that "it's human nature to always want the story." Returns can certainly raise an emerging manager's visibility, but that manager must be able to explain how those returns were achieved and why they expect them to continue. Coming from a research group, Sanborn admitted that his team is very data-driven and they certainly do look at history. "But there has to be an intuition of why the historical trend will be the case going forward." He explained that many emerging managers tend to come from the institutional side where they've had significant success managing portfolios. When they start their own funds, they're often challenged on the marketing side when they have to help investors understand their processes. Lisa Vioni, the CEO of Hedge Connection, noted that most managers generally want to focus on trading their portfolio and don't want to deal with the fact that they're running a business, too. Her advice was to understand in advance that "probably 70% of the business has nothing to do with trading your portfolio."

Ms. Vioni stressed the importance of building trust. "Investors are putting their money into a private investment vehicle that has a number of potential problems. There can be lack of liquidity, lack of transparency, etc. The most important thing is trust in the person managing the money." She was emphasizing a point made by another panelist about having documentation prepared when seeking capital from allocators. By the time an emerging manager is actively seeking capital from additional investors, ratings and the last several years of return information should be available to deliver to prospects immediately, not prepared after requested.

At Richey May & Co., we offer performance examinations for emerging managers to demonstrate their established track records as they're marketing their investment strategies to potential investors. We independently verify performance returns on a monthly or annual basis and issue financial statements with an examination report opinion, providing potential investors a higher level of comfort when reviewing pitch books and other marketing materials. Says Daniel O'Connor, Audit Partner, "When talking with clients, we are often asked, what is a performance examination and do I need one? Our response is that a performance examination takes place when a person is considering launching a fund structure and has traded their investment strategy in a separately managed account, or within their personal trading account. The person wants to use that history to show the success of their strategy in order to encourage potential investors to invest in their upcoming fund. The purpose of the performance examination is to have a public accounting firm sign-off on the past performance history, in which ultimately the firm will issue an opinion on the performance, in order to legitimize the trading strategy's performance numbers. In a typical report, the potential fund manager will show both their gross rates-of-return, as well as a hypothetical rate of return which includes both management and incentive based fees. Within the performance examination, we also see managers who choose to compare their strategy to a comparable benchmark, such as the S&P500 or some other type of benchmark, maybe one of the HFRI indices. From a capital raising standpoint, we feel that these performance examinations legitimize the returns of emerging managers, giving them credibility, especially in the current climate where reported performance numbers seems to be an SEC focus item."

The panel also stressed the importance of emphasizing different aspects of a fund based on the type of investor a manager is addressing. If the manager's strategy falls into multiple investment buckets, tailor each presentation to focus on aspects of the investment that are likely to resonate with each specific audience. A fund of funds might be seeking more equity market neutral with a focus on fixed income, while a family office might be interested in a little more risk. Successful managers can highlight the aspects of a comprehensive strategy that appeal to each of these groups.

A member of the audience asked about the typical length of a track record that investors will want to see. The panel explained that it would be different given different benchmark AUM amounts. At $10 million and below, they're going to understand that it's likely a pure startup with very little history and they'll look more at the concept and the prior record of the manager. At $25 million, a fund is more likely to be on people's radar. Analysis at this level might be driven by the idea that an allocator doesn't want to hold more than a specific percentage of the fund. At $50 million and up, larger institutions start to notice and they will look for longer track records. Lisa Vioni pointed out that managers should not wait until they reach the thresholds to start building relationships with potential investors. Get out to conferences and events to meet potential investors and begin to establish the trust that will help attract assets in the future.

Due Diligence

Another issue that remains critical for every investment but changes constantly is due diligence. The processes that investors and allocators use to determine the value of any opportunity evolve over time in order to effectively assess the value of new alternative investment vehicles. The Summit's second panel discussed some of the tools and metrics that top evaluators use to assess the potential of opportunities that might not have the history or track record that more established investments offer. Both of the panelists are portfolio managers; Jeff Spotts, CMT, with the Prophecy Fund and Mike Loughton with Pulteny Street Capital Management.

They began by answering a question about evaluating investments based on criteria other than performance. Jeff Spotts noted that what a manager shows you in a PowerPoint is almost always going to be different from what they do when they're actually trading. He starts his due diligence process by calling references within the financial field. "The performance has to fit [within platform limits], but I'm less about performance and more about process. How did this person come up with the strategy?"

Mike Loughton focused on investment risk going forward. "After I make my investment, what happens on day two?" He pointed out that many emerging managers attempt to create risk management processes aimed at eliminating drawdowns. In his experience, the drawdowns will inevitably happen regardless of strategy. "You want to have a manager who will look at opportunities during a drawdown and take advantage of them."

Moderator Lisa Vioni next asked the panelists about words or actions that constitute a "red flag" when evaluating a manager. Spotts replied that big numbers often raise suspicion. His team always asks for specific portfolio information and checks prices. They require managers who want to trade on their platform to post their own capital.

Loughton echoed the requirement that the manager have money in the fund and re-emphasized the value of background checks, "including asking some uncomfortable questions." He also suggested that when someone tells him, "Nobody invests like I do," it's generally not a good sign. "If nobody invests like you do, that means you've either got a flawed strategy or your strategy is not scalable."

When asked about operational risks or operational best practices that emerging managers should focus on, Spotts said that he likes to know what the person's workday looks like and what tools the manager built or subscribed to. Loughton agreed with evaluating the workday. His group is not looking to handcuff an emerging manager. They invest in someone when their research leads them to believe in what that manager is doing.

The moderator inquired about how funds can best find allocators, and both men stressed the importance of existing relationships. Loughton explained that the best way to reach him is through someone he knows. Spotts had a similar response, stating that, "We've had managers up and running in two weeks if we know where they're coming from." He went on to note that some third party marketers have been helpful and that resources like Hedge Connection have provided valuable introductions.

In closing, the panelists discussed the attributes of a manager that makes investors think, "That person is a standout." Both agreed that they were impressed when someone has clearly built a process that covers all of the bases and kept it transparent for investors. Loughton described the best manager he had ever seen as someone who "had a repeatable process…" and "made sure that all investors knew what he was doing. He told me what he was going to do and then he went out and did it."

Richey May & Co. hosts forums like this one throughout the year in order to support the financial services sector in our community. We bring together panels like these to provide fund managers with an opportunity to learn more about best practices that can help them succeed and to network with many of the investors and asset managers that are critical to their growth.

Our team of alternative investment industry experts offers more than 85 years of combined experience in the financial services sector. We have provided audit, tax and advisory services to hundreds of different types of alternative investment funds, including hedge funds, private equity and venture capital. We understand the special needs and requirements of this industry and strive to provide our clients and the financial community with ideas and opportunities that promote growth.

To learn more about upcoming conferences and webcasts, or if you would like an introduction to any of the panelists, please contact **Stephen Vlasak** at **svlasak@richeymay.com**. You may also visit our website at **www.richeymay.com.**

Alternative Investments

RICHEY MAY & CO

Alternative Investment Client Snapshot

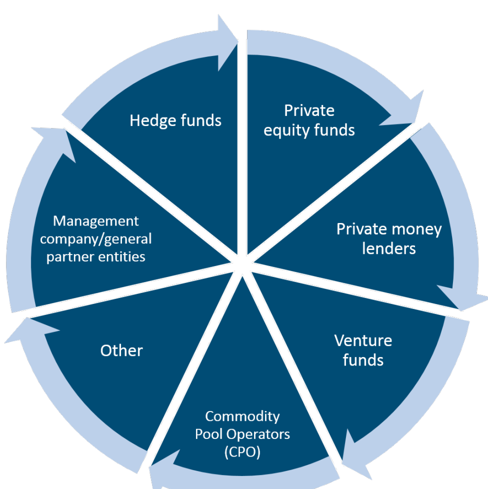
We serve alternative investment clients that range in size from $1M to $2.5B and have clients in over 36 states. We work with funds utilizing a wide variety of strategies, including, but not limited to, the following: arbitrage, ABS, catastrophic bonds, convertible arbitrage, cryptocurrency, currency, day trading, derivative funds of funds, distressed debt, emerging markets, energy trading, event driven, fixed income, foreign currency, global macro, funds of funds, high yield, long/short, merger arbitrage, mortgage backed securities, reinsurance, risk arbitrage, situational, and structured finance.

Specialized Industry Services

- Audits, reviews, compilations, agreed upon procedures and other assurance services
- Initial fund structuring and consulting
- Federal and state tax returns
- Management company/ general partner tax returns
- Tax estimates
- Valuation consulting
- Surprise exams
- Fund document reviews
- Performance examinations
- Offshore Cayman filing requirement (FAR form assistance
- Individual tax returns

FUND STRUCTURES

- Fund of funds
- Master-feeder
- Mini-master
- Domestic fund
- Foreign fund
- PFIC
- '40 Act
- REIT



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