Using Performance Exams as Part of Your Pitch Book Strategy

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As start-up funds face an uphill process to raise funds, the increasing use of performance examinations provides benefits to managers and investors. In order to realize the advantages, managers are advised to proceed with an integrated marketing communication approach.

Why are Performance Exams used?

A performance examination typically takes place when investment managers are considering launching a private fund structure following a live track record in a separately managed account or within their personal trading account. Typically performance exam strategies are used with more liquid investments, primarily consisting of level 1 or level 2 assets and liabilities, but more requests are coming from private equity and venture capital groups for these reports as well. Managers are advised to showcase their historical performance as a tool to demonstrate the strategy's success, build credibility and ultimately encourage potential investors to invest in the planned launch of their upcoming fund.

How do they work?

By engaging in a performance exam, a public accounting firm signs off on the portfolio manager's past performance history and issues an opinion on the performance in order to legitimize the trading strategy's performance numbers. Typically, the CPA firm will perform procedures such as recalculating the rates of return and sending confirmation requests to the investment manager's broker. On average, a performance examination takes 2 -3 weeks to complete from start to finish.

In a typical performance examination report, potential fund managers will show both their gross rates of return as well as a hypothetical rate of return, which includes both management and incentive based fees. The returns presented are usually shown on a monthly and cumulative basis over the examination time period. Within the performance examination, managers also compare their strategy's rates of return to relevant benchmarks, such as the S&P 500 Index and one of the various hedge fund industry benchmarks, including Hedge Fund Research, Inc.'s HFRI Indices, in order to provide a framework to highlight their returns compared to those of the overall markets or their peers. Included with the performance examination returns are footnotes, highlighting the methodologies used to calculate the various returns, as well as the typical fees, such as annual management fees of 1.5% calculated on a monthly basis and annual incentive based fees of 20%. The calculation of returns net of various fees allows potential fund investors to have a comparable basis for the returns they would have expected over that historical time period.

"I have been capital raising for almost two years and noticed a big difference in potential investors' confidence when I was able to provide them with a report from a third party verifying the returns I have produced. It has definitely helped with meeting the due diligence requirements for larger contributions coming from family offices and institutional investors."

With a performance examination report issued by a public accounting firm, fund managers now have credible documentation of their track record in order to persuade potential investors. When it comes to presenting this performance information within key marketing collateral items including a pitch book and tear sheet, fund managers would be wise to avoid common traps that inhibit effective communication with potential investors:

Trap #1: Leading with performance

Investors need to build a trusting relationship with you, not with your data. Relationship building is your top priority. It's never too early to begin prospecting. Focus on people before performance by telling your story first, making it personal yet succinct. Create and practice your elevator pitch.

Trap #2: Showing rows and columns of data points without visual format or captions

Almost no one can distill a sea of returns or NAVs covering a page. Make it visual and easy to understand, including the key takeaway as a caption or headline with your graph of returns Present a cumulative line chart reflecting the net monthly returns vs. 1-2 benchmarks. Note the performance exam, source firm and methodology in the disclosure section.

Trap #3: Pitch books without required disclaimers

Many fund managers eager to "get to market" with their new deck may not have obtained compliance or legal review. However, each manager's own facts and circumstances may necessitate customized disclaimer language and placement of disclaimers relative to any performance data. Even the disclaimer font size may need adjustment. It's best to seek applicable review and apply requested edits prior to sharing the presentation with prospects.

A performance examination report issued by a respected CPA firm, along with a well-designed pitch book presentation incorporating a compelling message, will present a strong and persuasive case for potential investors to commit to your fund. For more information on how a performance exam and pitch book strategy can benefit your start-up fund, please contact **Daniel O'Connor** at **danny@richeymay.com** or **Stephen Vlasak** at **svlasak@richeymay.com**. You may also visit our website at **www.richeymay.com**.