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New hedge funds face life or death battle for funding

By **Chris Flood**

Securing early-stage funding is a life or death challenge for new hedge fund managers who face intense competition to win capital.

With more than 800 new hedge funds starting up in 2013 and many more potential candidates seeking funding, investors have plenty of choice and are demanding favourable terms before allocating money.

"It is a very tough environment for new hedge fund managers. Starting out with just $20m of your own money is now the exception. The barriers to entry and success are getting higher as the industry matures," says Anita Nemes, global head of capital introductions at Deutsche Bank.

Ms Nemes says new hedge funds need to have secured a minimum of $100m in their first 90 days to be judged by investors to have made a credible launch. They are also likely to need "institutional-quality" infrastructure at launch with in-house compliance functions they previously would have outsourced to save money.

But Ms Nemes says investor appetite for new hedge funds is improving and there is a healthy launch pipeline in place for 2014.

Average seeding tickets (pre-launch commitments) by investors increased to $39m last year, from $30m in 2012, according to Deutsche, which last month published its 2014 Alternative Investment survey.

But Ms Nemes also points out that seeders might see between 300 and 400 managers in a year and provide funding to only three or four.

There are more launches by "second-generation" managers that have experience at other hedge funds and fewer by former traders from investment banks' proprietary trading desks, historically a ready supply of start-ups.

For managers that do not have a record with a previous fund, investors have to do intensive due diligence, qualitatively assessing their ability to generate returns, Ms Nemes adds.

Philippe Ferreira, head of research for Lyxor's managed account platform, says the French asset manager is continually looking for funds to add to its platform but that this can be a lengthy process.

"We do see a strong appetite for managers that offer new investment philosophies and innovative approaches in new asset classes," says Mr Ferreira, pointing to the example of Melanion Capital, a dividend futures trading specialist brought on to Lyxor's platform in 2013.

The increasingly rigorous demands of investors are also reflected in their performance requirements, with new funds expected to deliver quickly.

"New funds are under real pressure to produce results rapidly," says Mr Ferreira.

Blackstone and two specialists, Larch Lane and NewAlpha AM are among the largest providers of early-stage funding. Swiss private wealth managers are also active but reluctant to discuss their involvement for fear of reputational damage if any of their investments turns sour.

Paris-based NewAlpha AM has invested $900m across 29 partnerships since 2004. It generally provides seed capital for three years in return for a revenue-sharing agreement lasting eight years. This model can enhance returns significantly as the seed investor benefits from the new hedge fund's asset growth and the performance delivered by the new manager.

Philippe Paquet, managing partner and head of business development for NewAlpha, says he believes that more-recent vintages of hedge funds are of better quality as they outperform more established rivals in an adverse environment.

In the US, the healthy pipeline of investment opportunities has attracted at least one new investor.

Mariner Investment, a New York-based manager, set up a dedicated incubation platform in 2013 and has won a $500m mandate from APFC, the state-owned Alaska Permanent fund.

Mariner's aim is to develop new funds managed by industry heavyweights including Richard Rumble, a former head of emerging markets equity proprietary trading at Goldman Sachs, and Eric Pellicciaro, former head of the global interest rate strategy team at BlackRock.

Bracebridge Young, Mariner's chief executive, says its aim is to attract top industry talent and to provide them with access to institutional clients, sovereign wealth funds and also distributors to retail investors.

Mesirow, a Chicago-based financial services provider, has been investing in new hedge funds since 1994. It currently has two vehicles that allocate capital to start-ups and to new strategies from existing hedge fund managers.

Steve Vogt, chief investment officer for Mesirow Advanced Strategies, says: "Mesirow is a fundamentally orientated investor and so we have found it easier to align with new hedge funds that share a fundamental approach in equity and credit and even macro strategies."

He adds that the environment for new hedge funds has changed substantially from the pre-crisis era, when there was an excess of capital relative to truly high-quality investment opportunities.

"Before the crisis, it was easier for someone from a bank trading desk to set up. But now we have second and even third-generation managers and can ask, 'Has this person worked with the best, have they truly been trained in hedge-fund thinking?' It is a much higher hurdle to overcome to be a credible start-up," says Mr Vogt.