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Business 101 – How to Launch a Hedge Fund

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**Business 101 - How to Launch a Hedge Fund**

Every year, hundreds of new managers start the journey to build a new Hedge Fund and raise significant investor capital. However, many fail. This article is designed to discuss some of the classic building blocks required for building a Hedge Fund and the reasons why many of them never get off the ground.

Let’s look at some of the core components listed below:

1. **Business 101 - The Business Plan**
2. **Business 102 - Business Partners**
3. **Business 103 - Investors and the New Playing field**

**Business 101 – The Business Plan**

The *Single Biggest* point of failure in most hedge funds comes from improper planning. This then results in operational due diligence failure carried out on behalf of the potential investor. Lack of a proper structure or processes typically planned during the course of writing a business plan are surprisingly common. A Hedge Fund is a business looking for cliental. This is no different to every other industry and therefore potential investors need to be given a well thought out business plan.

What is a business plan, why would a business plan be required for a Hedge Fund Launch and what should the key components be?

**WHAT DO WE MEAN BY A BUSINESS PLAN?**

First, let’s remove the misconception that a business plan is an academic paper prepared as a presentation to a professor or a bank for lending. We are focusing upon the “Internal” business plan - a logical process of thought which defines different aspects of the business and processes to give a road map for building the business.

**WHY IS THIS REQUIRED?**

The first years of any business are critical for survival but at the same time the platform utilized for future growth is established. A business plan is needed to:

- Define the Investment/Opportunity cost
  - Emerging managers typically underestimate this cost or necessary requirements
- Reality Check
  - Do you have what it takes and can you find people to complement your weaknesses
- A Test Drive for the concept

**WHAT ARE THE COMPONENTS OF THE HEDGE FUND BUSINESS PLAN?**

The following, although not in any way a comprehensive list, should be addressed in the business plan. (For further resources please contact us at Equinoxe)

- Investment Cost and Funding
The management company cost and on-going cash requirement to reach profitability
- Most managers underestimate this cost which includes technology infrastructure (trading systems/voice/general computer and pricing data), staff & related benefits, real-estate, marketing materials and regulatory/legal costs.

Initial Hedge fund launch capital
- How much is the manager investing (as investors call it skin in the game)?
- Where are your Stage 1 investors? What is the likelihood of commitment from this soft circle group of investors?

Management Team
- What team members are required to run the fund?
- Are there particular skill sets that investors will be looking for and is this addressed by the current team?
- As assets grow at what point will you add additional resources?
- Is there Key Man risk? How are you addressing this?
- Is the management team drawing a salary? If so, has this been considered in the funding aspect of the management company?
- Is the management team investing personnel in the business or fund?

Investment Process and Risk Management
- Write out your investment strategy and process
  - How do you generate Alpha?
  - How do you replicate the process?
- How do you manage risk?
  - Who is responsible?
  - Is there segregation of investment and risk roles?

Service providers
- Do not forget the old saying “You get what you pay for.”
- Service Providers such as Prime Broker, Fund Administrator, Auditor, Legal and Third Party Marketers should all be viewed as partners in the business. They should be selected based on the fit with the Fund’s current and future requirements, rather than monetary cost (true cost defined below)
  - There have been numerous managers ruined due to poor service provider selection at the set-up phase.

Infrastructure & Technology
- What do you require to operate and what do investors expect you to have? You should benchmark your Hedge Fund against best practices in the market.
- Many funds underestimate the technology cost and do not consider the stages where technology is required. Develop a timeline and plan so that as you grow your assets you can show investors that you can scale the business.

Marketing and Investors
- Have you identified your Stage 1 investors and Marketing strategy?
- How are you going to obtain leads and convert them and give presentations to potential investors?
- Are you willing to execute side letters?
Growth Plan – this section should lay out the strategy for different phases of the business: launch capital, moving beyond known investors, and then the institutional phase.

Business 102 – Partners for your Business

There are numerous service providers available in the market. Ultimately, cost is a key factor in all of these decisions. However, what is often not considered is the true definition of cost.

Cost (definition)

- The total money, time, resources and opportunity (current and future) associated with a purchase or activity

This definition of cost is different to the focus on the monetary component by most people today. Why should time, resources, opportunity and future cost (intangible cost) be considered? Service provider selection affects asset raising and in turn the success of the fund. What are the intangible components?

1. Reputation of the Firm
   - Will your current and future investors accept this partner?
2. Scope of Services of the firm
   - Are there intangible benefits outside the standard services
   - Can they manage your business as it grows?
   - Is the service their area of expertise or is this an add-on service?
   - Is there more to consider than the fact I recognize the service provider’s name?
3. Cost of Firms Services
   - What is the cost of the service provider once I am at critical mass?
   - If I have to switch service providers later, what intangible cost does this incur?
   - If this provider does not deliver what is the cost to my business?
   - Will this service provider support me if things go wrong?
   - Will I lose an investment because of my service provider partners?

Below are 4 Important Service Providers and some issues to consider in their evaluation:

1. Administrator
   - AIMA Due Diligence Questionnaire
   - Can I access the management team?
   - Do they have a controls audit?
   - What strategies can they service?
   - Is there a risk they will no longer service us if we do not raise assets?
2. Auditor
   - Do I have access to the partner on the engagement?
   - What is their experience with my Fund/Strategy and potential reporting requirements?
   - Are they recognized by my target investors and the next stage investors?
3. Legal Representation
   - What is my access to the partner?
1. Do they have experience in my funds strategy and understand potential investor requirements?
2. Is this their primary industry focus?

4. Prime Broker
   ✓ Cost and Credit worthiness
   ✓ Are there other services such as Capital introduction available?

Business 103 – Investors and the New Playing Field

The key to the investor Ladder is to understand each potential hedge fund investor and at which stage they should be targeted. There are typically four (4) stages, as a rule of thumb in the marketing phase:

Stage 1: Launch and Initial Fund Raising

The starting point for every fund is the soft circling of potential investors for the initial launch. This period typically ranges from -6 to +6 months of the fund’s life. These investors are typically known to the managers as seeders who are prepared to invest for a share of the business.

Stage 2: Moving Beyond Known Investors

This phase should start within the first 6 months after the fund becomes operational when core personnel are in place, and marketing materials are ready for emerging manager investors. These investors may consist of Due Diligence firms, consultants, RIA’s, HNW individuals, FOF’s and Family offices.
Stage 3: Introductory Institutional Threshold

This stage is the hardest hurdle and represents the glass ceiling for most managers. At this stage managers probably had some success with family offices, FOF’s, consultants and third-party marketers however are unprepared to meet the requirements of institutional investors. The following is needed:

- **Replication**
  - ability to describe your process and replicate Alpha generation

- **Data**
  - Risk reporting, exposure analysis, benchmark analysis, asset allocation

- **All the team on the same page**
  - This sounds simple but the whole team need to message institutions in a consistent fashion. Very few firms do this extremely well.

- **Corporate Structure**
  - Organizational Structure and Fund Structure/documents are all viewed in depth at this stage and frequently changes are required prior to investment. Requirements for an independent board, additional personnel in the organization structure or fund documentation changes are often requested.

- **Ability to offer managed accounts**
  - This has become a new model for institutions but increases the operational workload for the investment manager

- **Institutional Quality Infrastructure**
  - Understanding the industry best practices and your own business requirements is vital. Many managers at this phase move to their own GL system and start looking at Control audits.

- **Key man Risk**
  - How has your firm addressed Key man risk

- **Understanding your weaknesses**
  - A weakness is only a weakness to an investor, if you have not identified it. In this circumstance a timeline for addressing the issue needs to be built.

- **Know your competitors**
  - Institutions examine many managers and like to benchmark strategies, so understanding where your firm stands in relation to your peers is important.

Stage 4: Institutional Threshold

Congratulations on achieving Stage 4. Now investors require long lead times and standards of best practices in the industry. Continual investment is a requirement to maintaining this standard.

Sometimes an external consultant can add value by reviewing your marketing material and investor targets. It can result in providing a number of comments that can save a number of rejections or wasted time. The key in this section of the business is to focus on higher quality leads and not waste time with a shotgun approach.
The Equinoxe Advantage

We are an independent third party administrator utilising institutional technology and procedures. Equinoxe holds a strategic relationship with XL Group plc. We offer a bespoke service in the time zone of the manager. With a pre-determined limit on the amount of clients taken on each quarter, senior management is committed to delivering premium service to each and every client, customised to meet that client's needs.

We spend significant time with each new manager and can help with the following:

1. Structuring Requirements
2. Offering Documents Review
3. Due Diligence Packages Review
4. System Selection
5. Service Partner Introductions
6. Operational Process Flow charting

Contact us today for a conversation about your upcoming fund launch and see how we can help you navigate the process for a more efficient launch.

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