Hedge Fund Incubation and Seeding. A perspective for 2009.

In the interest of full disclosure, First Avenue Partners of which I am a partner, runs a hedge fund seeding and incubation business. I generally don't talk my own book and I don't intend to start now, but I will speak generally about the industry without specific reference to what we do. So please read this with a skeptical eye, and if seeding sounds like it makes sense, there are a range of seeders besides FAP out there. Talk to as many of them as you can, and please feel free to tell me if I am out of my mind. With that out of the way, let's begin:

In 2006 if someone suggested that it was a good idea to be seeding and incubating hedge funds, I would have been **highly skeptical**. Managers who were any good were raising large amounts of capital on their own on day one, mediocre managers were able to start with credible amounts of day one capital and even managers who while talented had no idea how to run an investment management business could get into business. The hedge fund seeder faced insurmountable **adverse selection** problems.

Hedge fund managers willing to give away either a share in their management company or a share of their fees tended to be of lower quality. You didn't want to be seeding them.

Hedge fund managers of good quality but who understood the business development support role of a seeder and were happy to work with one were labelled as poorer quality and found it difficult to raise capital, so also were from a business perspective, less attractive to a seeder.

Seeding was simply a negative signal to the market all around.

In fact, **seeders play an important part** in the hedge fund industry. They provide all kinds of support that the fledgling hedge fund manager simply doesn't want to bother with such as infrastructure, business development and marketing, a stable base of capital, corporate governance, risk management and a host of intangibles such as a sounding board for trade or business ideas.

Of course until the adverse selection problem was resolved, none of this really mattered. And well it should be. The adverse selection up until the middle of 2007 was severe.

2008/2009. What's changed? Investors risk appetite has been drastically reduced. The number of new funds starting up is down drastically, the number of fund closures is up drastically. The size of the **hedge fund industry has halved** in size by assets under management according to several of the usual industry sources such as HFR, Eurekahedge and surveys conducted by the major prime brokers. Hedge funds which were previously closed to new investment with multiples of billions of assets under management are reopening their funds (after losing big chunks in losses and redemptions) and finding it hard to raise new capital. This it should be said, in an industry which managed to lose 20% in 2008 while the long only world lost double, and only in the second half of the year when regulated banks failed and regulators decided it was a good idea to ban short selling.

Investors are more discerning. Quality of the hedge fund manager matters. Quality of the strategy, idea generation, execution and trading, mid and back office, systems, counterparty management, liability management, corporate governance, investor management, all matter and matter more than they ever did 2 years ago when investors were happy to fund a business plan with two phone lines and a credit line.

That's a lot of considerations for a hedge fund manager striking out on his own. What is my strategy? Will it sell?

How do I represent it? Who should my counterparties be? Ditto service providers. Who should be on the board of the fund? My best mate's uncle or an industry professional? Who are my potential investors beyond my partners and I, our best mates' uncles and aunts? Should there be lock ups, gates, side pockets, NAV suspension rights, what are the right terms? And how do we divide the spoils?

A seeder can help. There are different seeding models to suit different manager objectives and immediate needs. Do I give up fees? Do I give up equity? What control does the seeder have? What services beyond capital can the seeder provide? Often the advice and structuring are worth as much as the capital. And if I brought all this in-house, what would be the cost of it all? Would it be cheaper than a seeder?

The raison d'etre of a seeder has never before been clearer; **the value that the seeder brings never been greater.**

2009 and beyond: For the prospective investor in a seeding fund, **what is the opportunity?**

First of all, the investor must want to invest in hedge funds. **No amount of incubation economics can make up for a bad investment.** Over the last 10 years, hedge funds have done better than long only equities (MSCI World), bonds (Barcap Global Bonds, the old Lehman bond index), commodities (CRB), and real estate (UK IPD all sectors) for example. In 2008, hedge funds lost less money than real estate, equities and commodities. In fixed income, depending on credit quality, you would have lost as much in credit (high yield) as in equities, or lost low single digits if you were in guvvies.

Second of all, **smaller, newer funds tend to do better than the big funds.** Its not always true but there are various academic studies that seem to indicate that this might be the case over a large sample of managers across the gamut of strategies. The truth is that **in some strategies size is an advantage**. Nothing like an 800 pound gorilla of an activist or distressed debt manager. For trading and liquidity constrained strategies, beyond a certain size the fund begins to behave like a beached whale. The real advantage with smaller funds is that they haven’t yet accumulated the arrogance that comes with multi billion dollar success to deny the hapless investor transparency, clarity or airtime. Beyond the transparency necessary for the proper monitoring and risk management of a fund investment, being in constant touch with the manager and being involved with their business and playing a part in their success is a highly rewarding activity. It is certainly why I love it.

If one is to invest in start up and new managers, there are of course **additional risks.** With less money to manage there is also less money to spend on systems and people. Shorter track records also make an econometric assessment harder to do. Risk of failure is higher than for a large fund, but surpringly lower than for a mid sized fund. Anecdotal and some albeit stale studies have found that while the big multi billion funds may have very low mortality rates, medium sized funds’ mortality rates can be substantially higher than that of small funds. Why is this? Big funds are well resourced and have the financial viability to maintain their resources. Also, big funds often have defined succession planning. The founding portfolio manager rarely abdicates but does take on a Presidential role rather than as lead General of the Campaign. Small funds may be thinner on resources but are likely fuller on resourcefulness and the drive to succeed. Medium sized funds exhibit high mortality probably because of lack of succession planning so that even a great track record may not survive beyond the management of the founder. Whatever it is, investing in small funds needs to be compensated over and above the returns they generate. Some seeders take a stake of equity in the investment management company, some take a share of the fees charged by the fund manager, and some take some combination of both. Some seeders provide only investment capital, some provide working capital as well, and still others provide infrastructure, risk management, marketing or other business advice.

Seeding and incubation, like so many things, is a highly **cyclical business**. A couple of years ago, the managers entertaining seed deals were mostly those who could not raise day one capital on their own. The number of hedge fund managers cognisant of the complexities of running a hedge fund business and saw the logic of partnering up with a seeder were few and far between. Today the landscape has changed. The pipeline of managers is supplied by both types of managers. **Seeders are spoilt for choice.** Where once capital went in search of talent which was relatively scarce, the world is relatively well supplied with talent. It is capital which is scarce.

Of course the competitive landscape for seeders has changed as well. The **number of seeders has diminished significantly**, as has the capital available for seeding. Why? It was a highly cyclical business and it was **victim not of the bust but of the boom** of the last 5 years. Too much money was chasing too few deals. *Manager quality times deal terms equals a constant.* In the good times, that constant was rather low. But the pendulum has swung the other way. Many of the deals struck in good times broke and incubation as well as incubated funds performed poorly, not always for lack of talent. More often than not, talent was abundant but non-investment support was not forthcoming or deals were structurally unsound and failed to align interests. As the tide of risk and capital ebbs, it leaves many stranded, but as it flows once more the opportunities in seeding appear brighter than ever.

In that context hedge fund seeding and incubation is a **recovery play,** one that if structured well, keeps paying for years to come.