Investment
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Soapbox: The Seed Investors' Hedge Fund Opportunity

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While the credit crisis has wreaked havoc on the financial industry, it has also opened up new opportunities. With hedge funds in a state of repair and growth, institutional investors—and their advisors—have a particularly unique chance to be "seed investors" at a time when many promising hedge fund managers need help raising capital.

Before the credit crisis, hedge funds had a strong run from the late 1990s through the early 2000s. During these boom years, anyone with a desk and a Bloomberg could call themselves a hedge fund manager. Now, the credit crisis has led to a massive exit of capital, cleared out many of these "hedge funds in name only," and also diminished the assets of good hedge funds with real growth potential.

Meanwhile, institutional investor demand for emerging hedge fund strategies is up and growing. At the same time, institutional investors are demanding that hedge funds implement their strategies using institutional-based processes.

This means that emerging hedge fund managers who want institutional money are seeking strategic capital, as well as help with compliance, distribution, and new product development. A number of investment management firms (I was the pioneer in founding such a firm in 1996) have popped up to fill this role, providing the hedge funds with capital and institutional investors with a means for accessing talented managers. Essentially, this means institutional investors can become partial owners in a small- to mid-sized hedge fund that is looking to grow, without having to do all of the research and monitoring themselves.

The best way to think about it is as getting a leveraged-like return without the risk of leverage. As seed investors working with an investment management firm specializing in this type of activity, institutions can own a revenue-sharing stake in multiple emerging hedge fund managers while also participating as investors in the fund’s performance itself. As the hedge fund’s assets grow, a seed investor will benefit from the growth in management fee revenue. This revenue is in addition to any returns from hedge fund performance. In fact, the potential returns from a manager’s fees can sometimes be greater than the direct performance returns of the managers themselves.

This type of investment would especially appeal to institutional investors, such as foundations and endowments, looking to increase their allocations to alternative managers to bridge the gap between their funding and their actuarial needs.

As with any investment, there are some important factors to research beforehand. You will want to thoroughly understand the investment management firm’s process for choosing and monitoring fund managers in its portfolio. Thorough due diligence is essential, including reviewing business models, team members, underlying fund investments, risk, and operational timelines.

The next generation of hedge fund managers is much more process-driven and institutionally minded than pre-crisis managers.This makes sense, because institutions are the bulk of the client base. Advisors who work with institutional clients are more than familiar with the types of questions institutions have when it comes to investing. How do you pick your investments? How deep is your management experience? What is

your process for risk management? Can you provide transparency and separate accounts? Do you have a qualified COO and CFO?

Hedge funds are shifting from a model where a single trader had a desk and a Bloomberg terminal, to becoming a real business. Now is the best time to get in on the ground floor of these emerging hedge funds of today, which could very well become tomorrow's big institutional alternative asset management firms.

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