HEDGEWEEK

INSIGHT REPORT

# THE NEXT GENERATION:

## How emerging managers are adapting to the new hedge fund landscape

JUNE 2022

SUPPORTED BY:

# EXECUTIVE SUMMARY

As the hedge fund industry continues to grow and evolve, and some established firms take a step back or convert into family offices, the fortunes of the next generation of managers are coming into sharp focus. Many larger hedge funds may have weathered the storms of recent years, but start-ups face an ever-expanding array of hurdles.

In this latest Hedgeweek Insight Report, we explore how early-stage managers have fared. The insights within are drawn from a Hedgeweek survey of 55 emerging and established hedge fund managers, a series of in-depth interviews with industry participants, and further background research.

A key hurdle, of course, remains capital-raising. Over 80% of emerging managers said this was their biggest single challenge, while close to half said attracting investor inflows is tougher now compared to 12 months ago. Our research also indicates that new funds are taking longer to launch.

Nevertheless, performance data commissioned for this report indicates that funds from emerging managers continue to outperform established hedge funds, which in turn is giving start-ups the confidence to refuse discounted fees for investors. Looking ahead, newer managers are more upbeat on 2022 performance prospects than the average manager.

Elsewhere, against a backdrop of accelerated institutionalisation and ongoing investor caution, cost-constrained emerging managers are continuing to seek outsourced solutions. While 64% of those surveyed are satisfied with their current balance between outsourcing and in-house expertise, more than a quarter plan to outsource more.

With the global investment landscape underpinned by uncertainty, this report offers a detailed and timely snapshot of the direction of travel within a key segment of this industry.

**HUGH LEASK, HEDGEWEEK EDITOR**
REPORT AUTHOR

# CONTENTS

3 KEY FINDINGS
4 SECTION 1 | US MANAGERS
9 SECTION 2 | EUROPEAN MANAGERS
14 SECTION 3 | INVESTORS
19 SECTION 4 | SERVICE PROVIDERS

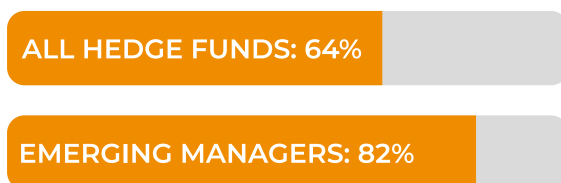
### METHODOLOGY

Hedgeweek surveyed 55 hedge fund managers on a range of topics important to emerging managers throughout May 2022. Of that group, 40% were classed as emerging managers, with assets under management under $250m and a track record less than five years.

# KEY FINDINGS

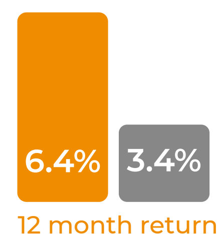
## CAPITAL RAISING FOR START-UPS IS HARDER THAN ESTABLISHED MANAGERS REALISE

Survey respondents that said 'attracting flows' is the biggest challenge for emerging managers



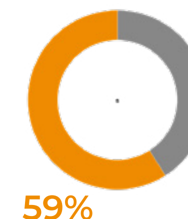

## BUT OUTPERFORMANCE IS GIVING START-UPS THE CONFIDENCE TO REFUSE DISCOUNTS

Emerging managers continue to outperform their established peers...




12 month return

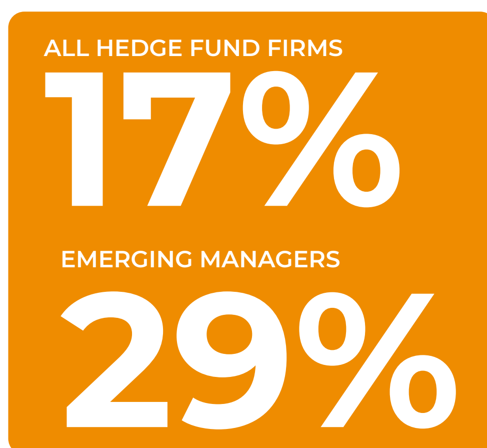
...and most do not offer discounted fee structures to early investors



59%

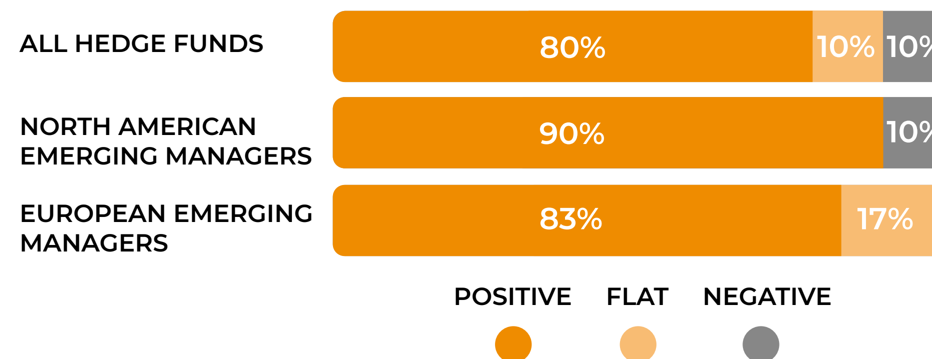
## OUTSOURCING TRENDS ACCELERATE AS INVESTORS DEMAND INSTITUTIONAL INFRASTRUCTURE

Survey respondents planning to outsource more of their operational functions:




## START-UPS ARE MORE UPBEAT ON PERFORMANCE IN THE REST OF 2022 THAN THE AVERAGE FUND

What is your performance outlook for your fund in the rest of 2022?



# SECTION 1 | US MANAGERS

## START-UP HEDGE FUNDS STAY OPTIMISTIC AMID A BATTERY OF CHALLENGES

**Outsourcing, budgets, and the quant-vs-discretionary debate loom large over the US start-up process, with seeders, platforms and pods becoming increasingly important for fledgling funds**

The institutionalisation of the hedge fund industry over the past decade is making launching independently with friends and family money extremely tough for prospective new managers, according to US hedge fund industry participants.

"Everyone's looking for institutional-grade quality now, and that's one of the biggest challenges for a smaller fund," says Wayne Yu, CEO and chief investment officer at BCK Capital, a long/short global equity-focused special situations manager which launched in 2015.

### Pushback

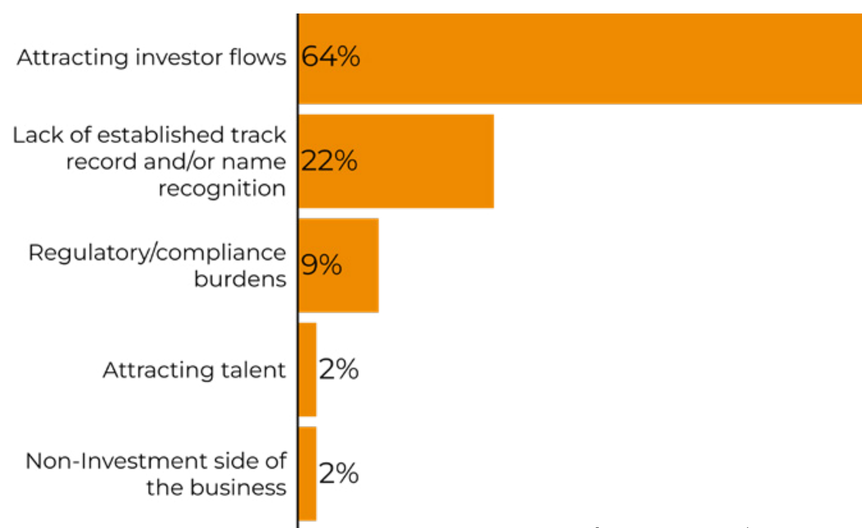
His comments chime with Hedgeweek survey data that shows attracting investor flows is now the biggest single challenge for emerging and start-up hedge funds during the initial launch stages.

Almost two-thirds – 64% - of all hedge fund managers polled said securing allocator capital was the biggest barrier for emerging managers (see Fig 1.1). Meanwhile, a fifth of respondents – 22% - cited a lack of established track record and/or industry name recognition as the primary challenge for newer funds, while close to 10% named regulatory and compliance burdens as the largest hurdle.

Anecdotal evidence suggests that launches are being pushed back by a month or a quarter, while managers who can open with $100 million or so of their own money may initially opt to launch as a family office before securing more capital to formally roll out.

Bloomberg data shows launches of equity long/short funds – traditionally the largest hedge fund sub-strategy and often seen as the cornerstone of the industry – have fallen sharply over the past year, down from 50% of all new

**Figure 1.1: The biggest single challenge for emerging and start-up managers according to hedge fund professionals**




Source: Hedgeweek survey

**Analyst note:** Question answered by all hedge fund managers surveyed, regardless of AuM and track record.

launches in Q4 of 2020 to less than a fifth (18.2%) in Q1 in 2022 (see Fig. 1.2).

Amid this tricky capital-raising environment, the expansion of boutique mini-prime brokers, compliance consultants, and specialist law firms focused on the next generation of managers can help hedge fund firms keep a lid on spiralling start-up costs, industry participants say, while the arrival of cloud software and remote working services have nixed the need for costly HQs in the well-heeled districts of Connecticut or Mayfair.

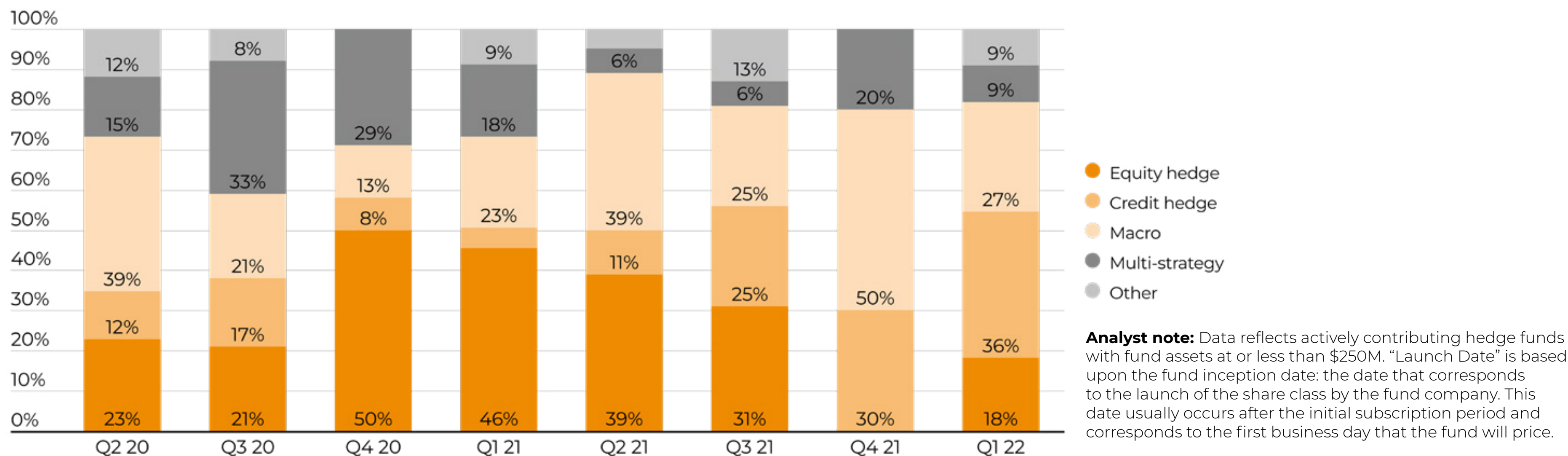
Hedgeweek's survey found that close to 77% of North America-based emerging hedge fund managers – with assets under $250 million and a track record under five years – are satisfied with their current balance between outsourcing and in-house expertise when it comes to operational functions. About 15% are planning to outsource more, while less than 8% intend to outsource less (see Fig. 1.3).

Pointing to the proliferation of infrastructure-focused third party service providers spanning accounting, compliance and tech, Faryan Amir-Ghassemi, co-founder of Epsilon Asset Management, which fuses bottom-up stock selection with systematic investment processes, says decisions over whether to develop (often costly) infrastructure in-house or instead outsource back-, middle-, or front-office functions to third parties carries far-reaching implications for emerging managers hoping to build early momentum in a fiercely competitive market.

## Barriers to entry

Budgetary priorities are also shaped by fund strategy type, with computer-based quantitative funds depending on a larger amount of technology, and traditional discretionary long/short managers meanwhile more focused on research and analysis.

## Figure 1.2: New hedge fund launches by fund strategy, Q2 2020 to Q1 2022




**Analyst note:** Data reflects actively contributing hedge funds with fund assets at or less than $250M. "Launch Date" is based upon the fund inception date: the date that corresponds to the launch of the share class by the fund company. This date usually occurs after the initial subscription period and corresponds to the first business day that the fund will price.

Source: Bloomberg Hedge Fund Database

With a nod to the hedge fund industry's ongoing discretionary-versus-quant debate, market participants observe how the quant fund operating model is markedly different to that of a traditional asset manager, requiring considerable amounts of infrastructure comprising systems and platforms that support machine-readable trading models and codes – potentially heralding sizable costs for budget-constrained start-ups.

"The germ which allows a discretionary manager to bloom is centred around the human capital - their experience, their ability to implement their process, the tools that they need. Even if they came from a very large established firm where they had access to a huge amount of resources, their skills and resources are largely transferable," Amir-Ghassemi says.

"I think there is a higher barrier to entry with quants - there's a trade-off in terms of resource allocation when you're a start-up quant - you have to make a build-versus-buy decision across the board with data sources, models, and infrastructure providers."

Underlining this point, Amir-Ghassemi says start-up hedge funds must define their 'circle of edge', noting how this influences decisions around order management, execution, trading and more.

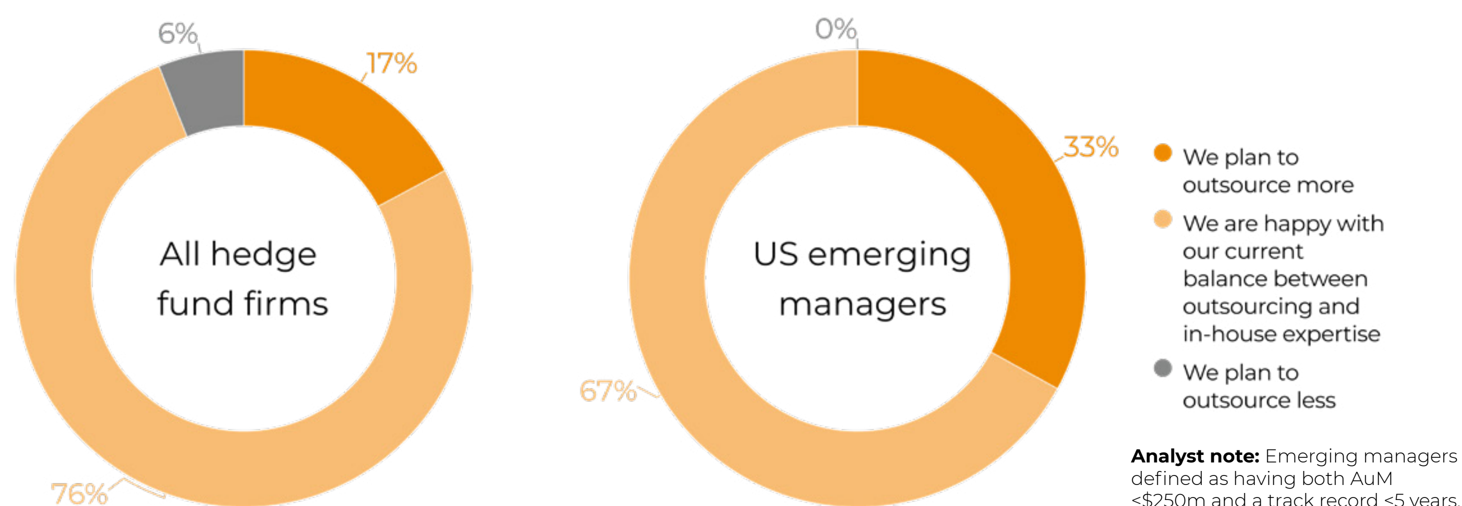
"We call it the 'circle of alpha generative competence'," he says. "You focus a lot of your build on that, and from there you really try to buy everything that orbits around that. The build-versus-buy decision comes down to whether the implementation is ancillary to your process within that circle of alpha generative competence, or it is something that you can build on your own to float yourself to a point where you can then commit to that spend.

"If you are high frequency, for example, you need to have your circle of alpha generative competence around your execution. If you're low or medium frequency, this might be the type of thing that you can partner with a service provider to get you 95% of the way there before getting to a meaningful scale where you can invest the resources to build out that last 5%."

## Taking the temperature

If the independently-launched shop – characterised as the 'two men and a

## Figure 1.3: Hedge fund manager descriptions of their firms' approach to the outsourcing operational functions




**Analyst note:** Emerging managers defined as having both AuM <$250m and a track record <5 years.

Source: Hedgeweek research

Bloomberg' set-up which helped define the industry's pioneering spirit during the late '90s and early 2000s – is becoming increasingly rare in today's institutionalised landscape, across the spectrum there lies an increasingly diverse range of fund hosting platforms, seeding and incubating solutions and multi-strategy pod structures offering various degrees of financial and operational support for new roll-outs.

Pioneered by the likes of Millennium Management, the $47 billion multi-strategy hedge fund giant established by Izzy Englander in 1989, the pod model can provide slugs of capital – together with operational infrastructure and regulatory support - to fledgling funds struggling to raise funds elsewhere.

On the flipside, launching on a platform means portfolio managers ultimately ceding a degree of control over their business. While platforms can meet managers' operational requirements, not every fund – particularly contrarian or estoeric strategies - will be a suitable fit for the platform or pod model, owing to platforms' risk parameters, which often tend to be low net exposure and market neutral.

"There are advantages to being a smaller fund - there certainly is the ability to trade in and out of things much quicker," says Yu. "In terms of the emerging manager environment, it's definitely a changing landscape - I think at this point it's very difficult to launch a fund without some strong initial backing - launching with a big partner is a stamp of approval." ■

### KEY TAKEAWAYS

- As the US hedge fund industry's turn-of-the-millennium 'golden age' recedes further from view, the days of 'two men and a Bloomberg terminal' appear to be over. As investors demand institutional-grade infrastructure, start-ups are looking to launch with stronger backing, increasingly from seeders and platforms, as two-thirds of emerging managers say securing investor capital is their biggest burden

- The expansion of outsourced services is bringing a degree of comfort to newer hedge funds, especially quantitative-focused managers who face particularly acute operational and tech challenges

Figure 1.4: Notable US hedge fund launches of the past 12 months

| Name | Headquarters | Launched | Pedigree | Key feature | Notes |
|---|---|---|---|---|---|
| Dark Forest Technologies | New York | Mid-21 | Bridgewater Associates | Fully cloud-native infrastructure | Quantitative strategy from former Bridgewater Associates "idea generator" Jacob Line. Launched in mid 2021 with a reported $250m. The firm has been vocal about its decision to launch with a fully cloud-native infrastructure, including use of FlexTrade's OEMS, from day one. |
| Greenland Capital Management | New York | Jan-22 | Millennium Management | Incubated at Millennium | A multi-strategy development platform for PMs founded by Michael Englander, son of Millennium Management founder Izzy Englander. The unit, which follows a similar approach to Millennium, incubated at Millennium for around four years and recently passed $300m in AuM. |
| SurgoCap Partners | New York | Early-22 | Lone Pine Capital | Potential $1bn raise from female founder | An equities shop founded by former Lone Pine PM Mala Gaonkar, perhaps the leading example among the recent raft of female founders touted by the media. Reports suggest she is in the process of raising $1bn for an investment strategy focused on disruptive technologies. |
| Braidwell | Connecticut | Apr-22 | Deerfield Management | Hybrid fund, multi-billion dollar launch | Reports had ex-Deerfield partner Alex Karnal's new firm launching with $3.5bn, making it one of the biggest hedge fund launches of the past ten years. Tapping into the growing investor interest in hybrid strategies, the fund makes public and private health-care investments. |
| Avala Global | New York | TBC | Viking Global | Hybrid fund, female founder, potential $1bn raise | The latest in a line of spin outs from Viking Global, which is fast gaining a reputation as a 'Tiger Cub' style development ground for modern hedge fund founders. Like several Viking alum before her, founder Divya Nettimi is expected to run a hybrid equities strategy and raise over $1bn. |

Source: Hedgeweek research

# SECTION 2 | EUROPEAN MANAGERS

## START-UP HEDGE FUNDS STAY OPTIMISTIC AMID A BATTERY OF CHALLENGES

**Fund launch process hampered by rising volatility, allocator caution and capital-raising challenges – but emerging managers' outlook stays buoyant**

Emerging and start-up hedge fund managers - defined in this report as firms managing assets of $250 million or under, with a track record of less than five years – say the current capital raising environment is tougher than a year ago.

Close to half (47%) of emerging managers globally surveyed by Hedgeweek said capital raising is now harder than this time last year. By comparison, a quarter (26%) of emerging managers surveyed said the capital raising environment is easier, while 27% said it was similar (see Fig. 2.1).

### Mismatch

Industry participants note that Covid-19 made traditional onsite investor due diligence difficult, and so investors have tended to stick with managers with whom they already had established relationships, in turn putting the squeeze on start-ups.

"During Covid, many investors saw it as potentially riskier to give that allocation to a new start-up which has not had that level of onsite due diligence," Donald Pepper, co-CEO at Trium Capital, says of the capital-raising challenge. "If there's a pension plan with $500 million, for instance, the path of least resistance is to give it to the managers they have already conducted onsite due diligence on in 2018 and 2019."

Pepper - whose firm seeks to attract talented and experienced portfolio managers and enable them to launch their own hedge funds, helping them to overcome the increasingly tough entry barriers from rising legal, compliance, operations and distribution costs - says investors are inclined to sit on the fence until a fledgling fund has built a two- or three-year track record, or reached a critical mass over

$200 or $300 million.

He explains: "Investors look for track record in some shape or form. Regrettably, a real frustration in the European industry is the mismatch between portfolio managers who have a proven ability to run a hedge fund based on their talent, and investors willing to give them relatively early money."

This stance has made life particularly challenging for start-up hedge funds. Portfolio managers tend to move around more now than in the past, observes Alyx Wood, chief investment officer at Kernow Asset Management, with the average fund manager's tenure falling from seven years to three – which then makes it tough to construct meaningful track records in the eyes of investors.

## Protracted

At the same time, the launch process for start-up funds has become more protracted over the past year, says Lucian Firth, partner at Simmons & Simmons, who notes the time between the initial conversations around a potential launch and the point at which there is money in the fund is now longer than ever.

Firth, who has a particular focus on start-up hedge funds at Simmons & Simmons, suggests that a greater risk aversion, stemming from the sustained upheaval of the last few years, has potentially dented emerging manager confidence when it comes to getting things right at launch.

"A few years ago, it felt like we saw more people who were willing to launch a fund that was well below the viable size, knowing they either weren't going to make money initially or were subsidising it for a while," Firth tells Hedgeweek. "Now, though, because of that uncertainty, more managers want to get a seed deal in place before they will launch. They want to have a seeder, or at least some decent amount of committed capital, before they will the start."

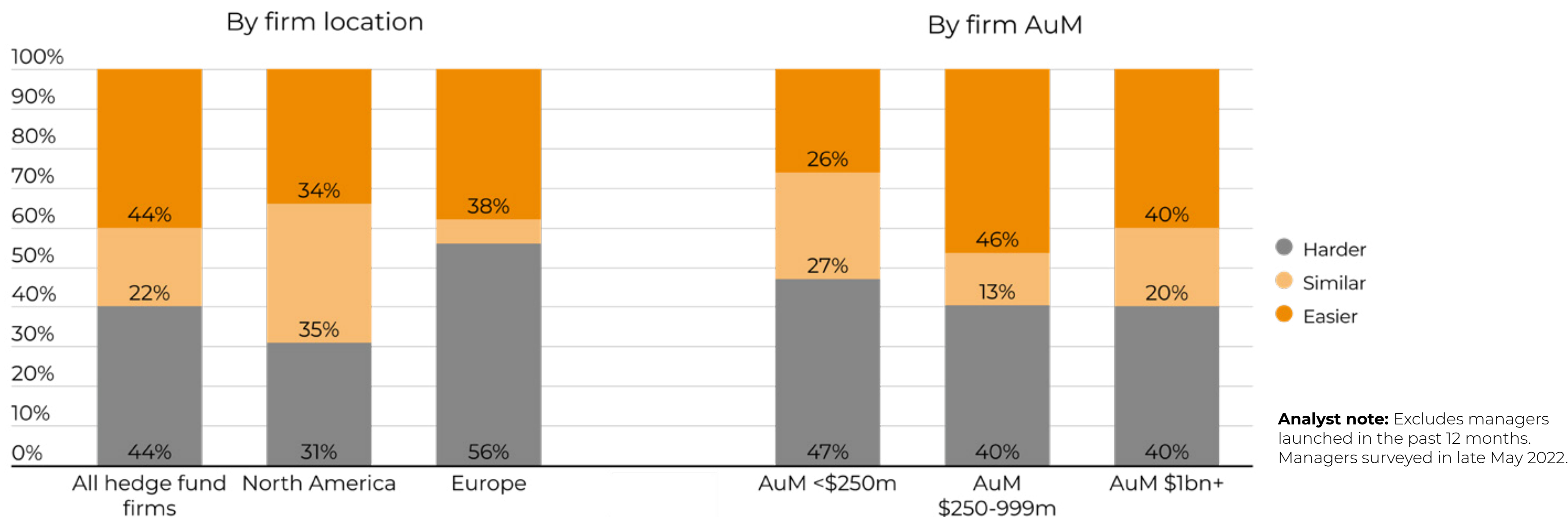
Ant Bennett, head of sales and client development, ACA Mirabella, says recent start-ups tailed off towards the end of last year and into this year, driven by investor caution over resurgent market volatility, which has calibrated focus around higher-quality launches.

"There are quite a few managers spinning out again. There had been a hiatus towards the back end of Q4, where a lot of fund launches from some talented managers – credit, global macro, distressed managers – were queuing up and waiting to go.

"They were not having the best of times in terms of getting the first seed investors onboard - a lot of those seed investors, in anticipation of the final wave of Covid, dropped off and the conversations were kicked into the long grass."

Bennett suggest investors were remaining on the sidelines as a result of considerable market volatility, underpinned by rising interest rates and inflation and the instability surrounding the Ukraine

**Figure 2.1: Hedge fund firms' assessment of the capital-raising environment now compared to this time last year, by firm size and location**




**Analyst note:** Excludes managers launched in the past 12 months. Managers surveyed in late May 2022.

Source: Hedgeweek survey

war, as well as the tapering off of quantitative easing.

"They didn't want to start writing cheques in Q1, and the start of Q2. We're only now just starting to see some of those launches kick off, and you are now seeing more separately managed accounts as different seed investor money comes in."

"The decision to set up on your own isn't one made lightly. There are fewer and fewer people out there who want to do it on their own nowadays," adds Alyx Wood, whose UK equities-focused long/short contrarian strategy launched in 2019.

"If you care about building a long-term, sustainable track record, and compounding your own cash, then you go down the emerging manager route. To do that successfully you have to own the majority of the company, which allows you to trade through the ebbs and flows. Conversely, if you want to make money fast for the highest bidder, then going it alone is not the right option."

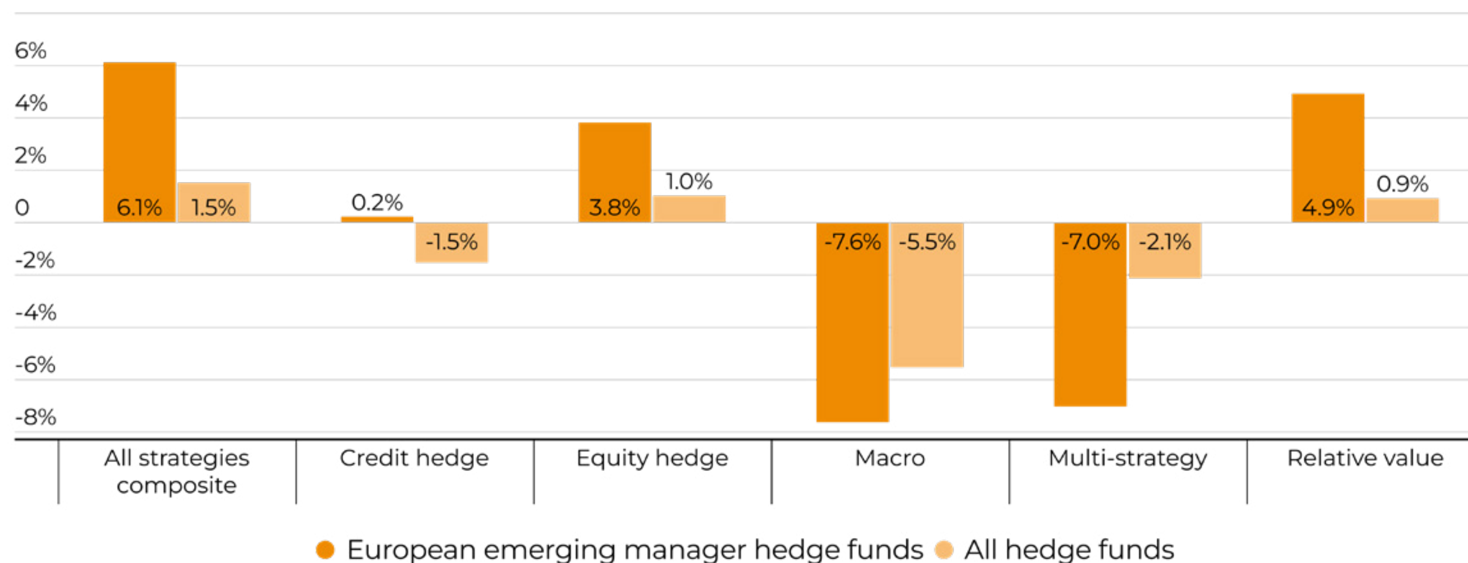
## Optimism and opportunity

Still, despite the assortment of challenges, a degree of optimism continues to underpin the emerging hedge fund manager space.

Surveyed on the performances of their flagship fund during the first half of 2022, one-third of European emerging manager respondents to Hedgeweek's poll said performance was in line with expectations, while another third said performance exceeded expectations. On the flipside, just 17% said performance fell short of expectations in H1 (see Fig. 2.3).

Looking ahead, European emerging managers are optimistic on their

Figure 2.2: European emerging manager fund performance versus all European hedge fund performance, YTD through April 2022




**Analyst note:** Selected top-level strategy indices featured. Macro includes crypto-focused strategies. Emerging managers defined as having both AuM <$250m and a track record <5 years.

Source: Bloomberg Hedge Fund Database

performance prospects for the rest of the year: 67% are 'somewhat positive', and 17% are 'very positive', compared to 17% who forecast performance to be 'flat' (see Fig. 2.4).

Delving deeper, industry participants maintain that start-up managers running nimble, niche strategies have the potential to successfully generate uncorrelated alpha in a competitive field dominated by long-running brand-name hedge funds.

"Large is safe; large feels warm and fuzzy. But, weirdly, asset management is one of the few industries where you get diseconomies of scale," says Alyx Wood. "Studies show that, without a doubt, emerging managers - the hungry ones, the ones that have an edge - outperform. That's where all the alpha is. It moves around, but that is where it is at."

He continues: "The allocators who frame themselves by performance, or finding niches or boutiques, have much better records by a staggering amount, for a reason, and that's their selling point. Boutiques outperforming on average is not even in question here. What you do get, though, is a wider dispersion - bigger wins, and bigger losses. That's where the smart allocators come into their own."

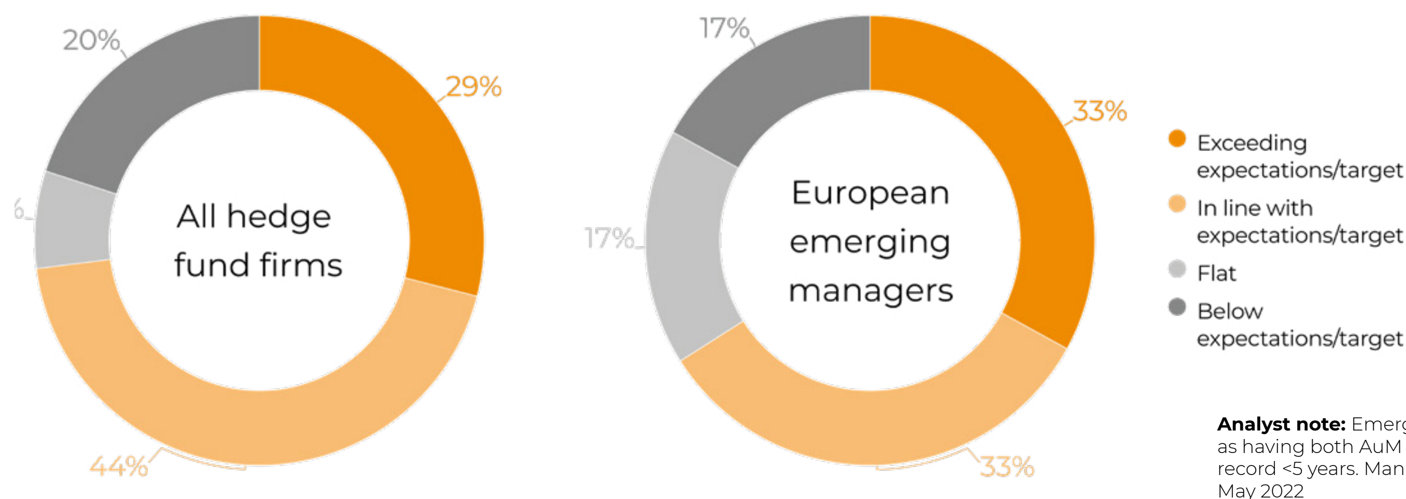
But while newer funds can often outflank their more established blue-chip competitors in terms of performance with more nimble and agile trading styles – and industry participants point to data indicating the incremental returns of newer managers typically ranges between 170-190 basis points - investor appetite often remains frustratingly mixed, with allocators often preferring bigger, more established funds.

"There's a well-known adage in the hedge fund market that size is the enemy of performance," adds Donald Pepper. "However, it's fair to say if you're only running $15 million, that can affect performance because there are certain fixed costs within a fund, and if those amortise across a small investor base this will lower returns, somewhat offsetting the lower management and performance fees.

"Another issue that investors worry about is if someone's running, for example, a $35 million fund, will they have the resources to be able to deliver optimal returns? Will they be able to hire that analyst, or will they be willing to bankroll build-and-they-will-come by having the right level of resources? This has led some such managers to join firms like Trium who will pay for these upfront costs." ■

---

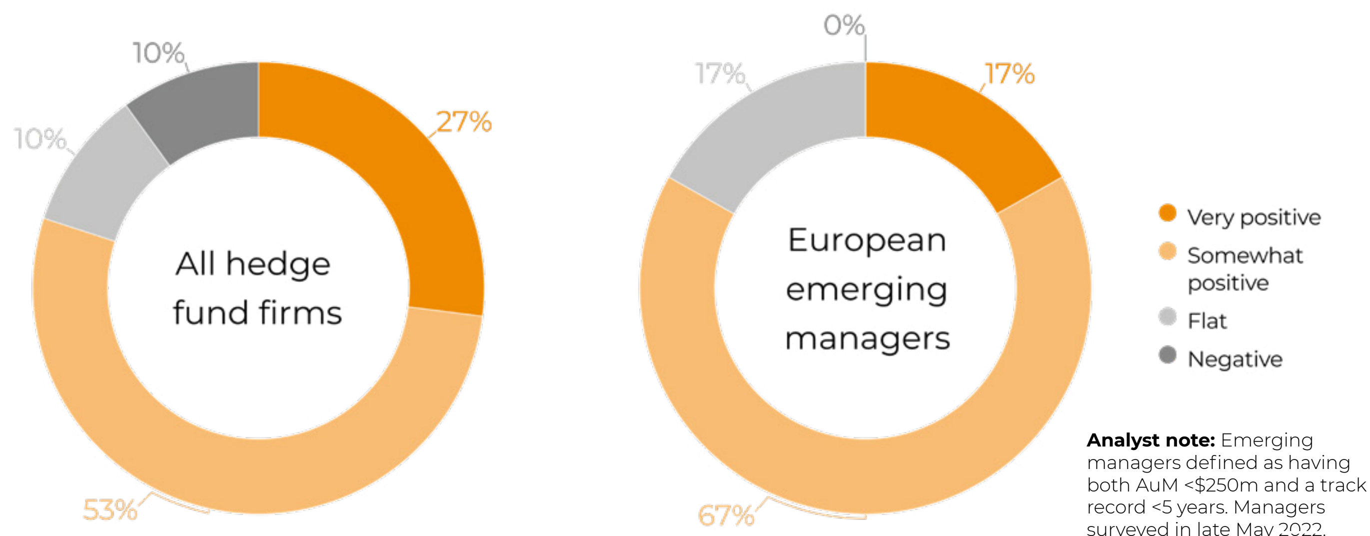
**Figure 2.3: Hedge fund survey respondents' description of the performance of their flagship hedge fund strategy YTD**




**Analyst note:** Emerging managers defined as having both AuM <$250m and a track record <5 years. Managers surveyed in late May 2022

Source: Hedgeweek survey

Figure 2.4: Hedge funds' performance outlook for the remainder of 2022




**Analyst note:** Emerging managers defined as having both AuM <$250m and a track record <5 years. Managers surveyed in late May 2022.

Source: Hedgeweek survey

## KEY TAKEAWAYS

- Asset-raising – a perennially-tricky task within the emerging hedge fund space – remains difficult post-Covid, as renewed market upheaval and geopolitical uncertainty appears to have dented confidence among both managers and investors, with prospective start-ups taking longer to roll-out
- Despite the caution, smaller and emerging managers appear generally satisfied with their investment performance this year, and a majority remain buoyant heading into the second half of 2022

## ANT BENNETT

HEAD OF SALES AND CLIENT DEVELOPMENT, ACA MIRABELLA

"The whole framework in terms of how funds are growing their AUM now is changing and evolving, and it's probably more complex. We see more separately managed accounts as investors want to go in first on favourable terms.

"The growth of assets has been driven by separately managed accounts, and the ability to support that lends itself rather well to using a regulatory host. The managers can focus on managing alpha, generating returns, investor relationships. Non-investment operations and the regulatory host cells can do all the heavy lifting in terms of setting up the separately managed account facing off versus different fund administrators, and spinning out the different reporting and compliance monitoring that goes with it."

# SECTION 3 | INVESTORS

## EMERGING MANAGERS STRUGGLE TO CAPTURE INVESTORS' ATTENTION

**A survey by Hedgeweek in May shows that 82% of emerging managers (<$250m) cite attracting investor flows as the single biggest challenge for emerging and start-up managers during the initial launch process**

Hedgeweek's survey found that 46% of emerging managers consider the capital raising environment to be harder than this time last year.

The data shows that investors are still not allocating to these nascent funds, with 18% of managers naming a lack of established track record or industry recognition as one of the main hurdles (see Fig. 3.1).

Emerging managers have increasingly been set up by experienced and established individuals from within the industry, but this doesn't always appear to convince investors.

"The bar has been raised across the board with emerging managers, with individuals who were already established portfolio managers leaving blue chip firms to set up their own," notes Marlin Naidoo, global head of capital introduction, BNP Paribas.

Despite this proof of success, investors are still unsure.

"You may have someone who has a ten-year track record in a particular strategy launching by themselves. And even though you can follow the

breadcrumbs of the track record, investors are still reluctant; it's frustrating," says Donald Pepper, Trium Capital's co-CEO.

The problems in confidence lie with the fact that managing an individual fund is very different to working for a large fund which is already established and has credibility and security.

"When launching your own boutique, there's an entire aspect of business management that you previously may not have been responsible for. You could be responsible for not just managing money, but also payroll, insurance and managing a wide-range of people," observes David Shalom, director, capital introductions at BNY Mellon | Pershing.

## US vs Europe

In North America, 46% of managers have found the capital raising environment to be either similar or easier than last year, in comparison to only 34% of managers based in Europe.

"In the US, people are more willing to have the courage of their convictions to recognise that it's the same manager, with the same strategy, often with the members of the same team," notes Pepper.

Wayne Yu, CEO and chief investment officer at BCK Capital notes that when allocators deal with newer managers, there are often concerns over track record and the ability to replicate the strategy's success outside of the environment they were previously in.

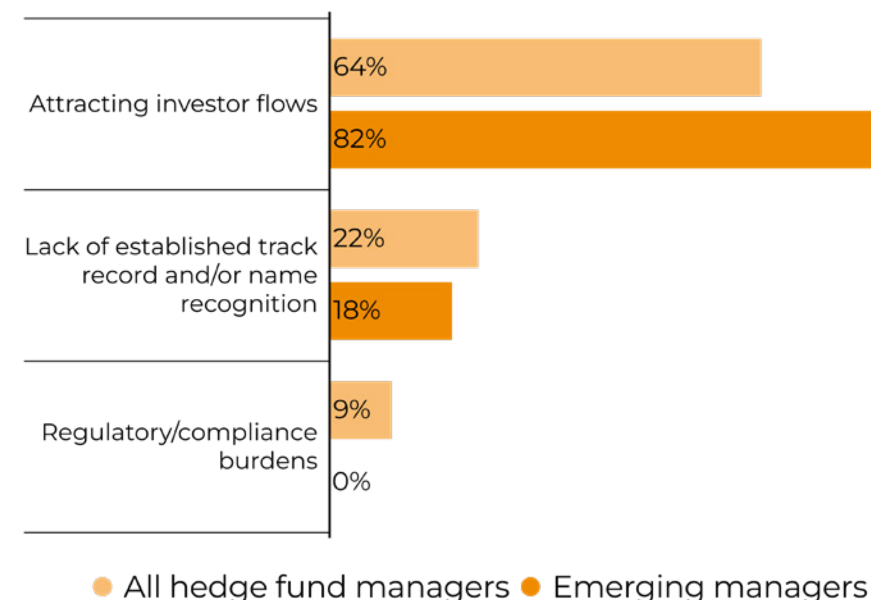
"There are all these questions that keep people from wanting to pull that trigger," Yu says. "Some of those newer managers are untested, and investors want to avoid the next big blow-up."

From Naidoo's perspective, investors are willing to take the market risk but not the business risk, and this often leads to hesitancy with investing in new managers.

"Emerging managers need to have the capital base to support a team of at least four or five people to be seen as credible and as a viable investment," he notes.

Shalom says that investors look for three key attributes in emerging managers: the manager's return history and previous experience; enough AuM to cover operating expenses and to manage business risks; and finally, proof of concept in the manager's ability to generate returns and grow their AuM, so that other investors will have confidence that the firm will grow in size over time.

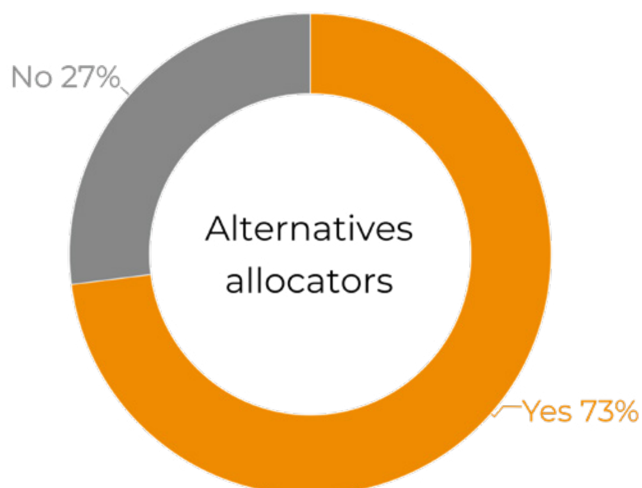
**Figure 3.1: The biggest single challenge for emerging and start-up managers according to hedge fund professionals at established and emerging managers**




**Analyst note:** Emerging managers defined as having both AuM <$250m and a track record <5 years.

Source: Hedgeweek survey

Figure 3.2: Proportion of allocators that invest in alternative investment managers founded less than two years ago




Source: Seward & Kissel

## Opportunity

However, while reluctance may be prevalent among certain investors, others have identified the opportunities.

Travis Williamson, head of hedge fund investment due diligence and partner at Albourne, argues that emerging managers can also offer investors alternative benefits.

"Emerging managers are often sought for diversification, not just within the overall portfolio, but within the alternative sleeve of a portfolio. The immediate question is: what does this emerging manager bring to my portfolio to warrant taking the start-up risk? Often, start-up managers have brought novel approaches to ESG and implementation to the investment process," he explains.

He adds that Albourne's clients are increasingly demanding diversity and inclusion, ESG and protocol questionnaires, all pointing to a desire for mission-based investing as well as increased transparency.

Smaller and emerging hedge funds can outperform larger, blue-chip names, and there is demand for them.

Emerging managers have outperformed all hedge funds YTD and over the past 12 months, with emerging managers performing 4.8% better than hedge funds on average across the past three years.

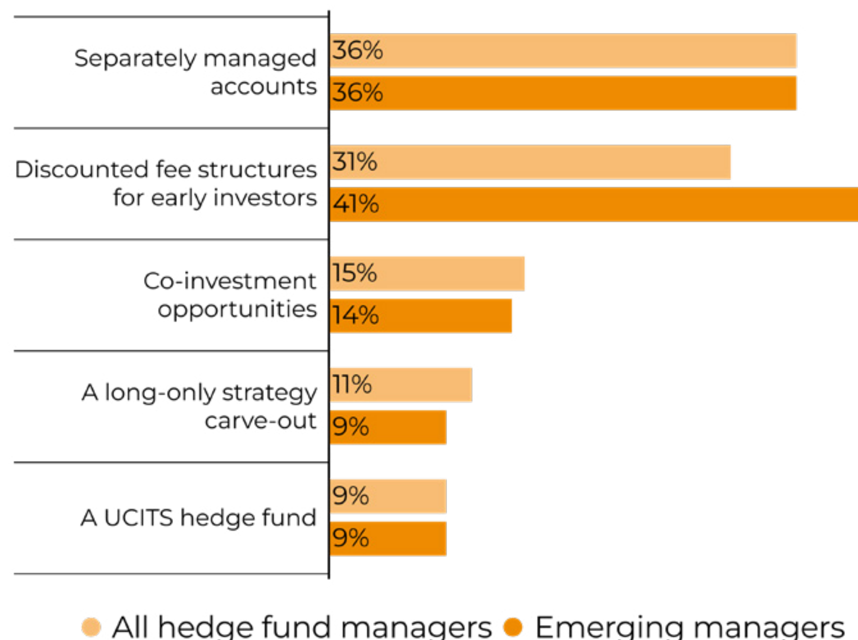
Data from law firm Seward & Kissel's 2022 Alternative Investment Allocator Survey shows that 73% of investors are investing in managers founded under two years ago (see Fig. 3.2).

Though this is a slight decrease from 80% in 2021, the interest in emerging managers remains notable.

"Innovation and fresh perspective remain highly valued in the hedge fund industry, as investors recognise that complacency leads to subpar returns, and emerging managers can bring novel approaches to their strategies," Williamson observes.

There can also be benefits to being 'first to fund' and making allocations earlier in the fund launch process.

Figure 3.3: Product features and structures offered or likely to be offered by hedge fund managers surveyed to attract investors




**Analyst note:** Emerging managers defined as having both AuM <$250m and a track record <5 years.

Source: Hedgeweek survey

Fee structures are sometimes set up with early bird share classes, or founder share classes, in Europe to benefit investors who come in early, according to Pepper.

The Hedgeweek survey shows that 41% of emerging managers are currently offering discounted fee structures to attract investors and motivate them to invest earlier (see Fig. 3.3).

"Investor expectations have evolved to the point where emerging managers need to have a path to institutionalisation early in their lifecycle. Investors are not waiting on the sidelines for new managers to produce a three-year track record, they're making allocations earlier in a fund's lifecycle, and with earlier support comes accelerated expectations," says Williamson.

According to Williamson, the motivating factors, such as guaranteeing capacity and favorable terms when the fund grows, are unchanged.

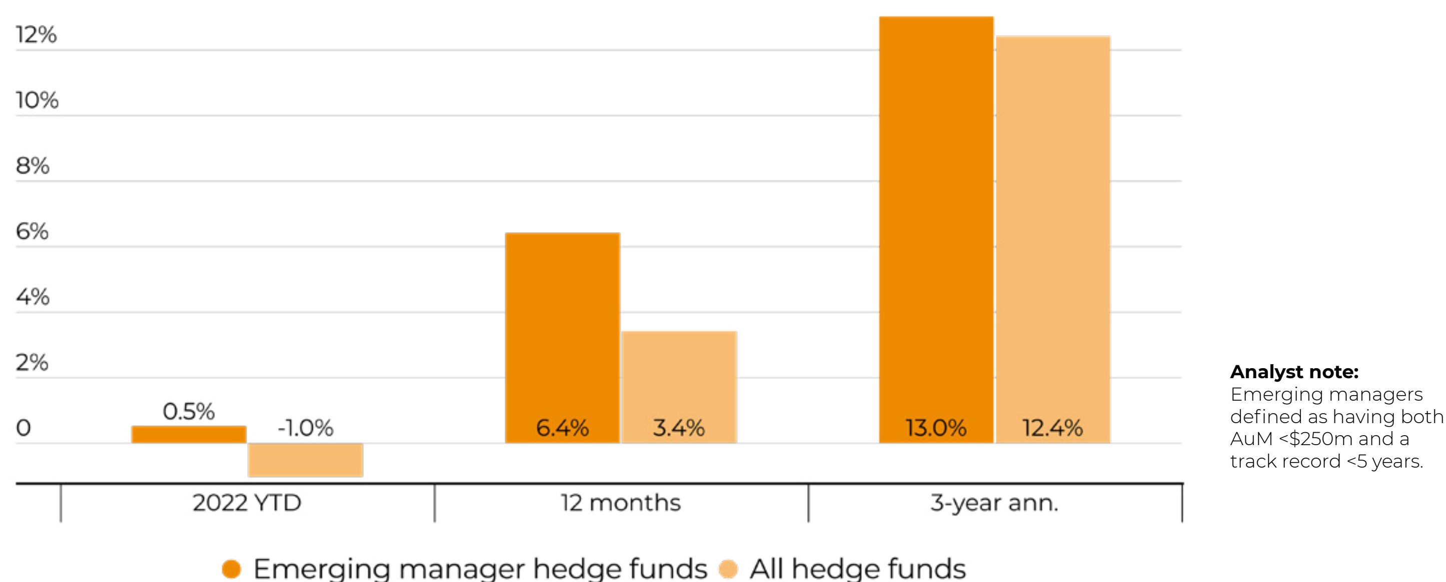
However, to be competitive, experienced early-stage investors recognise they need to pay higher fees when a fund is small.

"In the pre-formation and pre-launch phase, the competition for talent remains very high, with end investors competing with significant demand from platform funds," Williamson adds.

## Progress

The definition of emerging managers has always been fluid, but certain big pension funds have started to stretch the meaning to include

Figure 3.4: Emerging manager fund performance versus hedge fund performance across key metrics




**Analyst note:**
Emerging managers defined as having both AuM <$250m and a track record <5 years.

Source: Bloomberg Hedge Fund Database

diverse-owned and mission-based funds.

"On the mission-based investing side of it, there's a huge interest from investors. Yes, they want to ensure good returns, but some now also want to achieve a mission alongside their investment," says Shalom.

The mission can vary between investors, with US investors often prioritising Minority/Women-owned Business Enterprises (MWBE) and European investors pushing for ESG, according to Shalom.

While some consider the two to be distinct categories, Naidoo points out that minority-owned funds often fall within the two to three-year range of launch, thereby naturally falling into the emerging manager classification.

With increasing pressure from LPs, managers have started to consider this growing definition and make DE&I a priority within their funds, even if those funds aren't necessarily diverse-owned or founded.

"The two things which have become imperative for all managers are improving inclusion and diversity characteristics of the manager teams and having a strong grasp of sustainable investing/ESG in the investment processes," says Sara Rejal, WTW's global head of credit.

"Emerging managers are in a good position to start their firms with these attributes which can make them attractive to institutional investors," she adds. ■

## KEY TAKEAWAY

While some emerging managers have struggled to capture investors' attention and attract investor inflow, the Hedgeweek survey shows that emerging managers offer interesting benefits and returns to investors, after having outperformed other funds on average for the past three years (see Fig. 3.4).

# SECTION 4 | SERVICE PROVIDERS

## IN-HOUSE OR OUTSOURCE? MAINTAINING THE 'IDEAS FACTORY' IN A HYBRID WORKING ERA

**As challenges continue to mount up, the ways in which start-up hedge funds go about picking service providers and outsourcing certain functions – traditionally seen as the next step on the emerging manager journey following launch – remain in sharp focus**

The onset of the Covid-19 pandemic upended the investment management, hedge fund, and financial services sectors, with firms quickly pivoting towards remote working and trading, investor and operational due diligence processes migrating to virtual settings, and industry participants describing the crisis as the 'largest continuity test ever' for business operations.

More than two years on, as forms of hybrid working remain in place, the experience appears to have shifted the needle, bringing about the increased potential for a range of back-, middle-, and even front-office functions traditionally performed on-site to be made permanently remote.

Appetite for outsourcing remains high, according to Hedgeweek's survey findings. More than two-thirds (67%) of emerging managers globally are happy with their current balance of outsourcing, while 29% are preparing to outsource more functions (see Fig. 4.1). In addition, 55% have increased their outsourcing of compliance functions due to regulatory trends over the past year (see Fig. 4.2).

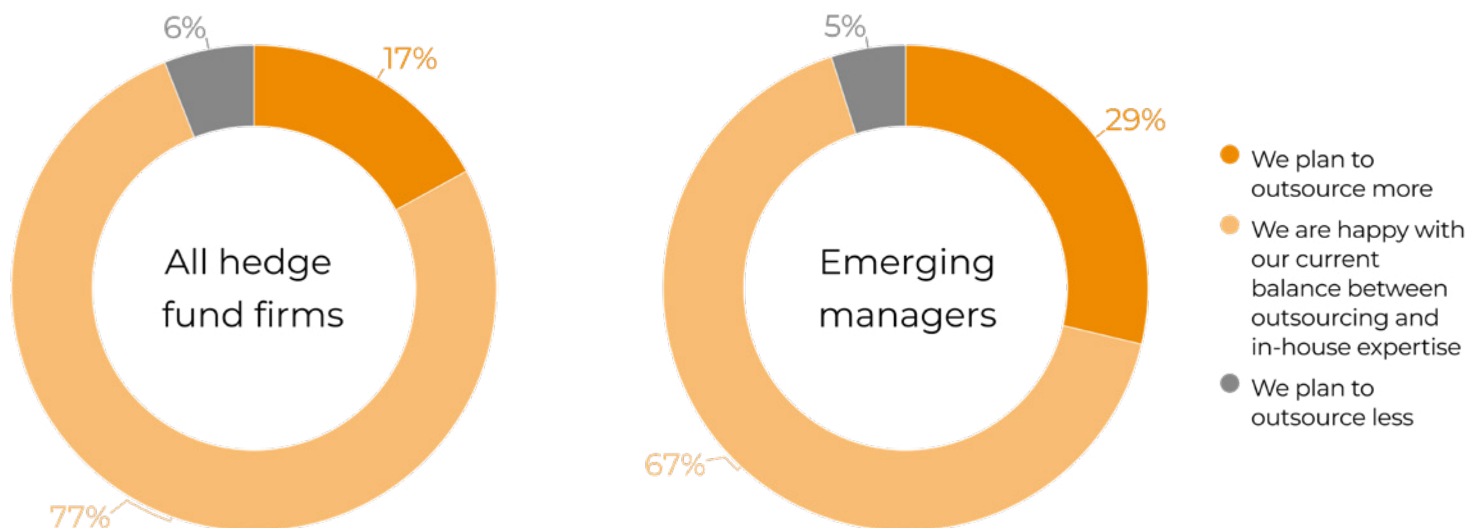
David "Tiger" Williams, founder of the equity execution service provider Williams Trading, observes how outsourced trading has provided emerging managers with added scalability.

"Things on the outsourced side are not always necessarily regulatory driven – it can be cost-effective as it's more of a variable cost than a fixed cost and the pandemic has certainly opened people's eyes to the possibility of a more scalable workflow going forward."

### Culture

With a rapidly expanding landscape of third party service providers offering an ever-broader

Figure 4.1: Hedge fund firms' plans for outsourcing of operational functions




**Analyst note:** Emerging managers defined as having both AuM <$250m and a track record <5 years.

Source: Hedgeweek survey

assortment of operational, tech, regulatory and trading products, the choice for cost- and time-constrained start-ups has never been greater.

But while the pandemic has helped accelerate the process of outsourcing, and demonstrated that many parts of the business do not need to be maintained all under one roof, managers say certain functions – those specifically relating to the 'alpha-generative process' – are best kept on-premise. In turn, newer managers' selection of service providers - be they prime brokers, administrators, or software systems – is more important than ever.

"I think everyone agrees that Covid has accelerated a normal trend – we had 10 years of digitalisation within one year," says Alyx Wood, chief investment officer at Kernow Asset Management.

For emerging managers, functions that form a core part of their competitive advantage, as well as functions that require full trust and oversight, should remain in-house or come under the scope of advisors, Wood says. In contrast, anything that is not a good use of managers' time, and which can be executed better elsewhere, should be outsourced, he says.

"What's our core competitive advantage? It's research - so all our research happens in-house, we would never outsource that," Wood says. "Everything else is about cost, speed and efficiency of service, whether it's done internally with great advisors, or outsourced."

The question of how fledgling hedge fund firms can maintain the balance between the increasingly loose constellation of networks brought about by remote operations while also fostering the creative "ideas factories" of physical trading floors critical to success also looms large over the outsourcing concerns.

"In terms of culture, having people in the room is really important. Being totally virtual would be wrong, so I think it's a hybrid, progressive model," Wood adds. "I think anyone who had legacy systems and were set up for the dark days before Covid, and then didn't have a technology-led mindset, has been through a rude awakening and will probably struggle to fully catch up."

## Regulation

Reflecting on the extent to which start-ups should rely on compliance consultancy firms, Ant Bennett, head of sales and client development, ACA Mirabella, explains how access to expertise, cost and time to market are the three main drivers.

"With time to market, if you're going through your own FCA application, there is a lot more that managers are now required to do upfront before even putting that application in place, though the timeframe is roughly the same," he says of the UK market. "With a regulatory host solution, managers do not need a full compliance manual upfront because that is provided for by the regulatory host; you're leveraging the permissions of the regulatory host firm. The complexity is still there, but you have the opportunity to familiarise yourself with the framework."

He adds: "We have seen some initial investors, some of the managed account platforms, are unwilling to allocate directly to a brand new manager unless that manager can demonstrate sufficient expertise to be able to handle and manage that regulatory framework.

"It's more accepted that you can leverage an outsourced middle and back office. We are increasingly seeing fund launches use a specialist launch COO to get up and running, what decisions need to be made in terms of the right growth trajectory, the initial costs, the main areas of focus.

"The willingness to stay with an outsourced compliance firm once a manager has gone live under its own FCA is growing more and more, and part of that is driven by some of the regulatory complexity."

## Prime brokerage

Meanwhile, selection of prime brokers – often considered the most important service provider – also remains critical to the start-up process. As the PB space has rapidly reshaped around consolidation trends among larger players and the continued emergence of smaller, boutique names catering to smaller hedge funds' needs, key prime brokerage functions continue to evolve.

"The nature of capital introduction has changed a lot," says Trium Capital's Donald Pepper. "Going back to the early 2000s, the capital introduction teams were the nexuses of knowledge. Now, though, there is a lot more knowledge in hedge funds' investor relations and sales teams whereby they don't need the same level of introductory services that they used to have in the past. A lot of the capital

**Figure 4.2: Actions taken by hedge fund firms as a result of regulatory compliance trends over the past 12 months**

**Analyst note:** Emerging managers defined as having both AuM <$250m and a track record <5 years.

Source: Hedgeweek survey

**ROXANA NADERSHAHI**
DIRECTOR, UK REGULATORY PRACTICE, ACA COMPLIANCE

## UK REGULATORY DEVELOPMENTS

NEW REQUIREMENTS
Firms now require a compliance manual and monitoring programme to be already in place when submitting an FCA application. "That has brought forward a lot of thinking around compliance testing or regulatory concerns that managers should have, and what new hedge fund managers should be thinking about at an earlier stage."

UK/EU DIVERGENCE
On the EU's MiFID II, the FCA has removed the need for firms to publish best execution reports, impacting MiFID-subject managers, as well as minor changes around paying for research reports.

"These minor changes to MiFID II mean that if you are launching a fund now you have to slightly adapt what you may have thought you might have to do later as an authorised firm. If you are a new MiFID manager you don't, for example, need to build in that extra process of publishing best execution RTS28 data on your website; meaning you don't have to collate the top five trading venues by asset class and volume."

AIFMD
The current directive has had murmurings of change from the European Securities and Markets Authority on potentially streamlining frameworks to bring AIFMs in line with MiFID managers.

"It's a tentative proposal released by ESMA last year. But given we are now in Brexit, wherever there is an update from ESMA, we are not necessarily seeing reactions in the UK from the FCA that we used to."

introduction people now call themselves capital intelligence – it's moved away from going to conferences and roadshows and introduction services.

He adds: "Hedge fund investors had to talk to the cap intro teams to understand who was the next big launch coming out. Now there is a lot more information about investors out there, and the value of having to speak to cap intro is more about hearing which investors are looking for strategies, rather than getting an initial introduction to these investors."

### Cybersecurity

The fallout from the pandemic has also brought greater scrutiny of how hedge funds and other asset managers handle cybersecurity. As businesses continue to operate with forms of hybrid working, investors are said to be looking more closely at the ways in which emerging managers and start-up funds manage cloud services, particularly as malicious actors look to take advantage in gaps in infrastructure.

"In the early 2010s, the idea that anyone that had information technology infrastructure would not have it on-premise, specifically when you're dealing with highly sensitive information such as algorithmic trading patterns or even just data - whether it's front of house or back of the house – was verboten," says Faryan Amir-Ghassemi, co-founder, Epsilon Asset Management.

Observing the sea-change in recent years, Amir-Ghassemi believes newer start-ups are well-placed to capitalise on the availability of outsourced cybersecurity and cloud options on offer.

"In the last couple years, it's become the de facto play, partly because of Covid, partly because of the changing landscape, partly because of the importance of cybersecurity and just the importance of information technology in running a modern business.

"Some of the very well-established, multi-decade hedge fund firms that have been building out processes and infrastructure in a methodical way are now the ones that are dealing with legacy technology and tackling the question of moving towards the best opportunities in the marketplace versus what they've inherited.

"But for the start-ups, they can almost leap-frog into the best-in-class options, and leverage that flexibility that the cloud offers, as opposed to building things on-prem." ■

### KEY TAKEAWAY

The drive towards outsourcing over the past decade, which has gradually gained manager and allocator acceptance, was further accelerated by the Covid-19 pandemic. Hedge funds are satisfied with the amount of functions outsourced, though a number remain keen to increase this level further. Start-ups and emerging hedge funds are well-placed to leverage the expanding range of products and services on offer from third parties without having to deal with legacy infrastructure

# HEDGEWEEK

**CONTRIBUTORS:**

**Hugh Leask**
**Editor**
**hugh.leask@globalfundmedia.com**

**Fiona McNally**
**Reporter**
**fiona.mcnally@globalfundmedia.com**

**Scott Newman**
**Art Director**
**scott.newman@globalfundmedia.com**

**Tony Griffiths**
**Head of Content, Hedgeweek**
**Tony.Griffiths@globalfundmedia.com**

**FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:**

**Jamie Home**
**Associate Commercial Director, Hedgeweek**
**jamie.home@globalfundmedia.com**

**Published by: Global Fund Media, 8 St James's Square, London SW1Y 4JU, UK**

©Copyright 2022 Global Fund Media Ltd. All rights reserved. No part of this publication may be reproduced, stored in a retrieval system, or transmitted, in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of the publisher.

Investment Warning: The information provided in this publication should not form the sole basis of any investment decision. No investment decision should be made in relation to any of the information provided other than on the advice of a professional financial advisor. Past performance is no guarantee of future results. The value and income derived from investments can go down as well as up.

SUPPORTED BY: