Of Mythical Beasts and Creatures: 3rd Party Marketing For Smaller Hedge Funds

When scientists visit a tucked-away part of the planet—say, a deep-ocean hydrothermal vent or an isolated jungle mountain—they routinely find dozens of species that have never been documented. It's discoveries like these that allow folks who believe in mythical beasts such as Bigfoot, the Loch Ness Monster and El Chupacabra to hold out hope that these creatures actually do exist. In most cases, hope is all they have, as the scientific evidence for such creatures simply isn't very convincing.

The same can be applied to 3rd party marketing for smaller hedge funds. Small hedge funds attempt to engage "Third Party Marketing (TPM)" services to **raise assets**. Candidly, few TPM services exist for small funds and such services for funds with less than $100 million AUM are non-existent. In fact, just completed research revealed that only "**1 out of every 275 sub $250 million AUM hedge funds establishes a true TPM relationship**". TPM is **NOT** a realistic or viable option for the vast majority of small hedge funds. However, understanding TPM is necessary to construct an **intelligent marketing process**.

What is a Third Party Marketer?

TPMs are FINRA-licensed, broker-dealers, who receive performance or transaction-related compensation for placing assets. (**Note:** ***ANY entity, even internal, receiving compensation as a result of investment activity will be seen as acting as a broker and must be licensed***). Most TPMs are created by individuals from investment banks, which focus on services to "institutional" investors i.e. public pensions, endowments, foundations, taft-hartley (unions), Islamic (Shariah) and sovereign wealth funds within North America, Europe, Middle East or Asia. As a result, most TPMs focus on "institutional" relationships **NOT** private wealth relationships (ultra-wealthy individuals, families and single/multi-family offices).

Institutional investors typically work on a mandate (RFP) basis and seek to place allocations of $25-$50 million on average. Such larger allocations can only be accommodated by funds with an "institutional-quality" operational infrastructure and minimal AUM of $250 million, which enables large investors to remain within their concentration limits by not exceeding a certain percentage of a fund's AUM (usually 5%-10%). These requirements exempt most small funds from institutional marketing and fundraising, which exclude them from TPM. (**NOTE: The mean size of an institutional allocated hedge fund is $565 million AUM**.)

Currently there are about 150 TPMs, each working exclusively with 2-3 funds at any given time. This places full capacity at approximately 450 funds that can be represented by TPMs. With 8000+ hedge funds, obviously a great number of small funds are left "alone". Given the small number of **QUALIFIED** and **REPUTABLE** TPMs as well as the high reputational risk of representing poor or fraudulent funds, TPMs are highly selective in the funds they choose to work with. TPM has a high degree of specialization, as firms focus on certain strategies, investor segments, distribution channels or geographical locations. As a caveat, low barriers to entry and reduction of Wall Street workforce have resulted in a significant increase in the number of individuals and firms representing themselves as "marketers", resulting in great disparity in quality and capabilities. Moreover, form is often greater than substance, leading to unqualified or unscrupulous individuals and organizations representing themselves as TPMs.

What can you expect from a relationship with a TPM?

TPM can be a valuable resource for a hedge fund should it qualify. The "right" engagement with the "right" firm can bring relationships, value-added resources and growth. A "qualified" TPM can efficiently identify REAL investors and gain ACCESS to them as well as contribute a great deal to the overall growth of a fund business aside from sheer assets. Going down the TPM route enables a fund to outsource some but not all of the marketing and sales function. The TPM 'rolodex' may contain contacts that a fund would not have been able to identify on its own or investors the fund could have reached had it the time, money and effort to put into doing the research and building the relationships. The best TPMs have spent entire careers building and profiting from exceptional analytical and relationship skills used to form solid buy and sell-side relationships. However, even the 'well-vetted' rolodex has been collateral damage of the credit crisis, global economic instability, volatility, workforce reductions and Madoff. As such, a small fund should not make the misguided assumption regarding the issue of 'who they know'. Just because a TPM "knows" or has a long-standing relationship with an investor or intermediary, doesn't mean he or she will be able to get that investor to invest in a fund. There are many factors including intermediation (presence of consultants and advisors) that influence the allocation decision. While solid investor/intermediary relationships of the TPM can get attention for a fund, it will not get allocations. No TPM can "make" an investor allocate ("institutions buy; retail gets sold"). It's a LONG road from introduction to allocation. Helping a small fund stay on the radar of targeted investors and consistently communicating a tight and concise story in a consultative manner are all characteristics of a good TPM.

The easier a fund makes the TPM's job of "telling and selling" an interesting story about a fund, the greater the odds of a successful relationship between both parties. A TPM will cover a majority of the marketing and fundraising logistics but the TPM may not be skilled enough to craft a fund or firm's story.
Having selling experience in telling a hedge fund's story, once this story exists, is not the same thing as having the expertise to create how a fund's story should be told. Here is what has been heard from principals of three different TPM firms:

1. **"While we say we offer hedge funds help in putting their stories together to explain how they invest, this isn't really where our expertise lies."**
2. **"Every time we had to begin our working relationship with a hedge fund manager by trying to get the story about how he invests out of his head and into marketing materials, we found ourselves thinking that we never got to the bottom of exactly what that manager's investment process was; and we were always less successful in our selling efforts for these hedge funds."**
3. **"I can sell a hedge fund that has an acceptable story, but figuring out how to create an acceptable story isn't something I really have much practice in. I'd rather not spend my time trying to figure that out."**

What Do TPMs Look For?

The basic requirements of a TPM are an experienced team (individual) with consistent performance, limited drawdowns, minimum $100 - $200 million AUM, momentum in asset growth, 3 years audited returns, robust operational infrastructure and a commitment to marketing.

What are "costs" of a TPM relationship?

Many small funds think that a relationship with a TPM is devoid of cost or financial commitment. They then approach TPMs with an "eat what you kill" compensation offer to "sell" or "market" their fund – in other words "Just bring me the assets"! A solid TPM has little incentive to work with a small fund on a solely success-fee/performance basis. Particularly given the long allocation (sales) cycle, which can range from 6 to 18 months. While the most significant portion of TPM compensation is derived from performance i.e. placing assets, a TPM engagement is comprised of preparation, consultation, analysis, due diligence, travel and other expenses, which are responsibilities of the fund and covered by a retainer. Retainers typically range from $5,000 to $50,000 and charged on a monthly basis. Among the ongoing expenses of the TPM relationship incurred by the fund are travel and related costs (T&E). Such expenditures often exceed the financial resources and capabilities of most small funds.

Many small funds fail to comprehend the resources and skill set required to gain investor relationships in order to extract the necessary market information, insight and intelligence to **extract allocations**. Furthermore, many funds under-estimate the degree of investor education now required. The complexity of some strategies can exceed the capacity of even the most seasoned investors and with new entrants to the asset class, the level of experience with even the most traditional hedge fund strategies can be elemental, not to mention those of a more esoteric nature. Moreover, with due diligence and allocation cycles protracted, the ability to get and keep the attention of an investor, decipher complexity, communicate simply and clearly are critical relationship skills in the successful placement of alternative assets. **QUALIFIED** and **REPUTABLE** TPMs have these abilities and talents as basic parts of their repertoire and such skills are **HIGHLY** sought after, as reflected by the increase in the demand and compensation of TPMs. As such, the compensation a **QUALIFIED** and **REPUTABLE** TPM **earns** in the form of retainer and performance fees, in our opinion, are monies well-invested.

TPM is not an instant allocation service and regardless of the source, AUM takes time (patience) to come online. TPM should be viewed as a possible component of a focused long-term investor acquisition process and investor-base management initiative for those funds that meet the requirements.

Start preparing NOW for successful marketing and fundraising.

While allocations to hedge funds are increasing primarily to "bulge bracket" funds i.e. $5+ billion AUM, smaller funds continue to experience significant difficulty marketing and raising assets. The importance and complexity of marketing and raising assets for a smaller fund calls for an intelligent, professional and proactive approach – one that understands the strategic and tactical nuances, regulatory requirements, required level of effort and magnitude of resources. Marketing and fundraising are inherently complicated by capricious fundraising climates, dynamic markets, demanding investors and a constantly evolving regulatory climate.

Intelligent high-quality marketing of a fund is a critical determinant in its ability to survive and succeed. The best thing a smaller hedge fund can do to meet the challenge of raising assets is to become better informed and optimally-prepared.

For any small fund serious about marketing and fundraising, the time to start preparation is **NOW**.

THE HEDGE FUND MATURATION PROCESS: MARKETING AND INVESTOR SEGMENTATION.

$0 - $100 Million AUM **Personal Finances, Family, Friends & Private Wealth (High Net-Worth Individuals/Family Offices)**	➢ **FUND FOUNDERS SOLELY RESPONSIBLE FOR ALL MARKETNG.** ➢ **Prime Broker Cap Intro interest: MUTED.** ➢ **Intermediation: Heavy, highly-fragmented, idiosyncratic & qualitatively diverse.** ➢ **Fund lacks critical AUM for QUALIFIED/REPUTABLE 3rd party marketing firm.** ➢ **Nascent operational infrastructure lacks institutional requirements.** ➢ **Undeveloped client service/investor relations strategy and structure.**
$100 - $250 Million AUM **(MINIMUM Institutional Threshold)** **Funds-of-Funds & Private Wealth**	➢ **FUND ACHIEVES *MINUMUM* INSTITUTIONAL AUM LEVEL** ➢ **FUND FOUNDERS PRIMARILY RESPONSIBLE FOR ALL MARKETING UNTIL FUND ACHIEVES CRITICAL AUM of $100 MILLION.** ➢ **Intermediation: Heavy, highly-fragmented, idiosyncratic & qualitatively diverse.** ➢ **Engages QUALIFIED/REPUTABLE 3rd party marketing firm to expand/diversify AUM beyond initial core investors into institutional segments.** ➢ **Prime Broker Cap Intro interest: LIMITED.** ➢ **Operational infrastructure requires augmentation (human & technological).** ➢ **Initiates structured investor relations/client service strategy.**
$250 - $500 Million AUM **(IDEAL Institutional Target Level)** **Pensions, Endowments and Foundations.**	➢ **FUND *SOLIDLY* ACHIEVES INSTITUTIONAL AUM LEVEL.** ➢ **REQUIRES HIRE OF A FULL-TIME DEDICATED INTERNAL MARKETER.** ➢ **Intermediation: Heavy, concentrated, idiosyncratic & qualitatively homogenous.** ➢ **Engages QUALIFIED/REPUTABLE 3rd party marketing firm to expand and diversify AUM to broader institutional community.** ➢ **Prime Broker Cap Intro interest: SUBSTANTIALLY INCREASED.** ➢ **Operational infrastructure appropriately resourced (human & technological).** ➢ **Augmented investor relations/client service strategy and team.**
$500+ Million AUM **(GLOBAL Institutional Threshold)** **Pensions, Endowments, Foundations and Sovereign Wealth Funds.**	➢ **FUND REACHES *GLOBAL* INSTITUTIONAL AUM LEVEL.** ➢ **SELECTIVELY AUGMENTS INTERNAL MARKETING TEAM.** ➢ **Intermediation: Heavy, concentrated, idiosyncratic & qualitatively homogenous.** ➢ **Engages QUALIFIED/REPUTABLE 3rd party marketing firm to broaden institutional coverage & expansion globally to further diversify and expand AUM.** ➢ **Prime Broker Cap Intro interest: OPTIMAL.** ➢ **Operational infrastructure well-resourced and robust (human & technological) serves as a point of competitive differentiation.** ➢ **Expands investor relations/client service strategy and team to meet demands of a globally diversified investor base with proactive investor base management.**

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