

LIQUID HOLDINGS

How to Raise Capital
from Institutional Investors

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\$300 BILLION IN ASSETS FOR THE ‘OTHER 90%’

As a fintech company in the alternatives space, we work with a range of emerging hedge funds that manage less than one billion dollars in assets. Across the board, the conversations focus on how to level the playing field with the ‘billion and above club’ to raise more capital from institutional investors. It’s a playing field that continues to grow. Hedge Fund Research (HFR) reported the hedge fund industry sat at a record \$2.94 trillion dollars in assets under management in April, and in the first quarter of this year alone, institutions allocated \$18.2 billion in net new capital to alternatives.¹

This growth has led to 10,200 hedge funds competing for and servicing investors today. Of those funds, the top 10%, an elite group with the strongest brand recognition, manages the lion’s share of the industry’s assets—\$2.64 trillion dollars.²

This leaves \$300 billion dollars in assets for the other 90%— emerging managers— to split.³

The disparity in assets between the top 10% and the other 90% comes as no surprise. Institutional investors favor the largest hedge funds because of their repeatable performance and infrastructure in place to safeguard assets. What might come as a surprise is that an increasing number of these managers are closing their fund(s) to new capital. This is good news for emerging managers because you can expect the pool of \$300 billion dollars in assets to grow as your larger peers turn away fresh capital.

But, with 27% of emerging managers planning to launch a new vehicle this year⁴, the key to raising more assets is ‘*knowing your investor*’ and ‘*understanding the manager selection process*’.

THE HEDGE FUND INDUSTRY TODAY



KNOWING YOUR INVESTOR & THE MANAGER SELECTION PROCESS

Today institutions account for more than two-thirds of the total hedge fund assets and will continue to eclipse high net worth individuals as the industry's primary source of capital. Public pension funds alone have quadrupled the share of their portfolios invested in hedge funds over the past five years to become the top investor; and private-sector pensions now account for nearly one of every five dollars invested in hedge funds globally, leaping ahead of sovereign wealth funds and endowments as the second-largest investor.⁵

The industry's shift to institutions has catalyzed significant changes in the way you need to structure and market your business. Transparency is now one of the top criteria in the 'manager selection' process. Institutions are demanding more detailed information from managers, arguing that they should have access to the same level of granular data as regulators.⁶ These same investors are requiring managers to handle different fund structures such as Separately Managed Accounts (SMA) and to validate risk management practices.

This is a conversation the largest hedge funds are comfortable having because of their heavy investments in infrastructure over the years. It's a talking point they use to differentiate themselves from

emerging managers with similar performance—as a result, institutional investors now expect emerging managers to have similar controls and infrastructure in place prior to allocating capital. Today's reality is deficiencies in your infrastructure and/or operations may very well result in no investment.

Understanding the infrastructure and operations requirements is a key to raising more capital. And it starts with the DDQ process—a process that has grown from a short form into a highly quantitative and detailed analysis of the fund, the risk taken to achieve performance, and the infrastructure in place to safeguard assets.

Five years ago, the primary reason for selecting a manager came down to repeatable performance and the overall make-up of the investment team. Fast forward to today, institutions dedicate entire sections of the DDQ to infrastructure, processes and controls. The sections include but are not limited to pre-trade research, risk management and operations. Below, we highlighted specific questions from the sections mentioned above as well as insights into the processes being examined by the pensions, sovereign wealth funds and endowments to determine if your business is prepared to take-on institutional capital.

PRE-TRADE RESEARCH & EXECUTION

This section of the DDQ covers compliance, order and execution management, and post-trade allocations. Expect to answer thirty-plus questions which include the systems and processes in place to:

- Enforce trading limits and restricted lists;
- Record details of open pre-execution orders;
- Calculate decision-support analyses;
- View positions and P&L at any point in time; and
- Allocate trades across accounts.

Investors want to understand your ability to proactively monitor pre-trade compliance checks, set up SMAs to provide investors with additional liquidity, and allocate positions in a compliant manner across different fund structures.

From here, your investors want to understand how trade and position-level data is shared intra-day across the investment team to help inform future investment decisions.

PORTFOLIO & RISK MANAGEMENT

Moving to portfolio and risk management, expect to answer twenty-plus questions on the processes and system(s) in place to:

- Calculate intra-day performance and risk;
- Determine the size of each position;
- Inform investors of daily changes to P&L;
- Liquidate positions; and
- Stress-test the portfolio to uncover hidden bets.

As discussed earlier, transparency is one of the top criteria in the manager selection process. Transparency begins and ends with the precise management of

data to report how your fund is performing, where the performance comes from, and the risks taken to deliver that performance. Addressing transparency might seem straightforward until you consider that the data is coming and going at all angles, in all sizes, from different sources and at various speeds.⁷

Institutions want confidence that your infrastructure can turn disparate data into a single source of truth to accurately manage and report on the health of the business at any point in time without relying on manual processes or spreadsheets that can introduce errors.

OPERATIONS

Across your operations, there are critical functions that might have seemed invisible to investors five years ago, but today are integral parts of the DDQ including the processes in place to:

- Reconcile trades and handle breaks;
- Shadow your fund administrator;
- Manage business continuity and DR plans; and
- Back-up all portfolio and investor data.

The DDQ moves the discussion from front-office workflows to how the business handles its start and end-of-day processes, and securely maintains portfolio and investor data. Investors want assurances that there is a concept of ‘separation of duties’ so that you as the portfolio manager can concentrate on generating alpha while a separate team maintains the operations, data and contingency planning so the business operates without disruption.

DRIVING DIFFERENTIATION THROUGH TECHNOLOGY

The DDQ process reveals that your ability to raise more capital is directly tied to your investment in infrastructure. From explaining how alpha generation is repeatable and the drivers of intra-day performance, the right mix of technology and market expertise will help address mandates from today’s investor.

Your infrastructure should synchronize the front-office with order, execution and risk management capabilities that allow the investment team to stage and execute orders, and monitor market and liquidity risks,

P&L, performance and shadow NAV in real-time. It should go a step further by transforming manually intensive middle-office processes into an automated experience that ensures the front-office is equipped with accurate portfolio and investor data at all times.

Finally, your infrastructure and data should be accessible while at the desk as well as from a mobile device, and be partner-agnostic so the business is able to connect to the liquidity destinations, prime brokers and fund administrators of choice.

THE ROI OF INVESTING IN INFRASTRUCTURE

As a case in point, a \$250 million-dollar equity long/short manager requested our services in 2014. The firm managed three hedge funds, had a five-year track record and was in capital-raise mode—but launching new SMAs to on-board new investors was a challenge.

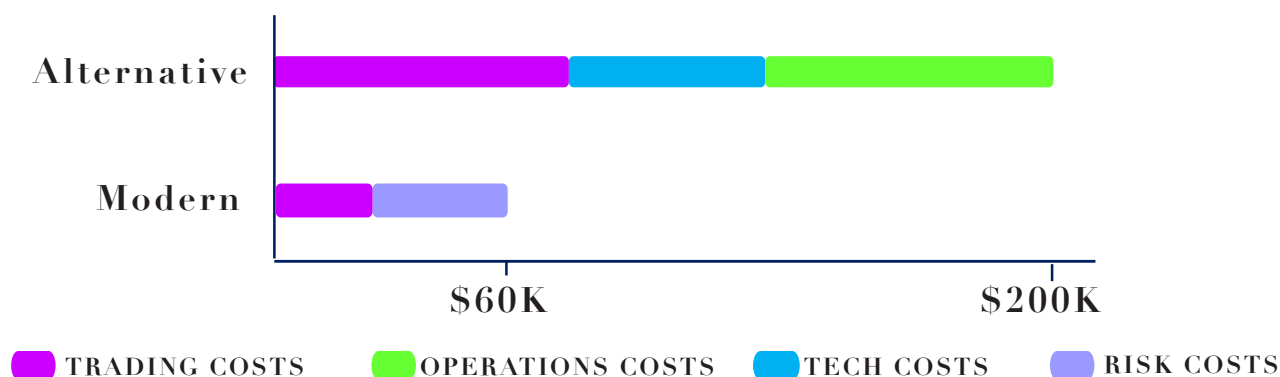
Its infrastructure consisted of four service providers (OMS / EMS / FIX Network / Hosting Provider), each positioned as ‘best-of-breed’ in their respective silo.

Data discrepancies between the disparate EMS and OMS systems arose during volatile market conditions. This required a portfolio manager to manually update the systems to report the drivers of performance to investors. And, intra-day views into the drivers of market risk did not exist.

Management needed to institutionalize the business to eliminate manual corrective measures that at times eroded performance. The CIO searched for a SaaS platform that unified real-time trading, portfolio and risk management with outsourced IT and end-of-day processes. She was confident that modern technology would allow the investment team to:

- Address the infrastructure requirements present in today’s DDQ process;
- Concentrate their time and effort on the preservation and growth of capital;
- Eliminate manual corrective measures that at times introduced errors in reporting; and
- Produce intra-day position and risk reports to support investment decisions as well as ad-hoc conversations with investors.

ANNUAL SPEND: TECHNOLOGY & OPERATIONS



The business was able to allocate \$140,000 per year back to the front-office

Five years ago, the business incurred high costs to link together separate systems from different vendors. Intra-day P&L statistics were hard to calculate at times, and risk measures as well as access to portfolio data from a mobile device were out of the question.

Fast forward to today, modern technology allows the investment team to accurately monitor and report all activity during the most volatile market conditions

from an iPad. Modern technology also reduced the firm’s annual technology and operations costs from two-hundred thousand dollars down to sixty-thousand dollars. The net savings of one-hundred and forty-thousand dollars was re-allocated to the front-office to help bolster the investment team.

Their investment in modern technology allowed the firm to grow its assets by thirty percent.

CONCLUSION

Your ability to raise more capital is key to building a reputable and reliable business. Doing so comes down to knowing your investor and their manager selection process, and demonstrating that the necessary controls are in place to generate alpha and safeguard assets. The right mix of modern technology, processes and market expertise is allowing emerging managers to appear as institutional as their larger peers to win larger shares of the net new capital allocated to alternatives from the pensions, sovereign wealth funds and endowments.

To receive a free evaluation of your infrastructure and to test drive modern technology that can help you raise capital in today's competitive environment, contact us at marketing@liquidholdings.com.

¹ Hedge Fund Research; Hedge Fund Launches Rise as HFRI Tops US Equities; June 19, 2015

^{2,4} The 2015 Preqin Global Hedge Fund Report; January 2015

⁵ Wall Street Journal: Hedge-Fund Bet Hits Pensions: <http://www.wsj.com/articles/hedge-fund-bet-hits-pensions-1434496049>

⁶ State Street; Chasing Alpha; 2014

⁷ [Liquid Holdings Group: Synchronizing the Front-Office Through Modern Data Management; 2015](#)



Liquid Holdings Group is a SaaS provider of investment management solutions to the buy side. The Liquid platform combines multi-asset order, execution and risk management with shadow NAV and investor reporting. Liquid goes a step further, backing its front-office capabilities with managed services to transform manually-intensive middle-office processes into an automated, seamless experience.

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