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Foresight For Established Investment Managers

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Law360, New York (June 16, 2010) -- While many investment managers of hedge funds, private equity funds and similar private investment fund vehicles feel that a consistent, long-term track record and generous capital inflows means that they've arrived, in reality this is just the start of the battle. Well-established investment managers have a whole different set of circumstances to deal with after the initial formative phase of their business. This article addresses the issues that these maturing managers need to consider.

Don't Look Back, Someone May Be Gaining on You

Mature managers should heed the words of the great baseball philosopher, Satchel Paige, who was very concerned about up-and-comers pushing him aside. The private investment fund business is a relatively young person's game and statistics have generally shown that the best performance is achieved in the fund's early years. So the question must be posed, "What happens after the early years?"

There are only so many variations of the same basic strategies. So if a mature manager is starting to lose that return edge, it could pose a problem relative to newer, more nimble peers. While the mature manager may be able to point to "long-term consistency," the manager nonetheless must be mindful of the competition, take corrective portfolio actions as needed, and even consider stopping (perhaps just temporarily) to take in additional capital that can lead to stressed performance and disgruntled investors. The manager should let available investment capital allocation opportunities and long-term traction be key drivers in this decision.

Expanding the Product Offering

Oftentimes, a manager may be known for a particular "flagship" strategy. While many managers may be content to trade just that one strategy, others, however, use the flagship product as an opportunity to branch out into other areas (e.g., including other fund strategies and even less liquid vehicles), with an already existing client base as a great launching pad.

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Some managers elect to stay within the same strategy, but consider setting up other types of investment vehicles to accommodate a different investor audience (e.g., a mutual fund can reach lower net worth investors). Expansion though needs to be carefully planned. While on the positive side it can create investment diversity for existing and prospective clients who might otherwise go elsewhere (and hence lead to more fees), it could also hamper the firm.

First, if the main portfolio manager is involved with the new product, it could be viewed as distracting from the primary flagship focus. Second, if the new business underperforms, it may to some degree taint the entire platform. Finally, the operation of the new product may create internal issues relating to taxation, compensation, staffing, office location and overall administration, as well as conflicts of interest and related compliance issues.

Institutionalizing the Brand

As the firm becomes more prominent, the manager may wish to take steps intended to strengthen the brand's appeal from an institutional investor perspective.

Some managers, at this stage, consider obtaining trademark protection for their name and greatly enhancing their Web site. Managers sometimes change their fee and/or liquidity terms to make them more institutional investor-friendly, and a number of managers even establish prominent, independent industry advisory boards.

Finally, beyond these undertakings, many mature managers will also look into registering with the U.S. Securities and Exchange Commission (if not already the case), as well as hiring third-party consultants and solicitors with institutional investor relations expertise.

Keeping Investors Happy

Investors are often a fickle lot. While they may be happy about a manager's last five years of performance, a few bad quarters can quickly change everything, as experienced by a number of well-known managers in recent years. As the firm matures, the manager must learn to neither rest on past laurels, nor take investors for granted.

Besides strong returns, communication is probably the best way to keep investors satisfied. So it is imperative that investors be actively involved in the business. Many larger managers host annual investor events, monthly calls or even have one-on-one meetings with key clients. Some even survey their clients before undertaking major firm actions. Still others offer greater transparency to their investor base.

All this is done to make sure that investors feel truly invested in the business, understand the story and provide useful feedback to their managers. There are many managers who have held onto or even grown their capital base without necessarily out-performing their peers, mainly because they were better able to explain what they were doing and what they had planned for the future.

Strengthening the Team

As the firm matures and overall outside demands become greater and more sophisticated, the manager must make sure that the right team is in place. Hiring, and of course retaining, key personnel becomes crucial to the future success of the business as the manager seeks to add perhaps a general counsel, additional investor relations, administrative and accounting people, as well as investment professionals. In conducting this process, the manager must consider various factors.

First, the manager should strive hard to maintain the original firm culture that helped get the firm to its current stage, while at the same time understanding that new employment/compliance policies, risk-management

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guidelines and employee-reporting lines may need to be created as the firm grows. As part of this, the manager must screen hires very carefully, looking at criminal, financial and academic backgrounds, personality traits, references and other relevant criteria.

Second, the manager must figure out the best way to keep key personnel incentivized. With success comes greater outside job opportunities for firm personnel. The manager should work with counsel, employee compensation consultants and industry experts to achieve a plan that rewards important team members immediately and also encourages them to stay for a long time, creates workplace stability, and elicits positive buzz from within the industry.

Finally, even with a great hiring and compensation process, it is inevitable that some personnel will depart — so the manager must also ensure that such exits do not result in the theft of confidential information such as proprietary strategies and investor lists, the poaching of employees and clients, and new competition cropping up.

Maximizing Manager Economics

Generally speaking, most mature managers are way beyond their original break-even point and hopefully are earning significant amounts of compensation. At this juncture, the manager may want to reevaluate circumstances so that evolving financial goals and opportunities are being maximized.

First, if the manager has children, and has not already done so, consideration should be given to whether now is the time to undertake some estate planning for them, as there are some interesting techniques that managers have utilized in this regard.

Second, if the manager has a seed investor, as many nowadays do, the manager way wish to approach the seed investor to take advantage of any buyout clauses in the deal and, even if there are no such clauses in the seeding contract, consider trying to negotiate one.

Lastly, the manager may want to commission an in-depth tax study around the firm's trading and structure. It is not uncommon for those managers who have undertaken this study to learn that there are some relatively simple adjustments to how they conduct their business that could result in a significant additional economic windfall to them.

Conclusion

Getting to the mature investment manager stage is a great thing and a very nice high-class problem to have. However, in order to grow the firm from there, the manager should be aware that there are various issues that will determine the longer-term success of the enterprise.

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