INSIGHTS

NOVEMBER 2022

GROWING PAINS

WINNING NEW BUSINESS AS AN EMERGING HEDGE FUND

EXECUTIVE SUMMARY

It's no secret that the headwinds facing emerging manager fundraisers are particularly strong. And if the weather turned in their favour during hedge funds' 2020-2021 renaissance, then those winds are back, at full strength, in 2022.

In a recent survey by Hedgeweek, nearly half of hedge fund firms with less than $250 million in AuM said the capital raising environment is 'harder' now than it was 12-18 months ago. Larger managers said the same, but not to the same degree. Furthermore, smaller managers were less likely to say the capital raising environment was easier.

Is that surprising? No, and herein lies the rub – the number of emerging managers has been advancing (slowly), buoyed by renewed interest in hedge funds during 2021, but the enlarged pool of investors once expected to seek them has not materialised, largely due to 2022's macroeconomic uncertainty and the resultant downturn in hedge fund performance.

There continues to be a host of fundraising opportunities for smaller hedge fund firms – their biggest challenge, then, will be standing out in the crowd. Early signs are that emerging managers are navigating that particular challenge in increasingly colourful, disparate, and innovative ways.

TONY GRIFFITHS
REPORT AUTHOR

CONTENTS

KEY FINDINGS 3

SECTION 1 - OPPORTUNITIES 4

SECTION 2 - CHALLENGES 11

SECTION 3 - DIFFERENTIATION 17

METHODOLOGY

The insights gathered here are drawn from a Hedgeweek survey conducted in Q3 2022 of 54 hedge fund managers across the globe, half of which managed less than $250 million in AuM, as well as a series of in-depth interviews with industry specialists and further ongoing background research. There are also references to preliminary data from an ongoing survey of alternative investment allocators, the full results of which will be released in December 2022.

KEY FINDINGS

1

Investor interest in emerging managers has gotten weaker

The biting mix of economic forces in 2022 has stifled what, at points in 2021, promised to be a widening pool of investors interested in emerging managers. Today, one third of emerging hedge fund managers surveyed said investor interest in their strategy was ‘strong’ 12 months ago, but only 26% said they would describe it as ‘strong’ today.

2

It is taking longer to win investment from interested parties

Many smaller hedge fund firms interviewed by Hedgeweek reported positive conversations with investors and successful allocations. However, most said they relied on the same distribution channels from previous years, while several suggested that the process was taking longer than ever. Today, relationships with investors can often take one year or more to yield investment.

3

Investors are doubling down on their investment thresholds

The biggest hurdles to raising capital as an emerging manager remain low AuM and short track records – and investors are being particularly stringent with these requirements in the current market. Some leniency is exercised within emerging manager programs, where a start-up meets additional requirements around DE&I. But such attributes merely open the door to a conversation.

4

Performance databases are popular for attracting interest

An increasing number of smaller funds are reporting performance to fund databases as a way of making it onto investor long lists, with several of the firms interviewed saying they reported to multiple platforms. Among survey respondents from smaller hedge funds (AuM <$250m), databases were the second most important service or function used for fundraising (43%) – behind only personal networks.

GOOD NEWS, BAD NEWS

As interest rates rise and equity markets roil, emerging hedge funds should be well placed – but most are still struggling to cut through to new channels

The capital-raising outlook for emerging hedge fund managers is – perhaps unsurprisingly – mixed. First, the bad news. With hedge funds' performance suffering in recent months, the fundraising environment is back to where it was before the pandemic: investors are taking fewer risks, strengthening their thresholds for investment, and pulling money from hedge fund products on a net basis.

Yes, rising interest rates and roiling equity markets have led many allocators to temper their excitement for private markets with a shift away from fixed income replacements and towards alternative investment products with greater liquidity. But the myriad other macro and microeconomic forces at play have created a complex picture – and that complexity has stifled what was starting to become, at points last year, a widening opportunity set for smaller funds.

One third of emerging hedge fund managers (AuM <$250m and track record <5 years) surveyed by Hedgeweek in Q3 2022 described investor interest in their strategy as 'strong' 12 months ago; among the same group, only 26% described investor interest as 'strong' today (see figure 1.1). Most emerging managers surveyed described investor interest in their strategy today as 'moderate'.

Reasons for optimism

Now, the better news. Although the opportunity set for emerging managers has not widened, there are signs that it has deepened. The current market environment may not favour emerging managers *per se*, but it is helping hedge funds create compelling narratives around navigating volatility and downside protection, and there are still plenty of investors actively seeking these stories.

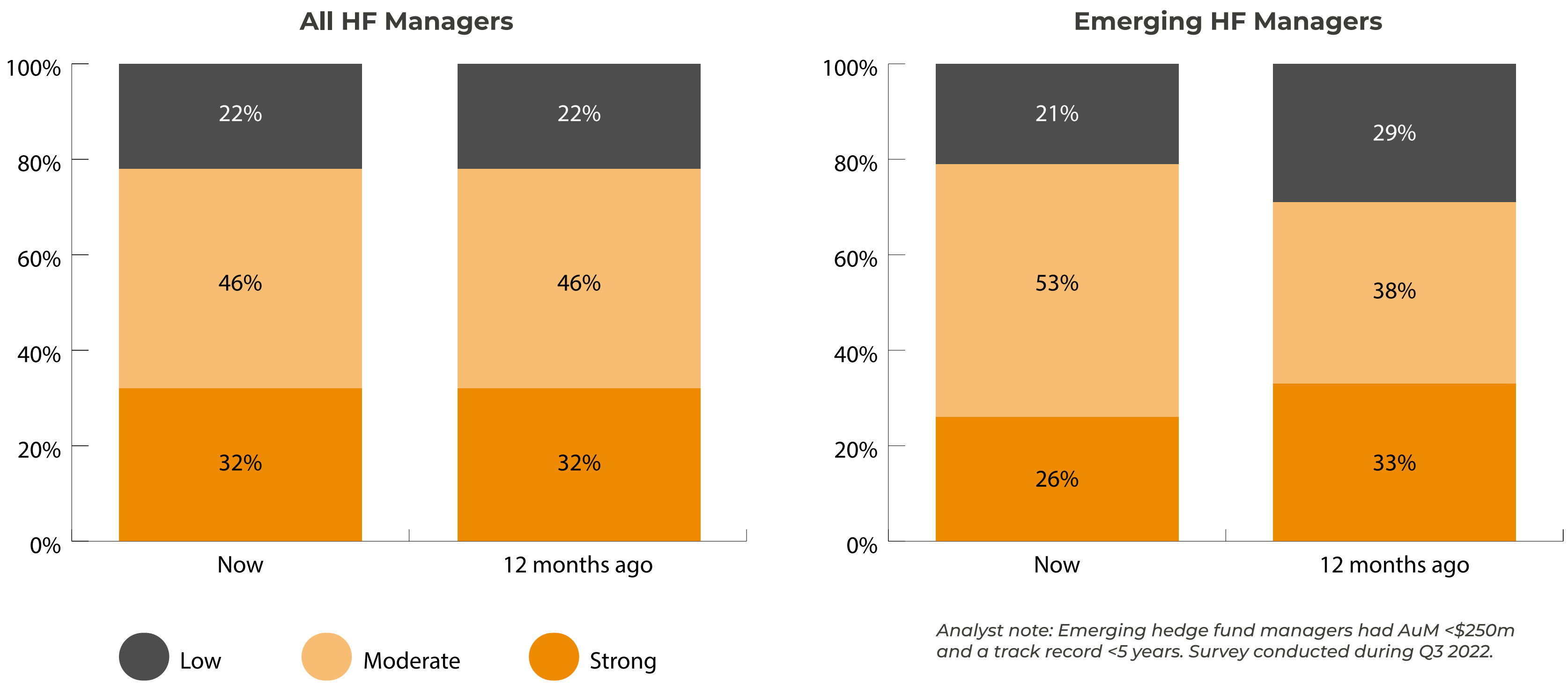
JUMP TO CONTENTS

According to the preliminary results of a new Hedgeweek investor survey, around one quarter of alternative investment investors are planning to increase their allocation to hedge funds over the next 12 months, with less than 15% planning to decrease their allocation.

More significantly, over half of allocators surveyed were either investing in emerging managers already or were considering investing (see figure 1.2). That interest continues to come primarily from family offices, private wealth investors, and funds of funds: around three in five investors across these groups invest in emerging hedge funds. Among those that don't, one in three are considering it. Larger allocators – pensions, insurers – remain unlikely to invest or consider investing in emerging managers (the full results of Hedgeweek's investor survey will be published in December).

Much still depends on investment strategy. During research interviews, Hedgeweek heard of returning – or sustained – investor interest in emerging managers running credit long/short

Figure 1.1 Hedge funds' descriptions of investor interest in their investment strategy versus 12 months previous



Analyst note: Emerging hedge fund managers had AuM <$250m and a track record <5 years. Survey conducted during Q3 2022.

Source: Hedgeweek survey, Q3 2023

JUMP TO CONTENTS

“

The fundraising channels for smaller managers are largely the same, but the process is taking longer

Steven Greenblatt, head of institutional sales, NightShares and equity market neutral strategies, and multi-strategy products.

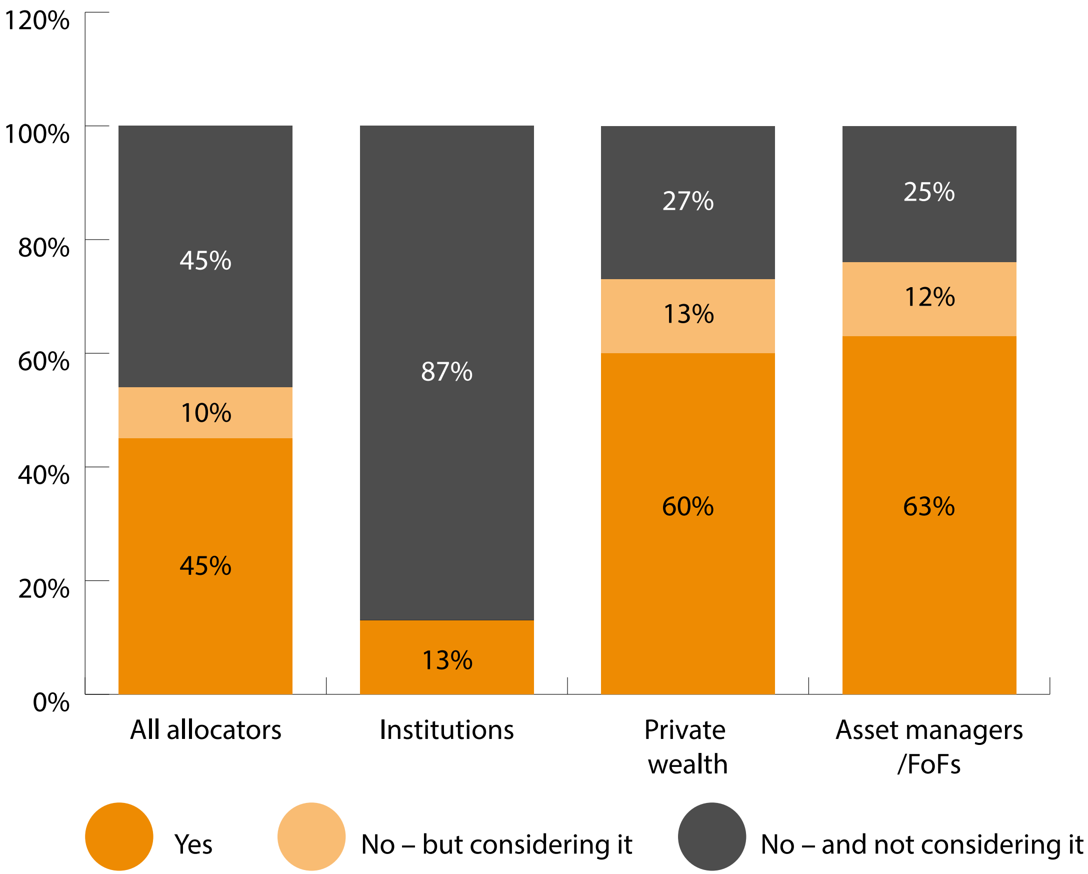
"The current environment is better than this time last year – we are seeing investors who we contacted over the last 18 months returning to have serious allocation conversations. I think this change is attributable to investors acknowledging an increase in macroeconomic uncertainty and overall market volatility. Our strategy resonates well with investors in this environment, says John Caruso, managing member of A.Line Capital Partners, a US equity and derivative centric multi-manager hedge fund implementing a first loss investment strategy. A.Line is seeing interest from consultants on behalf of family offices and endowments, fee-based RIA firms and seeding hedge funds.

Macro interest

Investor interest in global macro has generated headlines in recent months and the initial results of Hedgeweek's allocator survey supports suggestions it will be among investors' favoured strategies in 2023. Macro launches have long been stifled by particularly high barriers to entry and tier one macro brands hoovering up flows. Recent reports had Brevan Howard reopening its $10 billion flagship to new investors following returns of around 20% YTD through September. In a further indication of pent-up demand, the London-based macro specialist is introducing new 'pass through' fees as part of move.

But someone in the macro subset is losing out – mostly other large and midsized firms. Recent data from eVestment suggests macro hedge funds generally saw net outflows in September

Figure 1.2 Investor interest in emerging hedge fund managers



Analyst note: Allocators were asked, 'Are you currently invested in any emerging hedge fund managers?' Data is preliminary. Final allocator survey results due December 2022.

Source: Hedgeweek survey, Q4 2022 (ongoing) close to $5 billion, part of an industry outflow of $21 billion, despite the strategy being among the industry's better performers YTD. Hedge Fund Research's HFRI Macro Index has returned 11.5% YTD through October, compared to a -4.5% decline at the HFRI Fund Weighted Composite Index.

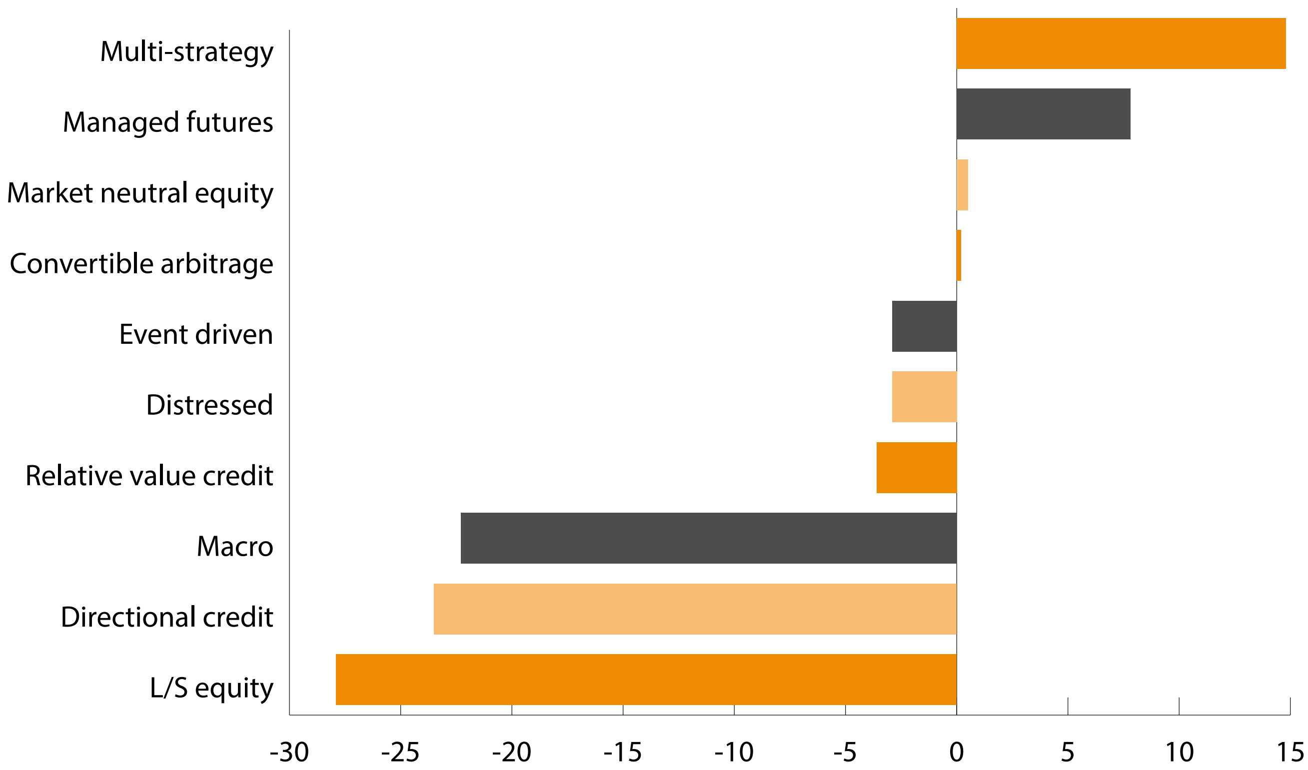
Of course, top-level industry data can paint a misleading picture of interest in emerging managers, especially when consumed alongside high-profile media reports of hedge fund redemptions. Smaller manager sentiment from Hedgeweek's research interviews could be characterised as pragmatic, with many reporting positive conversations and some successful allocations, albeit mostly through traditional channels. The caveat: winning new business requires more time and resources.

Patience and perseverance

"The fundraising channels for smaller managers are largely the same, but the process is taking longer," says Steven Greenblatt, head of institutional sales at NightShares, an emerging US-based ETF and fund manager. Greenblatt – who has been a hedge fund fundraiser for nearly 20 years, including roles at First Quadrant and FrontPoint Partners, and more recently smaller long volatility/options shop Logica Capital – draws a distinction between "celebrity" start-ups and regular start-ups. At the latter, he says, marketing professionals should expect relationships to take a year or more to yield investment.

But those relationships are forming, especially at managers running timely investment strategies.

Figure 1.3 Hedge fund investor flows YTD, through September 2022 ($bn)

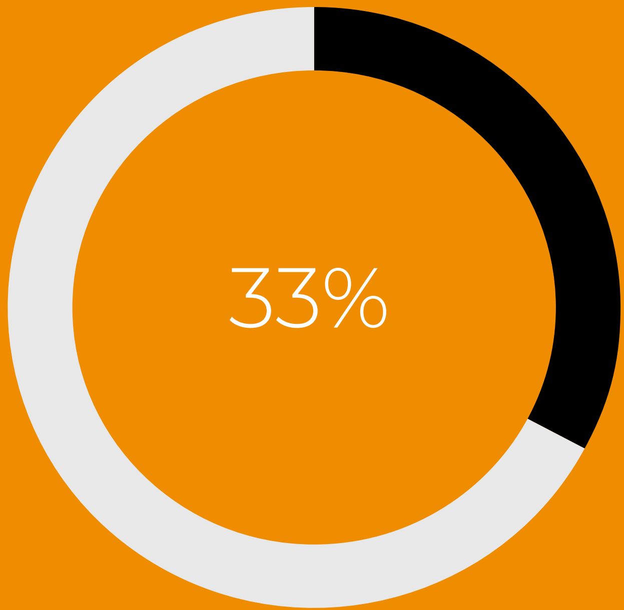


Source: eVestment

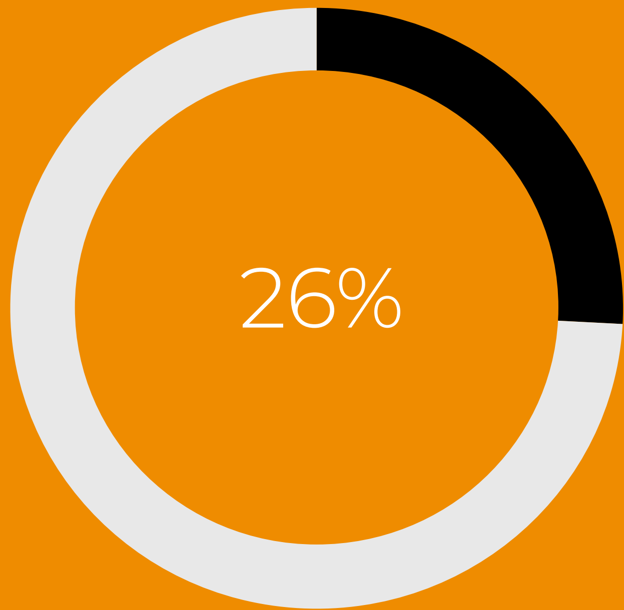
KEY FINDING

Investor interest in emerging managers is weaker than in 2021

Emerging managers reporting ‘strong’ investor interest in their strategy



Q3 2021



Q3 2022

INSIGHTS

Jonathan Bowers, CIO of London-based emerging alternative credit manager Acer Tree, says, "investor appetite has shifted in the last few months", in response to macroeconomic forces, reversing flows into fixed income/yield products and leading to increased demand for credit long/short strategies.

"We expect this trend to remain intact for several years and provide an important capital re-allocation opportunity for investors, in particular pension funds," Bowers explains. "We also expect manager performance to be highly skewed led by experienced teams in fundamental long/short strategies with a proven track record of delivering positive returns in volatile and bear markets."

More recently, Acer Tree has shifted to raising additional funds for its flagship credit opportunities hedge fund. There are opportunities for certain credit managers "unseen since the GFC", and Bowers feels the team's long/short fundamental strategy is well placed to capture them. In the past six months, Acer Tree's credit opportunities fund has prompted interest from investors in North America, Europe, and the Middle East.

As well as its hedge fund, Acer Tree runs a CLO business that has received "phenomenal support" from investors in the past 18 months, allowing the team to place 95% of the equity on its first deal. "We are seeing promising signs of a market pick-up for 2023," Bowers adds.

KEY TAKEAWAY

For managers | The increased volatility this year and resultant downturn in industry performance has stifled, what was last year, growing interest in emerging managers from new investor types. Still, there remains opportunities with familiar investor groups, even if allocations are taking longer to win.

> "
> **We are seeing promising signs of a market pick-up for 2023**

VOLATILITY AND DISPERSION

Emerging managers say it's been harder to win new business in 2022 than in 2021, with investors either backing off or doubling down on stringent investment thresholds

By and large, investor interest in smaller hedge funds has held firm. But is accessing that interest more challenging than this time last year? Asked to describe capital raising now compared to 12-18 months ago, 43% of the emerging hedge fund managers surveyed (AuM <$250m, track record <5 years) said it was 'harder' now than it was, while nearly a quarter said it was 'easier'.

Among all hedge fund respondents, 41% said it was 'harder' and 18% said it was 'easier' (see figure 2.1).

In many ways, these results reflect a key characteristic of the current market – the wide dispersion of fund managers' returns and experiences, with a significant number of hedge funds enjoying wild success and many more encountering serious challenges.

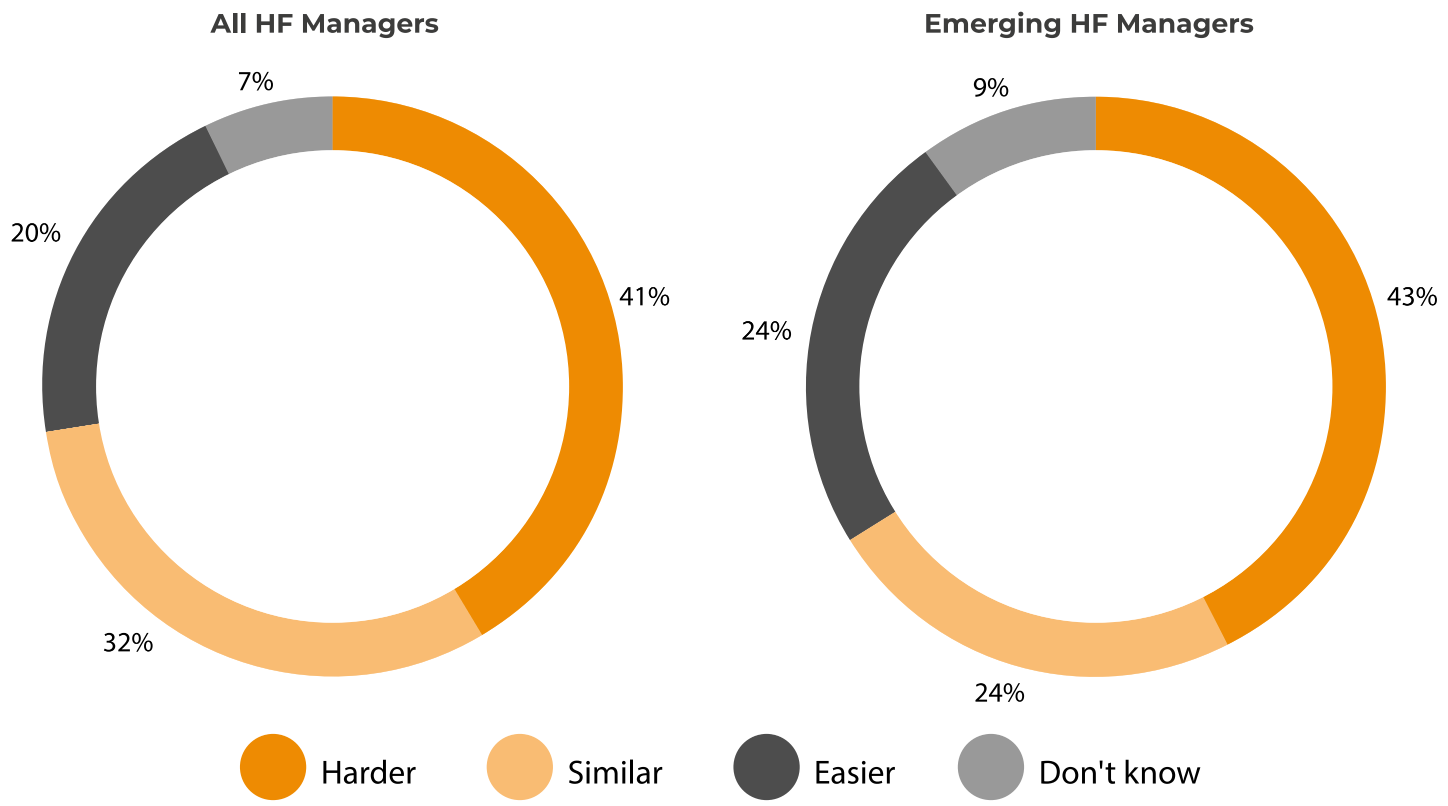
As a result, this has proved a fruitful period for media outlets. At the upper end of the AuM spectrum, there have been reports of Citadel posting significant gains YTD through October across its fixed income (25.8%), tactical trading (21.5%) and equities (17.4%), and Rokos Capital Management macro flagship being on course for a record annual haul, 44% YTD. Equity brands like Tiger Global and Whale Rock, meanwhile, have been reportedly posting eye-catching losses.

'Unfashionable' equity

Equity hedge fund managers were among the subgroups surveyed most likely to describe capital raising as 'harder' now than 12-18 months ago (47%). They were also marginally more likely to describe it as 'easier' than hedge funds overall, perhaps due to ongoing interest from asset managers and funds of funds (around two in five of these investors are planning to increase an allocation to long/short equity, the preliminary results of Hedgeweek's allocator survey suggest).

Furthermore, when asked to identify the biggest capital raising challenges currently, half of all equity hedge fund managers participating in Hedgeweek's Q3 manager survey said, 'an investment strategy that some investors consider unfashionable'

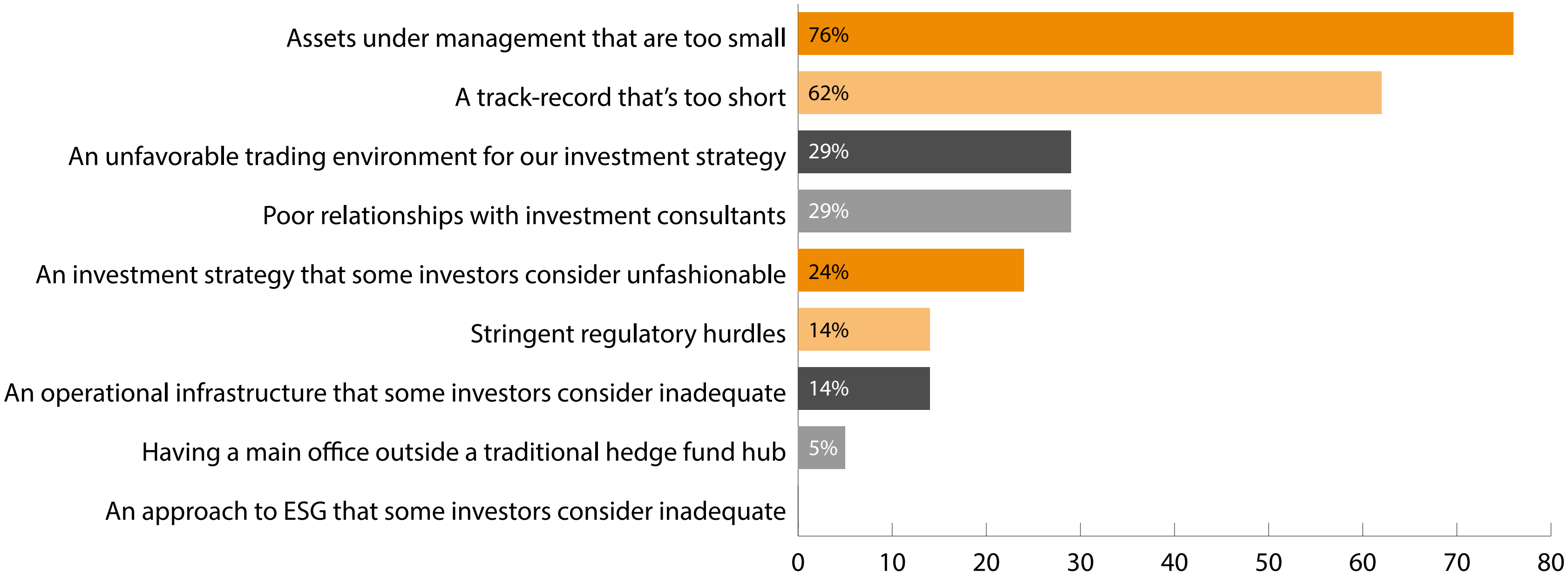
Figure 2.1 Hedge funds' descriptions of the current capital-raising environment versus 12 months previous



Analyst note: Emerging hedge fund managers had AuM <$250m and a track record <5 years. Survey conducted during Q3 2022.

Source: Hedgeweek survey, Q3 2023

Figure 2.2 Top-three capital-raising challenges according to emerging hedge fund managers

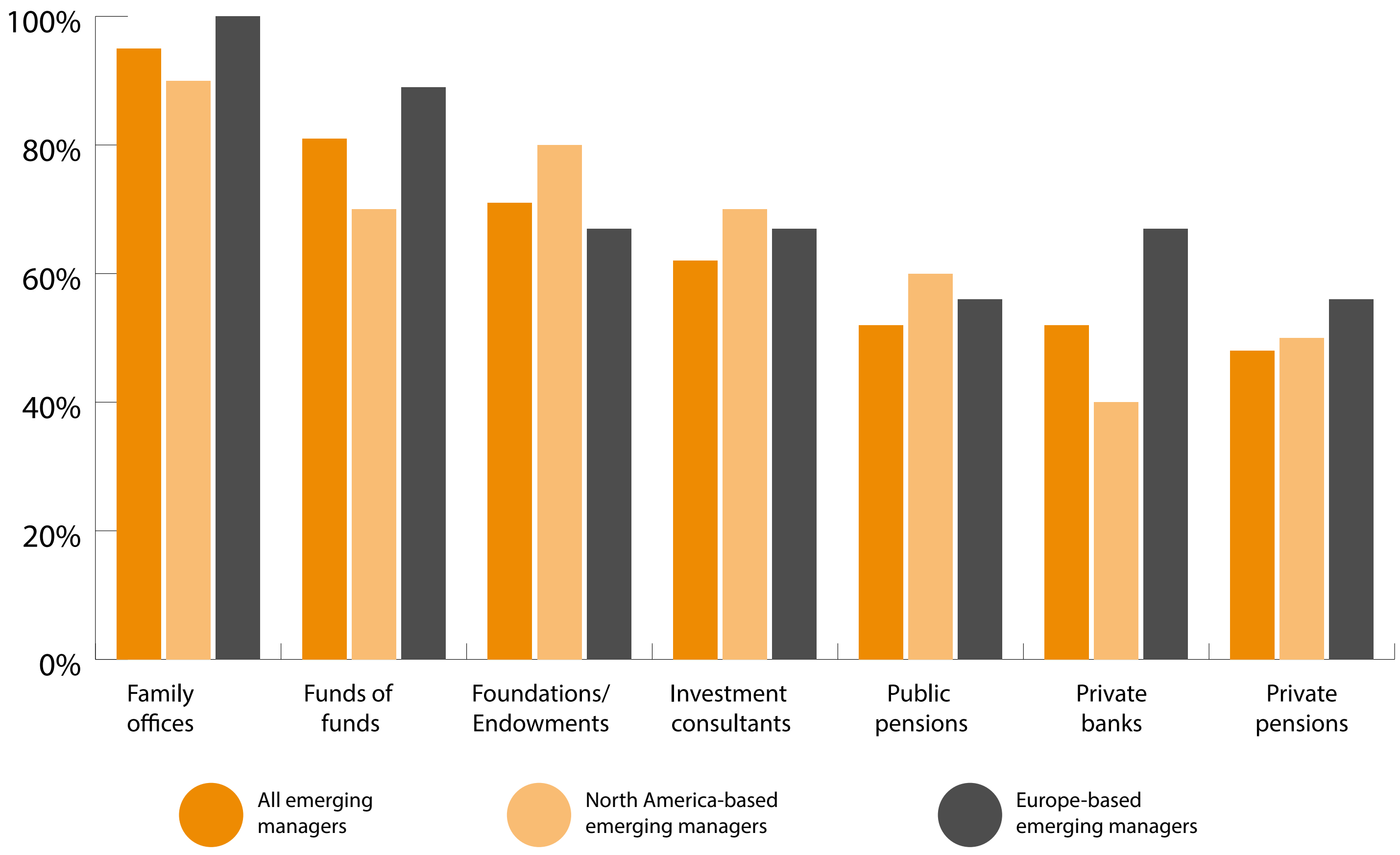


Analyst note: Emerging hedge fund managers had AuM <$250m and a track record <5 years. Survey respondents were asked to select their top three.
Source: Hedgeweek survey, Q3 2023

and half said, 'an unfavourable trading environment for our investment strategy'.

For emerging managers surveyed, the top-ranked challenges were as expected: assets under management that are too small and a track-record that's too short (see figure 2.2). Steven Greenblatt, head of institutional sales at equities-focused emerging investment business NightShares, echoed several interviewees when describing investors' attitude to AuM and track records as particularly stringent in the current market environment. Some leniency is exercised within emerging manager programs, where a start-up meets additional requirements

Figure 2.3 Investor groups/intermediaries emerging managers hope to engage with over the next 12 months



Source: Hedgeweek survey, Q3 2023

around DE&I. But, as always, such attributes merely open the door to a conversation.

Market conditions are requiring larger investors, in particular, to be ruthless in their assessment of existing investments and risk averse in their manager selection.

High-profile recent examples include Illinois Teachers Retirement System fully redeeming its $264 million investment in quantitative hedge fund firm PDT Partners, and The Detroit Policemen & Firemen Retirement System fully divesting from hedge funds.

More concerning for emerging managers was the news last month that Canada Pension Plan (CPP) Investments had chosen to withdraw its seed investment from emerging hedge fund firm BirchLane Capital. BirchLane, a relatively high-profile credit launch founded by former JPMorgan credit trader Fajr Bouguettaya, failed to meet CPP's targets for growth and returns, reports suggested.

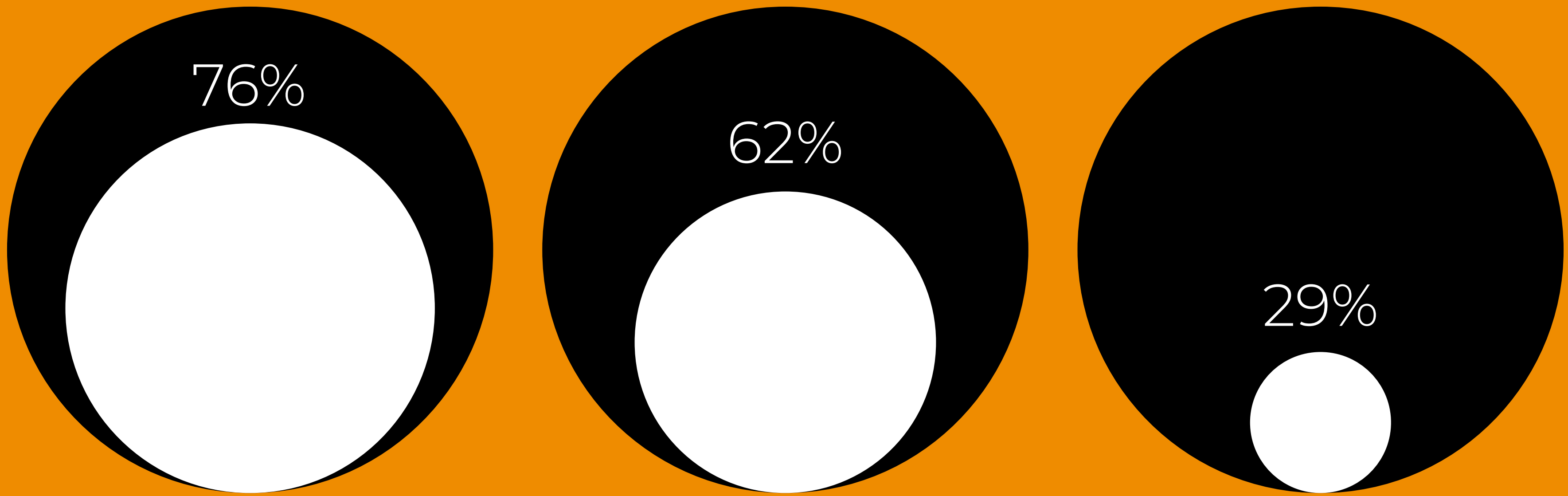
Assuaging concerns

What practical steps have emerging managers been taking to assuage client concerns during the recent market turbulence? Improved lines of communication are expected, of course, and where the

KEY FINDING

Investment thresholds remain the biggest hurdles to investment

Top three capital raising challenges according to emerging hedge fund managers



Assets under management that are too small

A track-record that's too short

An unfavorable trading environment for our investment strategy investor pool is small, benefit from being one-on-one. An Asia-based hedge fund firm interviewed by Hedgeweek on condition of anonymity has given its investors direct access to the firm's CIO. The key here, is ensuring that money managers are available to provide guidance without affecting their ability to manage the portfolio – most investors are hugely supportive of this balance.

Digital asset hedge funds have had to deal with more volatility than most – making the backgrounds and expectations of a fund's investors particularly important. Arianna Luna, partner, COO, and head of investor relations at emerging crypto specialist Campsor Capital, says the team is yet to face awkward conversations with clients, partly because the fund is yet to have a major drawdown, but partly because the majority of their investors have crypto experience, which the fund assesses ahead of accepting subscriptions, she says.

Crowded markets

Ultimately, the biggest challenge for emerging managers will be to stand out from the crowd (more on this in the next section); the biggest pitfall for their fundraisers being an overreliance on crowded markets.

Where will marketing professionals at emerging managers be competing for investment? The results of Hedgeweek's Q3 manager survey offer a note of caution, with familiar hotspots of activity. Figure 2.3 presents the results for emerging managers overall. The following investor type/region combinations are being targeted by at least one quarter of the emerging managers surveyed: US-based family offices (57%), funds of funds (48%), foundations and endowments (43%), and investment consultants (43%); family offices (38%) and funds of funds (29%) globally; and UK-based funds of funds (29%).

By region, the majority of US-based emerging managers are focused on family offices (90%), foundations/endowments (80%), and funds of funds (70%), predominantly in the US. In Europe, the focus is similar, albeit alongside the region's established network of private banks (67%). More significantly, European emerging managers' marketing teams will hope to engage with investor types globally – from the UK, continental Europe, and, to a lesser degree, the US.

For some smaller managers, the requirement to travel will stretch resources and divide attention at a time when resources are precious. For many others, this will be another opportunity to engage in virtual marketing. As discussed in the next section, this presents both challenges and opportunities.

KEY TAKEAWAY

For managers | The emerging manager market has rarely been so crowded, with fierce competition for familiar investor groups. It is imperative that firms differentiate themselves. IRs that are overly reliant on virtual marketing, dispensing with the human touch, may find it particularly hard to stand out.

STANDING OUT IN THE CROWD

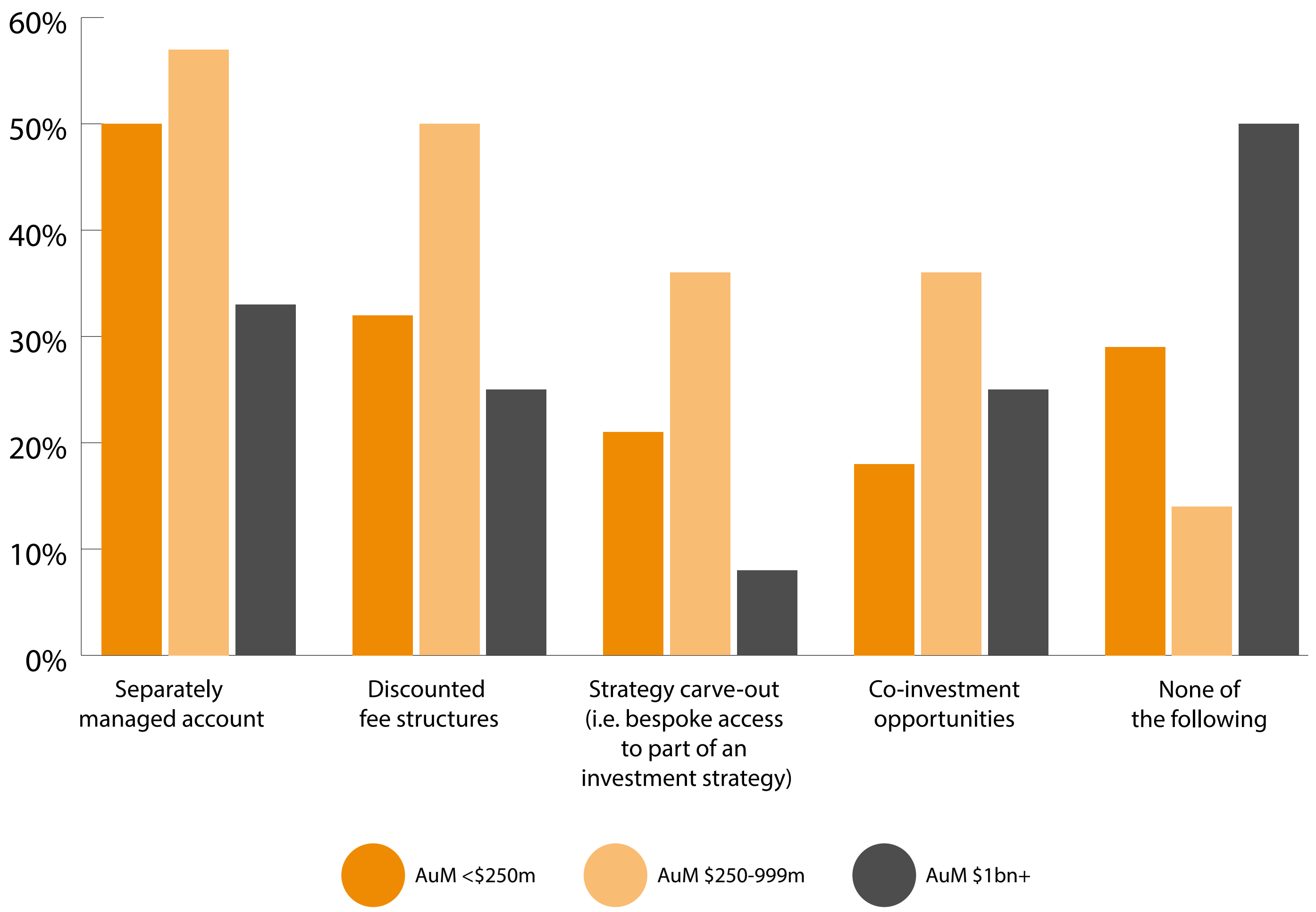
While analysis of the fundraising environment yields a familiar result, the ways emerging managers differentiate themselves is continuing to evolve

Even after the recent lull in hedge fund launch activity (HFR data suggests Q2 2022 saw the lowest number of new funds since Q4 2008), there remains a wealth of options for investors seeking emerging managers, including a succession of so-called 'celebrity' launches spinning out from, and with the financial backing of, brand-name managers.

So, how will start-up hedge funds stand out from the crowd in 2023? And what attributes, trends, products, and channels are cutting through the noise?

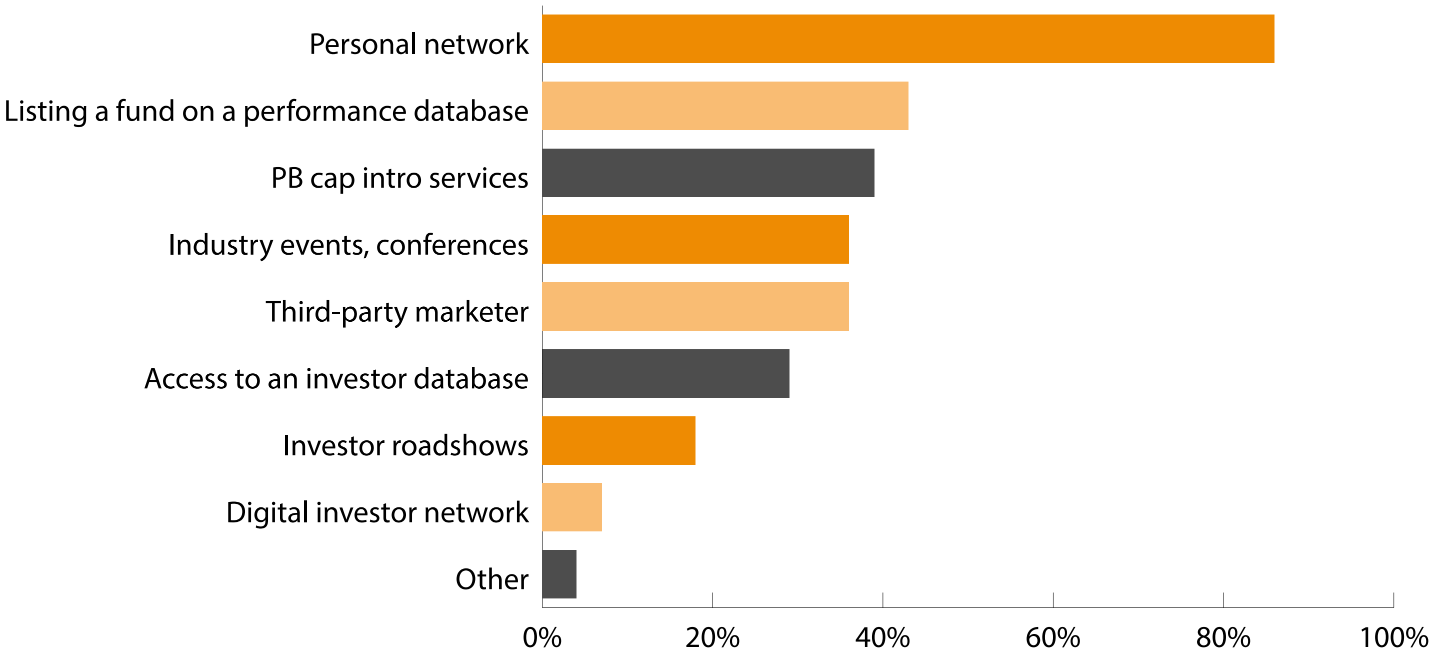
Some funds have been doubling down on the qualities that allocators associate with emerging managers more broadly, like the Asia-based long/short equity fund Hedgeweek interviewed targeting "more aggressive returns" and investors with

Figure 3.1 Proportion of hedge fund firms to field investor requests for bespoke products or terms, by firm AuM



Source: Hedgeweek survey, Q3 2023

Figure 3.2 The most important functions/services for fundraising according to smaller hedge fund firms



Analyst note: Smaller hedge fund firms had AuM <$250m. Survey respondents were asked to select their top three.
Source: Hedgeweek survey, Q3 2023

greater "appetite for volatility".

Others have taken the opposite approach, like emerging crypto hedge fund Campsor Capital. According to partner Arianna Luna, Campsor seeks to take "minimal market risk" by investing with a market neutral approach monetising market dislocations across a range of instruments and venues.

Beyond performance

However, most emerging hedge fund firms – Campsor included – recognise that an uncommon investment strategy is not enough. During her conversations with investors, Luna highlights the senior team's mix of backgrounds, which includes a 12-year crypto native and two partners from traditional finance. This, she says, has been resonating with those traditional investors exploring crypto and seeking expertise within a credible, institutional framework – an unusual combination among the initial burst of crypto launches that emerged during 2020-2021's bitcoin price surge.

Emerging credit specialist Acer Tree is similarly minded. When asked to describe how he articulates the firm's 'edge' to investors, CIO Jonathan Bowers headlines his list with "team experience", in part due to allocators' lower tolerance for mistakes in the current trading environment (see box-out).

Of course, professional investors seek long-term partners, not quick profits, and this has been increasingly true for interest in hedge funds, driving the industry's institutionalisation. Today that extends to emerging hedge fund managers. Investors are hoping to find the next Millennium Management, Viking Global or Brevan Howard – and they want to see senior executives with institutional experience, progressive ideas, and infrastructure built for sustainable growth.

This trend is a double-edged sword. On the one hand, it has been responsible for driving up the barriers to entry for new hedge fund businesses (and is the reason brand-name spin-outs, with their readymade safeguards, attract so much attention and capital). On the other hand, it has offered emerging hedge fund businesses a raft of new opportunities to differentiate themselves, such as building excellence around company culture or demonstrating a commitment to ESG or DE&I.

Softer factors

Of course, not all expectations are created equal. Interviewees said investors were still less willing to compromise on company culture and operational infrastructure than they were on ESG and DE&I. These latter soft factors were more likely to be accepted as works in progress, so long as policies and procedures exist and there is an identifiable roadmap to implementing them in the future.

Among the family offices and funds of funds surveyed so far for Hedgeweek's allocator survey, ESG was ranked fourth of four priorities for 2023, after performance, liquidity, and fees.

Encouragingly for emerging managers, investors are showing more understanding around what can be delivered on product types and terms. As figure 3.1 shows, demands for separately managed accounts, strategy carves-outs, co-investments, and – perhaps most significantly – discounted fees were less likely reported by smaller firms surveyed (AuM <$250m) than midsized firms (AuM $250-999m).

In terms of DE&I, emerging manager programs from large investors are continuing to turn heads and attract attention in the media. Campsor has a diverse board membership (as well as a female COO), but Luna doesn't believe its strong showing in terms of DE&I has "opened the door to more conversations" with allocators. "In this market, investors care about performance and risk management," she notes. "Perhaps in a couple of years it will help to differentiate."

A RAISED BAR

Jonathan Bowers, CIO, Acer Tree

The bar has been raised significantly higher as the market doesn't tolerate mistakes. Investors are more cautious and look for experienced teams which can generate alpha from long and short opportunities – our team has on average 25 years of complementary long/short credit experience and has been through numerous economic and credit cycles.

Performance remains at the forefront, but it is now applied to the current market: can management teams navigate what is to come? Can they capitalise the opportunities this market is presenting? Investors are aware the set of skills required to deliver returns are different in this cycle.

Due diligence on sensitivities and stress testing are now a common requirement: investors want to ascertain the survival of the strategy if we revisit scenarios such as the global financial crisis, Covid or single events such as Brexit, the recent UK mini-budget or specific sector blow-outs.

> The bar has been raised significantly higher as the market doesn’t tolerate mistakes. Investors are more cautious and look for experienced teams

Jonathan Bowers, CIO, Acer Tree

For marketing channels, emerging managers interviewed by Hedgeweek said getting on the radar of investment consultants remained important, while anchor/seed investors were as valuable as ever, especially while markets remained volatile and investors' appetite for risk was more muted.

Fund databases

But also notable were references to, and praise for the benefits of performance databases. Anecdotal evidence suggests an increasing number of smaller funds are using them as routes to investor long lists, particularly where establishing relationships with investment consultants is challenging. Several of the emerging managers interviewed said they reported to multiple databases. Among survey respondents from smaller hedge funds (AuM <$250m), databases were the second most important service or function used for fundraising (43%) – behind only personal networks (see figure 3.2).

Crypto fund Campsor reports performance to two databases – one from a well-known provider and one that specialises in crypto funds – after one of the firm's partners had success with such platforms previously and recommend their use, Luna explained.

She noted that "the majority" of her investor conversations were still being generated by the team's personal network, but "at this stage of the market cycle" it was important for the fund to find as many cost-effective avenues to investment as possible. Her primary concern, she said, was ensuring their database relationships were with "renowned" platforms.

Fewer smaller hedge funds surveyed identified cap intro (39%), investor events (36%), or investor roadshows (18%) as top channels for seeking investment. All three tend to require travel, and research interviewees suggested that the number of in-person meetings had decreased over the past 18 months as investors embraced virtual meetings to screen out funds quickly and efficiently during initial rounds.

Many marketers have mixed feelings about this. NightShares head of institutional sales Steven Greenblatt noted that, while virtual meetings had the advantage of getting you in front of once-unreachable overseas (and local) investors, they had the disadvantage of decreasing human interaction and the chances of successfully articulating your edge. Virtual meetings are here to stay. But the successful return of physical events also suggests that questions over the future benefits of traditional sales skills – especially within the emerging manager industry – are premature.

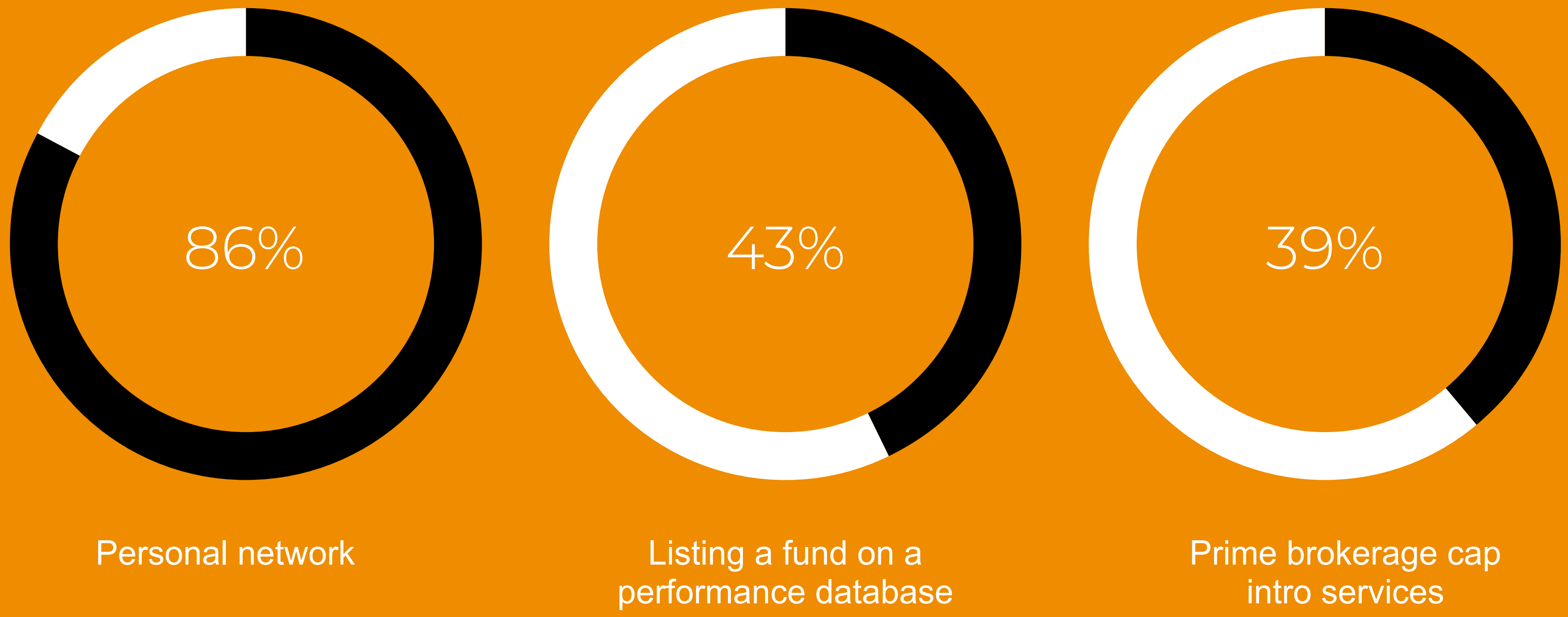
KEY TAKEAWAY

For managers | The importance of an anchor investor in today's market environment cannot be overstated. Launching without one – or without one lined up – is at best a material risk, at worst tantamount to a long, expensive road to liquidation.

KEY FINDING

Listing on a database is now a top-three fundraising method

Top three capital raising functions or services for smaller hedge fund firms (AuM <$250m)



HEDGEWEEK

AUTHOR:

Tony Griffiths
Head of content
tony.griffiths@globalfundmedia.com

FOR SPONSORSHIP & COMMERCIAL ENQUIRIES:

Jo Cole
Group Commercial Director
jo.cole@globalfundmedia.com

Published by: Global Fund Media, Lion Court, 25 Procter St, London WC1V 6NY