ifr market intelligence

WHICH WAY NEXT FOR HEDGE FUNDS?

A GUIDE FOR MANAGERS, BANKS AND INVESTORS

EDITED BY DAVID WALKER

THOMSON

SECTION 02 CHAPTER 04

HELPING YOUR HEDGE FUND CLIENTS ATTRACT INVESTORS

By Bruce Frumerman, Frumerman and Nemeth Inc.

There are thousands of hedge funds; more than enough to clutter the competitive landscape. The number of hedge funds making some data public has soared. A combination of new launches and more transparency has led, in one case, to the identification in 2005 of more than 13,600 funds and approximately 6,100 funds of funds – up two-thirds on the previous year, according to a study.

"There appears to be no shortage of new entrants into the marketplace," said a representative from Pertrac, which undertook the research.The study had found about 250 funds with more than US$1bn, but more than one-third had less than US$25m – a size industry participants warn is too small to survive.

Now, consider the hedge fund firms your prime brokerage business serves. Getting greater revenue from these firms is dependent upon two key factors: their ability to generate acceptable returns and their ability to attract new assets. So, how many of your hedge fund clients do you believe have the potential to deliver acceptable returns to investors? And how many of that group do you believe have the ability to out-market their peers?

When these hedge fund managers turn to you, their prime broker, for support, direction and counsel regarding attracting assets, what insights can you share with them? Based on my experience of over 26 years in the business of helping money management firms educate and persuade prospects to understand and buy into how they invest, this chapter details a few pointers you could offer.

Numbers alone are not enough

What is it that enables one money manager to grow and retain assets while a competitor cannot? Is performance the sole answer? Of course not. If that were so, there would be but a fraction of the number of money management firms there are. While performance is a significant ingredient in the formula for success in attracting assets, it is just part of the equation.

An institutional investor was quoted in the financial trade press as saying, "I am not going to buy a track record. I want to buy an investment process." Remember that comment – it lies at the heart of what a money manager is selling.

Is access to distribution channels the key to success? That can be important, too, but it does not mean demand exists for those products or that the channel is actively soliciting for investors in the firm's products.

Marketing is the other major factor that impacts a money management firm's ability to grow and retain assets. Marketing does more than 'get the word out'. It is what gives a firm its identity and positions it in the eyes of the marketplace of investors and those who influence their investment decisions. When marketing is given short shrift by a money management firm, its ability to attract and retain assets suffers.

There are two parts to marketing: sales marketing and communications marketing. Sales marketing is about the process of selling to prospects and their advisers. A salesperson or team, whether in-house or third-party marketers, identifies prospects, makes contact, gives face-to-face presentations and manages follow-up through the selling cycle for turning prospects into investors. But what is it that the target audiences are *told*? That's communications marketing. While good communications marketing cannot improve investment performance, it *can* help a firm have higher impact selling.

What does a firm's communications marketing consist of? The storylines and language it uses in its verbal and written contacts with clients, prospects and those who influence them. Communications marketing is what is used to get people to buy into the investment products the firm is selling and the *process* it uses to manage money. This includes everything from verbal sales presentations and marketing collateral to letters to investors and interactions with the press.

Most boutique money management firm owners begin by having investors who are friends and family; people who already thought well of them and trusted them. Once these money managers begin marketing to strangers, however, they often find themselves getting a much chillier reception.

As one boutique money management firm owner confided in me, after experiencing how tough it is to interest strangers in his firm and convert them into investors he realises that he could have been "speaking Martian" to some of his friends and family investors and they still would have invested. They knew him and, in their minds, that was enough. Selling to institutions, family offices, funds of funds, endowments and foundations, high net worth investors and financial planning and investment advisory firms that invest on behalf of their clients, however, is another story altogether.

Most money management firms do not put in the time and effort needed on planning their efforts to sell strangers on investing with them. Hedge fund firms that are willing to be contrarians (as all good investors are supposed to be) can use this to their advantage.

Cap intro presentations – the investor's view

At some point you may give the hedge funds that you serve the opportunity to explain what they do to an audience of prospective investors at a capital introduction event.

How effective will they be in taking advantage of this opportunity? To give you some food for thought, consider what I once saw at a cap intro event I attended along with high net worth, family office and fund of funds investors.

Five hedge funds were presenting. Each manager had 15 minutes to speak at the podium and show his or her accompanying slides. They were being videotaped so that streaming video of each hedge fund presentation could be posted at a password-protected website where accredited investors who did not attend the event could see the managers tell their stories. After all five presentations were made, the managers were stationed at separate tables so audience members could meet and question them and pick up marketing material to take away with them. The participating hedge funds knew how the cap intro event was to be run, and each paid to be able to present.

So how did this look from sitting in the audience? Here are some highlights:

- First up was a hedge fund manager from Europe. She read each slide, said not a word more and then sat down. What did she present? *This is our company. These are our people. Here are some performance charts.* Can I recall what they did? No.

- Second up was a fund manager in from California. And he was someone I spoke with *before* he presented. He claimed he ran a multi-strategy fund that did 'Thing A'. He said the same basic thing from the podium. So, after all the presenters had finished I went up to this fellow and commented that because of the 'Thing A' that he said his firm did they might be of interest to a financial planning firm client of mine who works with high net worth individuals. The manager looked at me and said, "Oh, we don't do *Thing A*, we do *Thing B*!" Now, I'd heard this guy twice within 90 minutes. If I'm getting his firm's story that wrong, just think about how much more confusing it is to people *not* in the business.

- A two-man 'tag team' from a European firm was up next, presenting about emerging markets investing. They wanted my money to invest in places such as the Bosnian and Nigerian markets, and they thought they could be good at going long on the rouble, too. They said they had a "proven risk management framework". They displayed some slides that didn't prove this at all. So, instead, their claim became very suspect. A presentation is supposed to instill comfort in the audience; not raise red flags and cause doubt and disbelief.

- A manager with an event-driven strategy began his narration and his slide show. Each slide had about seven bullet points. There was a lot of dense copy. This fellow was displaying slides containing around 150 words each. And remember, this is being videotaped: the video will be shrunk down to a few inches in size to appear like a pop-up window on a web page. Who is going read that? I was getting eye-strain just trying to absorb all that copy on a screen 10 feet wide.

- The only presenter who came across well began with a brief apology about the slides he brought not being all to the point, and spoke with rarely a click from one slide to another. And the audience forgave that because what he said was interesting. He told an engaging story about energy-related investing. He talked about the areas where he saw opportunity. He talked about where other, younger money managers were investing in the sector and why he thought their focus was misguided. He gave examples of what he had seen over the years that supported his opinion of what is the 'right way' and what is the riskier 'wrong way' (*my words, not his)* of hedge fund investing in the energy sector.

These examples are a good reflection of how emerging managers are attempting to sell.

What insights are there to glean from them? Here are three:

- A lack of a clear and interesting story is the *rule*, not the exception;

- The over-reliance on PowerPoint presentations as a crutch, and the lack of verbal presentation practicing, is endemic;

- Most money managers, and many third-party marketers, have not shown that they can distinguish between 'bullet point copy' and long copy being shoe-horned into a bullet point format. This reduces the effectiveness of many a slide show presentation and flip chart book.

Of course, how effective your hedge fund clients are in cap intro presentations is only one selling challenge they face. How they plan to handle their firms' one-on-one sales efforts is another.

Who will be telling and selling their story?

If the fund manager is going to be handling his own sales there is bad news and good news. The bad news is that he needs to build space into his weekly routine to spend actively introducing his fund to prospects, and pursuing them over time. The good news is that once he figures out how to communicate a compelling story about his fund, with consistency, all but the performance part of his story should be good for the life of his business.

If, on the other hand, the fund manager plans to hire an in-house salesperson, or use a third-party marketer, there is different good and bad news. He will have someone putting in a full time or part-time effort on his behalf to tell and sell his fund's story to prospective investors. However, not only does the fund manager now need to figure out how he should communicate his own story about his fund; he needs to construct a story that *another* person call tell, with consistency, to a prospect. And, the fund manager should want to feel assured that when he is brought into a second round meeting with that same prospect that what he tells the prospect will be reinforcing – rather than contradicting – everything that his salesperson had said at the first meeting.

Third-party marketing

On the subject of third-party marketers, let's look at some pros, cons and other considerations the money management firm owner faces. Going down the third-party marketer route enables him to outsource some (notice I do not say *all*) of the sales function to a person or outfit who may possess a list of prospective investors to pitch his fund to. Their 'rolodex' may contain contacts that the fund manager would not have been able to identify on his own. Or, it could be a list that the manager *could* have complied himself, had he the time, money and effort to put into doing the research.

Your hedge fund clients should not make the misguided assumption regarding the issue of 'who you know' that, just because a third-party marketer knows someone, he will be able to get that investor to invest with a manager's fund. Unless that prospect perceives the specific value that the fund could provide as an addition to his portfolio, *and* he sees investing with the money manager as being a defensible decision, it does not matter how well the third-party marketer knows him.

Next, consider the job of the third-party marketer. They may represent one or two handfuls of hedge funds. When the third-party marketer is out selling, they can earn a commission whether a prospect agrees to invest in fund number six or fund number one. So how can your hedge fund clients nudge a third-party marketer not to neglect them, and maybe even to favour them?

Well, here's the valuable secret: The easier a hedge fund manager makes the third-party marketer's job of telling and selling an interesting story about a fund, the greater the odds that their contacts will be hearing about that fund before they hear about the others on the third-party marketer's roster.

A third-party marketer may have a targeted list of prospects to pursue on a money management firm's behalf, and they can do the sales marketing legwork of telling and selling your story to those prospects. But are all third-party marketers also skilled enough to craft the money management firm's story? While some are, a great many are not.

Here are what principals of three different third-party marketing firms have said to me. One said, "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."

Another confided, “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.”

A third said, “I can sell a hedge fund that has an acceptable story, but figuring out how to create an acceptable story when it’s not already there isn’t something I really have much practice in. I’d rather not spend my time trying to figure that out. I’d rather spend my time out there selling.”

So, an important point for hedge fund firm owners (and prime brokers) to remember is this: 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 firm’s story should be told*.

The core of a hedge fund firm’s brand identity in the marketplace is the story of how it invests. So counsel your hedge fund clients to take the time and effort to get their stories right. And if they are turning to outside experts to help craft their stories, remind them that when they are conducting due diligence to see that the people they are thinking of working with have a depth and breadth of experience in doing this.

The way they do the things they do

How effective are the hedge funds your prime brokerage desk serves at communicating the soundness of their investment processes and the intellectual acumen of management?

Different firms face different challenges when it comes to how to best tell their story. However, the most common communications marketing error I see is telling an incomplete story.

While all money management firms say something about performance, portfolio and people at the firm, most of them underemphasize, do not explain clearly or leave out explanation about:

- **Place** – which is the context in which the investment should be viewed, shaping people’s perceptions about the roll the allocation could play within their total portfolios; and

- **Process** – which addresses how a money manager invests.

I am sometimes asked: what if you’re a start-up firm with no track record? All the more reason you need to have a good, and consistent, explanation about your investment process.

Selling scenarios

How the money management firm invests is the primary thing it is selling; and that story is the core element of the firm’s brand identity.

The scenarios that hedge fund managers face with their marketing challenges can be as varied as the strategies that they follow; yet it often comes down to a firm’s ability to tell and sell the investment process part of its story. See if some of the selling problems that your hedge fund clients tell you they are experiencing are similar to some of the challenges money managers have brought to my firm. Here are a few:

- An 18-month-old two-man hedge fund was preparing for its first ever presentation at their prime broker’s capital introduction event. They were concerned that their long/short strategy was nothing special, and they didn’t know how to explain what they did, other than saying “We look at the screens all day.” They told me they were concerned that a sceptical prospect may say to them, “My cat can stare at a screen all day. You must be doing something.”

An in-depth examination of what they did from day to day resulted in identifying things of interest to a prospective investor. They had not mentioned these points earlier because they had thought them to be too mundane, so they devalued information that had perceived value to an outsider. From this, the answer to how to tell their story was found.

When they gave their verbal presentation (no slide shows were permitted) and then distributed their hand-out, around one-third of the audience at the capital introduction event gave their business cards and asked for individual meetings. The head of cap intro at the prime broker approached the money manager, told him it was a great presentation and a highly professional handout. In complimenting the manager, the cap intro head asked the emerging manager how long he had been making such skilful presentations. “This is the first time I’ve spoken in public,” he replied.

▶ A hedge fund with a plain vanilla value investing strategy was struggling with how to differentiate itself and get more than a ‘So what?’ response from prospects who were not friends and family. Also, the fund needed to tell a story that middlemen such as financial planners could understand and retell to their high net worth clients. The fund managers got help to see their investment process from a buyer-focused perspective and a new storyline was developed for their marketing materials and presentations.

A financial planning firm president to whom they presented commented afterwards: “You guys hit on everything we’d like to know about how you do things. And I like that I can explain to my clients very clearly what you’re trying to do.”

Their legal counsel wrote them, “There is some good ‘user friendly’ information in this material about your investment approach. You could consider actually incorporating some of this information into your formal offering memorandum.”

Also, the hedge fund landed its first family office investor, a market it had been trying to crack for some time.

▶ How would you explain a quant-based hedge fund that is presently running a concentrated portfolio invested in precious metals, mining and related commodities; that had been invested previously only in tech, but got out before the bubble burst – and was holding a diversified portfolio for a few years thereafter before allocating to precious metals, mining? Not that easy. Prospects lacked a context in which to understand and appreciate the fund.

As the hedge fund firm owner recognised, while every money manager claims to have a disciplined process, he knew he actually had one; but his firm did not know how to explain it well. Because they never presented their story the same way twice they were unable to make their conceptual sell. So, prospects were not understanding that the firm was sticking to a single investment process whether it was running a diversified portfolio or one concentrated in a single sector.

Carefully structuring their explanation gave the firm greater control over how its investment story was told by its third-party marketers. As a result, both financial planning firm investors and more sophisticated institutional investors bought into the hedge fund’s concept and became investors.

▶ A 10-year old mid-size hedge fund was looking to recruit its first salesperson. They were turned down by the candidate to whom they offered the job. Why? He found that the co-managers could not agree with each other on how to explain to him how they ran the portfolio. Their prospective salesman was worried about what would happen in a second round meeting with a potential investor when the portfolio manager contradicted what had been told to that investor in a first meeting. Once the co-managers were brought to agreement on how to explain their approach, their marketing material was created and they were successful in recruiting an in-house salesperson and growing the business.

▶ A quant fund had a sales manager who had trouble answering prospects’ questions after she gave her presentation about the firm and its multi-factor analytics-based investing process. It turned out that the chief information officer had never clearly articulated to the sales manager the detail of the process he followed to build and manage the basket of holdings. So, all she could do was repeat the generalities she had been told. After the firm’s investment process story was taken from the CIO and put onto paper, the sales manager was able to run a presentation meeting from beginning to end without having to tell the prospect, “I don’t know.”

Developing a structured approach

To improve the ability of money management firms to differentiate themselves and attract new investors, Frumerman & Nemeth leads them through a structured approach to building the storylines about how they invest. We determine what should be the organisation’s buyer-focused key selling messages and the priority in which these points should be presented in order to communicate a linear storyline. (This is important because people have a greater ability to remember linear storylines rather than disparate facts.)

A key guideline we follow in building a storyline is that it must accurately represent the substance of how the manager thinks and what he does, while using language that the marketing and sales people need to communicate effectively to both sophisticated and unsophisticated investors. Once this storyline is developed it is used as the basis for all verbal presentations and written marketing materials. Importantly, since this is the 'evergreen' part of a money management firm's story, and provided the manager does not drastically change his investment beliefs, *it is good for the life of the business*.

The hedge funds you serve need to think about these issues as well. Their future success in out-marketing competitors will be dependent upon their abilities to educate and persuade people to understand and buy into how they invest. Achieving this requires developing a cogent and compelling way to best tell the investing story with consistency, applying it to all sales marketing efforts and obtaining third-party endorsement for and increased awareness of the intellectual acumen of management and the validity of the firm's investing process.

Bruce Frumerman is president of Frumerman & Nemeth Inc. (www.frumerman.com), a New York communications and sales marketing consultancy whose work has helped money management clients attract over US$7bn in new assets. Frumerman has over 26 years of experience in helping financial services firms create brand identities for their organisations and develop and implement effective new marketing strategies and programmes.He and his firm have worked with hedge funds, institutional money managers, mutual funds, private asset management firms for the high net worth market, brokerages, family offices and financial planning firms.