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Startup Firms Face Challenges

Many traders dream about striking out and starting their own investment firms. But with capital difficult to come by these days, startup shops are having to find innovative ways to market themselves and demonstrate the strengths of their strategies.

When Anthony Cambeiro left a large hedge fund to found Anthology Capital Group, the trader was surprised by how difficult it was to get investors to seriously consider his fund, in spite of his previous long and successful track record.

"It's definitely challenging out there," Cambeiro said. "Assume you are going to reach out to 1,000 people, talk to 100, to get one investor."

Though some traders turn out to be natural marketers, Cambeiro said that for him marketing involves a very different mentality from investing. A trader might have total confidence in an investment strategy, but demonstrating that confidence to prospective investors can be another thing.

Fortunately for him, Cambeiro frequently dealt with prospective investors at his old firm. However, that was as part of a team. Now, he has to sit down with prospects without a large sales team to provide assistance.

"In my previous hedge fund sales experience as one member of a team presentation, I didn't have to know everything and have it at the tip of my tongue," he said. "I now have to be able to talk and think ahead as to what the next key point is I have to communicate."

According to Cambeiro, the sales cycle has gotten longer since the financial crisis of 2008. These days, it's a six- to nine-month process, from meeting with potential investors to actually getting a check. And with some institutional investors, it can take years.

Bruce Frumerman heads the consulting firm Frumerman & Nemeth, which helps startup firms better position themselves to attract capital. He said that in addition to having all the right systems in place, such as trusted service providers and a solid legal structure, a firm needs to know how to properly tell its story, to fully relate how it does its research, risk management and decision making.

Bruce Frumerman

"There are two jobs for the prop trader who now has started his own shop," Frumerman said. "First, you have to deliver performance that is in the ballpark of acceptance. Then, you have to be able to educate and persuade people to understand and buy into how you invest, because that's what differentiates you from the competition."

According to Frumerman, the number one cause of money management firms closing their doors is not that their trading strategies blew up. Rather, it's because they couldn't get enough people to understand and buy into how they run their portfolios.

Though traders don't have to reveal every step in their process or every percentage of weighting they give to different stocks, they do have to effectively communicate how their process works. And sometimes, less is more.

Startup firms often make the mistake of giving a massive pitch book to a prospect before a meeting, and then reviewing some or all of the book when they meet. No prospect will read a long pitch book and retain all the information. Frumerman says a portfolio manager should be capable of delivering his presentation verbally—without walking the prospect through a flip chart page by page. He advises his clients to leave behind a brochure that re-explains the money manager's investment beliefs and process.

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One other thing Frumerman suggests is to pay special attention to risk management, which has increased considerably in importance since 2008.

Helping traders develop all-inclusive risk management is the specialty of Sam Won, founder of Global Risk Management Advisors. Won said nearly all investors today are demanding institutional quality risk management.

New funds need to be able to clearly state in writing what their framework is for risk management, he said, and to explain how the process is intertwined with the investment program. Being able to simply check off boxes on a due-diligence questionnaire is no longer sufficient.

"After the events of 2008, it is not enough for a fund manager to simply say they do some risk measurement," Won said. "Today, institutional investors expect a fund to substantiate that it has a true risk management process that encompasses controls, such as risk limits, and governance in the form of a risk management committee that has meaningful influence over the investment process."

Being able to measure risk is important, but funds today need to also demonstrate how they plan to hedge that risk, he added. In today's competitive environment, investors can always find another firm that offers comparable returns, and if that firm can also demonstrate consistency and sustainability, it will end up being the one with the investment dollars.

Having launched his own firm, Cambeiro has some advice about getting investor money: Line up as much of it as you can before striking out on your own. Some investors will end up contributing less than they initially say they will, and others who promise to invest will end up not putting in any money at all.

Still, he noted that marketing a startup firm can offer some pleasant surprises, too.

"Some of the people that you think will invest will never invest, and some of the people that you never thought would ever invest may invest," Cambeiro said. "You just never know."

—James Armstrong