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Start-up managers need to consider vendor management

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Vendor management has become a key component of enterprise risk management (ERM) for today's budding new hedge fund managers. This was not necessarily the case a couple of years ago, but with the introduction of the Alternative Investment Fund Managers Directive (AIFMD) the landscape has changed dramatically.

Now, start-up managers, keen to get their strategies up and running without necessarily becoming registered AIFMs from day one and reduce initial costs, are turning to fund platforms.

The problem is, there is such a plethora of platforms to choose from. They include both regulated umbrella platforms that allow start-ups to avail of a third party AIFM and fund platforms that allow trading strategies to develop without the burden of launching a standalone fund.

It is this component of vendor management that has become crucial in a post-AIFMD world. And an area that KPMG has been focusing on as they help advise clients move from concept to launch.

Daniel Page is Head of Asset Management Advisory with KPMG Ireland. Page has worked on both sides of the investor coin; as such, he is well placed to understand the pressures that new managers face when it comes to the first stage of enterprise risk management.

"For any new manager who is considering regulatory incubation and using a third party AIFM, they have to understand that they are outsourcing something that is highly material to their own success. They are, in essence, outsourcing their full 'Enterprise Risk Management'. Start-ups need to have a contingency plan in place should that platform fail to live up to their expectations, for whatever reason. This is why vendor management is important," says Page.

Despite its importance, platform selection is often underestimated.

Start-up managers will often select platforms that they like, perhaps because of personal contacts, but that does not always mean that they will be the best fit. There are plenty of infrastructure and operational considerations that need to be factored in. Does the platform have experience supporting the manager's strategy?

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Ultimately, making the right platform decision is critical to helping managers survive over the long term. It is, says Page, about having appropriate vendor management

Not all managers will choose to go down the platform route. Those who are fortunate enough to have the backing of a seed investor will look to establish their own standalone fund but even in this situation, understanding the enterprise risk management implications to accepting a seed deal need to be assessed.

In any seeding arrangement, therefore, managers need to know what the implications will be in terms of their own risk and capital raising capabilities.

Nevertheless, for the vast majority of start-ups, joining a regulatory platform is the quickest and most cost-effective way to building their track record.

“If and when a manager joins a platform and rents everything to operate in an AIFMD world, then it makes sense to have someone in place to manage the platform’s vendors,” adds Page.

Indeed, platforms will engage in multiple service provider arrangements to maintain their operational infrastructure. Start-ups with little or no experience in running their own business don’t always appreciate that the decisions they make have a direct impact on how much operating capital they have to work with. They aren’t managing a bank’s money but that of independent investors. That fiduciary duty often requires a significant change in mindset.

As such, working with a third party who can act in a disintermediary fashion and offer guidance to mitigate enterprise risk in the first couple of years can help ease the burden.

“If you’re a second generation manager spinning out of an established hedge fund you are likely to have more experience. You’ll understand what a general ledger means, what transfer pricing is and so on; it gives you a head start in terms of deciding whether to buy, build or rent your infrastructure from day one,” notes Page.

Once a manager has selected the right platform, the two most important elements to focus on are to generate good returns in the investment strategy and focus on growing the business step by step. That way, when it comes to sitting down in front of an investor, at least they can say: “We appreciate that we are renting infrastructure by sitting on a platform but we do have a plan to spin out over time.”

Investors will appreciate this as it will show that the manager is in control of the business. Typically, Page says that managers who launch with less than EUR50 million in assets choose to join a platform for at least a portion of a business.

If all goes well, and they double their assets to EUR150 million, the start-up manager will be better placed to spin out on their own and establish a standalone fund. One important facet of vendor management, at this stage, is making sure that when spinning out of the platform, the start-up is able to leave with their track record.

At this point, they will be required to comply fully with the AIFMD, although managers might still choose to avail of a fund platform for certain AIFM management functions.

“As managers get bigger they are going to retain anything close to their portfolio first and foremost – analysts, portfolio managers – and any technology that they need to do their jobs properly. Everything else can be managed as an outsourced vendor relationship. They need to understand the service offering of each vendor and that requires a supplementary skill,” explains Page.

Managers are therefore advised to take care when weaning themselves off a platform. The last thing they should do is overstretch themselves. Advisory partners, such as KPMG, can help managers to step back and assess the situation: This is the infrastructure you have. These are the controls. And this is how we can help you spin out on your own.

A manager can then say to investors: “In a post-AIFMD world I’ve joined a platform, I’ve grown to this AUM size and since spinning out I’ve maintained these parts of the fund’s infrastructure on a rented basis with oversight being provided by both myself and my advisory partner.”

It is this pragmatic approach that can go a long way to determining whether a manager has a good handle on their enterprise risk management and well placed to build a successful hedge fund manager. Buying the latest version of Advent Geneva and hiring three people might seem like the best option but that’s a significant capital outlay. Burning capital simply to own infrastructure is not always a sensible approach.

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Establishing a Board of Directors

Another important point to consider for start-ups is board construction. Having an independent and balanced board of directors sends out a powerful message to investors.

“There isn’t a single investor on the planet that wouldn’t want a proper board in place. We still have this battle in the sense that directors need to be independent and conflict-free i.e. not the partners of the fund. We spend a lot of time helping managers understand why spending that money is a worthwhile exercise,” stresses Page.

Unlike infrastructure spend, money isn’t actually the problem when it comes to constructing a good board of directors. It is more a case of convincing the right directors to join the board in the first place. It takes effort, but Page says it is certainly something “we encourage managers to do. We often ask start-up managers how much thought they’ve put into this and whether they’ve interviewed directors.”

Such practice is far more common in the long-only mutual fund space where independent boards are an absolute necessity.

“We ask start-up managers to pitch to directors – ‘This is our strategy, this is how we generate alpha, this is how we are going to build a long-term sustainable asset management business, and to do that we need a proper board.’

“It is still not as a common as it should be for investors to look at a Manager’s board of directors and think, ‘That’s impressive’,” says Page.

Along with proper vendor management, having a well constructed independent board that can provide good governance is another tool that today’s aspiring start-up managers should consider as they look to make an impact in an increasingly crowded marketplace.