BSP

Business Succession Partners

April 2014

A guide to setting up a fund management company

At BSP we are often approached by everyone from wealthy MBA graduates to seasoned investment professionals at large institutions wanting to start a 'hedge fund'.
In 99% of cases we find that they could answer this question themselves even before we get into the details behind their strategy and how they are going to beat the competition. Why?

We ask them these simple questions:

Why do you want to run a hedge fund?
If it is to manage personal wealth then that is fine but you should always weigh up the benefits of not earning an external income versus the potential returns.

How much money are you going to manage when you start?
If this is not $100m or at least has a realistic chance of getting to >$100m within the first 18 months – it is too little. Preferably the fund would need over $200m in 18 months

What is your LIVE track record and how much money were you running?
Back tests are only useful to the manager and unsophisticated investors, few investors believe in them as you rarely see a bad back test. It is easier to perform well with less AUM.

What is the make up of your team? How are they incentivized? How many of your team have run or worked for a small business?
Working for a small business is very different from working in a large institution where a number of the administrative and operational aspects are taken care of. Expect to spend a lot less time doing the day job and be prepared to 'empty your own waste paper basket and deliver the mail'

Which functions do you plan to outsource (if any)? Do you know how much this will cost?
Costs of managing a fund have gone up significantly over the last few years. Just keeping up with regulatory changes has become a full time job and there is an associated cost to this.

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A simple way to look at building the business is as follows:

Where most fund management teams get it wrong is that they think the most important position on the team is the Fund Manager, after all it is up to him to generate positive performance from implementing the strategy.

However he is dependent on the smooth running of the team, the efficient cost structure, good analyst picks, strong risk management and a good relationship with his investors.

It is for this reason that the IR/Sales person is up front. They are the people that raise the assets to pay for the costs of running the rest of the team and are therefore very much on the front line and under pressure to score goals.

It is strange therefore that the one person that is key to bringing in and keeping assets within the firm is often seen as unnecessary or only used as a substitute.

However like any good team each person relies on one another to get their job done and work with the rest of the team. Institutional investors need to see and feel comfortable with this before they invest.

Key Positions:

Full team

1. Compliance Officer
2. Back Office
3. Back Office
4. Middle Office
5. Risk Manager
6. Chief Operating Officer
7. Analyst
8. Analyst
9. Fund Manager (Deputy)
10. Fund Manager
11. Investor Relations/Sales

Small team (6-a- side)

1. Compliance Officer/Risk Manager
2. Middle Office/Back Office
3. Chief Operating Officer
4. Analyst
5. Fund Manager
6. Investor Relations/Sales

The positions in this team relate to the roles that they perform. For instance: the compliance officer is the goalkeeper, keeping the company from committing serious breaches and can be relied upon to control the men in front. The Risk Manager at the heart of the defense ensuring that everyone behaves according to the strategy and game plan. The COO in the middle of everything as he is responsible for the whole team. Before we even get to the investment team.

Clearly some asset management companies CEO's (the equivalent of the Manager in footballing analogies) have no choice but to outsource various functions such as middle and back office, compliance and sales in the early stages however this comes with a cost to their bank balance and time spent managing third parties. From an institutional investor point of view they may not be comfortable with smaller teams as they like roles to be backed up in case of illness or incapacity.

Now let's look at the numbers. Basic salaries for quality staff are estimated as:

- Compliance Officer, COO, Risk Manager, Fund Manager, IR/Sales = US$200k
- Analysts/ Middle office = US$100k
- Back office and support staff = US$50k

These figures are conservative estimates including medical insurance and other pension related costs. The Performance fee should be used to incentivize staff, not to run the business so we are only concerned about the management fee.

Based on the above

Position	Salary (US$)	AUM needed to cover salary based on 1%[1] management fee
Compliance	200,000	20,000,000
Risk Manager	200,000	20,000,000
Back Office (x2)	100,000	10,000,000
Middle Office (x2)	200,000	20,000,000
COO	200,000	20,000,000
Analysts (x2)	200,000	20,000,000
Fund Manager (x2)	400,000	40,000,000
IR/Sales	200,000	20,000,000
Total:	**1,700,000**	**170,000,000**

The total cost of running an institutionally investable fund management business purely based on salaries is US$1.7 million. Even a skeleton 6 a side team would cost ~US$1 million without taking into account Office rent, Bloomberg/Reuters, trading platforms and risk management systems, legal costs, auditing etc. Let alone travel costs for asset raising. Remembering costs to the fund adversely affect performance. On the full 2% fee this would still amount to a minimum of $50 million in AUM to start with.

So before you think that running a hedge fund is an attractive idea, do some basic math and see if you're truly prepared to take the risk of funding a business for 3 years (minimum track record length required by institutional investors). After all a hedge fund is just a small asset management business and like all small businesses operational risks often outweigh the potential return.

[1] Institutional investors are unlikely to want to pay more than 1% of AUM as a fee for larger funds and often want at least a sliding scale based on AUM.