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Ten practice areas  
focused on growth,  
security and  
performance.

## **Client Briefing**

Pre-Launch Hedge Funds

## **The Art of the Soft Circle**

Effectively Connecting with  
Early Stage Investors | 2014

### **Summary**

- One of the most challenging parts of the launch and growth process is understanding, setting and then exceeding investors' expectations.
- Define your unique strengths and anticipate questions - Why This, Why Now?
- Launching a fund typically requires an uncertain 6 to 8 month window. Early circling results may cool off if there is a delay.
- A well-appointed Portfolio Management and Investment Relations process can help keep early stage investors interested.
- Well managed hedge funds that cultivate satisfied initial investors can create informal marketing advocates.

## The New Reality

Policy intervention, capital flowing to the largest funds, regulatory burdens and underperformance relative to traditional investments were just a few of the factors that challenged emerging hedge fund managers in 2013. Even so, the hedge fund industry thrived in 2013, stronger than it started the year, surpassing the records it set in 2007 for assets under management and the absolute number of funds. While raising capital in the early years of a fund's life is still difficult, the environment is ripe for tenacious and entrepreneurial managers who can demonstrate an attractive track record.

It's a great time to launch with many of the largest funds at capacity. As a famous Silicon Valley venture investor said, "The parvenus and the pretenders are gone."

In the quest to build relationships with early investors, we hope our observations inspire you to be vigilant in understanding, building and exceeding your prospective investors' expectations.

## Gathering Prospective Investors

Early round investors often include a large number of long-term personal acquaintances - high net worth investors or their related foundations. Striking the right balance with prospective investors involves a series of responsive actions with a vision to creating the investor-manager relationship. Not surprisingly, there

are several hurdles when selling to existing acquaintances.

**The first hurdle (#1) is gathering information to develop empathy and an understanding of each investor's perspective.** It is advantageous to conduct an analysis of the investor's perception of the current opportunity, the benefits they are seeking and information regarding similar investment decisions they've made. Prepare for an interactive discussion tailored to the prospective investor's reasons for speaking to your team.

The importance of understanding client needs (also referred to as a consultative sales approach) cannot be overstated. Without understanding investors' needs, expectations and perspective, your conversation will most likely not address their real needs, questions and concerns. *For additional details please see "Know Your Audience" in the Appendix.*

**Identifying the time for a detailed discussion is the second hurdle (#2).** When reviewing your offering, a personal acquaintance will typically not give you the full allotment of time needed for decision-making. If you want a specific amount of time, schedule it. One of the best assets a fund management company can have is informed investors. *Informed investors are less trigger-prone with redemption decisions in weaker performance periods.* The challenge in spending time with acquaintances is that they enjoy your company and would like to do just that.

Highest priority prospective investors are those that share a long-term professional relationship with the management team. They have first-hand experience with the team's professional competence and credibility. Other investors don't offer this advantageous starting point. *Industry professionals can quickly turn into your informal marketing advocates* if they are well informed, treated fairly and perceive a well-appointed firm.

Developing consistent communications that set future expectations is especially important with close acquaintances. You may know them so well that (i) you contact them less for routine follow-up and (ii) share a fact or two that causes them concern or doubt. We all have doubts about the success of our new ventures whether we are head of the largest or smallest firm. A realistic viewpoint is never misplaced but *you should avoid releasing an inaudible sigh*. This includes confiding that the task at hand or the climb to "cashflow positive" is harrowing.

Explicitly sharing your team's capabilities and prior successes with those who are close to you is not boastful in the context of your business and investment program. A positive opinion of you will transcend the personal and apply to the professional context.

**It can be an advantage or hurdle (#3) should your acquaintances consult with each other and move in a herd.** Consistent messaging, terminology and presentation are critical in creating the right buzz. Setting expectations of the

launch time line, strategy dynamics, firm infrastructure and investor reporting will keep the buzz focused and positive.

### **Developing A Focused Presentation**

Presentation readiness that pre-addresses concerns will add to an investor's perception of the team's acumen. Experienced Investment Relations professionals keep it short and hold an investor's attention by providing a roadmap long on organization but concise. Even in informal discussions, know your "Table of Contents" and ensure the structure provides a plan of important details relevant to each investor's decision-making process.

Respect is earned during a presentation when appropriate weight is given to potential negative outcomes and risk factors. Investors will more readily accept future negative periods and will not feel blindsided, if they are aware of the dynamics. Preparing investors for future volatility will calm the fire drill of investor retention in periods of weaker performance.

Moving into the presentation stage requires careful organization. We have prepared an outline in the Appendix entitled *Know Your Table of Contents*. The list is focused on the investor perspective. It differs slightly from the issues that are typically on the mind of most PMs, who might have a scaled down version that often includes: deal flow, LPs and operational integrity.

## Why This? Why Now?

Once an investor is engaged, they are listening intently for deal make or break decision input based on personal criteria. **Hurdle (#4) is maintaining an open dialogue to understand their concerns.** Often, they are seeking answers to the following questions that identify an executable opportunity. You must anticipate the information they will need (but may not ask for) in order to enter the period of commitment, the soft circle.

### These Unvoiced Questions Include:

*They say it's the right time, but is it really? Will the portfolio manager be able to produce performance from an evergreen source of ideas and themes or if opportunities dry up, will the team be forced to rotate into an area where they don't have expertise?*

*Is this structure the best they can do for me? Greed is rife in the industry - is the manager taking too much of the profit? Is this a responsible structure that addresses non-investment related risks and prepares for the downside?*

*This is a good idea. Can I do this more efficiently myself? Can I get this exposure elsewhere, possibly in an ETF with better liquidity? Or is this an investment opportunity that gives me exposures best accessed through nimble players and active management?*

*Can they manage this? What if the hedge fund isn't cashflow positive for two years? Will this distract or*

*motivate management? Can the hedge fund team manage all the jobs in the firm? In other words, can they avoid distractions related to business management issues? Are they highly motivated to make this a success?*

*Does this give me something that I don't already have? Is this an investment that offers markedly different dynamics than other large holdings in my portfolio?*

### Tangible Things That Can Go Wrong

Prospective investors can easily lose confidence in their first dealings with a new organization. Small failures can derail their commitment. Below are some issues that can dampen enthusiasm:

- Small administrative errors
- Inconsistent portfolio management philosophy
- Missed customer service opportunities
- Casual non-professional communications
- Teams that appear to be fundraising too much
- A loosely defined firm structure
- Delay in responding to queries for documents or estimates

*Do you get the small things right? Errors or the lack of attention to detail undermine the whole firm, particularly as its reputation is being earned. Separation of duty and multiple levels of review for transactions and outgoing communications are important safeguards. Setting defined processes and timelines for the firm can help*

alleviate ambiguity, errors and service oversights.

### Timing

Once investors are properly informed and committed, **a final hurdle (#5) is maintaining their interest during the set-up process.** This requires a good assessment of the time horizon and an ongoing communications program. The setup of a U.S. onshore LP fund is a 6 to 8 month process even with the most nimble service providers (legal, tax, banking, accounting, administration, prime brokerage, directors).

Starting with a detailed term sheet, an experienced law firm can assess regulatory requirements and produce draft documents in a matter of weeks. The process of finalizing documents for the management company and fund with the inclusion of committed strategic partners and service providers can take months. Service providers are pleased to take your call but there is a long mutual approval process that involves reviewing the fund structure, documents and portfolio management process.

In addition, certain administrators, banks, auditors and prime brokers coordinate easily, while others simply cannot. Pulling this broader team of professionals together involves an understanding of each service provider's requirements.

The process of hiring an auditor can provide some insight. A manager's concerns typically include: How quickly will they comment on my fund

documents and approve me as a client? Do they have capacity during audit season to audit our financial statements in a timely manner? Will they coordinate with the administrator seamlessly with information that will ease the production of K1s? What are their operational and valuation concerns related to the offering? Is it likely they will produce an unqualified "clean" audit opinion? Will they provide support during the pre-audit period to review the fund's processes in support of a clean opinion? Do they ultimately strengthen our offering because of their reputation in the industry? Will they send the same team year after year? Will they be able to handle the firm's growth if we open a fund in another jurisdiction?

Maintaining committed investors and signing contracts with service providers are two of the most common sources of launch date postponement.

### Decagon Can Help

Our motivated team focuses on polishing the details of the fund, overseeing internal processes and service providers while improving investors' experiences, ultimately leading to higher retention and referrals. Your first investors can become your strongest proponents and a critical part of your marketing effort.

While early investors prefer to speak to their primary contact, the Decagon team provides support to your firm around the delivery of a high quality marketing strategy, efficient portfolio management process and operational

integrity that all give comfort to both investors and service providers. We provide a strategic advantage through our collective years of experience with fund launches, marketing preparation and due diligence while at family offices, private banks, hedge fund platforms and funds of funds. Our team also brings the coveted investor viewpoint.

Recent scandals and financial stress have increased the scrutiny and hurdles facing new and existing fund managers. The challenging job of adding investors to a new fund's roster of LPs or Ltds has expanded, along with the scrutiny placed on investment process, fund structure and service providers.

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### **About Decagon Advisors LLC**

Based in New York, the Decagon team provides comprehensive COO, CIO, Due Diligence and IR support globally to institutional investors and hedge fund owners. The Decagon team accelerates the success of growing investment businesses and programs by providing a competitive advantage and strategic partnership. We offer our advisory services and work with investors and managers that exhibit skill, experience, drive and a strong sense of fiduciary duty.

Our goal is to support innovation, durable investment programs, firm creation and job growth within the alternative investment management industry based on a foundation of best practices.

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### **The Art of the Soft Circle 2014**

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## Appendix: Know Your Audience

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### **Experiences**

Motivation behind prior investment decisions;  
Surprises encountered while investing;  
Experience with private investment vehicles;  
Long-term relationships they have maintained with investment advisors or financial intermediaries;  
Comfort with Private Placement documentation.

### **Unique Needs**

Special reporting requirements;  
IRA, ERISA requiring offshore fund;  
Tax sensitivity;  
Sufficient cashflow to pay taxes on undistributed income and gains;  
Are they accustomed to receiving K1s?

### **Current Perspective & Portfolio**

Outlook and positioning;  
Perspective on volatility and growth;  
Currency;  
Liquid investments;  
Alternative investments;  
Private investments.

### **Investor Details**

Beneficial Owners;  
Use of Family Trusts or Limited Partnerships;  
Other parties involved in the decision-making: family, consultants or accountants;  
Cashflow needs and time horizon;  
Unique circumstances or structure.

## Appendix: Know Your Table of Contents

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### **Fund Details**

Strategy description;  
Themes and parameters;  
Construction of portfolio;  
Team skills that address the risks assumed;  
Fund terms with a focus on fairness to both investor needs and manager constraints;  
Prior performance details if available.

### **Performance Dynamics**

A multi-level view of the market dynamics looking forward and during prior key periods;  
A realistic view of what is the best environment for the fund and what could be problematic.

### **Uniquely Rigorous Process**

Framework for the Portfolio Management and Research process;  
Thoughtful and unique analytical tools;  
Operational details;  
What systems are utilized to manage the variety of risks: market, strategy, custodian, operations, counterparties and liquidity?

### **Fiduciary Duty to Investors**

Investor relationship support and communications: statements, K1s, tearsheets, estimates, transparency reports, conference calls;  
Attention to fiduciary duty that encompasses internal controls, service providers and regulatory standards.