IMQubator: Innovation in seeding Hedge Fund Managers

Innovation is a word often used to grab the attention of prospective investors. However, the actual benefits to investors, expressed in risk-reward terms, of being innovative are sometimes less easy to describe. Why? Because evaluating new investment strategies requires other skills and tools than evaluating those with a long track record. Here the most important skills are the understanding of which dimensions of risk are relevant and knowing how to get the transparency to measure those risks. This is the only way an investor can evaluate if an innovative investment strategy has the potential to add value compared with an established investment strategy. Any investor considering the higher returns offered by innovative approaches needs to fully understand the risks and have the tools to measure them. Only then can he feel safe enough to seek out those higher returns.

Rikard Lundgren

Authors
Jeroen M. Tielman and Rikard Lundgren

The purpose of this article is to make the point that high risk adjusted returns embedded in seeding emerging hedge fund managers can be accessed through an innovative approach with regards to risk management and transparency.

Emerging hedge funds are often founded by investment teams that have been employed by financial institutions previous to setting up their own fund. IMQ Investment Management (“IMQ”), the manager of the IMQubator Fund has in the past 18 months reviewed over 250 new managers in the process of launching a fund. As of November 2010, a total of 7 funds have been selected for investment.

'Emerging managers generate excess returns of 2.3% p.a. relative to their later years of existence'

Background

Many institutional investors only invest in funds with a track record of more than 3 years and AUM of at least €100 million The reason for this being that many investors do not want to hold more than 10 to 20% of total fund assets and therefore hold a minimum investment of between €10 to20 million to justify higher monitoring requirements associated with hedge fund investments.

There is however compelling evidence that these emerging managers produce

higher returns than established managers. Intuitively this can be explained by the motivation and necessity for new teams to show consistent premium returns to attract more AUM. A smaller fund can also be more nimble in markets and focus on only their best investment ideas.

Aggarwal and Jorion[1] describe how emerging managers (defined as managers of 2 years and younger) generate excess returns of 2.3%[2] per annum relative to their later years. They also find that emerging managers with higher initial AUM perform better, which can be partly explained by the stronger revenue base to finance their operations. In addition, they also identified that after the start-up phase, each additional year of age decreases performance by, on average, 48 basis points. This would imply that after about 5 years the "emerging manager effect" has disappeared.

Jeroen M. Tielman

Financial Solutions firm Pertrac provide a "young hedge fund" index (defined as funds younger than 2 years), which, over the history of the index (1996-2008)[3], shows a return of 15.74% compared with 11.48% for "middle-aged" funds and 10.12% for "old" funds. The standard deviation of the category 'young' hedge fund managers was at 6.47%, the lowest of the three categories.

It is however important to remember that when looking at the total universe of new hedge funds, the so called 'mortality rate' can be very high. Up to 40% of new hedge funds close down within the first three years of operation. The main reasons for these failures are undue investment risks and lack of financial stability because of failure to attract a large enough asset base.

Approach IMQ

To minimize the risk of mortality due to investment risks, IMQubator demands full transparency from the manager to be able to continuously monitor and measure all the manager's actual investment positions. These are discussed in weekly meetings with each fund manager. This detailed monitoring effort significantly reduces or eliminates early mortality caused by undue risk taking by a new manager. To ensure 'quality and close monitoring', IMQubator requires the managers we invest with to establish their operation's "centre of gravity" in Amsterdam in the same premises as IMQubator. This enables us to have necessary face to face CIO2CIO meetings. By meeting often and discussing all positions we can ensure each manager to stay true to his investment style and within the pre-agreed risk boundaries.

'Innovation lies in the method of selection, not necessarily in its investment strategy'

Our starting point and focus in the selection process for new managers is to look for absolute return investment talent and investment experience rather than specific strategy styles. As a consequence we approach the diversification issue differently than for example a typical Fund of Hedge Funds. We define three different market opportunity settings for each new potential manager; the most benign when the manager should be exceeding his return targets, we call it "The Good", the scenario where the manager is expected to struggle to perform, we call it "The Bad" and the worst possible combination of market parameters for the manager's strategy where he can be expected to loose money. We call this "The Ugly".

Diversification is achieved by avoiding picking managers where an overlap of "Ugly" scenarios exists. We don't mind if managers make money at the same time but we don't want all managers loosing money at the same time.

We only invest with managers with a clear absolute return focus and discipline. We like the combination of high degrees of freedom and a manager who uses this to reduce overall risk when opportunities are scarce or when downside risks appear more significant. We don't believe in always having an exposure to a strategy for the sake of having exposure. We believe our managers' future returns are to a large extent opportunity driven and – because of our preference for manager with dynamic risk management and option like pay-out patterns – often "lumpy" and unlikely to be normally distributed. The priority should always be on capital preservation, which may mean that the manager from time to time has large parts of his AUM in cash. Because of this sought dynamic risk behavior in our managers, any traditional diversification by asset class is of little or no use. The consequence is that traditional Hedge Fund style classifications are of limited or no use in the diversification process as we look for managers that do not perform like investible HF style index.

Even if hedge fund management is skill-based, we know from experience that a high correlation exists between market opportunities and the performance of an individual manager's strategy. In other words, a manager's performance is to a significant part driven by the development of the opportunity space or market opportunity which he exploits. Each

	Young funds	Mid-aged funds	Old funds
Compound ROR	15.74%	11.48%	10.12%
StDev	6.47%	7.11%	672%

Source: Pertrac

strategy has its own cyclicality based on changes in the opportunity universe. During the selection process we spend considerable time and effort together with the manager to understand the manager's method and how it is connected to three market opportunity scenarios, which we categorize as "Good, Bad and Ugly". We evaluate the manager's awareness of how his strategy behaves in these scenarios and how he adjusts to changes in the scenarios. After we have invested we use the scenarios as a risk management tool. If a manager's performance is not in line with the market scenario, we see this as a warning signal, which requires more in depth analysis and perhaps intervention.

IMQ's uses risk management structures normally found in well-run investment banks' trading rooms. These combine high levels of freedom with strict adherence to given risk and performance limits, we call them "Outer Boundaries". A very rigorous and timely follow-up structure and control systems ensures that nothing slips through the net. This specific trading room style follow-up is one of the unique features of IMQubator compared with other indirect investment models such as Funds of Hedge Funds.

Our composition of a portfolio of hedge fund managers will never be based only on rules and checklists. We look at the combined attractiveness of all aspects how risks are taken and managed but also the overall "deal" with the manager.

In striking a "seeding" deal with the manager we include more investor friendly governance features that are not normally seen in standard Hedge Fund documentation.

Construction of alignment of interests starts with our requirement of full transparency, which IMQ can enforce not only as a seed investor but also as a 25% shareholder in the management company. The IMQubator fund is aligned with institutional investors in particular as it offers a degressive fee structure, in addition passes on the economic benefits of the ownership in the management company to investors, provides an equal voting seat in IMQubator's Investment Committee and secures the investor governance in the funds it seeds. We closely manage risks, provide residence to our funds in one office location and we protect the interests of 'end' investors both through requiring more specific 'end-investor' control in the funds IMQ seeds, including having certain veto rights in the management company of these funds.

As a seed investor IMQubator is in a unique position to ensure the interests of 'end investors' are served properly. IMQ believes this clear alignment of interests not only benefits investors but also the hedge fund community in general.

Notes

1. Rajesh K. Aggarwal and Philippe Jorion, The Performance of Emerging Hedge Fund Managers, draft, January 23, 2008. SSRN-id1103215.pdf
2. This number takes into account the survivorship bias and "backfilling" by managers.
3. www.pertrac.com/Per0020/web/me.get?web.websections.show&PER0020_1341