The Birth of a Fund

A natural and very understandable insecurity expressed to me by many emerging managers is how their strategies compare to other funds in my portfolio. Through individual reconnaissance and the assistance of a motley crew of advisors, emerging managers usually have some basic understanding of what LPs are looking for and which recent fund launches they consider comparable to theirs. In addition to providing useful information regarding the manager's potential place in the ecosystem, their research also provides a picture of areas in which they may be lacking.

Launching a new fund is a daunting task that highlights vulnerabilities and incites insecurities to a degree that can sometimes be paralyzing. An emerging manager on a quest to find a suitable destination (or at least the vicinity of one) must navigate treacherous terrain filled with peaks, valleys, cul-de-sacs, dark alleys, mirages, pirates, snake oil merchants, rocky rapids, and vicious predators. No foolproof map or reliable blueprint exists that ensures the successful creation of an investment strategy/fund – it is almost like the price of success (or some semblance of success) must be paid in strife, hazing, disappointment, sacrifice, and resilience. When completed, and if relatively successful, the anguish that emerging managers felt on their maiden fundraising journey can unarguably be described as a “rite of passage” once it is over.

The creation of anything worthwhile is difficult. Although somewhat selfishly due to a personal yearning to meet and assess funds that are tangibly different from the status quo, I tend to advise emerging managers to let their freak flag fly. However, even after an emerging manager has successfully demonstrated a differentiated product, prospective LPs still expect the GP to have convincingly thought out other key elements of fund management. Along with a GP's investment expertise, the following areas carry tangible weight within LPs' fund assessment frameworks.

- **Fund Versus Deal Mentality**: Most new GPs have investment track records made up of individual investments. These past transactions were usually executed within personal accounts, as fundless sponsors, as investment team members within a fund, via passing-the-hat structures, etc. Although useful in determining granular investment prowess, successful past/attributed one-off deals don’t provide critical assurance regarding how a pool of assets would be managed. A GP’s thoughtful consideration of aggregate risk, diversification parameters, allocation methodologies, portfolio cohesion, etc., plays an integral role in convincing prospective LPs that they deserve to graduate from good investors to trusted portfolio managers.

- **Portfolio Construction/Scenario Modeling**: Directly related to the above point, a fund manager’s clear thinking around how a portfolio will be constructed is essential for LP confidence. While serendipity of opportunities and imprecision of investment amounts tend always to be accommodated, prospective investors want some assurance that their fund managers are not just "spraying and praying," unless this is an explicit characteristic of the investment strategy. Even with "opportunistic" investment strategies, GPs must have a coherent idea of how a portfolio will be put together. Realistic modeling of the target number of investments, investment amounts, target return per investment (and hence the portfolio), worst-base-best cases, sector exposure, etc., provide prospective LPs a glimpse into a GP’s thoroughness of thought.

- **Fully Responsible for Other People's Money (OPM)**: Being fully on the hook for the stewardship of other people's money is a leap not easily taken by many. Investing personal capital or being a part of an established machine that invests outside capital contrasts significantly with taking full control of pooled capital from individuals and entities dependent solely upon your leadership. While this assessment is far from scientific, prospective LPs will utilize a variety of qualitative means to determine whether a GP can endure the pressure that comes from being the primary overseer of a fund (and the burden of accompanying decisions).

- **Sell Discipline**: Choosing when to exit an investment is equally, if not more, crucial than choosing when to enter it. This skill comprises an intricate combination of conviction verification, continuing risk assessment, upside runway review, ongoing target/potential/actual return integrity, and fiduciary duty. It is imperative for a fund manager who deals with other people's money to have a disciplined disposition when it comes to knowing when to exit a transaction. In many cases, emerging GPs have not had the opportunity to proactively mold their exit muscle, since their past investments have either matured naturally, are still unrealized, or included others who decided when to sell or keep holding. GPs must prepare themselves for intrusive questions from prospective LPs regarding their "sell" philosophy and how that would play out in different situations.

- **Client Services/Service Providers**: Prospective LPs are aware that new managers are likely to possess less "institutional" quality and client services know-how when compared to more established managers. Partnering with an entity at the initial stages of its existence (when things are raw and still being molded) is part of the appeal and often is where one finds "alpha". However, despite the subdued expectations of prospective LPs around institutional quality, GPs must show a willingness and proactive trajectory towards increased quality regarding client communications and back-office functions (reporting, accounting, compliance, legal, tax, valuations, IT, data management, etc.).

- **Likelihood of Becoming Unrecognizable**: Here, I am adding my little quirk to the assessment of a new manager. My preference is to avoid emerging managers who exhibit high levels of narcissism and show signs of being prone to quickly becoming too big for their britches. Life is too short for the inevitable headaches these types of managers bring. While it is true that attractive investment opportunities pursued by capable investors can at times make adhering to this inclination more challenging, I do my best to objectively ensure that FOMO does not trump discipline (that is well informed by past burns).

Despite the current brutal fundraising environment, especially for new fund managers, the in-progress/theoretical nature of their plans affords them relatively less stringent scrutiny in certain areas. It is not my intention to insinuate that the inability of prospective LPs to concretely assess certain aspects gives emerging managers an advantage, but I am suggesting that a thoughtful description/depiction of values along with a clear aspirational roadmap contribute greatly to investor confidence.

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