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Outsourcing: how far can you go?

Industry insights on GPP/AIMA Survey

in association with

How much to outsource: the risk of going too far

Hosted platforms – outsourcing by proxy?

Future trends and the role of cloud technology

Outsource more but have a clear risk framework in place

By James Williams

Introduction

Back in July this year, GPP, a London-based boutique prime broker, partnered with AIMA – the voice of the global alternative investment industry – to create an in-depth survey (www.gpp.group) on the emerging manager community; one that dominates the industry, in terms of fund numbers, yet rarely has its voice heard.

The survey canvassed the views of 135 global small and emerging managers – defined by AIMA as those with less than USD500 million in AUM – and the results went some way towards allaying concerns that running a profitable hedge fund has become too expensive in today's post-regulatory world.

To present the survey results and discuss one specific area of the survey – that of outsourcing – Hedgeweek hosted a breakfast event on 13th September with GPP at London's historic Reform Club. The purpose of the event was to explore the theme of outsourcing in more detail and get industry insights from leading practitioners.

To expand briefly on this, to add some context, the survey results found that the COO role is largely kept in-house (only 6% outsource), closely followed by marketing, investor relations and business development (10% outsource) and the Chief Risk Officer (15% outsource).

The legal function is the most likely

function to be outsourced, as cited by 62% of respondents, with slightly less than half of respondents (44%) confirming that they outsource the Chief Technology Officer role. Currently, only 31% said that they outsourced the Chief Compliance Officer role.

The panel session was moderated by James Williams, Managing Editor of Hedgeweek and included the following: Sean Capstick, Head of Prime Brokerage, GPP; Phillip Chapple, COO at Monterone Partners, a European equity long/short hedge fund; Erik Serrano Berntsen, CEO of Stable Asset Management, one of London's leading seeding firms; Praveen Joynathsing, Director, European Capital Introduction, Societe Generale Prime Services, and Tushar Patel, Managing Director, Hedge Funds Investment Management, an investment firm focused on emerging managers and adviser to one family office.

"The survey paints a very clear picture and one of the key takeaways for emerging managers is keep those costs down and outsource more."

Sean Capstick, GPP

Outsourcing – a risk of going too far?

When managers are in the early stages of building a hedge fund business, one of the biggest cultural shocks, for many, is the transition from portfolio manager/trader, to business manager. Running one's own hedge fund is infinitely more complex than working in the front office of an existing fund group.

With that in mind, there is an obvious appeal to outsource non-core functions to third party specialists but at all times, managers need to be cognizant of investor perception.

"The reality is, starting today compared to 10 years ago, one does need to have more longevity," said Chapple. "It takes longer to get from a standing start to breakeven and you do need to have deep pockets. You have to look at your costs, how you intend to manage them over two to three years, and balance it with investors coming in, who might be telling you to have an institutional infrastructure to meet their ODD requirements."

Therefore, it is quite tough early on to justify what to keep in-house and what to outsource.

Much of this will depend on the manager's strategy and where they can benefit from economies of scale by using third party infrastructure. "Look at each function and work out a) internally, where you can cost things and b) have the ability to explain to investors why you are outsourcing certain functions and that you have proper oversight in place," said Chapple.

There is no right or wrong answer to outsourcing but it does require a lot of controls and putting proper checks and balances in place. Ultimately, managers have to jump into the abyss and decide what they can genuinely pay for internally while building up performance.

As Patel pointed out, the extent of outsourcing depends on what stage of growth a manager's business is at.

"I've seen some smaller managers outsource the CEO for part-time support

rather than having a permanent CEO in place. It really boils down to expertise. If you don't have the requisite expertise in-house because your operating budget is tight, then outsourcing can make sense. From an investor's perspective, you tick the box in the sense that you are addressing the issue."

As a seeder, Stable Asset Management is quite hands-on with the managers it backs.

In Serrano Berntsen's view, if someone is chasing after institutional investors they have to have a minimal coverage of most functions in-house.

"On day one, our managers typically comprise four to five people – two PMs for example, an analyst, a COO. If you have those roles in place, and one of your service providers unexpectedly disappears, at least you'll be able to continue operating as a standalone entity and that I think is the minimum guarantee you need to give investors.

"The things that you can't outsource are investment management and the basic day-to-day operations (performed by the COO). All the other functions can be outsourced – IT, distribution, legal, to a certain extent," remarked Serrano Berntsen.

Striking the right balance is therefore critical, when it comes to outsourcing. At the end of the day, given the fees involved, investors are going to want some evidence that managers are committed and truly believe in their business; and, by default, are willing to invest the necessary capital.

But this can often be a Catch 22 situation as these managers tend to be the ones with strong track records and have the capital resources to properly invest in the business. This then helps them to attract more external capital, thereby creating a virtuous circle.

"Investors like managers who take investment risk as opposed to excessive operational risk," said Joynathsing. "Therefore, it makes sense to outsource only those functions like IT, payroll, etc, where you potentially will get a higher level of service than you would keeping them in-house. This could help reduce operational risk."

GPP's Capstick perfectly summed this up, stating: "You don't want to risk failing an investor's DDQ simply because you've decided to outsource everything."

"Always keep an eye on who your investors are and understand what they are comfortable with (from an outsourcing perspective)."

Phillip Chapple, Monterone Partners

Is outsourcing strategy-dependent?

It stands to reason that the extent one relies on outsourced support depends on the strategy they run. A quant-heavy fund that relies on complex IT and trading models is far less likely to outsource core functions, such as the Chief Technology Officer or Chief Risk Officer. On this specific point, speaking to Hedgeweek recently, Irene Perdomo, Principal & Founding Partner of Devet Capital, a London-based market neutral statistical arbitrage asset manager, said: "You cannot drive a car from the back seat. Technology is a big part of our business. We would not look to outsource the CTO function because then, what are we managing exactly? What are investors going to think? When I hear that someone uses an outsourced CTO, I am surprised because for me, it is a core part of the fund management business."

Then again, if the manager is trading 20 positions a month, outsourcing the CTO might make sense.

The GPP/AIMA survey found that the most popular strategy for outsourcing was event-driven. This could be down to the legal complexity of sourcing and assessing deals. As mentioned previously, outsourced legal counsel is largely embraced by the emerging manager community. Conversely, multi-strategy and managed futures funds are the most likely to keep everything in-house.

It's not just strategy though. It's about building a risk infrastructure around the business.

"People don't necessarily look at what is insourced versus outsourced, they want to know whether the manager has the proper risk infrastructure in place," remarked Chapple. "If you are outsourcing, do you have the controls in place? A lot comes down to cost benefit analysis and the risk benefit analysis of the manager's strategy."

Hosted platforms – outsourcing by proxy?

One of the more popular trends in recent years has been the increased adoption by managers to use regulatory hosted platforms, given the costs involved to become fully FCA authorised. These platforms offer the possibility to use existing infrastructure and operations and compliance personnel to help managers run their fund cost effectively.

"I think platforms are going to become more popular," asserted Joynathsing. "In the UCITS world, even multi-billion dollar managers are happy to use fund platforms. If you can lower your breakeven point by joining a platform and using their infrastructure, it might make sense."

Still, it is important that emerging managers maintain a degree of flexibility. When reaching a certain size on a platform a manager might decide it is time to take functions back internally. "I would advise managers to make sure the contract allows for that flexibility. One manager I spoke to was on a platform that charged them a revenue share. They also had a seeder that they paid a revenue share to. When investors looked at the manager, they thought it was starting to get a bit too complicated. Keep things simple and avoid trying to give too much equity away," suggested Joynathsing.

Serrano Berntsen was quick to agree on this point. In his view, there should be a ceiling on how much revenue share a manager is willing to give to a seeder, or platform.

"I think 20% is about right. Anymore than that and there becomes a bit of a skin in the game issue. We've addressed that in our model by trying to add value. We've built a team that helps our managers with distribution and operations so we are seen as more accretive than other seeders. It helps us be viewed as more of a closely aligned partner to the manager," he remarked.

Another model emerging, which allows managers to share the burden of infrastructure, is where multiple fund managers come together and join forces and share the cost base, with Joynathsing confirming: "A number of managers recently have asked us if we know any other portfolio managers who might be interested in joining forces with them to share the infrastructure costs."

"I think we are going to see a trend of managers using platforms more, as well as people joining forces to sit within an established manager, which will be cost beneficial."

Praveen Joynathsing, Societe Generale Prime Services

Investor disconnect

One of the surprising findings that came out of the survey was how overtly favourable investors were towards outsourcing, compared to managers. Some 83% said they didn't require internal Investor Relations staff before allocating to a manager, while an even greater percentage – 96% – said they would not object to the capital raising function being outsourced.

By comparison, only 10% of managers said that they currently outsourced the marketing, IR and business development function.

Part of the reason for this disconnect is that there is a tendency among some investors to look down on the sales function. "It's not something I agree with. We see that the funds that really do well are those that invest in distribution," said Serrano Berntsen.

The reality is, if you have a good distribution and communications platform you are better able to raise assets. Investors are more likely to have lower performance expectations provided there is evidence the manager has institutional processes in place; be they internal or external. Ultimately, investors don't have many concerns over where the marketing and distribution is coming from.

"We encourage our managers to have distribution as part of their internal team as quickly as the management fee allows," continued Serrano Berntsen. "We offer help from the mothership; as mentioned, we have a dedicated distribution and operations team.

We help with the first USD200 million or so, at which point we encourage managers to hire their own internal team. The IR bandwidth required to service 20 or 30 investors becomes a full-time job."

Capstick drew attention to the use of third party marketers (3PMs) and, more crucially, how they get paid.

"Typically, this will be based on a percentage of the total assets they bring in. A hedge fund that runs USD50 million and pays a 3PM a percentage on USD5 million in net new assets is not going to be as attractive compared to the fees the 3PM might receive if it were a USD100 million hedge fund. So the dilemma of the 3PM model is that it works really well for the big funds but less so for the smaller funds," proffered Capstick.

Culturally, there is also a more negative perception among European investors towards outsourced marketing compared to US investors. Therefore, the extent to which a manager might outsource this function will depend on where their investors are located.

There is an argument for using external sales people for hard to access markets. Germany is a good example, where a lot of people distributing UCITS funds rely on 3PMs because of the language barrier.

Combining both insourcing and outsourcing with respect to capital raising has its benefits.

The perception is that if managers have a sales person in house, who can be the face of the firm, they are going to know the strategy better. They are going to be working alongside the PM, day in day out, so it makes sense to keep that in-house where possible.

"I do think IR needs to remain in-house to maintain the relationship with investors and to do all the client onboarding and servicing," said Joynathsing.

Monterone's Chapple said that for those who outsource the marketing function in Europe, they need to choose the 3PM carefully as there will be regulatory repercussions if the fund ends up being mis-sold to investors.

"They are likely to charge a retainer for raising assets and when you talk to 3PMs they often say it takes 12 to 18 months. Therefore, that retainer can quickly build

"Be careful on what's cosmetic and what's real. Figure out what investors say on the one hand and what they expect you to do on the other hand; outsourced marketing is a good example of this."

Erik Serrano Berntsen, Stable Asset Management

up and sour the relationship. You have to find the right people with the right investor base that are likely to be interested in your strategy but it's easy to get this wrong. There's a difference between introducing and closing. The marketer's view is that it's their job to get investors through the door but it's then down to the manager to close the deal.

"I believe there is still a lot of misunderstanding and misconception in this area of outsourcing. It's a big decision and if you get it wrong, it can be materially bad for the business," explained Chapple.

Managers who fail to build sustainable businesses often fail in the early stages to focus on their name, their brand, where they came from. They just assume they can set up a hedge fund and bring the assets in. But as Patel emphasised on the panel, like any business, "you need to get the product in front of investors. I do agree that you need an internal IR person to interact with investors and handle information requests, etc, but 3PMs can also help managers to access markets and provide a lot of information flow to investors.

"If you can't access markets like the US, or Asia, in the early stages, using a 3PM can be a useful resource. Not all of them charge retainers. They want you to grow as a manager, so there is often an alignment of interests."

When it comes to responding to an investor DDQ, the manager must be able to explain why they choose that outsourced provider. As such, they need to understand what they are being offered and whether all of the services are applicable to their business.

The panel unanimously agreed that it is paramount managers have effective oversight of their outsourced providers and have the necessary risk framework in place for monitoring.

Future trends

The panel discussion concluded by considering future trends in relation to outsourcing; specifically the role of cloud technology: With the likes of Amazon Web Services and Microsoft Azure, start-up managers could, should they wish to, outsource literally everything front through back, save for portfolio management.

Chapple pointed out that some US investors have an allergic reaction as soon as one talks about the public cloud. Then again, there are others who see it as a cost reduction.

"The reality is this is not something people yet have a firm opinion on. It's a case of talking to the people you want to come into the fund at the pre-launch stage and see what they are comfortable with.

"We had a DDQ come in a couple of months ago and the investor had a very strong opinion on the public cloud and it took a lot of convincing just to get him comfortable with the private cloud. Know your audience before you go down that path, especially with cybersecurity being such a big discussion point today," said Chapple.

Indeed, going out of synch with one's investors is not a good strategy for any manager. "Don't try to run faster than your investors. If all of a sudden it's going to become an issue with an investor you're not going to being helping yourself," warned Capstick.

Again, the point to outsourcing is that while technology improvements are helping more non-core functions to be farmed out, managers shouldn't push the boundaries of what is possible too far; no matter what the economic benefits. They have to remain credible in the eyes of investors.

Serrano Berntsen sees no particular issues with cloud platforms, however, because their scale and sophistication goes way beyond what any single manager could do internally: "That said, you do have to be careful how you explain the public cloud. I would advise any manager to explain why they are using it and give the investor third party verification. Our view is that the scale of IT infrastructure that outsourced providers like Amazon have is vastly superior to anything a manager could build themselves."

"Going forward, I think there we will see more innovative outsourcing solutions to address investors' concerns, regulatory concerns, and managers' cost concerns, to maintain a fully competitive marketplace."

Tushar Patel, Hedge Funds Investment Management

The following remarks were offered in summary, by each of the panellists:

Sean Capstick: "The survey paints a very clear picture and one of the key takeaways for emerging managers is keep those costs down and outsource more."

Praveen Joynathsing: "I think we are going to see a trend of managers using platforms more, as well as people joining forces to sit within an established manager, which will be cost beneficial."

Phillip Chapple: "Always keep an eye on who your investors are and understand what they are comfortable with (from an outsourcing perspective)."

Erik Serrano Berntsen: "Be careful on what's cosmetic and what's real. Figure out what investors say on the one hand and what they expect you to do on the other hand; outsourced marketing is a good example of this."

Tushar Patel: "Going forward, I think there we will see more innovative outsourcing solutions to address investors' concerns, regulatory concerns, and managers' cost concerns, to maintain a fully competitive marketplace." ■

Alive & Kicking

AIMA/GPP Emerging Manager Survey 2017
The next generation of hedge fund firms

Tom Kehoe is Director, Global Head of Research at AIMA. Discussing the genesis of the survey to the audience, he explains: "We wanted to get under the hood and understand this community of managers, to weigh up the challenges and opportunities they face. Can we measure what this group of managers has to deal with relative to what is happening in the wider industry?

"The range of fund managers in the survey went from just USD100,000 in AUM to as high as USD500 million. Over half of the managers have been established for less than five years and just under 50% have one fund product under management."

A total of 25 hedge fund allocators were also surveyed. On aggregate they invest USD79 billion in hedge funds, and, significantly, 44% allocate more than USD1 billion to this asset class. With respect to where allocations were made in 2016, 72% cited equity long/short and 56% cited event-driven; the second most popular strategy.

Perhaps the most resounding finding to come out of the survey was that reaching profitability is much more achievable than perhaps people thought.

The press has written extensively that one has to be running USD100-200 million to be profitable.

"We respectfully disagree," says Sean Capstick, Head of Prime Brokerage, GPP. "Our survey found that 55% of respondents said they expected to break even with less than USD100 million and the average figure was USD86 million. We serve this group and we want to be their voice – what are the challenges they face? What are the aspirations of this group? That's what we wanted to find out in this survey."

Improvements in technology, increased adoption of outsourcing, and a shift in mindset whereby managers understand it is not always necessary, from a cost

perspective, to appoint tier one providers, could all be contributory factors when considering this lower than expected breakeven point, and a sign that the barriers to entry for operating a successful hedge fund are far from onerous.

"We looked at fees in the survey. Again, much has been written about fees collapsing. What our survey revealed is that while they are under pressure they are not collapsing. Some 14% are charging 2% or more. Half of our respondents were at 1.5% or more and 90% are paid at least 1%," confirms Capstick, noting that there was a very visible longevity bias in the survey. Those managers who have been running their businesses for longer are able to command a higher management fee.

Moreover, for these managers, the median AUM tends to be higher. The message here is that managers should stick with it as the longer they can build a sustainable business, the more successful that business could become.

Breaking it down by strategy, the survey found that global macro funds need the most assets to break even: USD132 million, followed by event-driven (USD108 million) and multi-strategy funds (USD98 million).

CTAs are the most profitable and have the lowest break-even figure – USD78 million – largely because they are systematic and require lower headcount. The same could probably be argued for quant funds. The average CTA that responded to the survey had just three staff compared to 12 staff for global macro managers.

Capstick is keen to stress that across all strategies in the survey, "we found that management fees exceeded operating costs and that managers were breaking even, which is very encouraging. Even with a modest AUM, managers can remain viable, and that is welcome news." ■