Overview of Hedge Fund Seeding

Many factors influence the success of a new hedge fund, including a sound investment strategy, a high-caliber team, robust operational infrastructure and qualified service providers. However, even with these qualities, there is no guarantee a fund will attract sufficient assets for survival. Most managers can’t launch with a large enough asset base to cover organizational expenses and be considered credible by institutional investors. There are distinct advantages for managers who can attract substantial client assets at inception:

- Increased focus on investment performance;
- An early build-out of personnel and operational resources; and
- Ability to take a longer term business and investment approach.

Historically, barriers to entry for new hedge funds were quite low. Today, they are much higher. Investors expect greater transparency, more client service, well-known third-party service providers and high-quality back office systems and personnel. As a result, the break-even asset level is much higher.

Managers have several options at the hedge fund’s inception:

- Self-fund with the expectation they will attract capital once they have a quality track record.
- Maintain a bare-bones operation, delaying new hires and support systems.
- Seek a strategic partner who provides a critical mass of capital in exchange for economic participation in the manager’s business.

If structured properly, the strategic partner approach can be highly beneficial to the manager and to investors who provide the seed capital.

1.1. Seeding Relationship Benefits Managers and Investors

By providing early-stage capital, seeders are instrumental in the development of start-up hedge funds. A strategic and significant seed investment can help a start-up hedge fund attract outside capital, perhaps serving as a “stamp of approval” and validating the firm’s viability. When an emerging manager has critical mass from a seeder, others are more willing to invest because they no longer represent too large a share of the manager’s assets. Also, many allocators have minimum asset level requirements that make it difficult for managers below a certain AUM level (typically $50 million or $100 million) to attract new investors.

In addition to capital, seeders may offer managers strategic support in other areas, depending on the legal and economic arrangements between the seeder and the fund and/or the new manager. These may include assistance on business development, marketing, risk management and governance, as well as guidance on business issues faced by new managers. The seeder’s support lets the manager focus primarily on fund performance at a critical juncture in the hedge fund’s life cycle.

Seeders benefit as well. Providing early capital typically entitles seeders (both direct seeders and investors in seeding vehicles) to share in the hedge fund’s revenue (“enhanced economics”). This participation can be quite profitable and takes a number of different forms, which we discuss below (see “Enhanced Economics of Hedge Fund Seeding”). Seeders can also gain other advantages such as early exposure to emerging managers, rights to future capacity, seeding rights for
future funds, full transparency, risk controls and the potential right to monetize their profit participation at a future date.

1.2. Early Exposure to Emerging Managers

A number of research studies show that emerging hedge funds have consistently outperformed more established hedge funds, both on an absolute and a risk-adjusted basis. Hedge Fund Research (HFR) found that over the 10-year period between 1994 and 2004, funds with less than a three-year track record outperformed older funds by over 5% annually, with nearly identical volatility. Outperformance was most pronounced during a fund’s first two years. (On a cautionary note, that same research also found a somewhat higher mortality rate for new funds, primarily due to operational risks (HFR Asset Management, 2005)). Similarly, a 2009 study by PerTrac Financial Solutions finds that younger and smaller funds have outperformed larger and older funds over the long term (Jones, 1996-2008). Specifically, PerTrac shows funds with less than $100 million in AUM outperformed funds with over $500 million in AUM by 377 basis points annually between 1996 and 2008, with only slightly higher volatility. During the same period, funds with less than a two-year track record outperformed funds with over a four-year track record by 562 basis points annually with lower volatility.

Neither the PerTrac study nor the HFR study made meaningful adjustments for survivorship or backfill bias. Survivorship bias occurs when funds that go out of business are excluded from an analysis. Backfill bias can occur when managers are able to retroactively report good initial performance and elect not to report poor initial performance. A 2008 study by Aggarwal and Jorion, made a number of adjustments to raw performance data to mitigate these biases. This study found returns lower than those in the PerTrac and HFR studies, but still reached the conclusion that managers generate “abnormal” performance of 2.3% during their first two years relative to later years (Aggarwal and Jorion, 2008)).

Thus, a number of independent studies have concluded that on average, emerging hedge fund managers outperform more established managers. Why? New managers may be highly motivated to outperform their peer group to attract assets and build a viable business. Emerging managers that are not too large also tend to be nimble. They are better able to make off-the-radar investments that are simply too small for multibillion-dollar managers to invest in, such as attractive small-cap companies.

By contrast, established managers typically have a more institutional investor base and institutional investors are normally not as performance-dependent. More established fund managers with larger AUM earn substantial management fees even with average performance. Therefore, established fund managers may not be as motivated to outperform, especially if it requires them to maintain the risk profile that produced their historic performance. Lower risk tolerance often leads to average performance.

1.3. Enhanced Economics of Hedge Fund Seeding

A seeder’s return potential is greater than that of other investors in a hedge fund because the seeder usually receives a portion of the hedge fund’s revenue stream. Thus, the seeder’s reward grows in sync with the hedge fund’s asset growth. The exact nature of the enhanced return varies substantially based on the terms of the seeding agreement. A seeder’s participation can range from a simple fee discount to a majority stake in the manager’s firm. The net return on investment to a seeder is always higher than that of regular LP investors in the seeding agreement. A seeder’s participation can range from a simple fee discount to a majority stake in the manager’s firm.


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Exhibit 1 shows how the return composition of a successful seed investment shifts over time. Typically, in the first several years after seeding a fund, the vast majority of the investor’s return comes from fund performance. Over time, as the fund’s AUM grows, more of the return comes from enhanced economics. In many cases, the seeder continues to share in the fund’s revenue even after redeeming the initial seed capital. These annuity-like payments may continue as long as the seeded manager continues to run a profitable firm. Also, depending on the deal terms, there may be a provision for the manager to buy out the seeder’s interest or for the seeder to participate in a “monetization event” such as a sale or public offering of the fund. These can significantly enhance the seeder’s return.

2. Where does this strategy fit in a portfolio?

Like hedge funds and private equity funds, a hedge fund seeding vehicle fits into a portfolio’s alternative investment allocation. However, because seeding vehicles have characteristics of both hedge funds and private equity funds, determining their proper role in an institutional portfolio requires careful consideration of factors such as return potential, investment risk and liquidity. On an efficient frontier, we believe the risk/return profile of a seeding vehicle falls between funds of hedge funds and private equity funds.
2.1. Diversification Benefits

Whenever investors analyze a potential investment such as a hedge fund seeding strategy, it is important to consider the likely correlation of the investment to the rest of their portfolio. A group of early-stage hedge funds (ESFs) is likely to have a reasonably low correlation to an existing portfolio of more established hedge funds. ESFs typically hold portfolios that are substantially different than larger, more established hedge funds. For example, as discussed above, ESFs can invest in smaller, “less crowded” trades. Consequently, adding a hedge fund seeding strategy to an existing portfolio can potentially enhance returns and reduce overall portfolio risk.

2.2. Liquidity

There are several layers to a hedge fund seeding investment and each has a different liquidity profile. First, there is the liquidity of the seeding vehicle; next, the liquidity of the investment in the seeded hedge funds; and finally, the liquidity of the individual hedge funds’ holdings.

Most hedge fund seeding vehicles require capital to be invested for an extended period, typically three to four years. This time frame is necessary because the seeding vehicle, in turn, commits capital to seeded managers for multiple years. If the seeding vehicle combines multiple seed investments in a single portfolio, it may take several years to identify and negotiate deals with a high-quality group of managers. In such cases, investors may agree to a staggered investment schedule, committing to an investment amount from which capital is drawn as seed deals are finalized. Specific liquidity terms vary depending on the structure of the seeding vehicle.

A seeding vehicle commits capital to individual hedge fund managers for a certain number of years and as those commitment periods expire, money is available to be reinvested or returned to investors in the seed vehicle. If reinvested, the money may be subject to the standard liquidity terms of the seeded hedge fund.

The fact that seeded hedge funds typically hold liquid securities distinguishes seeding vehicles from private equity funds, where the underlying investments are normally illiquid. The sponsor of the seeding vehicle can further improve liquidity by negotiating the right to redeem the seeded assets early if the seeded hedge fund violates certain terms, such as risk constraints or drawdown limits. For these reasons, a seeding investment is usually more liquid than a private equity fund and, in some cases, may even offer more liquidity than a typical hedge fund of funds.

The ability of the seeders to request and enforce portfolio risk constraints provides added accountability and may improve overall liquidity. In 2008, some hedge fund managers stayed from their stated investment strategies, putting money into illiquid deals that exacerbated losses during the crisis. This is less likely to happen when the manager of a seeding vehicle is monitoring the portfolio and has the right to redeem from that fund if any risk constraints or other contractual terms are violated.

2.3. Cash Flow Comparison Highlights Liquidity Advantages

Another way to look at liquidity is to compare seeding vehicles to traditional private equity structures. Exhibit 2 shows the gross investments and distributions of a typical private equity fund using data from Prequin Hedge’s Performance Analyst database, which includes empirical data for over 3,200 private equity funds worldwide. This private equity cash flow model shows that distributions exceeded the initial investment in year eight and, in fact, private equity vehicles typically return investor cash in seven to eight years. By comparison, hedge fund seeding vehicles typically return invested cash in three to five years.

Exhibit 3 shows how hedge fund seeding vehicles compare to other alternative investments in terms of liquidity, investment risk and correlation to traditional investment assets.

We believe the added return from enhanced economics is more than enough to compensate hedge fund seed investors for reduced liquidity relative to direct hedge fund investing. In fact, we believe hedge fund seeding vehicles may offer higher return potential precisely because they fill a liquidity gap between private equity and traditional hedge funds. Investors who are willing to consider an opportunistic strategy that does not fit neatly into a pre-defined investment silo can reap ample rewards.

3. Common Seeding Models

Thus far, this paper has focused on seeding relationships in which the hedge fund manager provides a perpetual revenue share in exchange for seed capital. Other seeding models are available and though a detailed
discussion is beyond the scope of this paper, below is a brief summary of three common approaches:

### 3.1 Equity Ownership

The seeder provides capital in exchange for equity ownership in the manager’s business and typically takes an active partnership role. Considerations in this arrangement include the deployment of the capital (which can be seeded into the manager’s hedge fund or invested directly into the management company), the level and nature of the seeder’s participation in the manager’s business and the potential tax consequences of being an active participant, rather than a passive investor.

### 3.2 Revenue Sharing

The manager agrees to share a certain percentage of management and/or incentive fees in exchange for an active participant, rather than a passive investor.

### Exhibit 4: Comparison of Hedge Fund Seeding Models

<table>
<thead>
<tr>
<th>Seed Model</th>
<th>Pros for Manager</th>
<th>Cons for Manager</th>
<th>Pros for Seeder</th>
<th>Cons for Seeder</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity Ownership</td>
<td>Maintain independence and build franchise value</td>
<td>No scale to hedge fund</td>
<td>Profit ability to exert control over manager’s business</td>
<td>Capital covers management company expenses, more dependent on growth in third party assets</td>
</tr>
<tr>
<td>Revenue Sharing</td>
<td>Maintain independence and build franchise value</td>
<td>M ore intrusive than pure revenue sharing</td>
<td>Capital exposed to investment strategy return potential</td>
<td>Potential liability and regulatory reporting issues</td>
</tr>
<tr>
<td>Hedge Fund Platform</td>
<td>Immediate access to significant capital</td>
<td>M inimal support aside from capital</td>
<td>Limited or no control over manager’s business decisions</td>
<td>No portfolio level control</td>
</tr>
</tbody>
</table>

| Source: Larch Lane Analysis |

In all seeding models, the manager and the seeder must negotiate a wide range of terms. Each model has advantages and disadvantages and the best solution depends on the preferences of the parties involved in the deal. Exhibit 4 summarizes the main considerations for the three seeding structures described above.

### 4. Case Study: The Life of a Seeding Transaction

Initiating, executing and monitoring a hedge fund seeding transaction is a complex undertaking. Experience is vital to a smooth and ultimately successful seed investment. While many fund of fund firms allocate capital to established hedge funds, the universe of dedicated seed capital providers is much smaller. The following case study presents a start-to-finish look at the life cycle of a seeding transaction.

#### 4.1 Sourcing

A hedge fund seeding transaction begins the same as any other hedge fund investment. The first step is to identify prospective manager candidates. Sourcing is an important component of the seed investment process and requires a strong network and specialized contact points outside the traditional hedge fund business.

#### 4.2 Investment Process Due Diligence

No amount of revenue sharing or deal structuring makes up for mediocre investment results. First and foremost, the team that is being seeded has to be talented and have the ability to generate attractive returns.

Though similar to the investment due diligence process for traditional hedge fund investments, choosing funds to seed is more challenging because shorter track records are common and quantitative analysis more difficult. Effective selection must consider the management team’s quality, investment experience and business management skills, the nature of the investment strategy and execution process, portfolio risks and the risk management process and trading capabilities. Developing a strong proof statement and conviction in the manager’s ability to generate returns is critical.

#### 4.3 Reference and Background Checking

Mark Twain is reported to have once said that history does not repeat itself, but it sure does rhyme a lot. We believe that saying applies to people as well. It is essential to engage in extensive reference checking because it indicates how an individual has behaved in the past, but more importantly, it provides indispensable insight into how the individual is likely to behave in the future, both in terms of investment acumen and integrity. References from peers, counterparts and clients quickly raise any warning flags such as exaggerated past performance or other integrity issues. Third party background checks should be performed on all principals of a potential seed manager.
4.4. Operational Due Diligence

Recently, some widely publicized hedge fund frauds have shaken investor confidence and underlined the importance of a strong operational infrastructure. A thorough operational review is critical to a hedge fund seeding decision for two key reasons: (1) more hedge funds fail due to poor business infrastructure than poor investment decisions, (Kundro and Fefler, [2008]), and (2) studies show that the higher failure rate of start-up managers compared to established managers is often due to business rather than investment issues (Christy, Daul, and Giraud, [2007]).

While ESFs may be held to different operational standards than established firms, the minimum acceptable standard for any hedge fund has risen. ESFs may not yet have dedicated, full-time compliance officers and technology professionals, but they are expected to have in place codified policies, controls and systems that are adequate for their current business and consistent with any legal or regulatory requirements to which they are subject. They are also expected to have relationships with reputable service providers. Seeded funds should meet minimum standards in the following areas:

- Governance structure and decision making processes
- Compliance policies and procedures; particularly valuation procedures
- Day-to-day operations
- Third-party service providers (audit, administration, prime brokerage, custodians, legal counsel)
- Internal controls, particularly cash controls

4.5. Structuring a Transaction

While many seeders have their own standard agreement and structure, each seed transaction is unique based on the management team, the seeder’s expectations and the investment strategy to be pursued. The categories discussed here pertain to most seed transactions regardless of structure.

Deal structuring negotiations serve as a useful extension of the due diligence process. How potential seed managers negotiate terms and the relative emphasis placed on particular terms provide insight into their business acumen and motivation. The negotiation process also provides a glimpse into the ongoing interactions after the seed investment is made.

Although there are many facets to every seeding transaction, here we focus on three primary features: economics, fund and management structures and risk controls.

4.5.1. Economics

The economic terms of seed transactions are among the most sensitive and are generally kept confidential from the marketplace. Revenue shares range from 10% to 40% or more. Where a given seed transaction falls within that range depends on many factors including the amount of capital provided, liquidity terms, seed fund capacity, strategy, team experience and competition. Before 2008, a widely accepted rule of thumb was for a seeder to expect 1% of revenues for each $1 million of seed capital. Though this rule breaks down quickly as seed transactions reach and exceed $50 million, at smaller transaction sizes, the rule still seems to hold. In some instances terms may be even more favorable to the seeder than the 1% per million rule of thumb.

4.5.2. Risk Controls

Controls on fund activities are intended to define the “bucket of risk” attached to the investment. Unlike investors in passive hedge funds where offering memoranda typically allow extremely broad latitude, seeders can negotiate real limitations on the seeded fund’s use of their capital. These risk controls are tailored to the strategy and the manager’s particular investment approach. Examples can include exposure limits, position liquidity limits, allowable securities or instruments and VAR allowances.

Once controls are set, the seeded fund must provide reporting and transparency, while the seeder must continuously monitor to ensure that limits are adhered to. The relationship between a seeder and the seeded fund is an evolving one. Adjustments to risk constraints are possible as the seeder works collaboratively with management teams to respond to changing investment environments and opportunities.

4.6. Ongoing Relationship

Once the seed investment is made, the parties enter a multi-faceted business relationship. One faces the continual monitoring of the seeded fund and management to ensure adherence with the agreement, particularly the risk parameters. Typically, management provides enhanced transparency into portfolio holdings and accounting records to facilitate monitoring. Because asset growth is necessary for a successful seed transaction, capital raising is a critical component of the ongoing seed relationship. In the platform model, marketing and capital

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Exhibit 5: Executing a Successful Seed Investment

- **Step 1**: Source Manager Candidates
  - Find candidates through:
    - Existing manager contacts
    - Former colleagues
    - Investors
    - Broker referrals

- **Step 2**: Conduct Investment Due Diligence
  - Select managers able to generate attractive returns based on:
    - Management team quality
    - Investment experience
    - Trading capabilities
    - Business management skills
    - Investment strategy and execution process
    - Risk management process

- **Step 3**: Check References
  - Contact manager-provided and off-list references:
    - Colleagues, current and former
    - Service providers
    - Other professional investors

- **Step 4**: Review Operational Framework
  - Governance and decision making
  - Compliance policies
  - Daily operations
  - Third-party service providers
  - Internal controls

- **Step 5**: Structure Transaction
  - Primary considerations:
    - Economics
    - Risk controls
    - Fund management structures

- **Step 6**: Foster Productive Relationships
  - Capital entry:
    - Lump sum investment
    - Capital provided at manager request
  - Monitoring seeded fund:
    - Daily position reports
    - Adherence to risk limits
    - Monthly portfolio update calls
  - Raising assets:
    - Confirm asset growth targets

- **Final Step**: Ending Seeding Relationship
  - Anticipate economic effects of separation scenarios:
    - Capital exit
    - Transaction completion
    - Early exit by manager
    - Early exit by seeder

Source: Larch Lane Analysis
introductions are largely driven by the seeder, while seeders using other models can take a more passive role.

4.7. Ending the Seeding Relationship
All seed transactions must plan for the relationship’s conclusion. Such planning includes (a) defining the circumstances or events that allow a party to separate, (b) outlining the economic effects of the separation and (c) specifying any continuing duties or obligations between the parties. Below are a few situations to be anticipated and their related issues.

4.7.1. Capital Exit
Seed capital is committed for a defined period of time to provide stability and promote the seeded fund’s growth. By its nature, seed capital represents a significant portion of the fund’s initial assets. If seed capital remains a significant portion of the fund’s total assets at the expiration of the seed commitment, the seeder and manager must manage the liquidation event, possibly even maintaining seed capital investments beyond lock-up, to avoid weakening the fund or inhibiting its growth.

4.7.2. Completion of the Transaction
Seed relationships that terminate as a result of “normal” contemplated events (the exercise of a negotiated buy-out, the achievement of certain return hurdles or the term expiration) generally result in a clean separation of the parties, leaving few, if any, continuing obligations.

It is important to note that the term of the seed capital investment and the revenue participation are not necessarily tied. In many seeding models, the completion of an investment term and withdrawal of seed capital does not end the revenue sharing arrangement.

4.7.3. Early Termination by Manager
A manager could end the seed relationship for any number of reasons, including lack of investment opportunities for the specific strategy, lack of fund growth and insufficient revenue for the management team. This is a painful option for the manager and can be accomplished only through dissolution of the seeded fund and/or the management company. Typically, seeded managers are subject to non-compete restrictions.

4.7.4. Early Termination by Seeder
The primary method for a seeder to end a relationship is to withdraw capital due to occurrences such as breach of a covenant or risk constraint. In such situations, the seeder must consider the potential impact of the capital withdrawal. In many cases, the early withdrawal of seed capital leads to the demise of the fund; especially if it has not yet raised significant external capital. Therefore, the seeder must weigh the seriousness of the breach against the strength of the manager’s strategy and the desire to continue participating in future economics.

5. Conclusion
The excess return potential from emerging hedge fund managers can provide attractive investment results. Seeders and investors in seeding vehicles earn higher returns than regular investors in the same hedge fund by sharing in the economics of the hedge fund manager. To the extent that a seeded fund attracts significant third-party assets, the seeder’s revenue sharing rights can significantly enhance return.

Hedge fund seeding vehicles are a practical, professionally managed option for institutions and individuals seeking to profit from the many available seeding opportunities.

A hedge fund seeding vehicle is particularly appealing to investors who:
- want greater potential returns than those of a typical hedge fund portfolio
- need to diversify a large multi-manager portfolio
- want more transparency than is typically provided by a traditional hedge fund
- are looking for interesting co-investment opportunities
- want to capitalize on the hedge fund industry’s growth, not just its return potential
- are interested in private equity-like returns with better liquidity

Our analysis suggests that seeding vehicles fall between hedge funds and private equity funds in terms of reward/risk and liquidity. Investors considering a seed investment strategy should have a multi-year investment horizon and be willing to tolerate some short-term volatility.

No seeding investments and no two seeding vehicles are identical. Every transaction is a highly structured, carefully negotiated deal. In the end, the success of individual seed investments and the performance of seeding vehicles depend on many factors, most notably, prudent manager selection, fair and informed negotiations and effective implementation. When evaluating a seeding vehicle, it is critical to carefully consider the sponsor’s history because prior seeding experience adds value at every stage of the process.

In the aftermath of 2008’s market upheaval, there is a tremendous shortage of capital available to new hedge funds. Meanwhile, the quality of new hedge funds seeking seed capital is significantly higher than we have seen in the recent past. Consequently, we find the current market environment extremely attractive for seeders. Investors who believe hedge funds will resume their growth trajectory and continue to play an important role in the investment landscape should consider a seeding vehicle as a way to capitalize on the industry’s recovery.
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Mark Jurish is the Chief Executive Officer, a Director and member of the Investment Committee of the Investment Manager. Mr. Jurish founded and controls Larch Lane Advisors L.P. and its general partner, Two American Lane Corporation, the prior investment managers to the Fund, and has managed the Larch Lane Funds from their inception. In addition, he is the founder and Chief Executive Officer of HFIC Partners, LLC and HFIC II GP, LLC, the managing entities for Hedge Fund Investment Company, L.P., HFIC Offshore, Ltd., Hedge Fund Investment Company II, L.P., and HFIC II Offshore, Ltd., all private investment vehicles investing in early-stage hedge funds. Previously, he served on the Board of Directors for the Managed Funds Association, on the Best Practices Committee of the Greenwich Roundtable and as an Independent Trustee of the MBA Capital/Claymore Managed Duration Investment Grade Municipal Fund. Mr. Jurish received his B.A. from State University of New York at Albany and his M.B.A. in Finance from New York University.

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References


