Early Stage Investing and Seed Fund Opportunity

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FIERA CAPITAL

Forward-thinking investors have recognized that a subset of the hedge fund industry – hedge fund seeding – offers a potential opportunity to benefit not just from attractive investment returns, but from the hedge fund industry's growth as well. For those investors who believe that the hedge fund industry will continue to grow, the environment for seeding could be extremely favorable.

EXECUTIVE SUMMARY

- Due to a multi-year period of sub-par performance, many hedge funds are liquidating or struggling to raise assets. This is particularly true for early stage hedge funds ("ESFs"). At the same time, there are high quality managers looking to start a hedge fund, especially those that have left funds that are closing down. Our experience shows that many of those managers have found that in order to attract a sufficient asset base to cover organizational expenses and be considered credible, they require the assistance of a seeder that can provide a critical amount of day one or early-stage capital. Consequently, we find the current market environment extremely attractive for seeders.
- A hedge fund seeding strategy may achieve a higher rate of return than an investment in a hedge fund or a fund of hedge funds due to the opportunity to participate in the seeded fund's revenue stream. We believe that the risk/return/liquidity profile of a seeding vehicle falls between funds of hedge funds and private equity funds. If an investor is willing to lengthen its investment time horizon, adding a hedge fund seeding strategy to an existing portfolio can potentially enhance returns, reduce overall portfolio risk and provide diversification benefits.
- We believe a hedge fund seeding vehicle is particularly appealing to investors who desire: 1) higher potential returns than a typical hedge fund portfolio; 2) exposure to ESFs; 3) pre-negotiated fund risk limits; 4) greater transparency than is typically provided by a traditional hedge fund; 5) opportunities for co-investment; 6) the ability to capitalize on the hedge fund industry's growth prospects; and 7) private equity-like returns with potentially less risk and better liquidity. Investors considering a seed investment strategy should have a multi-year investment horizon and be willing to tolerate short-term volatility.
- The former team at Larch Lane Advisors (now part of Fiera Capital), is one of the first dedicated providers of hedge fund seed capital. The team has seeded 26 hedge funds through three distinct seeding vehicles and continues to be an active capital provider for the hedge fund industry.[1]

This paper is for informational purposes and should not be considered investment advice or solicitation to buy, or an offer to see, a security. Inherent in any investment, there is the potential for loss. Please refer to Endnotes and Important Disclosures at the end of this document.

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OVERVIEW OF HEDGE FUND SEEDING

Investors can access hedge fund investment benefits through multiple strategies including direct investments, funds of hedge funds and hedge fund seeding vehicles. This paper focuses on the potential benefits and process of providing seed capital to hedge funds through a hedge fund seeding vehicle.

Many factors influence the success of a new hedge fund, including a sound investment strategy, a talented team and robust operational infrastructure. However, even with these qualities, there is no guarantee that a fund will attract sufficient assets for survival. Most funds cannot launch with a large enough asset base to cover organizational expenses and be considered credible by many investors. There are distinct advantages for funds that 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, but after the extended period of under-performance, they are much steeper today. Investors expect greater transparency, better client service, well-known third-party service providers and high quality back office systems and personnel. Hedge funds are also subject to more regulation. Consequently, the cost of operating a hedge fund is much higher than in the past as managers have invested in improving business infrastructure to cope with an increasingly sophisticated client base and to adapt to new regulations.[2] Hedge funds must demonstrate practical controls and processes on day-one with a clear action plan for obtaining institutional infrastructure in the future.

Funds that do not attract significant assets at inception have several options. The manager can:

- Self-fund operations with the expectation the fund will attract capital once a quality track record exists
- Maintain a bare-bones operation, delaying new hires and support systems
- Seek a strategic partner (“seeder”) who can provide a critical mass of capital.

If structured properly, both the fund’s manager and the seeder can benefit from a seeding arrangement.

SEEDING RELATIONSHIP BENEFITS MANAGERS AND INVESTORS

By providing early-stage capital, seeders can be instrumental in the development of new and ESFs. A strategic and significant seed investment can help ESFs attract outside capital, perhaps serving as a “stamp of approval” and validating the fund’s viability. We have found over our twenty-five years of investing in hedge funds that when an ESF has critical mass, others may be more willing to invest because they would no longer represent too large a share of the fund’s assets. Also, many allocators have minimum asset level requirements that make it difficult for funds below a significant AUM level to attract new investors. Another benefit is that seed capital is generally committed for multiple years, giving the ESF a stable asset base to build on.

In addition to capital, seeders may offer ESFs strategic support in other areas. These may include assistance with business development, marketing, risk management and governance, as well as guidance on operations and business issues. The seeder's support lets the ESF focus primarily on investment performance at a critical juncture in the fund's existence.

Seeders benefit as well. Providing early capital typically entitles seeders (both direct seeders and investors in seeding vehicles) to share in the ESFs revenue ("enhanced economics"). This participation can be quite rewarding 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 the extra return benefits of investing in ESFs, rights to future capacity, seeding rights for future funds, full transparency, risk controls and the potential to monetize their profit participation.

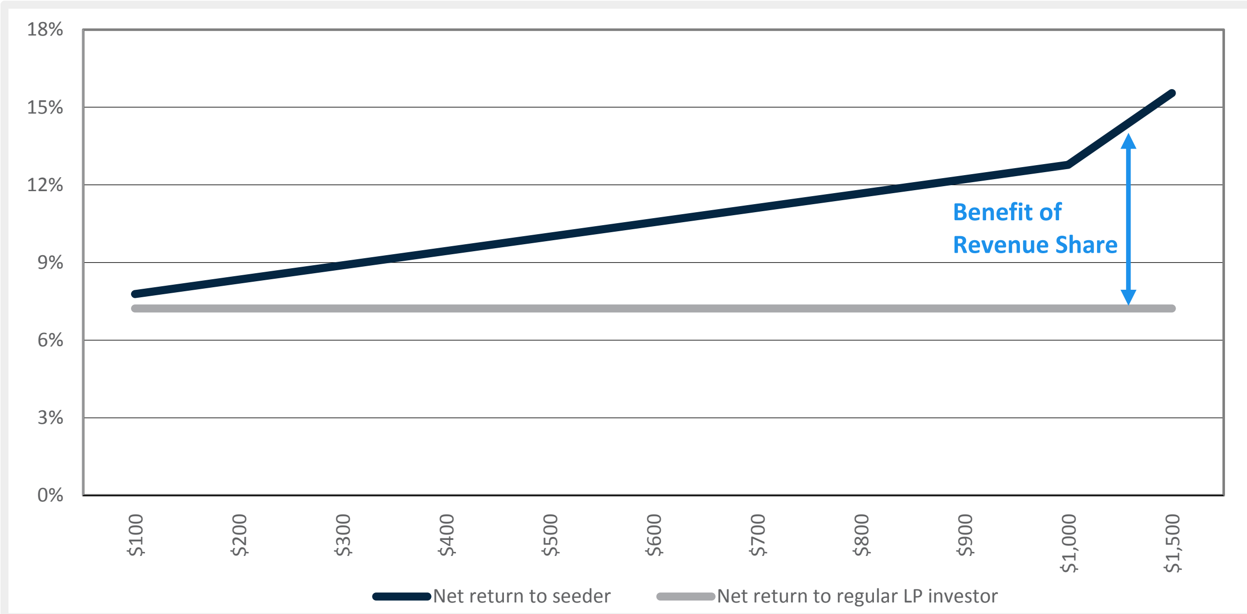
ENHANCED ECONOMICS OF HEDGE FUND SEEDING

A seeder's return potential is greater than that of other investors in a hedge fund because the seeder receives a portion of the hedge fund's revenue stream. Thus, the seeder's return profile increases in tandem 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. Figure 1 compares the potential returns of a typical limited partner ("LP") in a hedge fund to those of a seeder who shares in the fund's gross revenues.

As shown in Figure 1, the net return on investment to a seeder is always higher than that of a regular LP in the same fund. Even in unusual cases where no additional third-party assets are raised, the seeder generally receives an effective fee rebate through a share of the management and incentive fees applied to the seed capital. (For a more detailed comparison of returns for a typical hedge fund investor and a hedge fund seeder, please see the Appendix.)

FIGURE 1: SEEDERS ENJOY ENHANCED RETURN OPPORTUNITIES



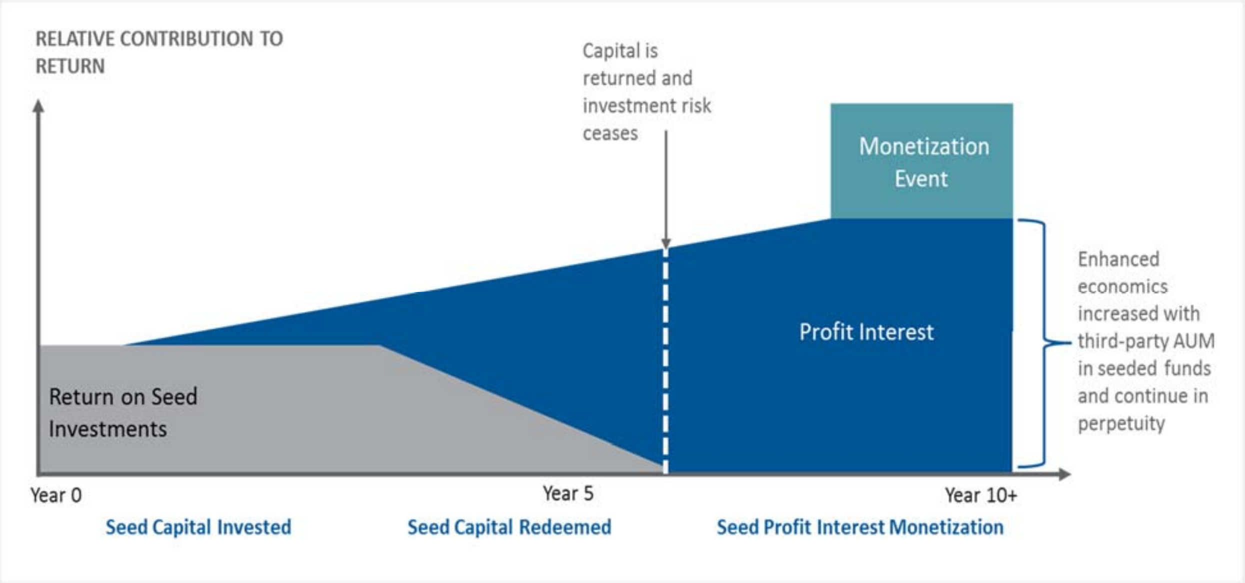
Source: Fiera Capital proprietary research. Net return to regular LP investor assumes a 10% gross return of the hedge fund LP interests with 1.5% management fee and 15% incentive allocation. Net return to seeder makes same assumptions, and also includes a 20% share of the seeded hedge fund's gross revenues, and 1.5% management fee and 20% incentive fee for the seed vehicle at various assumed hedge fund asset sizes up to $1.5 billion. The Illustration in Figure 1 is highly simplified and does not take into account the range of provisions possible in a seed agreement, such as limitation on the seeder's share of management fees above or below certain asset levels or reduction of a gross revenue share for management company expenses. This example also assumes the seeder keeps the original capital fully invested with the manager. However, in a typical seed deal, the seeder commits for a limited period of time (usually multiple years) after which the seeder has the right to withdraw the investment while retaining the economics. ***There is no guarantee that any of these return streams will be positive (or how big the streams will be) or, when the return streams would be generated, if at all. Inherent in any investment is the potential for loss.*** *For important information regarding the calculations in the chart above, please refer to endnote 3.*

MANAGER PERFORMANCE DRIVES DUAL RETURN COMPONENTS

A seed investment incorporates two components of return – investment performance and enhanced economics. Obviously, investment performance depends on manager skill. Perhaps not as evident, but equally important is the connection between manager skill and enhanced economics. Enhanced economics depends on asset growth and, as with most investment vehicles, hedge fund asset growth tends to be highly correlated to performance. Managers with below- average performance will deliver neither the investment returns, nor the asset growth necessary for a successful seed investment. Therefore, seeding only managers with the ability to generate attractive risk-adjusted returns is essential.

Figure 2 shows how the return composition of a successful seed investment varies over time. Typically, in the first several years after seeding a fund, the fund's performance provides the vast majority of the investor's return. Over time, as the fund's AUM grows, more of the return comes from enhanced economics. In many cases, the seeder continues to receive enhanced economics 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. This event could significantly enhance the seeder's return.

FIGURE 2: COMPOSITION OF A SEEDER'S RETURN OVER TIME



Source: Fiera Capital proprietary research. For illustrative purposes only. Actual results will vary from fund-to-fund. This chart is highly simplified and meant to delineate a seeder's investment return into its key components. It depicts a hypothetical example of the amount and timing of three sources of a seeder's returns (the seed investment return in grey, the enhanced economics in blue and the seed monetization event in green). ***There is no guarantee that any of these return streams will be positive (or how big the streams will be) or, when the return streams would be generated, if at all. There can be no assurance that a seed investor will realize such any benefits or that a seeded hedge fund will be able to raise capital. Inherent in any investment is the potential for loss.***

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 investor's 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.

From a liquidity perspective, 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 funds 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 more liquid than a private equity fund and, in some cases, may offer even more liquidity than funds of hedge funds.

Another way to look at risk and liquidity is to compare seeding vehicles to traditional private equity. Figure 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 hedge funds. Importantly, the revenue share to investors in seed funds continues even after their capital is withdrawn from the seeded hedge fund. This provides an effective "risk free" return stream, which is not captured in an IRR calculation. Investors who are willing to consider an opportunistic strategy that does not fit neatly into a pre-defined investment silo can reap ample rewards.

FIGURE 3: RISK AND LIQUIDITY CHARACTERISTICS OF VARIOUS ALTERNATIVE INVESTMENTS

STRATEGY	TYPICAL LOCKUP PERIOD	LIQUIDITY OF UNDERLYING ASSET	INVESTMENT RISK (VOLATILITY)	CORRELATION TO TRADITIONAL ASSETS
Venture Capital	10+ years	Less Liquid	High	High
Infrastructure	10+ years	Less Liquid	High	High
Private Equity	5+ years	Less Liquid	High	High
Hedge Fund Seeding	3-4 years	Varies	Low/Medium	Low/Medium
Passive Hedge Fund of Fund Investing	Varies	Varies	Low	Low/Medium

Source: Fiera Capital, Institutional Investor, Pensions and Investments, EnnisKnupp

CONCLUSION

The prospective investors for a seeding strategy may be a select group, but those who are willing to consider an investment strategy such as this – outside their traditional framework – may reap ample rewards:

- The return potential from ESFs can provide attractive investment results.
- Seeders and investors in seeding vehicles can 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 outside assets, the seeder's enhanced economic rights can significantly increase return.
- Hedge fund seeding vehicles are a practical, professionally managed option for institutions and individuals seeking to profit from the many available seeding opportunities.

We believe a hedge fund seeding vehicle is particularly appealing to investors who desire:

- Greater potential returns than a typical hedge fund portfolio;
- Exposure to ESFs;
- Diversification of a large multi-manager portfolio;
- increased transparency and better risk controls than a typical hedge fund would offer;
- Interesting co-investment opportunities;
- An ability to capitalize on the hedge fund industry's growth, not just its return potential; and
- Private equity-like returns with better liquidity.

Our analysis suggests that seeding vehicles fall between hedge funds of 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 potential 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, carefully consider the sponsor's history because prior seeding experience adds value at every stage of the process.

Based on the dynamics in the hedge fund industry that we have previously highlighted, it is clear to us that there is a shortage of capital available to new and ESFs. Meanwhile, the quality of new hedge funds we have recently seen 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.

APPENDIX

ILLUSTRATION OF SEED ECONOMICS

	SEED CAPITAL PROVIDER				
	NON-STRATEGIC INVESTOR	$200MM AUM GROWTH	$400MM AUM GROWTH	$900MM AUM GROWTH	$1,400MM AUM GROWTH
Capital Invested	$5,000,000	$100,000,000	$100,000,000	$100,000,000	$100,000,000
Current Fund AUM	$500,000,000	$300,000,000	$500,000,000	$1,000,000,000	$1,500,000,000
Seed Capital Provider's Share of Gross Revenues	N/A	20.00%	20.00%	20.00%	20.00%
Management Fee	1.50%	1.50%	1.50%	1.50%	1.50%
Incentive Fee	15.00%	15.00%	15.00%	15.00%	15.00%
Gross fund return	10.00%	10.00%	10.00%	10.00%	10.00%
(Less management fee)	8.50%	8.50%	8.50%	8.50%	8.50%
Incentive Fee	1.28%	1.28%	1.28%	1.28%	1.28%
Net fund return	7.23%	7.23%	7.23%	7.23%	7.23%
Return on capital invested ($)	$361,250	$7,225,000	$7,225,000	$7,225,000	$7,225,000
Management Fee Share	N/A	$900,000	$1,500,000	$3,000,000	$4,500,000
Incentive Fee Share	N/A	$765,000	$1,275,000	$2,550,000	$3,825,000
Total return on investment ($)	$361,250	$8,890,000	$10,000,000	$12,775,000	$15,550,000
Total return on investment (%)	7.23%	8.89%	10.00%	12.78%	15.55%

Source: Fiera Capital proprietary research. For illustrative purposes only. Net return to regular LP investor assumes a 10% gross return of the hedge fund LP interests with 1.5% management fee and 15% incentive allocation. Net return to seeder makes same assumptions, and also includes a 20% share of the seeded hedge fund's gross revenues, and 1.5% management fee and 20% incentive fee for the seed vehicle at various assumed hedge fund asset sizes up to $1.5 billion. ***There is no guarantee that any of these return streams will be positive (or how big the streams will be) or, when the return streams would be generated, if at all. There can be no assurance that a seed investor will realize such any benefits or that a seeded hedge fund will be able to raise capital. Inherent in any investment is the potential for loss.*** *For important information regarding the calculations in the table above, please refer to endnote 3.*

ENDNOTES

[1] On September 1, 2016, Fiera Capital Inc. assumed all of the assets of the advisory business of Larch Lane Advisors LLC ("Larch Lane"), including all of Larch Lane's duties, obligations, liabilities and rights under Larch Lane's advisory contracts with its Clients. Although the Investment Committee associated with Larch Lane's portfolios and products has changed as a result of the transaction, the portfolio management team running these portfolios and products of Larch Lane on a day-to-day basis before and after the transaction is the same.

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[2] According to Preqin's 2016 Global Hedge Fund Report

[3] The following equation is used to calculate the data in Figure 1 and in the table "Illustration of Seed Economics" in the Appendix.

GR = Gross Return of Fund

MF = Fund Management Fee

IF = Fund Incentive Fee

RS = Revenue Share received by seeder

AR = Ratio of non-seed assets to seed capital invested= (Third-party capital ÷ Fund AUM)

Return to Seeder can be calculated as follows:

R= {Fund Net Return} + {Management Fee Share} + {Incentive Fee Share}

$R = [(GR-MF) \times (1-IF)] + [RS \times MF \times (1+AR)] + [RS \times ((GR-MF) \times IF) \times (1+AR)]$

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