Fund Managers Disease: Common Symptoms and Proposed Remedies

May 3 2016 | 6:11pm ET

Editor's note: The cadre of 25 research analysts at ***Murano*** *speaks with more than 150 investors every day. Tactically, these real-time conversations help the company match funds with investors, saving time and money for both. But strategically, they also provide insights that allow Murano to draw reliable observations about current institutional investor sentiment and intentions.*

Among those observations is a theory developed by Murano's CEO, ***Ole Rollag****, which contends that most alternative fund managers are ill-equipped to manage the operational functions necessary for a fund to resonate with investors. Collectively, he says, this "Fund Manager's Disease" is limiting the growth of alternatives as an asset class.*

Fund Manager's Disease: Common Symptoms and Proposed Remedies

By Ole Rollag, Founder/ CEO, **Murano**

In the course of Murano's work, our research analysts speak with literally hundreds of fund managers and institutional investors every single day, which enables us to gauge, on a fairly accurate basis, the current intentions of the asset community.

Based on what we've heard and witnessed over the past six years, we believe that a great number of fund managers suffer from an affliction we call Fund Manager's Disease. This disease impairs a fund manager's ability to run a business by being too focused on the product, and more specifically, its performance. It afflicts most often emerging or small managers, because they lack the resources to delegate responsibilities and the capital to ward it off.

Fund Manager's Disease is fairly idiosyncratic to the asset management business. Whereas every other industry commits an important share of the balance sheet to the marketing and sales function, in asset management we find a total lack of resources for growing a business.

Fundamentally, the industry has not been honest with itself about the challenges of raising assets. The most common misconceptions are that performance alone will get a manager noticed, or that third party marketers or cap intro teams will grow assets for them.

Additionally, fund marketing is often based solely on the merits of their offering, without taking into account the needs of investors. Few funds, for example, ever conduct even rudimentary research regarding product positioning, pricing, liquidity, legal structure, and other drivers that determine whether the investment is suitable to the target market.

Contracting Fund Manager's Disease

Over the past decade, alternatives have graduated from a high net worth niche business to a mainstream player in the asset management industry. In terms of magnitude, there are now more than 14,000 hedge funds. This product volume growth has been matched by a similar acceleration in the number of institutional investors and allocators, now estimated at more than 30,000, receptive to alternatives.

Accordingly, competition in alternative investment is fierce by any standard. In terms of sales dynamics, there is now a large supply imbalance of fund managers attempting to gain investor allocations. Alternative industry statistics on AUM distribution bear this out - funds with AUM under $100 million are estimated to control less than 8% of all assets, while funds with AUM over $1 billion control 61%.

Thus on the surface, the market potential for most small and medium-sized funds looks bleak. Nearly 74% of industry funds have assets under $100 million. The largest $1 billion club (around 4% of the industry) controls around 60% of all the assets. Although this may paint a grim picture, it isn’t abnormal; the top 25 U.S. mutual funds control 72% of the assets.

Notwithstanding tough market dynamics that would discourage entry and success of a business in any industry, a great number of fund managers of all sizes may be taking steps that actually increase their likelihood of contracting Fund Manager’s Disease. Here are three of the most common self-inflicted symptoms:

- *Lack of Working Capital*: This is a rookie mistake. Managing a portfolio and managing a business are two different skill sets. We’ve seen managers launch funds with $50 million from friends and family, and no investment in a business development manager or meaningful working capital. Successful businesses in every industry are required to spend money to generate sales, but this Management 101 practice is not yet understood or applied by most hedge fund managers.
- *Improper Product Structure*: Managers are often so focused on the investment-related aspects that they overlook key product-related issues, such as legal structure, liquidity and fees. Too often, expensive lawyers recommend a structure that is ill-suited for a target market; for example, using a Cayman-domiciled long-only fund for retail investors, or highly liquid funds including illiquid assets in their portfolios.
- *Poor Market Understanding*: There are far too many shortcomings in this category to include here, but the most notable errors include lack of product differentiation, and marketing to the wrong investor audience. Sadly, too many fund managers believe that having a great product is the only ingredient necessary for success. We rarely find managers of any size who can put their egos aside at the outset, and invest the time necessary to understand the needs of specific types of investors, tailor products that address those needs, and market them correctly.

This collective lack of business sophistication continues to have a detrimental impact on the marketability of the entire “alternative investment” asset class. Unfortunately, Fund Manager’s Disease has now reached epidemic proportions, and the DNA of alternatives is being compromised.

The Road to Recovery: The Shopkeeper Model

For most fund managers, the pathway to avoiding or recovering from Fund Manager's Disease does not involve great expense or wholesale operational disruption. But it does require some meaningful changes in business practices, and more importantly, a major shift in personal attitudes related to fund priorities.

Using a neighborhood flower shopkeeper as an example, here are some basic business principles that fund managers must address on the road to building a healthy enterprise:

<u>What is the opportunity, and how big is it?</u> The prospective flower shop owner must gauge market demand, the size of the potential market, projected sales and profits, inventory and operational expenses, and perhaps an eventual exit strategy. These are fundamental questions that will be asked if he's seeking capital or a line of credit. *Answers to opportunity related questions will help a fund determine whether the potential rewards are worth all the effort.*

<u>What type of products should I sell?</u> The flower shop owner must use his insights about the target market to decide whether his products will include cut flowers, potted plants, decorative arrangements, shrubbery and garden supplies, and decide what to offer within each. *A fund will likely fail if it lacks a product offering relevant to investor needs.*

<u>Who will buy my products?</u> Will the flower shop cater to individuals or companies, or both? Will sales be in-store or delivery-based? What are the pricing and margin implications for servicing different types of customers? *Funds need to know exactly what type(s) of investor is right for its product.*

<u>What's my competitive edge?</u> How many shops are servicing the market, what is their strategy, and are they succeeding? What will we do that is better or different? Is there a market segment that's not being served? *A fund must have this knowledge in order to make key decisions about where and how to market itself.*

<u>How will I sell my products?</u> How will the flower shop differentiate its brand? Should it purchase advertising, support local charities, use direct mail, or rely on word of mouth? *Marketing solutions often become self-evident if a fund has reliable answers to the other questions on this list.*

<u>What resources do I need?</u> Who will run the front and back-end of the flower shop? Will it require product or customer specialists? More importantly, how will it recruit, incentivize and retain qualified people? *Many funds use a "jack of all trades" approach to operations, often with disappointing results.*

Here's the harsh reality: most small, successful local businesses invest more thought and capital in building a profitable enterprise than the average fund manager. The primary reason? Attitude.

Attitude Adjustment Absolutely Required

In disease management, most physicians believe there is a strong connection between mind and body. On that basis, we offer the following attitudinal adjustments for fund managers determined to create a healthy business:

1. **Performance isn’t as Important as You Think**. Broadly, there are two kinds of investors: those who chase performance, and those who don’t. Most seasoned investors are the latter. Too many funds pander to performance chasers, even though they are the first to leave when things take a turn for the worse. Selling performance rather than investment process is guaranteed to yield a poor client base.
2. **Being an Artist is Noble, but Rarely Profitable**. Most managers are specialized in a certain market and do not look at segmentation or market demand; they are product driven, rather than demand driven. Artists operate in similar fashion – they have a unique style and hope it will attract buyers. Unfortunately for both professions, starving artists and fund managers often share a similar fate.
3. **Being a Good Manager Does Not Mean You’re Perfect**. Some of the best fund managers in the world have mediocre years. Even the best surgeons can’t save every patient. If a manager has a great 10-year track record, but has a bad year or two, that doesn’t mean that the fund needs to close. It simply means that to maintain well-earned credibility, the fund manager needs to explain to investors what happened and why.
4. **There Will Always be a Fund That Performs Better**. Being at the top of a league table does not always mean that a competing fund is better for an investor. Sometimes, outperformance might be based excessive risk taking, or underperformance on avoiding an asset a manager believes to be flawed. What’s more important is to establish performance expectations with investors, based on relevant benchmarks and time periods.
5. **Performance and Marketing are NOT Correlated**. Fund managers who only market when their performance is good will hurt their brand with investors. In fact, investors greatly value communication during bad times, so that they have a reliable basis on which to judge whether the asset class is having trouble, the manager is a victim of circumstance, or just incompetent. Here’s the irony: managers base marketing strategy solely on their performance, but investors are primarily seeking reliable partners. If a fund doesn’t market, it’s viewed as being “on the ropes.” The lesson: Either market the fund, or close the fund.

Regardless of its size or niche, every fund has its own unique challenges. Large managers must prove they can consistently deliver returns in line with their peers. Small managers must deliver good returns while fighting for visibility with investors, often with limited resources. Generic products, such as long-only, are hard to differentiate and complete largely on price. Niche products compete for a narrow investor base that is costly to reach and influence.

What’s most important for all fund managers to understand is that there is an investor for every type of fund, and that Fund Manager’s Disease simply represents shortcomings that can be addressed and improved.

The process begins with the acknowledgement that the business of asset management is very different from the fund manager’s profession. Often, fund managers make very good investors but very poor business managers. The solution for turning around a struggling fund involves finding, managing and investing in people who can work together to build an organization recognized by investors as an asset far more meaningful than a track record.

On a more personal basis, Fund Manager's Disease begins and ends with hard-nosed recognition of one's individual strengths and weaknesses. It's always difficult for a fund manager to acknowledge that he or she is not equipped to deliver equal levels of excellence in all areas of financial, operational, marketing and people-related tasks. The importance of this critical attitude adjustment is well stated by novelist Evelyn Waugh, who said, "When we argue for our limitations, we get to keep them." And for most fund managers, managing one's limitations can be the key to long-term success.