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Investcorp
Riding with the times

(L-R): Lionel Erdely and Nick Vamvakas, Investcorp

Investcorp Ride With the Times

Acceleration capital and MAP suit the current environment

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Investcorp, the global alternatives business, was founded in 1982, and launched its hedge funds group in 1996. This third leg complemented their corporate investment and real estate businesses. Corporate investment is Investcorp's private equity group that conducts transactions using a deal-by-deal model and without a dedicated fund structure. So Investcorp has a history of being a proprietary investor which co-opts external capital on a project-by-project basis. This approach has been taken into its hedge fund business.

Investcorp has consistently maintained a significant level of co-investment in its hedge funds programme, in line with its philosophy of co-investing alongside its clients. At the end of last year the firm had a total gross exposure of $480 million to hedge funds. The firm's proprietary capital committed to hedge funds has grown from $50 million to $480 million over the course of the last 17 years from its $2.5 billion balance sheet.

Within the hedge funds business, Investcorp invested via its own funds of hedge funds until late 2004, when it added single-manager funds to its platform. More recently came the addition of the much smaller-scale special opportunities portfolios. Each of these means of taking exposure to hedge fund strategies is conducted on a co-investment basis. This means that Investcorp invests from its own balance sheet, and works with clients to see which opportunities that are being exploited are suitable for them.

Table 1 shows that Investcorp manages/advises on extensive client assets – $4.2 billion in total. Around half the client assets are in customised funds of funds and nearly half of the total is in the single-manager programme run by the alternative investment specialists from its office in New York.

To find out more about the single-manager part of the hedge fund business of Investcorp, which provides seeding and acceleration capital, *The Hedge Fund Journal* spoke to Lionel Erdely, head and chief investment officer of the hedge funds group, and Nick Vamvakas, head of Investcorp's single-manager business.

According to Erdely, Investcorp has a good name in the alternative investment business. "Investcorp is a strong brand name and Investcorp has earned a good reputation," he states.

Investcorp management see their hedge fund business as being distinguished through:

1. A unique philosophical approach to manager selection;
2. A disciplined strategic allocation process;
3. An aggressive approach to tactical allocation between strategies, based on an assessment of the current economic and investment environment; and
4. A continued emphasis on improving its ability to control risks and seize opportunities (i.e., managed accounts).

Table 1 Assets under management in hedge funds

Source: Financial results for the six months ended 31/12/13

HEDGE FUNDS (US$m)	DEC-13	JUN-13	% CHANGE B/(W)
Client AUM			
Customised fund of hedge funds	2,202	2,007	10%
Single managers	1,879	1,564	20%
Special opportunities portfolios	136	120	14%
Total client AUM - at period end	4,217	3,691	14%
Average total client AUM	3,954	3,620	9%

Single-manager platform

Investcorp has believed in the unique opportunities accessed through emerging manager hedge funds, and has made significant investments with these types of managers since the programme's inception in 1996. The single-manager platform was launched in 2004 to merge the institutional-quality investment and risk-management framework of Investcorp with the alpha-generating skills exhibited by smaller and more nimble hedge fund managers.

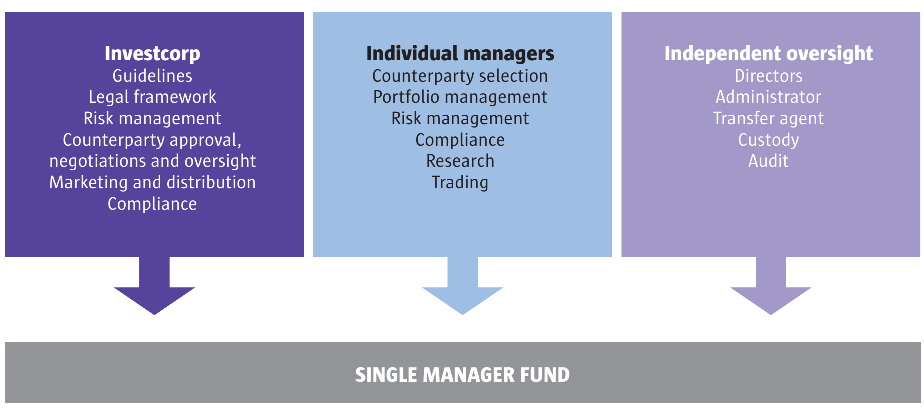
The platform creates a partnership between Investcorp and promising 'early-stage' investment managers. Investcorp provides these managers with the initial capital, distribution strength, risk oversight, and operational support in return for their alpha-generating skills. Investcorp's business model is intended to balance a manager's autonomy with the financial and operational support of a well established financial services organisation.

For investors, the platform creates direct access to differentiated alpha sources in specific hedge fund strategies, and mitigates many of the business risks associated with early-stage investing.

Vamvakas says that Investcorp has a very entrepreneurial spirit. "Having said that, it is worth stressing that the entrepreneurialism operates with an institutional infrastructure. In some ways we have an old-school model which I describe as being a moderated risk-taker. We have a very flat structure, a good team spirit, and our business model is based on alignment [of interests]."

Investcorp is involved in both seeding capital and acceleration capital for hedge fund managers. For Investcorp, seeding is providing capital in an extremely early stage, where there is no formal track record and no capital. Acceleration capital is providing capital where the manager is further along with a track record and some capital balance in the fund.

Fig.1



Barriers to entry

In looking at the single-manager hedge fund business, Lionel Erdely says that the barriers to entry for the hedge fund business are much higher post credit crisis than they were before – he thinks that this is amongst the biggest changes in the industry.

"The small-scale start-up has all but disappeared. The chances of a three-person team making it through to commercial success are a great deal less than they used to be. This is because institutional investors apply a lot more constraints than the HNWIs that used to provide the industry's capital." For example, institutions usually have a minimum AUM that they will apply, say $100 million.

Erdely continues, "The key question for immature hedge fund businesses is, 'How do I get to the $100 million or the $250 million levels that are the thresholds for large allocators of capital?' If you look at the curve of hedge fund asset raising (for an individual fund) there is a huge acceleration after $250 million, precisely because of the institutionalisation of the industry. That is why there is a massive need for acceleration capital post the credit crisis."

"Start-up managers need a partner like Investcorp who can give them critical mass and help them avoid speed bumps in their business development," says Vamvakas. "We also help with sales and marketing support to grow the asset base."

He continues, "We want to keep the arrangement with the manager simple and straightforward from an economic point of view. It has to be conducive to the manager's business aims, and create an alignment of interest in the business model and in the outcomes of the investment process. We believe that the best way to do this is a revenue sharing arrangement."

The exact terms vary dependent upon the investment strategy, team size, and the ongoing costs of the business, amongst other things.

"We avoid (and don't like) the buy-back as a means to end the arrangement we have with managers," says Vamvakas. In a buy-back arrangement (typically with a five-year term), where part of the general partner may be owned by a seeder, the manager has to calculate a discounted present value of their business. This in itself can be difficult. That difficulty is compounded by the necessity of the manager having to fund the consideration over what is a short period in business terms. The lump sum has to be paid by the manager to the seeder over a year, or maybe two, and usually out of post-tax dollars. That puts a big burden on the hedge fund manager, and is inefficient for tax.

When there is a buy-out clause, the revenue sharing will still be ongoing. So the manager can be left with difficult decisions to be made about the operational capabilities of his firm. The cash flow available may not be sufficient at any one time to both grow the business and finance a buy-out.

In contrast, Investcorp strongly believes that they should support their managers to grow their businesses and be able to invest in their people, systems and infrastructure as the business dynamics of the time demand. So the Investcorp view is that it is better to avoid creating a potential pinch-point for the manager by not having a buy-out clause at a fixed point or effective over a short period.

The average term for Investcorp seed arrangements has been around seven years. Although deals for seeding elsewhere are currently available with five to seven-year terms, the duration of deals done by Investcorp has typically been longer than those done by others on the Street. This is by choice, as Investcorp management believes this is part of the alignment of interests.

The outcome over the full life of a seeding deal tends to be that the cost to the hedge fund manager of cutting a deal with Investcorp will tend to be lower than with other seeders. In addition, Investcorp offers marketing and sales support to managers at Investcorp's expense. "We are looking to establish long-term relationships with a manager," says Vamvakas, and the capital raising efforts are a part of that.

Since 1997 Investcorp has invested with 75 managers during the first 12 months of their existence, including some of today's titans. Seeding is part of the DNA of Investcorp, according to Erdely.

Other investors like that Investcorp is a principal investor by providing capital from its balance sheet into single managers. It is a comfort to them. At the end of 2013, the balance sheet co-investment in single managers was $240 million, including an initial investment of $50 million with Kortright Capital Partners, the specialist event equity fund manager. Since the last year-end, Investcorp has provided acceleration capital to Eyck Capital Management, a specialised event-driven and distressed credit strategy that invests in European assets.

The list of known recipients of seed and acceleration capital from Investcorp since inception of the single-manager programme is given in Table 2. Table 2 shows that the single-manager programme has had biases in terms of strategies seeded. Erdely suggests that perhaps it is more difficult to have complete conviction about a pure quant manager, for example. The level of understanding necessary to get to the point of committing capital is much more difficult to reach because there is always a component of the

Table 2 Known recipients of seed/acceleration capital from Investcorp *Source: The Hedge Fund Journal*

MANAGEMENT COMPANY	INVESTMENT STRATEGY	INITIATED	DATE
Cura Capital Management	Fixed-income relative value	2004	Last SEC filing March 2012
Interlachen Capital Group	Multi-strategy	2006	Last SEC filing March 2012, $211 million
Washington Corner Capital Management	Distressed/credit-based investment	2007	Invested November 2007, announced unwinding March 2009
WMG Asia	Asian long/short equity	2007	Last SEC filing September 2009
Silverback Asset Management*	Convertible arbitrage	2006	$516 million AUM in SEC filing of Feb 2014
Stoneworks Asset Management	Global macro	2007	"Obsolete record" on databases July 2012
Ballast Capital Management	Long/short equity	2010	
Prosiris Capital Management*	Structured credit	2011	
Kingsguard Advisors*	Global macro-driven fixed income	2012	
Kortright Capital Partners*	Event equity in small/mid-cap	2013	
Eyck Capital Management*	Specialised event driven/distressed	2014	

**Firms currently part of the programme* processes that remains opaque to external parties, in Erdely's experience.

What Investcorp does do is try to ensure that each additional manager has a pattern of return that is not correlated to those of the funds already there. In particular, the way the strategy is implemented should incur losses at different times to the incumbents. That is, it is downside risk that is of most concern. Also, Investcorp likes to support managers that produce differential returns when compared to other funds in the same style category. This enables the funds to be attractive to external investors as diversifiers relative to funds already invested in, say, global macro.

In the investment management agreement that Investcorp strikes with a manager there are clear guidelines to be followed. The intention is that the portfolio concentration levels and VaRs, etc. that are agreed allow the manager to use the style with which they built their historic track record. The details are worked out during the due diligence process by the members of the risk team at Investcorp. To date, Investcorp has not had to terminate a manager agreement because of a guidelines breach. When the future commercial viability of the manager has been threatened then termination has to be considered, as it was post credit crunch. So a manager may have avoided a catastrophic loss, but lags the peer group to such a degree that they cannot attract external capital.

"Being at the very top of the peer group for performance in a strategy is not what matters for raising assets," explains Erdely. Consistency of return and repeatability of the returns are what matters in capital raising, he says: "We are not looking for managers that are top-performers for two years then bottom-quartile performers for two years. That is not what sells. The managers must have a robust investment process and produce consistent returns, taking account of volatility and correlation of the track record. Sometimes investors hold off from investing in a manager until they see how the manager handles losses."

Vamvakas joined Investcorp from Lyxor Asset Management four years ago. Since then, as head of Investcorp's single-manager business, in three and a half years he has looked at 1800 potential managers.

Investcorp applies a number of criteria to managers they seed. First, they want the manager to have invested successfully in the strategy for a period of time. "We are seeders, not incubators," explains Vamvakas. "We are looking for business acumen, and a passion for and commitment to the business – launching a hedge fund business is challenging work."

Investcorp's single-manager business also prefers managers to have some kind of pedigree. This helps give neophyte managers credibility with potential investors. For example, at the time that Kortright Capital Partners joined forces with Investcorp last year, Vamvakas says, "The familiarity and continuity between Matt Taylor and Ty Popplewell, as well as their proven pedigree of managing large amounts of capital (at Och Ziff Capital Management) were critically important factors in our final decision." Over the course of their careers, Taylor and Popplewell have managed over $1 billion in hedge fund assets.

Investcorp provides the funds it seeds with an initial investment of between $50-$100 million. In addition, the seeder provides risk oversight, marketing, and operational support. Investcorp provided early-stage capital to Kingsguard Advisors 20 months ago. Cyrus Pouraghabagher, a founder of Kingsguard, said at the time, "Investcorp provides the investment and operational risk management support necessary to grow our firm so that we can focus on delivering alpha to our investors."

A good current example of how the seeding arrangements can work is Prosiris Capital Management, which specialises in monetising long and short investments within the structured credit markets. Table 3 shows the yearly returns over the three-year history of the Prosiris Global Opportunities Fund. The returns have been good enough for Prosiris Capital Management to be nominated for performance awards – the Global Opportunities Fund was named the best emerging hedge fund at the *HF Review* Americas Awards 2013, and the fund was nominated in the *Investor Choice* Awards this year. Stimulated by the return series and awards, the growth in AUM has followed the curve of the growth of assets as described by Erdely previously.

Table 3 Prosiris Global Opportunities Fund

YEAR	ANNUAL RETURN	AUM (US$)
2014 YTD	4.13%	1114.00 million
2013	16.35%	975.00 million
2012	22.49%	444.00 million
2011**	13.13%	124.00 million

Source: Barclayhedge ***start date July 2011*

The Prosiris team has extensive experience in structured credit trading, credit analysis, structured finance technology and legal and regulatory analysis of credit products, and there is a rich opportunity set in structured credit because it is a market where the barriers to entry are disproportionately high relative to the estimated $1 trillion market. Vamvakas comments that "by our estimates, the team at Prosiris could manage a multi-billion-dollar portfolio given their range of skills and the opportunity set in the market." So not only has Prosiris Capital Management breached the billion-dollar barrier, but the firm can go on from that level of AUM.

As the final column in Table 1 shows, Investcorp's hedge fund business achieved a good growth rate last year, with the single-manager hedge fund side growing at 20%. There were net subscriptions of $440 million from investing institutions last year across the single-manager and fund of funds lines. One reason could be that Investcorp's single-manager programme does not charge an additional layer of fees. Investors make direct allocations to one or more of the single-manager products.

"Start-up managers need a partner like Investcorp who can give them critical mass and help them avoid speed bumps in their business development"
– Nick Vamvakas

Most of the external assets raised for funds on the single-manager programme come from North America. After the majority (75%) contribution from North American investors comes 15% from Middle East, and the balancing 10% from Europe. By type, 85% of the assets have come from institutional investors, and 15% from a combination of funds of funds, family offices, and other hedge funds.
To a great extent, the geographical source of assets is a function of the resource bias of the firm's hedge fund business. The major research centre is in New York, and there are five dedicated senior sales people and four support staff in the US. Investcorp management is looking to add hedge fund sales resources in London in the next year, and selling in the Middle East is done by generalists rather than dedicated specialist staff members. It is indicative of the management style of Investcorp that senior sales staff are involved in the assessment of potential seed candidates.

Structurally well positioned

"We've held the view for a long time that emerging managers have the ability to play an important role in the management of an investor's portfolio," discloses Erdely. For example, the partnership with Kingsguard provides Investcorp and its investors with exposure to an emerging manager with insight into opportunities across a full range of fixed income products. That insight can be just as valid as that obtained by Och Ziff's largest investors who enjoy access to Daniel Och, or the many investors who read Bridgewater's outward communications.

Vamvakas observes that large investors in hedge funds are going downstream in AUM size to small and mid-sized managers. "The motivation is partly because the larger managers produce less returns, and partly that the bigger managers may be closed," he explains. However, the scale of the investors means that they will not be going to the $100 million manager – they are more likely to go the $500 million manager. Also, investors can achieve a better diversification going away from the largest managers. Smaller funds can be more nimble and engage in different trading strategies than large funds are able to execute. Erdely postulates: "I can see that there will be more of an equilibrium in flows emerging in the next few years – so larger managers will not dominate the capital flows to the same extent, and the smaller managers will see an increase."

The structural approach of Investcorp to investing in hedge funds is very suitable to the times. The vast majority of flows to hedge funds are from investing institutions. Those institutions are disinvesting from funds of hedge funds on a net basis, and adding single-manager hedge fund exposure to the highest-calibre hedge funds that are still open. Furthermore, Investcorp has over the years developed a managed account platform through which it routes its own investments in hedge funds, and those of its clients when those clients appreciate the advantages of a MAP. Managed account structures for investing in hedge funds are very popular amongst investing institutions, so again Investcorp is on the money. Finally, investing institutions are in the process of moving away from very diversified hedge fund exposures to more concentrated programmes, and have started to ask consultants to address the potential of hedge funds outside the $5 billion club. Again, Investcorp has been structured to address these points for years. Overall, Investcorp believes that the hedge fund industry is well positioned to grow strongly over the next few years. Better yet, it looks like Investcorp is structurally and attitudinally well positioned to fully participate in that growth. **THFJ**

Please note that Investcorp did not provide any performance data for this article.