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Will Investor Due Diligence Uncover Your Firm Has These Business Risks?

by Bruce Frumerman, CEO, Frumerman & Nemeth Inc.

Sophisticated investors do not want to take on significant business risk exposure when allocating to an emerging manager.

Such investors understand that business risk is different from strategy risk. Their strategy risk evaluations have much to do with how sound investors perceive the investment process and the intellectual acumen of the portfolio manager. In contrast, their business risk evaluations have much to do with perceptions about the emerging manager firm owners and whether they demonstrate having small business owners' heads on their shoulders. Here, the issue is how likely does it appear that the firm owners can grow the business enough to cover overhead expenses, support ongoing growth, and then generate a profit. Until that point, a money management firm's longevity remains a question and an uncertainty.

AUM is the key at-a-glance data point that raises the specter of potential business risk in the minds of sophisticated investors; even those who are prospective seed investors.

The smaller a money management firm is in assets under management the greater the likelihood that a sizeable investor's allocation to the firm would be the, or a, major allocation.

Therefore, a primary factor that reduces an investor's business risk exposure to an emerging manager is growth of assets under management, particularly where allocations come from new investors. This is not just a matter of having a larger AUM, it is having a larger and therefore more diversified investor base. As more investors come on board the financial risk of one or two investors pulling their allocations become less of a business risk.

So, how do sophisticated investors in their due diligence look to determine how much of a business risk an emerging manager firm presents? They only need to decide how lacking they find a firm to be in regard to five factors.

1. Lacking the capital to run the business.

The emerging manager needs to have a war chest large enough to fund running the business for a minimum of two years. Anyone with less than that needs to realize that while friends and family may be willing to risk making an allocation to such a portfolio manager, few sophisticated investors would.

2. **Lacking investment in the fund by the portfolio manager running it.**

   There are two ways an emerging manager firm demonstrates having skin in the game. The first is in funding business operations and the second is in investing in their own strategy. Owners of small money management firms may have allocated most of their savings to funding business operations, and that's fine; but it helps to have at least a token allocation to the strategy that outside investors are being asked to invest in.

3. **Lacking the gumption to run the business.**

   Sophisticated investors look for emerging managers who are clearly comfortable in betting their livelihoods on their abilities. Those who aren't show it.

   For example, every year I get phone calls from some start-up managers who, during the conversation, admit that their plan is to give it a year to see if they can land some good-sized investors by then. If so, they would invest those revenues from these early, big believers into running their business; because they did not have enough of their own money to run an institutional investor caliber operation. If not, they planned to shutter their business and give back the assets allocated by the investors who took a chance with them and did invest. Such emerging manager firm owners lack the confidence, drive and desire needed to succeed. Sophisticated investors look to weed these people out when conducting their early-stage due diligence. (So, too, does my financial communications and sales marketing consulting firm. We will not work with such emerging manager firms.)

4. **Lacking detailed communications and marketing action plans for raising assets.**

   How does the emerging manager firm plan to reach prospective investors, educate them about how it thinks and invests, and supply them with the detail their investment committee members need to decide whether to allocate? This is a business risk question sophisticated investors ask.

   They appreciate that the number one factor that most often closes down an emerging manager shop is not a trade that blows up; it is lack of success in educating and persuading enough people to understand and buy into how the firm invests.

   Giving comfort factor to prospective investors about how a firm is aiming to address asset raising requires delivering a thoughtful and detailed response about how the owners plan to handle both communications and sales marketing — two separate things needed to work in tandem in order to successfully out-market competitors and win new allocations.

5. **Lacking a business plan spelling out how management aims to reinvest its revenues into the business.**

   Here the firm owners need to communicate their thinking on issues such as what business operations tasks will be outsourced, which will be intended to be handled by in-house staff, and when (at what point might it become affordable to hire such in-house staff members). This can cover the gamut from trading and compliance to IT and sales.

Also, emerging manager firm owners will find themselves being asked what plans are to add to portfolio management staff, with the aim of training someone to be able to fulfill the role of co-portfolio manager. This goes a little way toward lessening the perceived business risk from the 'hit by a bus' scenario often brought up in regards to one-person money management firms.

Make an effort in your marketing to demonstrate to prospective investors that your emerging manager firm is not lacking in these five areas. Reduce concerns regarding these types of business risk considerations and you can redirect your prospects' attentions back onto the primary thing you have to sell: the intellectual acumen of management driving the strategy you created.

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About the author

Bruce Frumerman is CEO of Frumerman & Nemeth Inc., a 34-year-old financial communications and sales marketing consultancy that helps financial services firms create brand identities for their organizations and develop and implement effective new marketing strategies and programs. Frumerman & Nemeth's work has helped money management firm clients attract over $7 billion in new assets, yet they are *not* third-party marketers.

Frumerman & Nemeth is internationally recognized for its work in crafting for clients the beyond-the-numbers story of how they invest — content that investment committees actually discuss, debate and vote on behind closed doors when considering firms on a short list for potential investment. Importantly, this is required due diligence content that cannot be communicated in pitchbook format.

Frumerman & Nemeth's work also includes providing strategic consulting on product and strategy-specific branding, crafting the required strategy-specific content detail and designing and producing the marketing tools needed to make it through the two-month to two-year institutional selling cycle. Clients also employ Frumerman & Nemeth to help promote the intellectual acumen of management — helping them get speaking opportunities, write and give speeches as panelists or stand-alone speakers at industry conferences, and through media relations marketing services.

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