The Family Office's Guide to Fund Manager Selection

A Guide to Assist Single and Multi-Family Offices in Identifying Top Fund Managers

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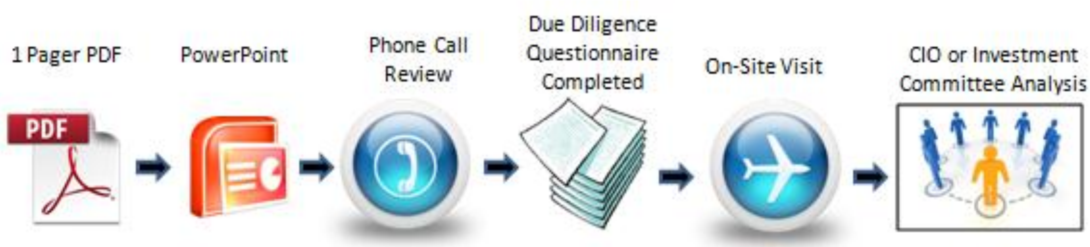
The Family Office Fund Manager Selection Process

One selection of the wrong fund manager can be very costly and the family offices we've spoken with on this topic emphasize the importance in putting fund managers through a rigorous selection process. Choosing the wrong fund manager could result in principal loss, unnecessary lock up of capital, low tax efficiency for an investment strategy, a bad reputation, regulatory action, or even civil and criminal liability.

Family offices have a fiduciary duty to complete due diligence on fund managers and select them with care. In this report, we will share some of the insights we have gained through dozens of interviews with family office executives and chief investment officers on how they go about selecting a fund manager. The goal is to make the fund manager selection process more understandable and yet highly rigorous to ensure that family offices are only evaluating high-quality fund managers.

The Six Step Fund Manager Selection Process

The typical family office fund manager selection process, as seen in the diagram below, can be broken down into six macro-steps; there are sometimes sub-steps to these at larger institutions. This is not a recommended process to follow but rather a collective view of what the industry is currently employing around the world at the 1,000-foot level.



The Six Steps of Fund Manager Selection:

1. The first step is typically to review what is called the "one-pager" or tear sheet of a fund manager. This is typically a very brief 1-2 page PDF document that contains the fund's investment performance, team, investment process, disclosures, and complete contact details. It is meant to explain the investment strategy to the investor and present a 10,000 foot view of what the fund offers. Typically these are reviewed for a short amount of time, just 5-10 minutes, by investors who know very quickly whether the rest of this process should be followed for the specific fund manager being reviewed.

2. The second step in the process takes place when the investor has some interest in the investment thesis or team of the fund and would like more details; they are sent

a PowerPoint presentation on the fund manager, sometimes referred to as a "deck" or "pitch book." This PowerPoint is typically 15-80 pages long and reviews the fund's team, unique edge in the marketplace, investment process, risk management procedures, operations, service providers, investment examples, and future plans.

3. If the PowerPoint is well received, most investors will then want to move to the third step and set-up a phone call to discuss the materials of the presentation. These calls can last anywhere from thirty minutes to two hours and usually consist of a fund manager partner walking the investor through each page of the presentation, stopping for questions and fielding additional questions at the end of the phone call. During these phone calls, analysts, investment committee members, or the chief investment officer of a family office may start asking tough questions about style drift, the effect of a key executive leaving the team, or how, why, and for how long they may have "gone to cash" in the last recession. It is during these phone calls that investors get a feel for where the strengths and weaknesses of a fund manager are, and where more research and data will be needed.

4. The fourth step of the fund manager selection process involves the review of a due diligence questionnaire, or DDQ as they are often called. These DDQs consist of hundreds of questions and can often be well over one hundred pages long once completed by the fund manager. The point of the DDQ is to dig into the granular details of the fund's operations, legal structure, compensation structure, portfolio of investments, future plans for growth, etc. This, combined with the PowerPoint, one-pager, and phone call, is the bulk of what many analysts and investment committees use to review fund managers in a relatively comprehensive manner. Sometimes step four in this process is required before step three and that is important to note. Most of the other steps will not change order, but can in some situations.

5. The fifth step that most family offices complete while selecting a fund manager is conducting an on-site visit. Sometimes, due to geographical distance, the fund manager will come to the offices of the family office, but this is an exception and not the rule since it is more valuable to see the real office of the fund. A lot can be learned by seeing how a team works together, trades, selects investments, and treats each other on a day-by-day basis. Almost all of the family offices I have spoken to and worked with require a face-to-face meeting, but some will rely on a third party investment consultant or compliance team to do this for them.

6. Typically, the final step in the selection of a fund manager is further research, analysis, and deliberation by the analyst, investment team, chief investment officer or investment committee, or all of the above. In some cases a unanimous agreement is required to invest in a fund manager, in other cases only the chief investment officer has the authority to select a fund manager for an allocation. Every family

office has a slightly different process for deciding what is needed before a new fund manager is selected.

Family Office Investment Preferences

With so many funds marketing to family offices, it can be difficult for a chief investment officer at a family office to sift through each fund and decide if it is a good fit for the family office and its investment portfolio. Through our interviews with family office executives and CIOs, we have developed a general outline of family office preferences.

These points of interest serve primarily as filter that removes those funds from consideration that do not meet their initial requirements, leaving only those funds that have met their criteria and therefore warrant closer due diligence and thorough review. Family office managers may want to review these preferences to gain a better understanding of what other family offices are investing in right now.

Point of Interest	Family Office Preferences
$ Amount of Assets Under Management	When it comes to the size of the fund, manager preferences of family offices will change depending on fund type. For a micro-cap or small-cap fund, the universe is a bit smaller than a global macro or diversified private equity firm. As a general rule for hedge funds and most long-only managers, having $100M+ will be enough in assets that 85-90% of family offices will at least not deny a meeting with the fund due to being too small. Many family offices will say at conferences and in surveys that they will consider managers of any size, but in my experience those are only managers that have very long-term relationships or family ties already in place. Most family offices look for $100M+ fund managers and some require much more in assets before being considered. Most family offices do not want to be more than 5-10% of a fund's total assets.
Preferred % of a Fund's Total Assets Under Management	As previously mentioned, most family offices do not want to be more than 5-10% of a fund's total assets. However, exceptions are made for exceptional opportunities and I have seen some family offices make up 20% of a fund in the past.
Reporting	Consistent and accurate reporting of taxes, returns, positions, and risk is highly valued by investors, yet not always delivered by fund managers. Many times, even a $1b fund manager will be slow to produce a report, late in sending one, or they may turn in reports with mistakes and errors. Quality reporting is not something many family office investors specifically screen for upfront, but it is sometimes one of two or three factors that lead to a family office replacing a fund manager with another.
Team Experience	Family offices prefer experienced teams with deep expertise directly tied to their investment process, asset class, and investment thesis. Hopefully the team has worked together for some time in managing similar types of portfolios. Many family offices look for consistency in the team to ensure that the track record being reviewed is the true long-term track record of

	the current fund management executives in place. Family offices want to work with world class teams with deep benches of talent and publicly recognized expertise. While looking at teams, family offices want to find a superior level of integrity and character.
Team Size	Team size is important. How stable can an investment fund really be if there are just two or three people on the team? Unless there are plans and signs of growth toward adding a few more people soon, some family offices will see that type of fund manager as a startup that has some embedded extra business risk. Most family offices would like to see teams of at least six to eight professionals or more, depending on the investment strategy and assets under management. To be specific most family offices would like to see teams of 15-20+ professionals behind an investment fund. This does have to be balanced with the investment preferences of the family office though; some family offices only invest in $1B+ managers while many look for $100M+ funds that are under $800M, so that can greatly change the expected team size of an investment fund.
Compensation Structure	The family office will most likely dig into how team members are compensated. Most will like to see that long-term incentives are in place, such as multi-year profit sharing, vested profit sharing or bonuses that accumulate over time, or equity partnership offers to senior team members who are critical to the long-term success of the fund. The method is less important than the existence of some tools to keep the team in place long-term; not having these in place can contribute to a family office deciding not to invest in a fund manager.
Investment Style Consistency	Family offices like to see that the investment processes and risk management procedures are carried out like clockwork at funds. They do not want a manager blindly following a strategy that is outdated and want to know that the existing track record is due to a refined approach and not a reckless trend or rumor following coincidence. Analysts will hunt for evidence as to exactly how consistent or non-consistent a fund's investment and risk management processes are. When a manager does not follow the investment parameters or process they themselves have set forth or claimed to follow, this is often referred to as "style drift," and is again something that often leads to a family office deciding not to invest in a fund manager.
Investment Process	Family offices have more sophistication than high net worth individuals for making various types of fund manager investments, but they do not have the deep analyst teams that large institutional investors, like pension funds, often have. This means that a fund manager's investment process must be clear enough that a family office analyst or chief investment officer that may not look at fund managers on a full-time basis can still understand how the investment process words. If the family office does not understand a fund manager's investment thesis, edge in the marketplace, and connection between the team and their own internal research, portfolio construction methods, and team expertise, they may move on and not even complete a full due diligence review on the investment fund manager.
Current Investors	Family offices often select their service providers, business partners, and fund managers based on referrals. They prefer to invest in fund managers

	that already have received capital from several other peer-level family offices.
Crystal Clear Advantage	This final fund manager preference point is highly important. Family office analysts and chief investment officers often look at 20-100+ fund manager PowerPoint presentations and one-pagers every week. They need to be able to quickly determine exactly what the fund manager's unique advantage in the marketplace is and how their operations, investment process, and team support that in every way possible. If this is not immediately apparent the fund manager's marketing materials are often immediately put aside.

Top 5 Most Costly Fund Manager Selection Mistakes

The following are the top five most costly fund manager selection mistakes, as well as solutions for family offices to avoid these mistakes.

Mistake #1: Performance only.

In the constant search for alpha, many investors fall into the trap of paying too much attention to performance and overlook other important considerations when evaluating a manager. Of course, performance is a key factor influencing whether or not to invest in a fund; however, that performance can sometimes come with an unforeseen cost. For example, a strong-performing manager may be inclined to chase even greater returns by increasing the leverage or taking on a riskier investment strategy.

Perhaps the greatest risk associated with high-performing funds is that investors are less inclined to complete thorough due diligence on how the fund is achieving those returns, how the strategy will perform in various scenarios, and other important considerations that could risk hurting your investment.

Mistake #2: Underestimating business risk of the fund.

An investment fund is a business, albeit with a different structure than a retail store or even an investment bank. Terrific fund managers can be terrible business managers simply because to achieve great returns to their investors may require different skills than successfully managing the day-to-day operations of a business. This aspect of evaluating fund managers is often undervalued because investors tend to see funds as unique from other businesses and therefore not subject to the same issues that can cause a business to fail; such as poor risk management, flawed accounting, lacking a continuity plan, or simply ineffective management of the firm.

These issues can sometimes bleed into the performance of a fund; like when a failure to address a concern brought forward by the chief investment officer causes him or her to leave the fund and start a competing one. It is best to get a deep understanding of how the fund operates not only as an investment vehicle, but also as a business. An on-site visit can be a great way to see ascertain the business risk of the fund.

Mistake #3: Not evaluating alignment of long-term interests and incentives.

The alignment of long-term interests and incentives is key to establishing a successful relationship between the limited partner and general partner of an investment fund. For example, a family office that is most interested in capital preservation may be evaluating a hedge fund which has compensation terms that are weighted heavily toward the performance fee.

This might present a misalignment of interests and incentives as the fund manager could be incentivized to take greater risks and expose the family office to losses, because the compensation structure is set so that the manager is rewarded primarily through his ability to generate high performance rather than preserving capital. This is just one example of a misalignment of interests; there are many ways in which a family office might not be a good long-term fit for a fund manager, and it is best to anticipate these issues before committing to the fund.

In addition to a manager's alignment of interests with your own investing interests also look at how their team is compensated. Do employees have the chance of earning equity or a profit share of the total business? Are bonuses paid out and vested over several years? Or is everyone just working for their monthly or quarterly paychecks and short-term bonuses? That will tell you how long the team will hold together through challenges and volatile economic times.

Mistake #4: Not meeting in person at the fund manager's offices.

The majority of the family offices that I have spoken with are careful to avoid this mistake and will make at least one visit to the fund manager’s office. However, there are still some investors that see an on-site visit as too inconvenient and therefore will commit to a fund only after conducting phone interviews or even just e-mails. This is a potentially very costly mistake, as you lose out on an opportunity to meet and evaluate the management team and you increase the risk of exposing your family office to fraud or at least misrepresentation.

For example, you might be evaluating a fund that purports to have a deep, experienced team of 30+ full-time professionals working out of a New York City office, only to find upon your visit that the fund is two guys trading from a studio apartment. Perhaps that is an exaggeration but cases of fraud and misrepresentation do occur in the investment industry and you may reduce your risk by completing an on-site visit to verify the team, strategy and business. It can be very inconvenient to fly from Singapore to New York City just to do a face-to-face meeting with a fund manager; however, many family offices feel that this is worth the time and effort simply to know that your money is placed with a team that you have met in-person.

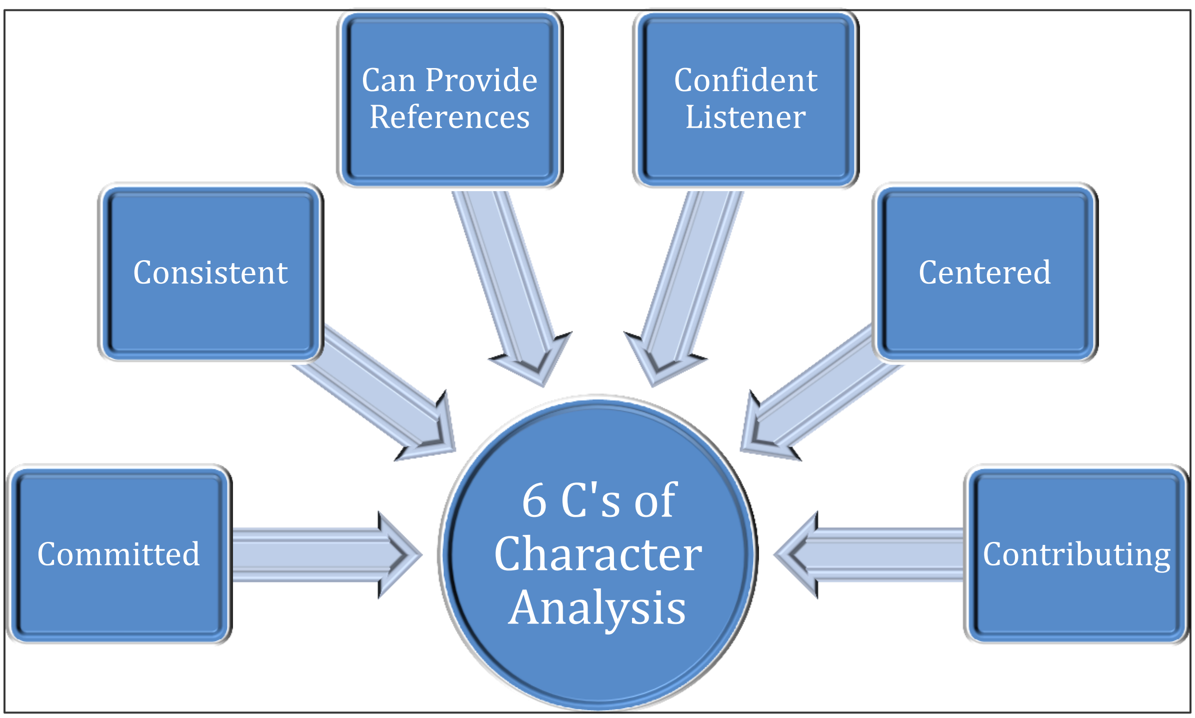
Mistake #5: Judging teams based on a background check.

This last mistake in evaluating fund managers is a little more abstract but nonetheless important. Most family offices will complete a background check on a potential fund manager during the due diligence process. However, your investigation into the manager should not stop there.

While a manager may not have committed any serious crimes or defrauded investors in the past, you should pay close attention to those factors that will not arise in a background check such as evaluating objectively the quality, integrity and character of the fund's principals and team members. The next section will provide you with several factors to consider when evaluating a fund manager's character.

The Six C's of Character Analysis

The following is a diagram I developed to explain what to look for in analyzing fund managers and evaluating their character. No, this will not predict their investment returns or guarantee avoidance of working with a fraud, but it is a step-up from blindly trusting your gut or that of your new analyst while deciding whether to work with someone or invest in a team.



I will now walk you through the 6 C's of Character Analysis to explain why each is an important component to consider while evaluating someone you may invest in or partner with.

1) Committed: The number one most important thing to remember is that someone who has invested in their self, their team, and their fund management business is planning to stay around and stay in business for a long time to come. If someone has not taken the time to properly prepare their marketing materials, prepare for a meeting, or document their investment process or risk management procedures, how serious can they really be about their business?

Humans naturally are short-term biased; we reach out for the quick reward, the fast success. When shortcuts are available, many of us like to take them, and sometimes this is done without regard for promises to investors or even industry regulations. What you want to look for in fund managers is a long-term bias in everything they do. Look for signs that the fund manager is committed to working with family offices, committed to running their fund, and committed to being a thought leader or at least on top of developments within his or her asset class and industry.

Ask yourself, "Has this person or team gone the extra mile to ensure the long-term success of their venture and possibly established themselves as a thought leader in their space?" You could also ask yourself, "Are they doing the bare minimum with few long-term commitments to the industry or working with your family office?"

2) Consistent: The cousin of Commitment is Consistency. Numerous scientific studies confirm that the majority of what we do is out of habit and on a subconscious level. This is where the saying, "how we do one thing is how we do everything," should be applied. It is true, time and time again in my interviews with family office managers, they noted how important consistency was in a fund manager. It’s crucial that a fund manager has a strategy and a process that is consistent and will not deviate greatly from one quarter to another. Of course, it’s impossible to know absolutely how a manager will act in the future, but by speaking with other investors and interviewing the manager several times, you can get a better sense of whether he is consistent.

From many small and medium family offices, I often hear that it is costly and time consuming to meet with a fund manager enough times to complete a thorough evaluation. Typically, I find that it takes 3 to 7 face-to-face meetings to get to know someone well enough to make an initial judgment of character, and it will help if you meet them in diverse environments and locations such as at their offices, over coffee, or at a cocktail reception It is easy to "pull off" or fake friendliness or interest for one or two meetings, but much harder to do over time. Get to know a manager over several months to see how consistent or inconsistent they are.

3) Can Provide References: References are a great way to speed up character analysis. As long as you can trust the source of the reference, you may be able to talk to another family office and leverage their knowledge about some of the very issues we have discussed above. One challenge in consistently taking the time to objectively evaluate the character of fund managers is the fact that family offices are typically flooded with requests for capital.

This is a basic point, but one that can be overlooked or skipped when in a hurry to evaluate a fund manager without feeling like you are asking for "too much." Asking for references should never be too much; references are frequently requested by employers before making a hiring decision, why should you be any less diligent? If someone gets angered by the thought of providing references, then that discussion more than the result may be educational.

4) Confident Listeners: In my experience, there are two types of good listeners: t hose who are new to an industry or area so they can't help but just listen because they don't know what to say, and those who are very well experienced, confident, and constantly attentive to the needs of investors.

Most high character professionals are confident in their knowledge and abilities because they do things that build their own knowledge and business daily, and their time horizon is extra-long. They have invested in themselves for so many years, and they are so centered on where they are headed that it is only a matter of hard work and time before they reach their goals. Those who are confident, but not overconfident, are more likely to be better listeners than those who are not, but the opposite can be true if someone is overconfident in their abilities and accomplishments.

It is critical for many reasons to meet in-person while evaluating one's character and one should evaluate confidence under pressure. One of the reasons is to get a sense for how the individual or entire team deals with adversity. When the market is down or when assets are lost, do they still answer their phones? Do they consistently respond to client requests and fulfill commitments, even when it may be easier to not do so? Stressful moments unfortunately can bring out flaws large or small, and it is better to have a sense for how that may play out or affect the service you will receive before you place money with a fund manager.

Here is a quote from Charles Grace, who has over 50 years of experience in running multi-family offices and selecting fund managers: "The thing that’s most valuable is whether they can listen and communicate."

All family office investors want to be listened to, and do not want their time wasted. It does not matter whether a fund manager has $200M or $20B in assets under management, if they are bad at listening and responding to the requests of a family office, they will often be shut out of the capital allocation process.

5) Centered: Looking for people who are centered means finding individuals who have naturally surrounded themselves with clues of integrity. Those with a high degree of character have made long-term consistent commitments to their life priorities.

We are the sum of our environment. Harvard professor and researcher William James has argued that the company we hold is more powerful than our education, experience, or practical knowledge and abilities in determining our success or failure in life.

The schools we attend, the friends we keep, the quality of professionals on our team, the conferences we attend, the news we consume, the books we read, the movies we watch, and our family life completely shape our habits, biases, desires, and ethical framework through which we make decisions in life. While assessing someone's character, take all of these factors into consideration. Is the fund manager at the black jack table, family dinner table, or leading an industry thought panel table at a conference?

There are a few details of someone's personal life that alone could turn off a family office investor, but most details are just additional facts to pay attention to and take notes on while learning more about someone. Last year I conducted an hour long expert audio interview with a due diligence expert who told me that part of his routine due diligence process now is to check everyone's Linkedin.com, Facebook, and Twitter profiles to see what type of a person they are. Naturally most of us already consider these factors, but I believe one's environment is more powerful than most of us appreciate.

6) Contributing: The final attribute to look for while analyzing the character of a fund manager is whether they create value first. Do they give back to the industry by writing, speaking, leading an organization, teaching, or providing you with market insight or introductions to valuable professionals? Do they listen first and try to be helpful before trying to sell you their fund and raise capital from you? The less pushy of a sales person someone is and the more genuinely helpful someone is, the more likely it is that they are committed to growing a long-term relationship with you, instead of making a quick sale. Look for multiple pieces of evidence that the individual is contributing and not just selling. By making a contribution to their industry, that manager is investing time and energy in those around him. This speaks volumes about the character of that individual and how well he will serve his clients.

By using the 6 C's of Character Analysis you should be able to more systematically evaluate teams and individuals who manage investment funds. Over time, a slight improvement in your selection of fund managers could make the difference between thriving and barely surviving as a family office investor.

Conclusion

A good deal of this fund manager selection guide is informed by our own efforts evaluating fund managers and the work we have done in understanding what family offices desire in a manager. At the Family Offices Group we are constantly reaching out to family offices to learn more about their investment preferences and how they select fund managers. This research has allowed us to only work with those fund managers that match family office investing preferences.

If you would like to discuss the family office marketplace, or if your ultra-weatlthy family or family office needs help please email me at Richard@FamilyOfficesGroup.com or visit http://FamilyOfficesGroup.com.

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Richard is CEO and founder of the Family Offices Group, the #1 largest networking association in the family office industry with over 60,000 global members. Richard works with ultra-wealthy families around the world, and provides with live workshops, a printed newsletter, training platform, and exclusive peer connections.