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The Key First Hire for Emerging Managers

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The Key First Hire for Emerging Managers

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Conventional wisdom holds that emerging managers must hire a Chief Financial Officer as the first non-investment professional. While there are sound reasons for this view, recent developments have led to a re-evaluation of this maxim. Key factors driving this re-evaluation include the growth of quality outsourcing options, the increasing acceptance of these solutions by investors, and a shift in desirable skills possessed by a first hire.

Alternatively, emerging managers may be better served by seeking a first hire who has a broader skill set. These skills include the ability and experience to oversee the efficient buildout of the manager's middle and back office, along with the ability to communicate the manager's vision and investment philosophy to potential investors. With a first hire who possesses these capabilities, managers will have more time to focus on their core competency - namely, managing the portfolio.

Origins of the Conventional Wisdom

Like most conventional wisdom, the notion of hiring a CFO as the first non-investment professional is rooted in sound logic. In this section we consider some of the many reasons for this view.

Limited resources. Most emerging managers start with rather limited resources, and most of those resources are dedicated to human capital, including – quite rightly – hiring the best possible investment team. Beyond the investment team, emerging managers generally need to hire at least one professional who can effectively address some of the many tasks and operational risks associated with running a firm. With limited resources, an emerging manager is often able to initially hire only a single non-investment professional.

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The views expressed by the authors are their own and not those of any current or prior employer.

Assessment of Needs and Risks. A critical task and corresponding risk in creating an asset management firm is the establishment of proper financial controls over the receipt and disbursement of assets, including both the fund's and the firm's cash. Someone with an accounting (or "financial") background is generally well suited to assume this task and manage this risk.

Of course, emerging managers face other critical non-investment tasks and risks, such as legal and compliance, information technology and cyber security, trading and settlement, counter-party and treasury management, business development and investor relations, public relations and human resources. However, each of these additional areas can be adequately served by outside experts (or to some extent by the investment team). Consider legal needs. Many outstanding law firms specialize in serving emerging managers. Law firms assist in structuring funds, drafting documents, negotiating agreements and providing regulatory advice. In today's market, outsourcing legal and certain compliance functions is perfectly acceptable, and in fact expected. Moreover, much of the cost of these services can be disclosed in a fund's offering documents and expensed to the fund – one less cost to the manager.

Lack of Quality Outsourced Alternatives. Unlike legal services, the supply of quality outsourced solutions for CFO-related functions has historically been more limited. Much of this can be traced to a reluctance on the part of investors to accept outsourced solutions. Their concerns were harder to displace when it came to delegating functions such as trade reconciliations, fund accounting and management company accounting to third parties. This reluctance to accept outsourcing also discouraged the development of third-party firms capable of offering CFO services.

Investor Expectations. As suggested above, many institutional allocators took a dim view of firms without a Chief Financial Officer. Some investors even refused to consider making an allocation unless a firm had a CFO. This expectation placed additional pressure on managers to first hire a CFO. Note also that while third-party fund administrators could provide certain middle and back office support, investors generally looked to the manager (or another third party) to run shadow books and records and to manage or provide oversight of the administrator.

Conclusion. Given the many reasons cited above, it's not surprising that conventional wisdom dictated the hiring of a CFO as the first non-investment professional. Conventional wisdom, we can add, also suggested the CFO's role could grow to manage the entire middle and back office, and hopefully without too many costly stumbles along the way. If not, managers could hire a person capable of that broader role once the firm achieved sufficient size.

Challenging the Conventional Wisdom

Like most conventional wisdom, the belief in hiring a CFO as the first non-investment employee loses it prominence only slowly. In this section, we review developments over the past few years that have led to a re-evaluation of this conventional wisdom.

Emergence of Quality Outsourced Options. Following a period of substantial growth in the alternative fund space, the industry has recently experienced more consolidation and even, some might say, a bit of contraction. As a result, there has been an increase in the number of highly qualified professionals, and in some instances more than the industry can employ in-house. Moreover, many professionals who were employed at firms that have shut down and have sought a more stable environment for their next role. This environment has led to an increasing number of outsourcing firms with experienced professionals capable of filling the traditional CFO function for emerging managers.

Outsourcing firms can now offer complete middle and back office solutions to emerging and established managers alike. These firms can perform tasks such as reconciling trades, reviewing profit and loss statements, and tracking a fund's margin/buying power. They can also reconcile month-end NAVs, process fund expense payments and reconcile of capital activity.

Straight-Through Processing and Improved Technology. The advent of straight-through processing systems – which combine into a single system order management, portfolio management and investor-level allocation of profit and loss – now include automated reconciliation tools. The reconciliation tasks previously were managed and/or mitigated with procedures and internal controls overseen by an internal employee with accounting skills (i.e., the CFO). The new tools reconcile transactions among the system, prime brokers and administrators, and thereby eliminate most of the manual reconciliations that were previously performed in-house and which added a significant degree of operational risk. Finally, cloud computing now further allows outsourced firms to access a manager's system and thereby work with multiple managers.

Investor Expectations. With input from outside experts and their own operational due diligence, institutional allocators have become more accepting of the outsourced model, including the functions historically performed by an in-house CFO. An emerging manager might also agree to re-evaluate the outsourcing arrangement once the firm attains a particular asset size. Based on this commitment and on an assessment of firm needs, the manager might determine at some point to move some or all of the outsourced CFO functions in-house.

Fee Pressures and the Realization of the Need for a Broader Skill Set. The alternative fund industry also faces increasing costs to meet regulatory and investor expectations which, combined with growing pressure on fees, has flowed through to emerging managers and impacted their ability to hire non-investment professionals. Faced with limited options as well as increased investor and regulatory expectations, emerging managers may look to hire a non-investment professional with a broader skill. The qualities of such an individual are described in more detail below.

Emphasis on Capital Raising. In recent years, capital raising has become perhaps the biggest hurdle to a successful launch and to the continuing viability of an emerging manager. This environment has shifted some of the emphasis on the core skills expected from the first non-investment hire to include some ability to interact with potential investors.

Conclusion. Given the many reasons cited above, the old maxim – in our view – no longer holds true. An emerging manager should consider a broader set of skills and abilities when making the first non-investment hire. The skill set should include the ability to oversee the buildout and management of the middle and back office, along with the ability to communicate effectively with potential investors.

The Optimal Skill Set

The optimal skill set will vary somewhat depending on the firm's strategy, projected growth and available talent. In general, there is no "one-size-fits-all" background required of the first non-investment hire. But certain skills are sought nonetheless. An accounting background remains a desirable skill set, as does a degree of familiarity and trust by the manager. Other beneficial backgrounds can include legal, business development, trading, operations, and even information technology. The key, however, is for the first hire to possess certain abilities which we have previously identified and are described in more detail below. These skills should enable the manager to limit the amount of time spent focusing on issues other than managing the portfolio.

An Ability to Build Out and Oversee the Manager's Middle and Back Office. The ability to build out and manage the middle and back office requires a number of different talents and experience. A first hire should have a high degree of knowledge about the business of running an alternative fund firm and all its component parts. This knowledge, which will help the first hire set priorities and allocate resources, is typically gained through prior experience in senior positions in the industry. A first hire also should have a working knowledge of service providers, technology and systems. This knowledge will be necessary to engage and manage necessary vendors at the buildout stage and throughout the future growth of the firm. Similarly, the first hire will need solid organizational and leadership skills to oversee key contacts at service providers – many of whom work remotely – including the quality of their deliverables and costs. Finally, a first hire also should have a good peer network, typically demonstrated by participation in industry committees and forums. The ability to seek and obtain reliable advice from peers can prove invaluable.

An Ability to Communicate with Potential Investors. As previously noted, raising capital remains one of the biggest hurdles to success. A first hire should have the ability to meet with potential investors and communicate the manager's vision and investment philosophy, including the reasons that differentiate the manager and that can make the investment strategy successful over an extended period of time. This ability doesn't necessarily mean that a first hire must have a limitless rolodex; there are plenty of capital introduction services that can introduce potential investors. However, a first hire should be able meet independently with potential investors, garner their interest and help screen the true lead from the merely curious. At that stage, the manager can become more involved with a potential investor.

An Entrepreneurial Spirit. Starting an alternative fund business is costly and in the early days, even assuming eventual success, the manager will have limited resources to compensate the first hire. Accordingly, a first hire should commit to the venture and its potential with the understanding that any significant compensation will come later. Typically, this means that a first hire will initially receive a relatively small salary and some equity stake in the business. The first hire should also understand that requesting too high of an equity percentage may limit the firm's ability to attract and retain talented personnel in the future.

Business Judgment. Finally, a first hire should have sound business judgment. The manager will rely heavily on the first hire to build the firm. The individual's business judgment can help the firm make proper decisions on the necessary structure for long-term success and help avoid costly mistakes.