New hedge funds require lots of groundwork. Here are some things worth focusing on.

From Star to Founder EastRock

Preparing for Launch: Advice from a Day-One Investor

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MY PARTNER PATRICK ANDERSEN HAS INVESTED in over 20 startup hedge funds and coached many more through the early stages of preparation and launch. In fact, when Insider assembled a list of people to know when starting a hedge fund, Patrick was the only allocator to make the list. Patrick is a generous spirit when it comes to sharing his time and experience. In the following interview, I sat down with him to gather some of his best advice to prospective founders.

Adam: What are some core "do's" and "don'ts" when getting a new hedge fund off the ground?

Patrick: The biggest "do's" are to be prepared and give a lot of thought to what you want the future to look like. The most successful founders typically have been thinking about going out on their own for a long time. Theirs is a decision of choice rather than necessity. This contrasts with those striking out on their own as a fallback plan because their previous firm struggled or they didn't get the role they wanted.

That said, there is such a thing as too much thinking. I've talked with some prospective founders for many years about doing their own thing – yet they never actually do it. There's a tipping point where what might appear to be thoughtfulness at first actually reflects a lack of confidence or even fear.

Can you say more about what it means to be prepared for launch?

I'm favorably inclined toward pre-launch managers who have been laying the groundwork for their launch in a deliberate and methodical manner. There's one person I have in mind. He took various jobs to build his skillset, worked hard to build a relationship with me, and had references at the ready. As the point of launch approached, he was able to move things forward with a real sense of urgency.

Prepared also means having committed to an investment strategy that fits the founder. One biotech manager who launched somewhat recently was skilled at shorting stocks but didn't see it as the best return on his time. He knew some investors would prefer a long/short strategy, but he felt strongly that his returns would be better if he fully dedicated himself to understanding the latest science and digging into promising individual companies that he could buy and hold. He stuck to that approach, and it has paid off.

You mentioned having references at the ready. How important are they?

Very important. If I'm one of the first prospective allocators and the manager has a high-quality reference list ready, that's a signal that matters. And when those references are informed about the manager's strategy, that sends a great message about how prepared they are.

In contrast, when I highlight to prospects that references are a key part of my process, there can be some resistance. We understand that it can be uncomfortable to invite others to talk about you. But if we sense a real reluctance, it makes us wary.

During reference checks, I've occasionally been surprised by a reference asking me questions like, "So what will [the founder] be focused on?" If their own reference doesn't know, it's a clear signal that the founder hasn't given this enough thought. Looking back, there really seems to be a relationship between managers who haven't considered the tough questions and references who aren't appropriately aware of their plans.

When it comes to allocating time, what do you like to see as priorities?

Despite the many demands on a manager's time, I feel it's important for the manager to be running a personal account [a portfolio of personal investments] in the pre-launch phase. When a prospective founder isn't doing that, it may signal a lack of enthusiasm for investing — that they intend on being more of a business builder than a portfolio manager. This is a reasonable strategy for some, but not what we look for.

I think another common mistake is spending too much time on decisions that can be changed somewhat easily down the road. Examples that come to mind are the choice of administrator, accounting firm, or prime broker. These functions are important but not directly impactful on returns, and they are easier to undo than hiring a COO or selecting the first institutional investors.

In the end, what *really* matters is performance in the first couple of years, and it is critical to never lose sight of that as a priority.

So, is there more you can say about how best to maximize early performance?

It's crucial to remain close to innovative ideas and how the markets are trending. My advice is to lean on your network of buyside peers. Here, your fund's small AUM is an advantage because your colleagues can share investment ideas without negatively affecting their own performance. You might be surprised, but many of these folks really do want to help a friend succeed. Some may even offer to invest in your fund, which is a great way to assemble an initial stake of capital and have a talented group aligned with your success.

What is the minimum amount of capital that a new hedge fund should launch with?

For long/short equity strategies, no size is too small. Don't be afraid to start with whatever you can raise.

Fundraising becomes easier as your hedge fund becomes more tangible. Many prospective LPs will increase their engagement as the firm is more established with an actual portfolio and track record. Said differently, at some point you're going to be a two-year-old fund. Reaching that milestone will meaningfully change how fundraising goes — so you might as well get to the two-year mark as quickly as you can.

Is there capital that a new manager shouldn't take?

Yes, but sometimes it takes due diligence to know the difference. Some allocators spend a lot of time with prospective founders, only to propose one-sided terms at the last minute. If you do your research, you won't have to wait until the end of a long process to learn that an investor is not a good fit.

The other kind of capital to avoid is capital that is misaligned. One manager we worked with had a lot of money flowing in after some early success. However, that capital had a short time horizon, which conflicted with how the founder wanted to run his fund. He found the money irresistible and took it, despite our warning, and it quickly became a problem when he faced a performance hiccup.

Conversely, the biotech founder who didn't want to short stocks made sure not to take money from investors who might ask him to do so. He stuck to his vision and continues to operate on his own terms and timeline.

Can you name some seemingly minor details that might make a big difference when launching a fund?

When you're deliberate about how you portray yourself outwardly, it shows you're thinking from the perspective of the allocator. A good Zoom setup with a high-quality camera, microphone, and background sends the right signal to your audience. So does making your materials entertaining as well as informative. I recall a great presentation that ended with a "bad" joke that worked in the moment because it hit just the right tone of being playful and memorable.

Finally, the name of the firm can send a signal, both negative and positive. I've found names that are overly contrived leave a lasting impression for the wrong reasons. That said, I really appreciate a name that reflects a concept that closely relates to the manager's approach. I can think of several names derived from medical research, sports, and nature that are somewhat esoteric, but for those who understand them they conjure memorable images of their firms' styles and cultures. When you can thread the needle with a name like that, it can be a nice icebreaker in a first meeting and create momentum for communicating your story in a compelling way.

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Insights from partnering with exceptional investment managers as they launch and build new firms

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